DEPARTMENT OF STATE REVENUE

02-20110039.LOF

Letter of Findings: 02-20110039
Corporate Income Tax
For the Years 2001 through 2005

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ISSUES

I. Statute of Limitations – Corporate Income Tax.

Authority: IC § 6-3-1-11; IC § 6-8.1-5-1(c); IC § 6-8.1-5-2(g); 45 IAC 15-9-1; I.R.C. § 6501(h).

Taxpayer argues that the assessment of 2001 corporate income tax is barred by the statute of limitations.

II. Interest Expense Disallowance – Corporate Income Tax.

Authority: IC § 6-3-1-3.5(b); IC § 6-3-1-3.5(b)(9); IC § 6-3-2-2(l), (m); IC § 6-3-2-2(p); IC § 6-8.1-5-1(c); Gregory v. Helvering, 293 U.S. 465 (1935); Lee v. Comm'r, 155 F.3d 584 (2d Cir. 1998); Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992); Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 3.1-1-8; Black's Law Dictionary (7th ed. 1999).

Taxpayer challenges the Department's disallowing certain claimed interest expenses.

III. Foreign Source Dividend Deduction – Corporate Income Tax.

Authority: IC § 6-3-2-12; IC § 6-3-2-12(b); IC § 6-3-2-12(b)(1); IC § 6-3-2-12(c); IC § 6-3-2-12(d); IC § 6-3-2-12(e); IC § 6-3-4-14; IC § 6-3-4-14(b); IC § 6-3-4-14(d); IC § 6-8.1-5-1(c)); Indopco, Inc. v. C.I.R., 503 U.S. 79 (1992); Parker Pen Co. v. O'Day, 234 F.2d 607 (7th Cir. 1956); Mynsberge v. Dept. of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Johnson County Farm Bureau Co-op. Ass'n, Inc. v. Indiana Dept. of State Revenue, 568 N.E.2d 578 (Ind. Tax Ct.1991); State v. Smith, 158 Ind. 543, 63 N.E. 25 (1902); Florer v. Sheridan, 137 Ind. 28, 36 N.E. 365 (1893); Ind. Dep't of State Rev. v. Food Marketing Corporation, 403 N.E.2d 1092 (Ind. Ct. App. 1980).

Taxpayer maintains that the cumulative or aggregate "ownership" interest of all members of the federal affiliated group should be used to determine the ownership percentage of the foreign entity paying a foreign source dividend.

IV. Net Operating Loss Calculation – Corporate Income Tax.

Authority: IC § 6-3-2-2.6; IC § 6-3-2-2.6(c)-(d); IC § 6-3-2-12; IC § 6-3-2-12(b); IC § 6-8.1-5-1(c); 45 IAC 3.1-1-9.

Taxpayer maintains that it correctly calculated its Net Operating Loss by including foreign source dividend deductions.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the pharmaceutical and health care business. Taxpayer develops, licenses, manufactures, markets, distributes, and sells pharmaceuticals and related consumer healthcare products. Taxpayer has Indiana property, inventory, rental property, and payroll.

The Department of Revenue conducted a corporate income tax audit for the years 2001 through 2005. The audit resulted in the assessment of additional income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for its protest. This Letter of Findings results.

I. Statute of Limitations – Corporate Income Tax.

DISCUSSION

Taxpayer argues that the Department's assessment of 2001 income tax is barred by the statute of limitations.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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 Department made various adjustment's to Taxpayer's "net operating loss" for 2003, 2004, and 2005. The Department's audit "Summary" states:

> In summary, there is a reduced deduction for foreign source dividends in 2003 and 2004 and no foreign source dividend deduction in 2005. Audit adjustments for interest expense disallowed, prior amended returns... have all been reflected in the schedule to compute the proper [net operating loss] carryback/carryforward.

Elsewhere, the audit Summary states:

> The adjustments made in this report are reflected on the Net Operating Loss Schedule... and affect the carryback from 2003 to 2001. The [T]axpayer filed an amended return to carryback the unaudited loss from 2003 to 2001. After audit adjustments to interest expense and foreign dividends, it was determined that

> [T]axpayer did not have a net operating loss for 2003. Therefore, upon audit the 2003 carryback to 2001 was eliminated. The [T]axpayer's Net Operating loss from 2003... that was carried back to 2001 was eliminated. This results in the deficiency in this report for the year 2001. (Emphasis added).

