DEPARTMENT OF STATE REVENUE

02-20090945.LOF

Letter of Findings: 09-0945
Corporate Income Tax
For the Tax Years 2005-2007

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I. Adjusted Gross Income Tax–Disallowed Expenses.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-62; Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 63 S.Ct. 1132 (1943); Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer protests the Department of Revenue's decision to disallow certain of its royalty and interest expenses that were paid to a related entity.

II. Adjusted Gross Income Tax–Business/Nonbusiness Income Classification.

Authority: IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; May Dep't Store Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001).

Taxpayer protests the Department of Revenue's decision to re-classify its interest and dividend income from nonbusiness income to business income.

III. Tax Administration–Penalties.

Authority: IC § 6-3-4-4.1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of penalties.

STATEMENT OF FACTS

Taxpayer is a consolidated group of corporations doing business in Indiana and several other states. For the tax years in question, Taxpayer filed consolidated Indiana corporate income tax returns that included two of its subsidiaries ("Sub A" and "Sub B"). The Department audited Taxpayer's Indiana corporate income tax returns for the 2005, 2006, and 2007 tax years. As a result of the audit, the Department assessed additional adjusted gross income tax, interest, and the negligence penalty for the 2005, 2006, and 2007 tax years. The Department also assessed underpayment penalties for the 2006 and 2007 tax years. The Department determined that Taxpayer's returns as originally filed distorted its Indiana income and resulted in an unfair reflection of Indiana income. The Department disallowed certain royalty expenses and interest expenses that Taxpayer had claimed for the payments it made to a related entity in order to fairly reflect Taxpayer's income. Taxpayer protested the assessments. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as necessary.

I. Adjusted Gross Income Tax–Disallowed Expenses.

DISCUSSION

As noted in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

During the years at issue, the Indiana filing subsidiaries, Sub A and Sub B, paid royalties and interest fees to a related entity, which was not included in Indiana income tax return filings. Specifically, Sub A and Sub B paid royalties totaling approximately $500 million in each year to the related entity ("Sub RI"). Sub RI used these royalties to make loans back to the Sub A. The loans are supported by loan contracts, but the contracts are open ended with no stated amounts due and no set maturity dates. For illustrative purposes, for the tax years in question (with the numbers rounded to the nearest billion or million dollars, respectively) the outstanding loan balance due grew from $2 billion to $3 billion over the three years with approximately $100 million, $150 million, and $200 million in interest payments made in each of the respective years, but with only one principal payment made during the 2007 tax year in the amount of $300 million.

The Department determined that the level of Taxpayer's intercompany royalties and interest transactions significantly distorted Taxpayer's reported Indiana adjusted gross income. The Department disallowed a portion of these royalty expenses and all of these interest expenses in order to fairly represent Taxpayer's Indiana income. In support of that position, the audit report cited to 45 IAC 3.1-1-62 and IC § 6-3-2-2(m).

45 IAC 3.1-1-62, states:

> All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of

income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

(Emphasis added.)

IC § 6-3-2-2(m) provides:

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

(Emphasis added.)

The statutory provision cited provides the Department with authority to distribute, apportion, or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect Indiana income.

The Department also refers to IC § 6-3-2-2(l), which provides:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) the exclusion of any one (1) or more of the factors;

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other methods to effectuate an equitable allocation and apportionment of the taxpayer's income.

(Emphasis added).

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." Id. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." See Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer maintains that it has charged an arm's-length rate for the royalties and interest payments, and, therefore, the full amount charged for the royalties and interest should be allowed as expenses. Taxpayer further argues that the Department does not have the authority to disallow these expenses because it is not an item of allocation or apportionment. Taxpayer also suggests that the audit report merely makes statements and and does not explain why the adjustments were made.

Taxpayer's first point of protest is that the Department did not state or assert that the transactions were not at arm's-length. As part of the protest process, Taxpayer has provided documentation supporting its position that the transactions were conducted at arm's-length. Upon review, Taxpayer is correct that the Department did not challenge the arm's-length status of the transactions. However, the arm's-length status of the transactions is not a factor upon which the adjustments were based. Rather, the Department explained that the Taxpayer's interest and royalty expense transactions while having no effect on the consolidated group's adjusted gross income, distorted and unfairly represented the Indiana consolidated group's Indiana-sourced income. The audit report did not contest the arm's-length nature of the transactions because that factor is not germane to the determination of whether or not Taxpayer's consolidated group's deductions fairly reflect Taxpayer's consolidated group's Indiana adjusted gross income.

