DEPARTMENT OF STATE REVENUE

02-20100220.LOF

Letter of Findings: 02-20100220
Corporate Income Tax
For Tax Years 2004, 2005, and 2006

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ISSUES

I. Corporate Income Tax – Disallowance of Expenses.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-3-2-2.4; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-8; Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992), aff'd 639 N.E.2d 264 (Ind. 1994).

Taxpayer and its affiliates argue that the Department of Revenue erred in disallowing certain business expenses claimed by Taxpayers on their Indiana income tax returns.

II. Tax Administration – Negligence Penalty.

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

Taxpayer and its affiliates protest the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer and its affiliates are in the business of manufacturing, packaging, marketing, and distributing products for a consumer goods industry ("operations"). Taxpayer and some of its affiliates conduct business in Indiana (collectively "Taxpayers") and file consolidated Indiana adjusted gross income tax returns. Taxpayers ultimately share the same parent company ("Parent"), an out-of-state holding company, which wholly or partially owns, as well as directly or indirectly controls, Taxpayers through multi-tiered subsidiaries. Taxpayer and four (4) of its affiliates, in turn, jointly own a subsidiary ("Subsidiary Company"), which was incorporated in 2002 pursuant to the law of the state of Delaware and conducts business within and without the United States. Subsidiary Company is also a qualified "foreign operating corporation" as outlined in IC § 6-3-2-2.4.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayers' business records and tax returns. The audit resulted in the assessment of additional tax stemming from the disallowance of certain business expenses which Taxpayers paid to Subsidiary Company for tax years 2004, 2005, and 2006 ("Tax Years").

Taxpayers disagreed with the audit conclusions and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax – Disallowance of Expenses.

DISCUSSION

The Department's audit disallowed certain business expenses because it determined that Taxpayers' returns, as filed, did not fairly reflect their income derived from Indiana sources. Specifically, the audit disallowed a portion of payment, which Taxpayers paid to Subsidiary Company for product to be used in the operations and for procurement services.

The expense issue stemmed from a series of business arrangements which occurred in 2002 among Parent, Taxpayers, and Subsidiary Company. The Department's audit determined that the arrangements were intended to shift Taxpayers' income out of Indiana. Their returns, as filed, did not fairly reflect their income derived from Indiana sources. The 2002 arrangements are designated as Product Operation and Procurement Operation:

Product Operation: Prior to the formation of Subsidiary Company, Taxpayers had rights to directly purchase Product from one of their affiliate companies ("Supplier") to be used in their operations. Upon the formation of Subsidiary Company, Taxpayers executed the Assignment Agreement ("First Agreement") assigning/transferring their rights to purchase Product to Subsidiary Company. Taxpayers then executed the Sales and Supply Agreement ("Second Agreement") to purchase that same Product from Subsidiary Company (which they had owned outright). Pursuant to the Second Agreement, Subsidiary Company resells, with a mark-up, Product to Taxpayers to be used in their Product Operations.

Procurement Operation: Taxpayers also transferred their accounts payable and then paid Subsidiary Company for its Cash Management Services ("Services"). The Services, as outlined in the Second Agreement, include: (1) receiving funds from, or for the account of, Taxpayers and processing funds for Taxpayers' accounts; (2) arranging, managing, and administering all bank loans and other financing on behalf of Taxpayers; and (3) paying off payables on behalf of and for Taxpayers' accounts from Subsidiary Company's funds. Parent, pursuant to the 2002 Ancillary Services and Lease Agreement, supplies "office personnel and equipment," and leases "office space" to Subsidiary Company to accomplish this task, although it should be noted that Taxpayers maintain that Subsidiary Company "uses its own employees to perform these activities."

Taxpayers' documentation demonstrated that Parent is the ultimate owner of the intangible used by

Taxpayers in their Product Operations, and Subsidiary Company licenses the producing rights from Parent and further sublicenses to Taxpayers. Both Subsidiary Company and Taxpayers agreed that Subsidiary Company will charge "an appropriate Product Purchase Price" that "equals to a mark-up of x [percent] of gross sales" of Taxpayers, and that Taxpayers will be allowed to cover their "expected operating expenses" and have an "arm's length Operating Profit Margin." Taxpayers then claimed and deducted the amount which they "paid" to Subsidiary Company for purchasing Product and Services as "ordinary and necessary" expenses.