In other words, Taxpayer previously carried back a net operating loss from 2003 to 2001 and claimed a refund of 2001 taxes; that refund was granted. Subsequently, the audit disallowed the 2003 loss and "reversed" the 2001 refund issued to Taxpayer on April 7, 2008. Taxpayer claims that the resulting assessment is barred by the statute of limitations. Taxpayer relies on IC § 6-8.1-5-2(g) which states:

> If any part of a listed tax has been erroneously refunded by the department, the erroneous refund may be recovered through the assessment procedures established in this chapter. An assessment issued for an erroneous refund must be issued:
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> (1) within two (2) years after making the refund; or
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> (2) within five (5) years after making the refund if the refund was induced by fraud or misrepresentation.

Taxpayer points out that the Department issued the 2001 refund check on April 7, 2008. Under Taxpayer's application of IC § 6-8.1-5-2(g), the Department had two years – until April 7, 2010 – to retrieve what Taxpayer categorizes as an "erroneous refund under IC § 6-8.1-5-2(g)."

Since the Department did not issue the proposed assessment until, December 6, 2010, Taxpayer concludes that the proposed assessment is barred as untimely by IC § 6-8.1-5-2(g).

The audit found that the 2001 assessment was not barred by the statute of limitations under 45 IAC 15-9-1 as set out below:

> (a) In determining the time limitations within which a person may file a claim for refund, the due date of the return shall include extensions of the due date as provided under IC 6-8.1-5-2.
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> (b) When claiming a refund arising from a net operating loss, the three (3) year limitation shall be determined by the year in which the net operating loss is incurred, not the year to which the loss is carried back.
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> A taxpayer has a $50,000 net operating loss in 19X4. The loss is carried back to 19X1, 19X2 and 19X3. The three (3) year limitations will begin to run on the latter of the due date of the 19X4 return or the date the return for 19X4 is filed.

It should be noted at the start, that Taxpayer signed a series of waivers each entitled "Agreement to Extension of Time" for the years 2003, 2004, and 2005. Taxpayer neither claims, nor is arguably entitled to claim, that the years 2003, 2004, or 2005 were "out of statute."

The Department is unable to agree that the 2001 assessment is barred by IC § 6-8.1-5-2(g) because there is no indication that the 2001 refund was "erroneous." There is no indication that Taxpayer filed false returns leading to the 2001 refund; there is no indication that the 2001 refund was generated due to faulty or incorrect information contained in Taxpayer's returns; there is no indication that the 2001 refund was attributable to a calculation error on the part of the Department; there is no indication that the refund was attributable to an error contained in the Department's records or its computer system. The April 7, 2008, refund was applied for and issued in the ordinary course of the Taxpayer's business and the ordinary course of the Department's business. At the time it was issued, there was nothing "erroneous" about the refund because both Taxpayer and the Department believed that the refund was based upon a correct application of the facts and the law.

Instead of IC § 6-8.1-5-2(g), the issue is governed under I.R.C. § 6501(h) which states:

> In the case of a deficiency attributable to the application to the taxpayer of a net operating loss carryback or a capital loss carryback (including deficiencies which may be assessed pursuant to the provisions of section 6213(b)(3)), such deficiency may be assessed at any time before the expiration of the period within which a deficiency for the taxable year of the net operating loss or net capital loss which results in such carryback may be assessed. (Emphasis added) (See IC § 6-3-1-11 incorporating by reference "provisions of the Internal Revenue Code....")

Taxpayer signed a series of waivers extending the time in which to adjust Taxpayer's 2003, 2004, and 2005 returns. The Department "adjusted" Taxpayer's 2003 net operating loss based upon a "reduced deduction for foreign source dividends...." Because Taxpayer had previously "carried back" that loss into 2001, the Department's adjustment had the effect of creating a 2001 "deficiency" governed under I.R.C. § 6501(h). Because the 2003 year was in statute and the adjustment was made to that year's net operating loss, the Department was entitled to make an assessment of the 2001 refund.

FINDING

Taxpayer's protest is respectfully denied.

II. Interest Expense Disallowance – Corporate Income Tax.

DISCUSSION

On its Indiana consolidated return, Taxpayer's Subsidiary claimed interest expenses paid on an intercompany loan. Disregarded Entity also claimed interest expense on an intercompany loan. The interest was paid based on money lent by Affiliate. The issue stems from the audit's determination as follows:

> After careful examination of the intercompany transactions between the controlled group of affiliated companies, it was determined that the intercompany interest expense deducted on the Indiana return of [Subsidiary] understates Indiana source income and should be removed.

Affiliate is a C corporation, is a wholly owned subsidiary of Taxpayer, is incorporated in Delaware, and is domiciled in New York. Affiliate was included on Taxpayer's federal return but was not included in the Indiana consolidated return.

