DEPARTMENT OF STATE REVENUE

02-20090706.SLOF

Supplemental Letter of Findings: 02-20090706
Corporate Income Tax
For Years 2002, 2003, and 2004

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ISSUES

I. Corporate Income Tax – Imposition – Inclusion of Insurance Company.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dept of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); I.R.C. § 816; I.R.C. § 831; Treas. Reg. § 1.801-1; Treas. Reg. § 1.801-3; Treas. Reg. § 1.831-3; Congressional Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84; Allied Fidelity Corp. v. C. I. R., 572 F.2d 1190 (7th Cir. 1978); H.R. Conf. Rep. 108-457 (2004), as reprinted in 2004 U.S.C.C.A.N. 538; Pension Funding Equity Act of 2004, P.L. 108-218.

Taxpayers protest the Department's inclusion of one of Taxpayers' subsidiaries in the combined filings.

II. Tax Administration – Negligence Penalty.

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

Taxpayers protest the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer ("Parent") is a multinational company that manufactures and sells consumer goods. Through its multi-tier corporate structure, Taxpayer wholly or partially owns, as well as directly or indirectly controls, its multi-tier subsidiaries. Taxpayer and certain of its subsidiaries/affiliates (collectively, "Taxpayers") either file separate or consolidated Indiana corporate income tax returns based on their Indiana activities.

The Indiana Department of Revenue ("Department") conducted an income tax audit of tax years 2002, 2003, and 2004. Pursuant to the audit, the Department proposed that Taxpayers file combined adjusted gross income tax returns for those years to fairly reflect their income derived from sources within Indiana. The Department's audit also disallowed some of the net operating losses incurred by Taxpayers and which Taxpayers carried forward, resulting in additional income tax, interest, and penalty.

Taxpayers timely protested the assessments. A hearing was held. Letter of Findings 02-20090706 (March 23, 2011) ("LOF"), 20110323 Ind. Reg. 045110112NRA, sustained Taxpayers' protest in part and denied their protest in part. Subsequently, Taxpayers submitted additional information and requested a rehearing. The rehearing was granted based on the additional information concerning Insurance Company O4 and was limited to the issue of whether Insurance Company O4 should be included in the combined returns. This Supplemental Letter of Findings ensues. Additional facts will be provided as necessary.

DISCUSSION

I. Corporate Income Tax – Imposition – Inclusion of Insurance Company.

The Department's audit found that Taxpayers, through various intercompany activities, maintained a unitary relationship. Upon reviewing Taxpayers' returns, as filed, the Department's audit concluded that the returns, through deductions on various expenses between the intercompany activities, had underreported their taxable income in Indiana, resulting in shifting the deemed Indiana income out of Indiana for those years. Thus, to fairly reflect Taxpayers' taxable income derived from sources within Indiana, the Department's audit combined their filings for those years, which eliminated the intercompany transactions among Taxpayers. The LOF concluded that Taxpayers should file their Indiana returns on a combined basis but should exclude the qualified foreign operating companies. Thus, pursuant to the LOF, Insurance Company O4 remained in the combined returns for those years. Taxpayers continue to protest that Insurance Company O4 should be excluded.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dept of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayers assert that the Department's audit erroneously included Insurance Company O4, which is a non-life insurance company providing "Workers' Compensation and Employers' Liability" insurance coverage to Taxpayers, in the combined filings. Taxpayers also assert that the LOF, which denied Taxpayers' protest on this issue, mistakenly applied Treas. Reg. § 1.801-1(b), a federal regulation which was superseded and replaced by Treas. Reg. § 1.801-3(a) in 1955.

