DEPARTMENT OF STATE REVENUE

02-20100412.LOF

Letter of Findings: 02-20100412
Corporate Income Tax
For the Years 2007, 2008, 2009

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Corporate Income Tax – Addback of Interest Expense Deduction.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; 45 IAC 3.1-1-62; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the add-back of an interest expense deduction on its Indiana return and the subsequent recalculation of the amount of Taxpayer's income apportioned to Indiana resulting in the assessment of additional Indiana income tax.

II. Tax Administration – Negligence Penalty.

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

Taxpayer protests the assessment of negligence penalty.

STATEMENT OF FACTS

Taxpayer is a manufacturer of kitchen cabinets and vanities for remodeling and new home construction markets. Taxpayer operates manufacturing facilities and builder service centers throughout several states, including Indiana.

The Indiana Department of Revenue ("Department") conducted an income tax audit of Taxpayer for the years 2007, 2008, and 2009. Taxpayer filed a separate Indiana income tax return for the years at issue. The Department added-back to Taxpayer's Indiana income tax returns certain interest payments Taxpayer made to a subsidiary ("Sub") which resulted in an assessment of additional income tax, interest, as well as a negligence penalty. Taxpayer protested both the assessment of additional tax and the penalty. A hearing was held on the issues relating to Taxpayer's protest and this Letter of Findings ensues. Additional information will be provided as necessary.

I. Corporate Income Tax – Addback of Interest Expense Deduction.

DISCUSSION

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A single issue arose during the Department's audit relating to Sub. Sub, a subsidiary of Taxpayer, was formed in due part as a result of an agreement between Taxpayer and the Kentucky Economic Development Finance Authority ("KEDFA") where Taxpayer agreed to establish an "economic development project" consisting of the "acquisitions, construction, equipping a manufacturing facility for the manufacture of kitchen cabinets..." within the state of Kentucky. In so doing, Taxpayer would receive several million dollars worth of economic development tax credits. According to Taxpayer, KEDFA required Taxpayer to borrow the amount required to finance the project and for which KEDFA would eventually provide tax credits. Taxpayer therefore formed Sub and transferred certain monies to Sub in order to fund Sub. Taxpayer then borrowed the monies from Sub signing a promissory note with Sub dated December 31, 2001. Taxpayer was to make annual interest-only payments until and including January 2017, whereby the principal would also be paid off. KEDFA was to subsequently provide the tax credits "at the appropriate time." The Department's audit noted that deposits were made into a bank account controlled by Sub, then "swept back" to Taxpayer's operating account. Taxpayer deducted the interest expenses on its federal and Indiana returns. The Department's audit added-back the interest expense deduction on the Indiana return to recalculate the amount of Taxpayer's income apportioned to Indiana.

The Department relied on IC § 6-3-2-2(l),(m) and 45 IAC 3.1-1-62 in adding back the interest expense deduction to the Indiana returns.

IC § 6-3-2-2 states in relevant part:

(l) 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) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(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 method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) 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.

...

(o) Notwithstanding subsections (l) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is:

(1) a foreign corporation; or

(2) a corporation that is classified as a foreign operating corporation for the taxable year by section 2.4 of this chapter.

(p) Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

45 IAC 3.1-1-62 states:

Special Formulas for Division of Income. 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.

The Department's audit found that the sole purpose of this intercompany loan from Sub to Taxpayer, funded with Taxpayer's own money, was for Taxpayer to qualify for the economic development credits from the state of Kentucky. The Department's audit also noted that all interest paid by Taxpayer was returned to Taxpayer for its use in a circular flow of funds. The loan transaction was therefore without economic substance, and the interest payments made by Taxpayer to Sub substantially reduced Taxpayer's Indiana income. Furthermore, a review of Sub's balance sheet showed no assets or liabilities, no notes receivable, capital or retained earnings. Officers and board members were all employees of Taxpayer. The Department's audit, therefore, added back the interest expense deduction on the Indiana return.

In its protest, Taxpayer argued that it was simply acting according to the requirements of the state of Kentucky. Subsequent to the hearing Taxpayer provided documentation that showed that the interest payments were connected to being approved for KEDFA tax credits. Taxpayer also demonstrated that it made annual interest-only payments to Sub. Taxpayer provided documentation showing that all of the bank accounts of Sub and all but the operating account of Taxpayer were "zero balance accounts" i.e., monies were swept from all accounts on a daily basis into Taxpayer's operating account.

The formation of Sub and the loan arrangement between Sub and Taxpayer, were, in the end, a formalistic compliance with KEDFA's requirement that Taxpayer finance its project as a condition to eventually receiving KEDFA's tax credits without the substantive obligations present in typical third-party arm's length financing arrangements. Said another way, while Taxpayer had a business purpose in entering into this arrangement, Taxpayer's loan from its Sub lacked the economic substance that typically accompany lender-borrower relationships. As the Department's audit states, "the profitability of [Taxpayer] declined as a direct result of the payment of interest to [Sub]" under the conditions described above resulting in a distortion of Taxpayer's Indiana apportioned income.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

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 placed 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 standard for waiving the negligence penalty is given at 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.

Taxpayer has established, as required by 45 IAC 15-11-2(c), that its underpayment of income tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the disallowance of its interest expense deduction is denied.

Taxpayer's protest of the negligence penalty is sustained.

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