According to the audit report, Affiliate was formed in order to make possible the acquisition of Pharmacy Business.

In order to facilitate the purchase of this Pharmacy Business, Taxpayer capitalized Affiliate with 14 billion dollars in cash and notes. Affiliate established a line of credit with Subsidiary for 10 billion dollars. Affiliate set up a second line of credit with Disregarded Entity for 4 billion dollars.

Thereafter, Subsidiary used the money to purchase the Pharmacy Business. According to the audit report, both Subsidiary and Disregarded Entity "have [subsequently] drawn from the line of credit in additional amounts after the purchase...."

The audit report illustrates the transaction as follows: Subsidiary and Disregarded Entity paid approximately $700 million in interest to Affiliate. Thereafter, Affiliate paid a $700 million dividend to Taxpayer. Taxpayer avoided taxation on this amount because of the "Qualifying Dividend Deduction." It should be noted that interest expenses of both Subsidiary and Disregarded Entity were disallowed for substantially similar reasons.

The audit report provided the following reasons for disallowing the interest expense claimed by Subsidiary and Disregarded Entity:

> The interest expense deducted by [Subsidiary] was a duplicate of interest expense already deducted by the parent on their return for the same money. [Taxpayer] borrowed approximately 6.5 billion in order to fund [Affiliate]. [Taxpayer] deducted the interest expense (approximately 300 million) on their tax return included in the Indiana consolidated return. [Taxpayer] took this borrowed money and loaned it to [Subsidiary] and [Disregarded Entity] (through [Affiliate]). [Subsidiary] deducted interest expense (approximately 700 million) on their return included in the Indiana consolidated return for the same borrowed money.
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> In substance over form, this is merely an[] intercompany loan between a parent and its subsidiary. The vehicle for the loan was [Affiliate]. The only purpose for the existence of [Affiliate] was to facilitate the intercompany loan transaction. [Affiliate] was fully funded by [Taxpayer] the parent for 14 billion. This money was in turn loaned to the subsidiaries ([Subsidiary] and [Disregarded Entity]) through two lines of credit of 10 billion and 4 billion totaling 14 billion. The interest expense paid by [Subsidiary] and [Disregarded Entity] was returned to the parent in the form of a dividend....

The audit explains that "normally, any intercompany transactions between affiliated companies in a consolidated return are eliminated." However, because Affiliate is domiciled outside the state, "no intercompany elimination was made." The audit further explained:

> This is the reason... why the law was written to allow allocation of income and expenses among a controlled group. The law recognizes that when income flows among a controlled group it may distort taxable income from operations that gets apportioned. [The audit report stated that the] transaction severely distorts Indiana source income from operations.

The audit report stated that the loan transaction at issue "did not exist" on the federal consolidated return. In addition, the transaction was also eliminated on the return of the state in which Affiliate was domiciled.

In addition to the reasons listed above, the audit questioned the amount of interest paid. According to the audit report, the interest expense was "substantially overstated because the interest paid was not based on a "true market rate of interest." The audit claimed that the interest expense claimed was "double the market prime rate of interest" and that Affiliate showed "only a few hundred thousand in salaries and miscellaneous expenses on its federal rate."

In contrast to the interest rates claimed by Affiliate and Disregarded Entity, Taxpayer's parent company borrowed approximately 6.5 billion dollars in order to facilitate the transaction. According to the audit report, the parent company deducted approximately 320 million dollars in interest on its federal return and concluded that parent company was paying interest at approximately a rate of five percent. The audit questioned whether there was a rational relationship between the five percent interest rate parent company was apparently paying and the nine to eleven percent interest rate it was charging its own subsidiaries. In other words, there was an apparent "disconnect" between the amount of interest parent company was paying on the source funds (five percent) and the amount of interest expense (nine to eleven percent) the interrelated parties were charging each other. However, Taxpayer explains the interest rates claimed: "Given the timing of the interest and principal payments (i.e. yearly and balloon payments, respectively), it is reasonable that the interest rate charged was higher than the prime rate."

Fundamentally, the audit questioned the underlying business rationale underlying the transactions. The audit found that there was "no third party involvement" in the transaction and the loan "only exists on paper between related parties...."

The audit report stated:

> The loan agreement only allows for the payment of interest. No principal is due until the end of the loan. This allows [T]axpayer to take substantial tax deductions at a high rate of interest that actually increased during the audit period. Normally, with any loan you would see a reduction of interest during its life. [A]s this loan

only exists on paper between related parties, it is not representative of a true market transaction.