Taxpayers explain that the audited years at issue are 2002, 2003, and 2004, but it was not until 2004 that the Congress added I.R.C. § 831(c), which clearly refers to I.R.C. § 816(a) to determine whether a company qualifies as an insurance company for the purposes of I.R.C. § 831. For the tax years 2002 and 2003, Taxpayers argue that in the absence of a statutory definition, pursuant to then effective Treas. Reg. § 1.801-3(a), O4 qualifies as an

insurance company for the purposes of I.R.C. § 831, and that, for the tax year 2004, under the I.R.C. § 816(a) definition, O4 also qualifies as an insurance company for the purposes of I.R.C. § 831. Taxpayers thus maintain that O4 qualifies as an insurance company for the purposes of I.R.C. § 831 pursuant to federal case law, statutes, and regulations for those years, and it cannot be included in Taxpayers' combined filings. Rather, Taxpayers maintain that O4's Indiana income should be computed pursuant to IC § 6-3-2-2(r).

IC § 6-3-2-2(r) states:

This subsection applies to a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or **an insurance company that is subject to tax under Section 831 of the Internal Revenue Code**. The corporation's adjusted gross income that is derived from sources within Indiana is determined by multiplying the corporation's adjusted gross income by a fraction:

(1) the numerator of which is the direct premiums and annuity considerations received during the taxable year for insurance upon property or risks in the state; and

(2) the denominator of which is the direct premiums and annuity considerations received during the taxable year for insurance upon property or risks everywhere.

The term "direct premiums and annuity considerations" means the gross premiums received from direct business as reported in the corporation's annual statement filed with the department of insurance. (**Emphasis added**).

I.R.C. § 831 provides:

(a) General rule.–Taxes computed as provided in section 11 shall be imposed for each taxable year on the taxable income of every insurance company other than a life insurance company.

(b) Alternative tax for certain small companies.

(1) In general.–In lieu of the tax otherwise applicable under subsection (a), there is hereby imposed for each taxable year on the income of every insurance company to which this subsection applies a tax computed by multiplying the taxable investment income of such company for such taxable year by the rates provided in section 11(b).

(2) Companies to which this subsection applies.

(A) In general.–This subsection shall apply to every insurance company other than life (including interinsurers and reciprocal underwriters) if–

(i) the net written premiums (or, if greater, direct written premiums) for the taxable year do not exceed $1,200,000, and

(ii) such company elects the application of this subsection for such taxable year.

The election under clause (ii) shall apply to the taxable year for which made and for all subsequent taxable years for which the requirements of clause (i) are met. Such an election, once made, may be revoked only with the consent of the Secretary.

(B) Controlled group rules.

(i) In general. –For purposes of subparagraph (A), in determining whether any company is described in clause (i) of subparagraph (A), such company shall be treated as receiving during the taxable year amounts described in such clause (i) which are received during such year by all other companies which are members of the same controlled group as the insurance company for which the determination is being made.

(ii) Controlled group. –For purposes of clause (i), the term "controlled group" means any controlled group of corporations (as defined in section 1563(a)); except that–

(I) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a), and

(II) subsections (a)(4) and (b)(2)(D) of section 1563 shall not apply.

(3) Limitation on use of net operating losses.--For purposes of this part, except as provided in section 844, a net operating loss (as defined in section 172) shall not be carried–

(A) to or from any taxable year for which the insurance company is not subject to the tax imposed by subsection (a), or

(B) to any taxable year if, between the taxable year from which such loss is being carried and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by subsection (a).

(c) Insurance company defined.--For purposes of this section, the term **"insurance company" has the meaning given to such term by section 816(a).**

(d) Cross references. –

(1) For alternative tax in case of capital gains, see section 1201(a).

(2) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842.

(3) For exemption from tax for certain insurance companies other than life, see section 501(c)(15). (**Emphasis added**).

I.R.C. § 831(c), in 2004, incorporates the definition of "insurance company" established by I.R.C. § 816(a).

The definition of "insurance company" in I.R.C. § 816(a) was enacted as part of an overhaul of the federal income tax provisions for life insurance companies within the Deficit Reduction Act of 1984, P.L. 98-369. It became effective beginning in 1984, and, in relevant part, provides:

> For purposes of the preceding sentence, the term **"insurance company" means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies**. (**Emphasis added**).