The Department's audit concluded that Taxpayers' claimed deductions of their payment for purchasing Product and Services shifted their income to Subsidiary Company. As a result, Taxpayers' Indiana returns, as filed, did not fairly reflect their income derived from sources within Indiana. The Department's audit arrived at its adjustment under authority of IC § 6-3-2-2(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.

A. Statutory Authority.

Taxpayers claimed that the auditor has "misapplied Ind. Code § 6-3-2-2(m) and is violating Ind. Code § 6-3-2-2(o)" because Subsidiary Company is a qualified foreign operating corporation which cannot be included in Indiana returns for Tax Years. Taxpayers further asserted that IC § 6-3-4-14(b) "prohibits the inclusion in an Indiana consolidated return of any corporation that does not have income derived from Indiana sources."

As a threshold issue, it is Taxpayer's responsibility to establish that the tax assessment is incorrect. As stated 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."

The Internal Revenue Code requires taxpayers to report and pay their federal income tax when their gross income exceeds a certain amount. For state income tax purposes, the presumption is that the taxpayers properly and correctly file their federal income tax returns and, thus, to efficiently and effectively compute what is considered the taxpayers' Indiana income tax, the Indiana statute refers to the Internal Revenue Code. Thus, IC § 6-3-1-3.5(b) provides the starting point for determining Taxpayers' taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows...." The Department's Administrative Rules repeats the basic principle at 45 IAC 3.1-1-8 stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code – section 63) with three adjustments...." Thus, the taxpayers' federal "adjusted gross income" is the starting point to calculate their Indiana income tax; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point.

IC § 6-3-2-2 addresses issues of "adjusted gross income derived from sources within Indiana." Specifically, section (m) provides "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."

In this instance, the Department's audit concluded that, because Taxpayers' "payment" to Subsidiary Company concerning Product Operation and Procurement Operation distorted Taxpayers' income, and thus their returns, as filed, did not fairly reflect and report their income derived from sources within Indiana for Tax Years. The audit also determined that Subsidiary Company is "an 80-20 foreign operating company that cannot be included in a combination filing." However, Taxpayers cannot use the 80/20 nature of Subsidiary Company as a shield to justify the substance of the very arrangements Taxpayers entered into with Subsidiary Company which have created the targeted Indiana income distortion. The Department's audit thus disallowed a certain portion of Taxpayers' deductions, which Taxpayers claimed they "paid" to Subsidiary Company and deducted as "ordinary and necessary" expenses. The audit's determination–which disallowed a portion of Taxpayers' deductions and attributed the disallowed amount to Taxpayers' income–did not include Subsidiary Company's income in the Indiana returns, and thus is in compliance with Indiana law.

In short, the Department's audit, following IC § 6-3-2-2(o), did not include Subsidiary Company's income in Taxpayers' Indiana returns. Rather, the Department's audit properly disallowed portion of Taxpayers' purported expenses pursuant to IC § 6-3-2-2(m). Thus, Taxpayers' protest is respectfully denied.

B. Income Distortion.

The Department's audit noted that while Taxpayers had an average of approximately 4 percent profit margin for Tax Years, Subsidiary Company had an over 90 percent profit margin from merely purchasing Product for Taxpayers and providing Services to Taxpayers during Tax Years. The Department's audit further noted that:

> [Subsidiary Company's] biggest asset is its inter-company receivable. The increase in the inter-company receivable for each year approximates the net federal taxable income for the year which suggests instead of collecting these receivables, the receivables stay in the books or [are] loaned back to the [] customers/partners.

Additionally, the Department's audit noted that Taxpayer's responsible officers were also Taxpayers' responsible officers and Subsidiary Company's responsible officers throughout Tax Years. Thus, the Department's audit concluded that Subsidiary Company "has no control of its investible assets rendering it [] a mere tool to shift income for state income tax advantage" and that Taxpayers' Indiana returns, as filed, failed to fairly reflect and report their income derived from sources within Indiana. Upon further reviewing the federal consolidated returns of Parent and Taxpayers for Tax Years and documentation of the 2002 arrangements, the Department's audit, concluded that, as a group, the average consolidated net profit rate is approximately fifteen (15) percent. Thus, the Department's audit adjusted Taxpayers' claimed deduction to fifteen (15) percent of their "payment" to Subsidiary Company for Tax Years and disallowed the remainder of the "payment" to Subsidiary Company.

