DEPARTMENT OF STATE REVENUE

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Supplemental Letter of Findings: 02-20110565
Indiana Corporate Income Tax
For Tax Years 2007 and 2008

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ISSUES

I. Corporate Income Tax–Exclusion of Entities.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-3-2-12; IC § 6-3-4-14; IC § 6-5.5-4-6; IC § 6-8.1-5-1; 45 IAC 3.1-1-49; 45 IAC 3.1-1-111; I.R.C. § 3121; I.R.C. § 3306; Rev. Rul. 69-316, 1969-1 C.B. 263; Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999).

Taxpayer protests the Department's decision to exclude two of its subsidiaries from its consolidated income tax return.

STATEMENT OF FACTS

Taxpayer is a parent corporation doing business in Indiana and other states. Taxpayer files its Indiana adjusted gross income tax returns on a consolidated basis with its subsidiaries. Taxpayer filed its 2007 and 2008 Indiana corporate income tax returns on a consolidated basis. In particular, Taxpayer included two subsidiaries (Sub L and Sub G) on these returns.

The Indiana Department of Revenue ("Department") determined that Taxpayer had included Sub L in its consolidated Indiana adjusted gross income tax returns despite the Department's contention that Sub L did not have Indiana source income and excluded Sub L from the consolidated returns. Further, the Department determined that Sub G's inclusion in Taxpayer's consolidated income tax return resulted in an unfair reflection of Taxpayer's overall income. Thus, the Department separated Sub G from the remainder of Taxpayer's consolidated return and determined Sub G's tax separately from the remainder of Taxpayer.

Taxpayer protested these adjustments. Previously the Department issued a Letter of Findings partially sustaining and partially denying Taxpayer's protest. Taxpayer requested–and was granted–a rehearing. The Department conducted another administrative hearing and this Supplemental Letter of Findings Results.

I. Corporate Income Tax–Exclusion of Entities.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

A. Sub L.

The Department removed one of Taxpayer's out-of-state subsidiaries (Sub L) from Taxpayer's consolidated Indiana income tax return. The Department removed Sub L because the Department determined that Sub L did not have Indiana source income. Sub L was excluded from the returns because it did not meet the Indiana source income requirement found in IC § 6-3-4-14. The out-of-state subsidiary reported zero Indiana property, payroll, and sales.

Pursuant to IC § 6-3-4-14(a)-(b), "[A]n affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3... 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." (Emphasis added). This is further explained in 45 IAC 3.1-1-111, which states in relevant part:

> The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state, as that phrase is defined in IC 6-3-2-2. For purposes of this subsection, "Adjusted Gross Income derived from sources within the state" means either income or losses derived from activities within the state.

IC § 6-3-2-2(a), in relevant part, defines "adjusted gross income derived from sources within Indiana," as follows:

> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation from a trade or profession conducted in this state; and
> (5) income from stocks, bonds, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
>
> In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources

within Indiana. **In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana....**

(b) Except as provided in subsection (l), **if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction**, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3)....

(**Emphasis added**).

Accordingly, when a taxpayer has business income that is earned from sources within and without Indiana, it is only the amount of the business income that is apportioned to Indiana that is deemed to be derived from Indiana sources. Thus, a taxpayer only has business income from Indiana sources to the extent that it has Indiana property, payroll, or sales factors found in IC § 6-3-2-2(b). Therefore, since Sub L has no Indiana property, payroll, and sales factors, Sub L's business income times zero results in Sub L having no income that is derived from Indiana sources.

In Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999), the Department removed three corporations from the taxpayer's return because the corporations did not have Indiana source income, which meant the corporations did not have nexus with the state for adjusted gross income tax purposes. The Tax Court found, as follows:

[Since] neither of the three corporations had any Indiana property, payroll, or sales factors during the tax years at issue.... none of three corporations had adjusted gross income derived from sources within Indiana, a statutory prerequisite to filing a consolidated return. Accordingly, the Department properly removed these corporations from Hunt's consolidated returns.

Id. at 781.

The Tax Court explained:

[W]hen dealing with business income, one does not attempt to determine the source of a particular item of income. Rather, business income is apportioned based on the property, payroll and sales factors of the corporation. See IND. CODE § 6-3-2-2(b) (Supp.1985). Therefore, if a corporation has no Indiana sales, payroll or property, then the corporation has no adjusted gross income derived from sources within Indiana, unless, of course, the corporation has non-business income allocable to Indiana. See id. § 6-3-2-2(a) (Supp.1985) ('In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection [6-3-2-2](b) shall be deemed to be derived from sources within the state of Indiana.').