Prior to the enactment of the I.R.C. § 816(a), a Congressional Joint Committee on Taxation report, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (the "Joint Committee Report"), JCS-41-84, in relevant part, explains:

> [T]he Act adopts a stricter and more precise standard for a company to be taxed as a **life insurance company** than does the general regulatory definition of an insurance company. Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will **depend on the facts and circumstances**. **Factors to be considered include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities. It is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Code**. Id. at 583. (**Emphasis added**).

In 2004, the reference to I.R.C. § 816(a) was added to I.R.C. § 831(c), through the conference agreement, as part of the Pension Funding Equity Act of 2004, P.L. 108-218. (Same reference was also added to I.R.C. § 501(c)(15)(A) at the same time.) The conference agreement, H.R. Conf. Rep. 108-457 at 50-51 (2004), as reprinted in 2004 U.S.C.C.A.N. 538, 561-62, follows the Senate amendment provision and applies to taxable years beginning after December 31, 2003. The Senate amendment, in pertinent part, explains that:

> [F]or purposes of determining whether a company is a property and casualty insurance company, the term **"insurance company" is defined to mean any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies**. Thus, the Senate amendment conforms the definition of an insurance company for purposes of the rules taxing property and casualty insurance companies to the rules taxing life insurance companies, so that the definition is uniform. The Senate amendment adopts a stricter and more precise standard than the "primary and predominant business activity" test contained in Treasury Regulations. **A company whose investment activities outweigh its insurance activities is not considered to be an insurance company under the Senate amendment.** It is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income. Id. at 50-51. (**Emphasis added**).

While I.R.C. § 816(a) has been in effect since 1984, the I.R.C. § 831(c) reference to I.R.C. § 816(a), however, was not enacted until 2004. Neither the Senate amendment nor the conference agreement referred to Treas. Reg. § 1.801-3 when the Congress added the reference to I.R.C. § 816(a) in I.R.C. § 831(c). Additionally, the Congress in 1984 actually intended to adopt "a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company" (referring to Treas. Reg. § 1.801-3). Thus, prior to 2004, to determine whether a company qualifies as an insurance company for the purposes of I.R.C. § 831 (non-life insurance company or insurance company other than life insurance, i.e., property and casualty insurance company), in the absence of the statutory definition, the courts and the Internal Revenue Service primarily refer to the federal regulations although it should be noted that, in this instance, the federal regulations do not always provide clear guidance on resolutions.

Treas. Reg. 1.831-3(a) (first promulgated in 1960 and last updated as of Oct. 17, 1963), which applies to non-life insurance companies and applies to taxable years beginning after December 31, 1962, states, in relevant part, that:

> [T]he term "insurance companies" means only those companies which qualify as insurance companies under the definition provided by **paragraph (b) of §1.801-1** and **which are subject to the tax imposed by section 831**. (**Emphasis added**).

Treas. Reg. § 1.801-1(b)(2), in pertinent part, provides:

> Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on**, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code.** For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954 within the meaning of the Code and the regulations thereunder. (**Emphasis added**).

In Allied Fidelity Corp. v. C. I. R., 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978), the United

States Court of Appeals upheld the United States Tax Court's decision, in favor of the Commissioner of Internal Revenue, that an Indiana corporation, as a wholly-owned subsidiary of the petitioner, did not qualify as an insurance company during the taxable years in question for purposes of I.R.C. § 831 and I.R.C. § 832. The court in Allied concluded that the Indiana corporation's business, which is primarily engaged in writing surety bail contracts, did not constitute the writing of insurance contracts. Id. at 1191. The court in Allied, in the absence of the statutory definition, referred to the federal regulations to determine whether a company qualifies as an insurance company for the purposes of I.R.C. § 831. The court in Allied explained, in relevant part, that:

> Insurance companies, other than life and mutual, are taxed in accordance with the provisions of 26 U.S.C. §§ 831 and 832. Unfortunately, neither of these sections provides a definition of the term "insurance company". However, we do gain some guidance from the regulations promulgated under § 831 which define "insurance company" by reference to the definition in the regulations under § 801 of the Code. Treas. Regs. § 1.831-1(a) (1960). The regulations under § 801, as are relevant here, provide that:
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> **Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code**. **Treas. Regs. § 1.801-1(b)(2) (1960)**. Id. at 1191–92. (**Emphasis added**).