Taxpayers, to the contrary, assert that the audit ignored "relevant, reliable probative evidence that establishes [their] returns do fairly reflect income from Indiana sources" to justify resorting to the remedies found at IC § 6-3-2-2(m). Taxpayers stated that:

> The auditor's analysis of [Taxpayers'] returns for fairness is entirely based on a comparison of the Indiana returns with the federal returns filed by the entire affiliated group. The auditor then concludes that because [Subsidiary Company] – a foreign operating corporation which is not includable in the Indiana return, but is includable in the federal return – and several other [] support entities (also not includable in the Indiana consolidated returns) alleged earn 80[percent] of the net federal taxable income reported on the consolidated federal return, income in the Indiana returns is not fairly reflected. (Emphasis in original).

Taxpayers also emphasize the fact that the Internal Revenue Service ("IRS") had examined the pricing charged by Subsidiary Company to Taxpayers and that the IRS "did not attribute any of Subsidiary Company's profit to the Taxpayers." Taxpayers thus asserted that the inter-company transaction between Subsidiary Company and Taxpayers was based on an "arm's length" price and supported by the third party transfer pricing studies. Taxpayers further maintained that "[i]t is inappropriate for the auditor to use the federal consolidated return as the benchmark for determining whether income reported on an Indiana consolidated return is fairly reflected."

The Department must disagree. As discussed in Part A, for state income tax purposes, the presumption is that Taxpayers properly and correctly file their federal income tax returns, and that Taxpayers' federal adjusted gross income is the starting point to compute the Indiana state income tax. Thus, reviewing Taxpayers' federal returns for Tax Years is the first step and logical approach to efficiently and effectively determine whether Taxpayers' Indiana returns, as filed, fairly reflected their income derived from Indiana sources.

Taxpayers maintain that the audit ignored the evidence showing that the charge of the inter-company transaction between Subsidiary Company and Taxpayers was supported by the third party transfer pricing studies, which were under the IRS's scrutiny and the IRS did not make any adjustment concerning the inter-company transaction. Although the IRS's practice is beyond the scope of Taxpayers' protest and this discussion, the same third party transfer pricing studies which Taxpayers rely on in their protest, however, clearly state, in pertinent part, that:

> 6. the understanding that this report is solely for your [Taxpayers'] benefit and may not be relied upon by any other person or entity other than the IRS;
>
> 7. the understanding that only the specific US federal income tax issues and tax consequences discussed herein are covered by this conclusion, and no other foreign or US national, **state**, or local taxes of any kind are covered by our report.... (**Emphasis added**).

Furthermore, Taxpayers claim that because Subsidiary Company "guarantees" Taxpayers an average of 4 percent profit margin, Subsidiary Company bears higher risk, which allows Subsidiary Company a higher profit margin–over 90 percent. The same third party transfer pricing studies which Taxpayers rely on in their protest, however, fail to support Taxpayers' assertion and, in fact, mention that Taxpayers bear most of the risks–the "inventory risk," "product defect risk," and "credit risk."

Even if, for the sake of argument, the Department agrees that Taxpayers' transfer pricing studies set bona fide "arm's length" rates for the intercompany transactions, the analysis, under Indiana law, does not stop there. The Department's audit documented that the 2002 arrangements among Parent, Taxpayers, and Subsidiary Company established the Product Operation and Procurement Operation, which, in turn, generated the inflated business expenses during Tax Years, and, as a result, shifted Taxpayers' income to Subsidiary Company, which is a qualified foreign operating corporation. The Department's audit further documented that Taxpayers jointly own and control Subsidiary Company, and that the same individuals not only served as responsible officers of Taxpayers, but also served as responsible officers of Subsidiary Company. While Taxpayers' responsible officers were to exercise their business judgment to make best decisions for Taxpayers' best interest, the same responsible officers also represented Subsidiary Company and were to exercise their business judgment to make best decisions for Subsidiary Company. Thus, the Department's audit certainly did not draw its conclusion by simply comparing "the Indiana returns with the federal returns filed by the entire affiliated group."