Taxpayer explains why no principal was paid on the loans made to Affiliate and Disregarded Entity. "The borrowers agreed to make interest payments at least once a year and to pay the aggregate principal amount outstanding at the end of the Availability Period (ten years from the date of the loan, essentially a balloon payment." Taxpayer further explains, "in addition, there was a partial principal repayment during the Availability Period. Since [Affiliate] was liquidated into [Subsidiary] on August 31, 2009, [Subsidiary] and [Disregarded Entity] did not have to repay the principal of the loan in cash. The restructuring was done in order to simplify the legal entity structure and to alleviate the costs incurred by [Affiliate]."

Questioning whether the interest expenses were attributable to loans having any "economic substance, the audit concluded that, "[U]pon audit the intercompany interest paid to [Affiliate] by [Affiliate] and [Disregarded Entity] were eliminated as an intercompany transaction as should be reflected on a consolidated return."

IC § 6-3-1-3.5(b) provides the starting point for determining taxpayer's 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...."

The Department's Administrative Rule 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)...." However, the taxpayer's federal "adjusted gross income" is merely the starting point; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point.

The audit made its adjustment to the "Allocation of Net Income" under IC § 6-3-2-2(l) and (m) which 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:
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> (1) separate accounting;
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> (2) for a taxable year beginning before January l, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
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> (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
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> (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.
>
> (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. (Emphasis added).

In exercising the authority under IC § 6-3-2-2(l) and (m), IC § 6-3-2-2(p) provides additional guidance:

> (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). (Emphasis added).

As noted in Part I above, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. IC § 6-8.1-5-1(c) states that it is Taxpayer who has "[t]he burden of proving that the proposed assessment is wrong...."

Taxpayer argues that the Department does not have authority under IC § 6-3-2-2(l) and (m) to disallow the interest expense. In making that argument, Taxpayer points out that the period under audit was 2003 through 2005 and that an amendment to IC § 6-3-1-3.5(b), requiring an "addback" of qualifying interest expense, did not take effect until July 2006. Under Taxpayer's interpretation of IC § 6-3-1-3.5(b), the Department was only entitled to make a limited and specific number of modifications to a taxpayer's taxable income as determined under I.R.C. § 63. Taxpayer maintains that the Department lacked authority to even consider disallowing the interest expenses until July 2006. Taxpayer argues as follows:

> By using discretionary authority under Ind. Code § 6-3-2-2(l) & (m) to disallow the interest expense the Department is effectively adding back interest that was properly deducted by [Subsidiary] and [Disregarded Entity]. If this was the intended use of discretionary authority, the Department would not have had to codify the interest expense add-back provisions in July 2006.... Moreover, the provisions cited by the Department only provide discretionary authority with respect to allocation and apportionment. Therefore, the adjustment

exceeds the authority conferred by the statute inasmuch as the adjustment relates to income/expense, not allocation/apportionment, and the years at issue relate to years prior to the effective date of the interest expense add-back provisions.

The authority to disallow the interest expenses to which Taxpayer points is found at IC § 6-3-1-3.5(b)(9) which states:

(b) In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

(9) Add to the extent required by IC 6-3-2-20 the amount of intangible expenses (as defined in IC 6-3-2-20) and any directly related intangible interest expenses (as defined in IC 6-3-2-20) for the taxable year that reduced the corporation's taxable income (as defined in Section 63 of the Internal Revenue Code) for federal income tax purposes. (Emphasis added) amended by P.L.162-2006 effective to taxable years beginning after June 30, 2006.

However, the Department does not agree that the audit acted outside its statutory authority in disallowing the interest expense as originally claimed. Without reverting to IC § 6-3-1-3.5(b)(9), IC § 6-3-2-2(l), (m) specifically provides for the "employment of any other method to effectuate an equitable apportionment of the taxpayers income..." if the normal allocation and apportionment provisions "do not fairly represent the taxpayer's income." Taxpayer places too stringent an interpretation on the authority granted the Department under IC § 6-3-2-2(l), (m). The plain language of the law states that "[i]f 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 department may require, in respect to all or any part of the taxpayer's business activity... the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." IC § 6-3-1-3.5(b)(9) had the effect of requiring that a taxpayer add back certain "intangible interest expenses" but there is nothing in the statute which states that the Department did not have the authority to add back those same interest expenses in years prior to July 2006.

IC § 6-3-2-2(p) reinforces the proposition cautioning the Department not to include other "income, deductions, and credits" 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)." Recognizing Taxpayer's argument that IC § 6-3-1-3.5(b)(9) is effective for "taxable years beginning after June 30, 2006," it should be noted that IC § 6-3-2-2(l) and (m) were fully in effect during the audited years.