The court in Allied, acknowledging that Treas. Reg. § 1.801-1(b) was originated from a series of the United States Supreme Court's decisions, concluded, in relevant part, that:

> [T]he language of the regulation is plain and will give the proper deference to the expertise of the Internal Revenue Service in matters such as this. The phraseology of the regulation is clear. The first three elements, name, charter powers, and subjection to State insurance laws, should be "significant" in our evaluation. But, the "character of the business actually done" will be the standard by which we will determine if appellant is taxable as an insurance company under the Code. Id.

The court in Allied further explained that while the name, charter powers, and subjection to State insurance laws may be significant, they are not controlling. Id. The court reasoned that "a state classification of a corporation as an insurance company is not necessarily binding on the Commissioner for Federal tax purposes." Id. Rather, the court in Allied opined that, "in the final analysis, review the nature of the system of bail and how it relates to the characteristics of an insurance contract before we can finally determine the character of the business actually done." Id.

The court in Allied further illustrated, in pertinent part, that:

> [I]nsurance is an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency whereby the insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss.... [A]n insurance contract contemplates a specified insurable hazard or risk with one party willing, in exchange for the payment of premiums, to agree to sustain economic loss resulting from the occurrence of the risk specified and, another party with an "insurable interest" in the insurable risk. It is important here to note that one of the essential features of insurance is this assumption of another's risk of economic loss. Id. at 1193. (Internal citations omitted).

The court in Allied concluded that the Indiana corporation primarily engaged in the business of writing surety bail contracts is not an insurance company for the purposes of I.R.C. § 831 and § 832 because its primary business activity did not qualify as insurance.

Accordingly, to determine whether a company qualifies as an insurance company for the purposes of I.R.C. § 831, prior to 2004, pursuant to Treas. Reg. 1.831-3(a) and the Allied decisions in 1978, in the absence of statutory definition, the Treas. Reg. § 1.801-1(b) definition of "insurance company" remains in effect, by reference, although Taxpayers may claim that Treas. Reg. § 1.801-3 replaces Treas. Reg. § 1.801-1 in 1955. Thus, in this case, for the tax years 2002 and 2003, pursuant to Treas. Reg. 1.831-3(a) and the Allied decisions in 1978, Treas. Reg. 1.801-1(b)(2) remains the proper standard to determine whether O4 qualifies as an insurance company for the purposes of I.R.C. § 831. For the tax year 2004, the statutory language in I.R.C. § 831(c), referring to § 816(a), is the proper standard to determine whether O4 qualifies as an insurance company. Nonetheless, both standards are essentially the same–the character of a taxpayer's business actually performed for a taxable year determines whether the taxpayer qualifies as an insurance company for the purposes of I.R.C. § 831 for that taxable year.

At the rehearing, Taxpayers provided additional information explaining what O4 actually did during the years at issue. Upon reviewing Taxpayers' documentation and the Department's audit, Taxpayers have met the requirements of IC § 6-8.1-5-1(c).

In short, O4 qualifies as an insurance company for the purposes of I.R.C. § 831 for the years at issue and should file its income tax returns pursuant to IC § 6-3-2-2(r) for those years. The Department will remove O4 from the combined filings in a supplemental audit review.

FINDING

Taxpayers' protest is sustained. The Department will remove O4 from the combined filings in a supplemental audit review.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayers protest the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a return for any of the listed taxes;

(2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

(4) fails to timely remit any tax held in trust for the state; or

(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further states:

"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 Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, 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.

Taxpayers have demonstrated that the imposition of the negligence penalty is not appropriate.

FINDING

Taxpayers' protest of the negligence penalty is sustained.

SUMMARY

For the reasons discussed above, on the Issue I, Taxpayers' protest of inclusion of the Insurance Company O4 is sustained. Taxpayers' protest of the negligence penalty is also sustained. The Department will recalculate Taxpayers' tax liabilities in a supplemental audit review.

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