Taxpayer's second point of protest regards the Department's reference to 45 IAC 3.1-1-62 in making the adjustments to Taxpayer's income. Taxpayer maintains that this regulation only allows the Department to make changes in allocation and apportionment methods, not to add back claimed expenses as was done here. The Department refers to IC § 6-3-2-2(l), which allows the Department, when standard allocation and apportionment methods do not fairly reflect a taxpayer's Indiana income, to use any other method to calculate a fair allocation and apportionment of a taxpayer's Indiana income. In the instant case, fair allocation and apportionment is achieved by adding back deductions from certain inter-company expenses and then applying the standard allocation and apportionment procedures.

Taxpayer's last point of protest is that the Department's audit report merely makes statements and does not explain why the adjustments were made. However, the Department's twenty-six page audit report explains the adjustments in detailed text and diagrams that account for more than fifteen pages of the report. The Department's report explains and provides reasons why the royalty expenses were excessive and why the

interest expenses were not ordinary or necessary business expenses. For example, as provided in the audit report, Sub A and Sub B were paying royalty for activities for which Sub A and Sub B either receive management fees to provide the same services or are to provide those services themselves under the trademark agreement. Sub A received loans back from Sub RI to provide money for its operations that would not be necessary but for the large amounts of royalty payments made to Sub RI. Taxpayer could not identify the employees of Sub RI that performed the activities for which royalty payments were received. The audit report found no clear justification or need for either the large amount of royalty payment or interest payments. Taxpayer used the same money to essentially take two deductions for intercompany transactions that significantly lower Taxpayer's Indiana source income, but have no effect on the Taxpayer's entire group's income.

In conclusion, the arm's-length nature of the transactions is not a determinative factor in the Department's decision that the claimed deductions do not fairly reflect Taxpayer's Indiana adjusted gross income. The Department is allowed to use "any other methods"–including the method used in this case–to fairly reflect Taxpayer's income. The Department adjustments were explained in the audit report. Therefore, Taxpayer has failed to meet its statutory burden under IC § 6-8.1-5-1(c) of demonstrating that the Department's decision to disallow a portion of the royalty expenses and all of the interest expenses that were paid to a related party was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax–Business/Nonbusiness Income Classification.

DISCUSSION

The Department determined that Taxpayer incorrectly classified interest income and dividend income from short-term investments of its excess cash as "nonbusiness income." The audit reclassified the interest and dividend income categories as "business income."

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. IC § 6-3-2-2(b). In contrast, nonbusiness income is allocated to Indiana or it is allocated to another state. IC § 6-3-2-2(g)-(k). Therefore, "[W]hether income is deemed business income or nonbusiness income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Dep't Store Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer's argument that this income is "nonbusiness income," is significant because if Taxpayer is correct, all this income is allocated elsewhere and is not relevant in calculating Taxpayer's Indiana adjusted gross income tax.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "nonbusiness income." IC § 6-3-1-20 defines business income, as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business.

Conversely, IC § 6-3-1-21 provides that "nonbusiness income" means "all income other than business income."

The Indiana Tax Court in May addressed the statutory and regulatory language cited above, and outlined the transactional and functional tests the Department must apply to distinguish business from nonbusiness income. The court found that "[I]n passing IND. CODE § 6-3-1-20, the General Assembly provided two tests for defining business income... the 'transactional' and 'functional' tests." Id. at 662. The court goes on to say that IC § 6-3-1-20 "requires that not only the property's disposition but also its acquisition and management must be integral parts of the taxpayer's regular trade or business." May, 749 N.E.2d at 664.

Under the transactional test, income is classified as business income when the income arises from transactions that occur in the regular course of a taxpayer's trade or business. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59. Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or nonbusiness under the transactional test. 45 IAC 3.1-1-29 states that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 states:

> "For purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:
>
> (1) The nature of the taxpayer's trade or business.
>
> (2) The substantiality of the income derived from the activities and the percentage that income is of the

taxpayer's total income for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

Additionally, in May, the Tax court noted that the transactional test also considers the following:

(1) the frequency and regularity of similar transactions;

(2) the former practices of the business; and

(3) the taxpayer's subsequent use of the income.

Id. at 660.