Assuming for the moment that the Department had the authority to disallow the interest expense, did the audit correctly determine that Taxpayer's returns – as originally filed and as determined under I.R.C. § 63 – did not "fairly reflect" Taxpayer's Indiana source income? The question is not inconsequential; the audit disallowed approximately 2.4 billion dollars in interest expenses. According to the audit report:

"These amounts were taken from the [T]axpayer's records and represent the interest income reported by [Affiliate] from [Subsidiary] and [Disregarded Entity]...."

Taxpayer and its related parties entered into loan transactions which led to claimed interest expenses of approximately 2.4 billion dollars. These were loans to which the parties agreed to an interest rate approximately twice that of the prime rate, were loans for which there is no timely expectation of repayment, and were loans apparently structured in such a way as to gain a substantial and disproportionate state tax advantage. Taxpayer argues that without the loans, "the Companies would have been unable to purchase [Pharmacy Business'] stock."

Because the audit questioned whether the subject transactions lacked "economic substance," the Department must consider whether the interest payments were attributable to an intercompany transaction which had no other purpose than to avoid taxation; did the loans and the interest payments fall within the definition of a "sham transaction" which is defined as "[a]n agreement or exchange that has no independent economic benefit or business purpose and is entered into solely to create a tax advantage...." Black's Law Dictionary 1380 (7th ed. 1999). The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id. at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[T]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950). "[T]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Comm'r, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, ex ante, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1237. The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual

one. Lee v. Comm'r, 155 F.3d 584, 586 (2d Cir. 1998).

Taxpayer protests arguing that the transactions had "economic substance." Taxpayer states that "[Affiliate] loaned funds to [Subsidiary] and [Disregarded Entity]... so these entities could purchase [Pharmacy Business]. If [Subsidiary] and [Disregarded Entity] had not borrowed funds from [Affiliate], they would have needed to obtain loans from other third party lenders in order to acquire the stock of [Pharmacy Business]. Accordingly, Taxpayer believes the transactions were entered into for a business purpose other than simply harvesting tax benefits." Taxpayer supports its argument that the loan transactions had "economic substance" stating that:

> During the years at issue, [Affiliate] had employees that essentially performed the activities of the treasury functions, including the management and investment of funds, research and investment decisions, and other investment related activities. Such employees updated the interest calculations for changes in rates, maintained the loan cards to be distributed to the accounting department for them to book their entries, managed the external bank accounts, physically moved the cash on the loans via wire transfers and other means, worked... to invest the [Affiliate] cash and maintained the loan payment plan.

Although the issue naturally arises as to why Affiliate did not directly purchase the target pharmacy business, the Department will not question the business decisions entered into by Affiliate's employees. Taxpayer is, of course, entitled to manage its business affairs in any manner it deems appropriate and to vigorously pursue any tax advantage attendant upon the management of those 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). Especially bearing in mind the substantial sums involved and the audit's determination that Affiliate "showed only a few hundred thousand in salaries and miscellaneous expenses on its federal return," the Department must question whether the activities undertaken by Affiliate's employees were disproportionate in value to the 2.4 billion dollars in interest expenses claimed. In addition, the parties involved agreed to the payment of interest at approximately twice the prime interest rate when there were no specific plans to ever repay the loans. Under IC § 6-8.1-5-1(c), Taxpayer has failed to meet its burden of demonstrating that the Department lacked the authority under IC § 6-3-2-2(l), (m) to disallow the interest expenses. Under IC § 6-3-2-2(l), (m), the audit was authorized to resort to "any other method to effectuate an equitable allocation and apportionment of the [T]axpayer's income" in order to "fairly reflect and report the income derived from sources within the state of Indiana...." IC § 6-3-2-2(p) circumscribes that power " unless the department is unable to fairly reflect the [T]axpayer's adjusted gross income for the taxable year...." Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) of clearly and decisively demonstrating that the loan transactions were negotiated at "arms length" and that the interest payments are anything other than an artifice. The Department must conclude that the transactions were "motivated by nothing other than the [T]axpayer's desire to secure the attached tax benefit." Horn, 968 F.2d 1326.

FINDING

Taxpayer's protest is respectfully denied.