Taxpayers are, of course, entitled to structure their business affairs in any manner they see fit and to pursue any tax advantage attendant upon the management of their business affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992), aff'd 639 N.E.2d 264 (Ind. 1994). In assigning/transferring Taxpayers' rights to purchase Supplier's product and their accounts payable to Subsidiary Company, paying for the same product and Services, developing a business structure and financial plan, Taxpayers sought for a variety of reasons to make the decisions they did and – for purposes of this discussion – the Department has no quarrel with any of the particulars of their business plan. What is incontrovertible is the fact that both Taxpayers and Subsidiary Company structured their agreement, which covered Taxpayers' expected operating expenses and allowed Taxpayers an average of approximately 4 percent net profit margin, and allowed Subsidiary Company to keep the remainder–over 90 percent or more of the net profit for Tax Years–which Subsidiary Company then loaned back its "receivables" to Parent and affiliates. Moreover, Subsidiary Company's income from the "payment" for purchasing Product and Services and the receipt of interest income were not subject to state income tax because Delaware does not impose income tax on intangibles. Furthermore, because Subsidiary Company is a qualified foreign operating corporation, its income for Tax Years was also excluded from state income tax where states have adopted/required a filing method of combined reporting. As the Department's audit noted, this over 90 percent of net profit could only exist in a controlled environment where the purchasers own and control the seller allowing the purchasers to structure the business operations to their benefit shifting their income for state income tax advantages. When one considers the "substance" of the purchasing Product to be used in the operations and Services transactions, the Department was legitimately concerned that Taxpayers had shifted a substantial portion of their Indiana source income outside the state, that Taxpayers' Indiana income did not match their claimed Indiana expenses, and that it was appropriate to take steps to assure that Taxpayers' taxable income fairly reflected the income attributable to Indiana sources.

The Department's audit also documented alternatives of computing the adjustment to fairly reflect Taxpayers' income attributable to Indiana sources, and stated that:

> Alternative methods of computing their Adjusted Gross Income (AGI) were discussed with the Taxpayer. Alternative methods that were discussed included a proposal to combine operations as well as proposals to disallow a portion or all of the profits from the procurement operation. The Taxpayer suggested disallowing [a percentage] of the profits of the procurement operation. When asked for their justification of the [percentage] disallowance, the Taxpayer instead provided reasons why a combined filing is not an option.

The auditor, attempting to determine the reasonable and fair amount of Taxpayers' income derived from sources within Indiana, reviewed Taxpayers' documentation, including the claimed "payment" (ordinary and necessary expenses) to Subsidiary Company outlined in the Second Agreement, which established the formula calculating Subsidiary Company's charge for purchasing Product.

Subsidiary Company, as the audit noted, maintains its operations in addition to purchasing Product for and providing Services to Taxpayers. Taxpayers' documentation also demonstrated that, apart from the 2002 business arrangements, Subsidiary Company's business operations essentially aligned with Parent/Taxpayers' business operations. Thus, it is reasonable to refer to Taxpayers and Subsidiary Company's federal consolidated returns (which were properly and correctly filed as discussed above), to determine what could have and would have been proper "Operating Profit Margin" for Subsidiary Company. The Department's audit noted that "[t]he adjustment proposed in this audit is an attempt to fairly represent the actual activity and net income to be reported by the Indiana filing affiliates, by using a company-wide profit margin to bring the expense[s] to a reasonable level." From there, the audit proceeded to compute the amount which Taxpayers should not have deducted as expenses to reflect Taxpayers' Indiana income.

Of course, to achieve the goal to "fairly reflect and report" Taxpayers' income derived from Indiana pursuant to IC § 6-3-2-2(m), the audit's approach has to be reasonable. Taxpayers were afforded opportunities to discuss other reasonable approaches, as the Department's audit documented, to propose alternative methods to fairly reflect their income derived from sources within Indiana. Taxpayers proposed a percentage of disallowance, but Taxpayers did not, at the auditor's request, provide a rationale to substantiate their proposed alternative.

Finally, Taxpayers have invited the Department to interpret the U.S. Constitution and apply the Due Process Clause in their favor. The Department, however, must respectfully decline Taxpayers' invitation to address federal constitutional issues because an administrative hearing is not a proper forum to address Taxpayers' concerns regarding federal constitutional principles.

Given the totality of the circumstances, the Department is not able to agree that Taxpayers have met their burden. Thus, the audit reasonably disallows eighty-five (85) percent of three of Taxpayers' "payments" to Subsidiary Company for purchasing product and providing Services as claimed deductions for Tax Years.

FINDING

Taxpayers' protest of the Department's disallowance of expenses is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayers also 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 provided sufficient documentation to demonstrate that their failure to pay tax was not due to negligence.

FINDING

Taxpayers' protest is sustained.

SUMMARY

For the reasons discussed above, Taxpayers' protest of the imposition of negligence penalty is sustained. Taxpayers' protest of the Department's disallowance of expenses, however, is respectfully denied.

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