Under the functional test, the income arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. See IC § 6-3-1-20. The functional test focuses on the property being disposed of by the taxpayer. May, 749 N.E.2d at 664. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. Id. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner's retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

In the instant case, Taxpayer receives interest and dividends from the short-term investments of "excess corporate cash." Under the "transactional" test, this type of income is properly classified as business income because this income is derived from activities in which taxpayer regularly engages. There is nothing especially extraordinary about a company investing its excess cash in short-term, interest-bearing or dividend-paying securities; to the contrary, it would be decidedly irregular for any business entity–having access to unused cash assets–to allow those assets to remain dormant and unexploited. Taxpayer argues that it is in the business of "operating retail stores" and that it is not in the business of investing cash. However, the issue is not whether this income is or is not "retail operations" income; the issue is whether or not receipts in the form of interest and dividends are business income. Under the "transactional test," this income is business income.

This income is also properly classified as business income under the functional test. The property to which this income is attributable–excess cash–were all acquired and managed by Taxpayer "in a process integral to taxpayer's regular trade or business operations." May, 749 N.E.2d at 664. The cash is an essential component within Taxpayer's diverse but integrated business operation.

Alternatively, Taxpayer asserts that if this income is determined to be business income in general, a portion of the interest income that is derived from the short-term investment of the cash proceeds from the sale of one of its business division is nonbusiness income. Presumably, Taxpayer is asserting that the money from the sale of the business division would be classified as nonbusiness, and, therefore, the investment of this money would result in nonbusiness income. However, Taxpayer has not provided the amount of the interest income in question for this argument, any of the facts and circumstances of the sale of the division, nor has Taxpayer cited to any authority supporting its proposition. Without this information, the Department is unable to address Taxpayer's argument. Nonetheless, please note that a taxpayer's sale of a business division typically results in business income. See generally SLOF 99-0438; LOF 06-0187; LOF 02-0309; LOF 03-0166.

Taxpayer has failed to meet its statutory burden under IC § 6-8.1-5-1(c) of demonstrating that the Department's decision to classify the interest and dividend income as business income was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

III. Tax Administration–Penalties.

The Department determined that Taxpayer incurred an assessment that was due to negligence as found under 45 IAC 15-11-2(b) and imposed the penalty under IC § 6-8.1-10-2.1(a). Also, the Department found Taxpayer was subject to the underpayment penalty under IC § 6-3-4-4.1(d) for the 2006 and 2007 tax years. Taxpayer protests the imposition of the negligence penalty and the underpayment penalty.

A. Negligence Penalty.

Taxpayer argues that it is not subject to a negligence penalty with respect to the additional taxes assessed against it. In particular, Taxpayer maintains that it had reasonable cause to file its returns as it did. Accordingly, Taxpayer argues that it was not negligent in its tax return filings for the years in question.

The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty." Penalty waiver is only permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and

not due to willful neglect. IC § 6-8.1-10-2.1(d).

Further, the Indiana Administrative Code, 45 IAC 15-11-2(b) provides:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties place upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive the negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). In the course of the protest process, Taxpayer has established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c). While Taxpayer's current circumstances show that Taxpayer acted with reasonable cause, Taxpayer should be on notice that should these circumstances arise again, penalty waiver may not be warranted.

Therefore, Taxpayer's protest to the imposition of the negligence penalty is sustained.

B. Underpayment Penalty.

Taxpayer protests the imposition of the underpayment penalty. IC § 6-3-4-4.1(d) provides:

(d) Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to twenty-five percent (25 [percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year. A taxpayer who uses a taxable year that ends on December 31 shall file the taxpayer's estimated adjusted gross income tax returns and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year. If a taxpayer uses a taxable year that does not end on December 31, the due dates for filing estimated adjusted gross income tax returns and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year. The department shall prescribe the manner and forms for such reporting and payment.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment is not appropriate. Accordingly, Taxpayer's protest to the imposition of the underpayment of estimated tax penalty is sustained.

FINDING

Taxpayer's protest to the imposition of the penalties is sustained.

CONCLUSION

Taxpayer's protest to the disallowance of a portion of its royalty expenses and all of the interest expenses is denied, as discussed in Issue I. Taxpayer's protest to the classification of its interest and dividend income as business income is denied, as discussed in Issue II. Taxpayer's protest to the imposition of the ten-percent negligence penalty and the underpayment penalty is sustained, as discussed in Issue III.

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