III. Foreign Source Dividend Deduction – Corporate Income Tax.

DISCUSSION

The Department's audit adjusted the amount of Taxpayer's foreign source dividends that were deducted in computing Indiana adjusted gross income. The audit reduced the amount of dividends that Taxpayer claimed relying on IC § 6-3-2-12 which states as follows:

> (a) As used in this section, the term "foreign source dividend" means a dividend from a foreign corporation. The term includes any amount that a taxpayer is required to include in its gross income for a taxable year under Section 951 of the Internal Revenue Code, but the term does not include any amount that is treated as a dividend under Section 78 of the Internal Revenue Code.
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> (b) A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. The amount of the deduction equals the product of:
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> (1) the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by
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> (2) the percentage prescribed in subsection (c), (d), or (e), as the case may be.
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> (c) The percentage referred to in subsection (b)(2) is one hundred percent (100[percent]) if the corporation that includes the foreign source dividend in its adjusted gross income owns stock possessing at least eighty percent (80[percent]) of the total combined voting power of all classes of stock of the foreign corporation from which the dividend is derived.
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> (d) The percentage referred to in subsection (b)(2) is eighty-five percent (85[percent]) if the corporation that includes the foreign source dividend in its adjusted gross income owns stock possessing at least fifty percent (50[percent]) but less than eighty percent (80[percent]) of the total combined voting power of all classes of stock of the foreign corporation from which the dividend is derived.
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> (e) The percentage referred to in subsection (b)(2) is fifty percent (50[percent]) if the corporation that includes the foreign source dividend in its adjusted gross income owns stock possessing less than fifty percent (50[percent]) of the total combined voting power of all classes of stock of the foreign corporation from which

the dividend is derived.

Taxpayer filed a consolidated Indiana income return which included various related business entities which conducted business in Indiana. The issue stems from the audit's method of calculating Taxpayer's Indiana adjusted gross income. In order to explain the Taxpayer's argument and the Department's stance on this issue – and for illustrative purposes only – assume that an Indiana taxpayer's consolidated return included two entities. Entity One owns 30 percent of the voting stock of a foreign corporation and Entity Two owns 40 percent of another foreign corporation. Taxpayer would argue that the taxpayer was entitled to aggregate the two percentages (30 + 40 = 70) and calculate its foreign source dividend deduction based upon that aggregate number (70 percent). Under IC § 6-3-2-12(d), this exemplar taxpayer would be entitled to deduct 85 percent of its foreign source dividends because taxpayer crossed the 50 percent ownership threshold set out in IC § 6-3-2-12(d).

Following the audit's methodology, the result would be different because the audit would have considered each of the two Entities separately in determining the ownership percentage. Both Entity One and Entity Two would be entitled to deduct 50 percent of their individual foreign source dividends under IC § 6-3-2-12(e) because both entities' ownership interest is less than 50 percent.

Taxpayer believes it is entitled to aggregate the ownership interests in arriving at the deduction. Taxpayer explains:

> The statute does not explicitly state that the recipient who is filing as part of a consolidated return is the only entity that is included in the test to determine how much of the foreign corporation is owned. To the contrary, [IC § 6-3-2-12] cites IRC 951 when referring to gross income. IRC section 951 incorporates the definition of a US shareholder under IRC section 958 which includes indirect shareholdings in foreign corporation (IRC section 958(a)(2) as well as the attribution rules under IRC section 958(b). If gross income is determined using indirect ownership, then the ownership of the foreign corporation should also be determined using indirect ownership.

However, in setting out its objections Taxpayer is actually making two independent arguments. As noted in the example listed above Taxpayer argues that the ownership percentage is determined by using the aggregate ownership of all the entities in Taxpayer's federal affiliated group (30 + 40 = 70). Taxpayer also argues that the ownership percentage is determined by using the aggregate ownership of all the entities including any entity which is not a member of the Indiana consolidated group. As explained by Taxpayer, "The statute does not explicitly state that the recipient who is filing as part of a consolidated return is the only entity that is included in the test to determine how much of the foreign corporation is owned." To take the example cited above one step further, assume that Entity One and Entity Two were part of the exemplar taxpayer's Indiana consolidated group but that Entity Three owns 20 percent of the foreign corporation but is not part of the Indiana consolidated group. Taxpayer argues that it would be entitled to aggregate all three percentages (30+40+20=90) and deduct 100 percent of its foreign source dividends because taxpayer crossed the 80 percent ownership threshold set out in IC § 6-3-2-12(c).

Clearly a deduction such as that found in IC § 6-3-2-12 is not a tax "exemption." State v. Smith, 158 Ind. 543, 63 N.E. 25 (1902); Florer v. Sheridan, 137 Ind. 28, 36 N.E. 365 (1893). However, a deduction has the same result as an exemption and the taxpayer has the burden of establishing that it is entitled to that deduction.

> An enlarged deduction has the same end result as the enlarged exemption. In both instances, the tax burden of the individual taxpayer is decreased; but in so doing, the tax burden of all other taxpayers is increased. The allowed or enlarged deduction shifts the tax burden. Thus, like the tax exemption, the tax deduction should be narrowly construed. Ind. Dep't of State Rev. v. Food Marketing Corporation, 403 N.E.2d 1093, 1102 (Ind. Ct. App. 1980) (Staton, J. Dissenting).

The foregoing citation is, of course, to the decision's dissenting opinion, but the principle that deductions are narrowly construed is well-settled in federal law. "Deductions are exceptions to the norm of capitalization and are allowed only if there is clear provision for them in the Code and the taxpayer has met the burden of showing a right to the deduction." Indopco, Inc. v. C.I.R., 503 U.S. 79 (1992). "[S]tatutes creating deductions are to be strictly construed against the taxpayer." Parker Pen Co. v. O'Day, 234 F.2d 607, 609 (7th Cir. 1956) (citing Helvering v. Inter-Mountain Life Insurance Co., 294 U.S. 686 (1935)). "[D]eductions are strictly construed and allowed only 'as there is a clear provision therefore.'" Indopco, Inc., 503 U.S. at 84. Nevertheless, the Department is well aware of the countervailing rule that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991).

A. Aggregating the Members of the Federal Affiliated Group:

For purposes of determining the Taxpayer's foreign source dividend deduction, Taxpayer argues that it is entitled to aggregate the ownership percentages of all entities belonging to the federal affiliated group. The audit concluded that only members on the Indiana consolidated return should be considered.

IC § 6-3-4-14 provides as follows:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all

corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.

(c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.

(d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group. (Emphasis added).

For an entity to be included in an Indiana consolidated return, the entity must have Indiana adjusted gross income as provided in IC § 6-3-4-14(b) above. Any credits attributable to the "member of [the] affiliated group" are "applied against the tax liability of the affiliated group making a consolidated return" but there is nothing in IC § 6-3-4-14 which permits Taxpayer to aggregate credits purportedly attributable to an entity not part of the consolidated group to that group. The statute plainly contemplates applying credits to those entities which were members of the group "making [the] consolidated return." IC § 6-3-4-14(d).

B. Aggregating the Members of the Indiana Consolidated Group:

For purposes of determining the Taxpayer's foreign source dividend deduction, Taxpayer argues that it is entitled to aggregate the ownership percentages of all the entities included in the Indiana consolidated group. The audit concluded that only members on the Indiana consolidated return are considered and that each member's ownership percentage is calculated individually and the individual percentages should not be aggregated. In the example provided above, the exemplar taxpayer had two member Entities included in its Indiana consolidated return. Entity One owned 30 percent of the voting stock of a foreign corporation and Entity Two owned 40 percent of the voting stock of a foreign corporation. Taxpayer would argue that the exemplar taxpayer is entitled to aggregate the two percentages (30+40=70) and calculated its foreign source dividend deduction based upon that 70 percent aggregate ownership.

Bearing in mind that deductions are "strictly construed against the taxpayer...." Parker Pen Co., 234 F2d at 609 and that Taxpayer has the burden of establishing that the proposed assessment is "wrong," IC § 6-8.1-5-1(c), the Department concludes that the plain words of IC § 6-3-2-12 supports the audit's method of calculating the foreign source dividend deduction claimed by multiple entities on a consolidated return and does not support the Taxpayer's method of aggregating the ownership percentages.

In three separate sections of IC § 6-3-2-12, the statute speaks of applying the deduction to the " corporation that includes the foreign source dividend...." IC § 6-3-2-12(c), (d), (e) (Emphasis added). The statute repeatedly refers to the "corporation" as being entitled to the deduction. IC § 6-3-2-2-12(b), (b)(1), (c), (d), (e). Nowhere does it speak of the "taxpayer" being entitled to claim this deduction. In drafting this statute, the "General Assembly is, of course, presumed to mean what it says." Mynsberge v. Dept. of State Revenue, 716 N.E.2d 629, 634 (Ind. Tax Ct. 1999). Moreover, the Tax Court has instructed that, "Words and phrases should be taken in their plain, ordinary and usual sense, unless such a construction is plainly repugnant to the intent of the legislature or the context of the statute. Johnson County Farm Bureau Co-op. Ass'n, Inc. v. Indiana Dept. of State Revenue, 568 N.E.2d 578, 581 (Ind. Tax Ct.1991). The plain words of IC § 6-3-2-12 allow the individual business entities in a combined return to claim a deduction from each entities' adjusted gross income based on each entity's ownership of the corporation paying dividends to it. There are no "plain words" which support Taxpayer's argument that the Taxpayer is entitled to aggregate the ownership percentages and claim an enhanced deduction.

FINDING

Taxpayer's protest is respectfully denied.

IV. Net Operating Loss Calculation – Corporate Income Tax.

DISCUSSION

Taxpayer questions the audit's determination that the "Foreign Source Dividend Deduction" may not be used in arriving at Taxpayer's net operating loss. The Department's audit made an adjustment to the Taxpayer's net operating loss deduction decreasing the amount of the deduction.

A. Foreign Source Dividend:

The Department's audit cited to 45 IAC 3.1-1-9 in making the adjustment stating that the regulation "does not provide for a foreign source dividend deduction in computing a "Net Operating Loss deduction." The audit report

provides as follows:

The foreign source dividends deduction allowed in 2003 and 2004 reduce an otherwise net profit to zero, and allow for no carryback or carryforward from 2003 & 2004. The foreign source dividend deduction cannot convert an otherwise net profit into a loss for carryback or carryforward purposes.

No deduction has been allowed for foreign dividends for 2005, since a net operating loss exists before the deduction. Likewise, the foreign source dividend deduction cannot increase an existing Net Operating Loss into a larger one for carryback or carryforward purposes. This results in a smaller available loss carryforward and/or carryback than would otherwise be available. (Emphasis added).

As authority for this decision, the audit cites to 45 IAC 3.1-1-9 as follows:

The net operating loss as described in Internal Revenue Code §172 is an allowable deduction for corporations in computing Indiana Adjusted Gross Income. The amount of the loss which may be deducted is the Federal net operating loss after:

(1) All modifications required under IC 6-3-1-3.5(b); and

(2) After apportionment, if the taxpayer is doing business in more than one state and is required to apportion his income.

B. Calculating Net Operating Loss:

IC § 6-3-2-2.6(c)-(d) provides for the calculation of a corporation's Indiana net operating loss, as follows:

(c) An Indiana net operating loss equals the taxpayer's federal net operating loss for a taxable year as calculated under Section 172 of the Internal Revenue Code, derived from sources within Indiana and adjusted for the modifications required by IC 6-3-1-3.5.

(d) The following provisions apply for purposes of subsection (c):

(1) The modifications that are to be applied are those modifications required under IC 6-3-1-3.5 for the same taxable year in which each net operating loss was incurred.

(2) The amount of the taxpayer's net operating loss that is derived from sources within Indiana shall be determined in the same manner that the amount of the taxpayer's adjusted income derived from sources within Indiana is determined under section 2 of this chapter for the same taxable year during which each loss was incurred.

(3) An Indiana net operating loss includes a net operating loss that arises when the modifications required by IC 6-3-1-3.5 exceed the taxpayer's federal taxable income (as defined in Section 63 of the Internal Revenue Code), if the taxpayer is a corporation, or when the modifications required by IC 6-3-1-3.5 exceed the taxpayer's federal adjusted gross income (as defined by Section 62 of the Internal Revenue Code), if the taxpayer is a nonresident person, for the taxable year in which the Indiana net operating loss is determined. (Amended 2004).

C. Calculating Adjusted Gross Income:

IC § 6-3-2-12(b), provides:

A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. The amount of the deduction equals the product of:

(1) the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by

(2) the percentage prescribed in subsection (c), (d), or (e), as the case may be.

Accordingly, IC § 6-3-2-12 allows a taxpayer to take a deduction from its Indiana adjusted gross income for certain foreign source dividend income that has been included in that taxpayer's Indiana adjusted gross income. The foreign source dividend deduction is a specific deduction from Indiana adjusted gross income. However, there is no similar statutory provision for such a deduction in the computation of an Indiana net operating loss deduction. As provided above, the Indiana net operating loss deduction begins with federal adjusted gross income and is modified according to the Indiana statute. The foreign source dividend deduction is not one of the modifications allowed by IC § 6-3-2-2.6 in arriving at the Indiana net operating loss deduction. Therefore, Taxpayer's inclusion of the foreign source dividend deduction in the computation of its net operating loss deduction is contrary to IC § 6-3-2-2.6. Taxpayer's approach would result in compounding one deduction upon another deduction. Taxpayer has not referenced any statute or regulation which clearly requires the Department, or which allows the Taxpayer, to do so. Taxpayer, therefore, invites the Department to exceed the statutory authority of IC § 6-3-2-2.6. Under IC § 6-8.1-5-1(c), Taxpayer has failed to meet its burden of demonstrating that the audit's determination was wrong.

FINDING

Taxpayer's protest is respectfully denied.

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