Id.

Accordingly, in Hunt the Tax Court ruled that to be included in the consolidated return the entity would have to have Indiana apportionment factors to have business income from Indiana sources or have nonbusiness income sourced to Indiana.

At rehearing, Taxpayer indicated that Sub L had nonbusiness income allocable to Indiana. Taxpayer provided Internal Revenue Service adjustments that shifted certain foreign dividend income from Taxpayer to Sub L. However, even assuming this income was nonbusiness income, the income was dividends from a foreign subsidiary of Sub L. Under the legal interpretation most favorable to Taxpayer, the dividend income would have been included and then deducted in its entirety from Sub L's income pursuant to IC § 6-3-2-12. Thus, Sub L did not have nonbusiness income sufficient to permit inclusion of Sub L in its consolidated return.

Alternatively, Sub L stated that it in fact had payroll in Indiana. In particular, Sub L stated that it paid a portion of the compensation for executives common to Taxpayer and Sub L. In support of this assertion, Taxpayer provided internal accounting documents reflecting reimbursements from Sub L to Taxpayer. In addition, Taxpayer argues that Rev. Rul. 69-316, 1969-1 C.B. 263 (the "Ruling"), provides that Sub L was in fact the employer of employees paid by Taxpayer but for whom Sub L reimbursed Taxpayer.

In the Ruling, the issue was who would be considered the "employer" for three different taxes when a parent paid wages on behalf of a subsidiary's employees (or employees of both the parent and the subsidiary), but the subsidiary reimbursed the parent for those wages. The taxes were federal income taxes withheld on wages, Federal Income Contributions Act (FICA) taxes, and federal unemployment taxes. The Ruling held that the subsidiary was considered the "employer" for FICA taxes and federal unemployment taxes based on the wages paid on the subsidiary's behalf. However, the Ruling held that the parent was the "employer" for taxes withheld on employee wages.

However, effective January 1, 1979, Congress enacted I.R.C. § 3121(s) and I.R.C. § 3306(p). These sections have the effect of partially superseding the Ruling.

Indiana provides, pursuant to 45 IAC 3.1-1-49, that unemployment tax payment on behalf of employees is the presumptive basis for determining payroll location of those employees. However, Indiana law is silent as to the attribution of employer for payroll purposes.

Based on the information available in the Department's records, Taxpayer appears to have served as the common paymaster for any compensation remitted on behalf of Sub L. Taxpayer has not stated that any FICA taxes or unemployment taxes were remitted under Sub L's federal tax identification number. While the Department recognizes the reimbursement arrangement between Taxpayer and Sub L and also recognizes that the Department's holding in this case has potential ramifications beyond this case, the Department cannot say that its proposed assessment is incorrect.

B. Sub G.

Taxpayer protests the separation of Sub G from the remainder of Taxpayer's consolidated group. Sub G was formed in late 2007 as an umbrella company for certain foreign operations conducted by Taxpayer. According to the Department's audit, one of Taxpayer's subsidiaries, Sub I, loaned approximately $450,000,000 to Sub G in 2007 to purchase a corporation and that corporation's subsidiaries. Sub I was included as part of Taxpayer's Indiana consolidated income tax return. Taxpayer also loaned Sub G $337,000,000 to purchase a second corporation and the second corporation's subsidiaries.

In 2008, the loans were amended and consolidated into one loan agreement with Sub I. The same day the amended and restated loan agreement was executed, the loan was assigned to yet another entity, Sub S. As part of the assignment of the loan to Sub S, Sub I received "Preferred Equity Certificates" in Sub S. Sub S was not included in Taxpayer's Indiana consolidated income tax return.

Sub G deducted $3,900,000 in interest expense in 2007 and $52,500,000 in 2008. For 2008, Sub I received a $40,000,000 dividend from Sub S. While the dividend from Sub S was included in Sub I's federal taxable income, Sub I claimed a foreign dividend deduction for the $40,000,000 dividend pursuant to IC § 6-3-2-12.

The Department's audit, asserting that the inclusion of Sub G had the effect of not fairly reflecting Taxpayer's adjusted gross income, cited to IC § 6-3-2-2(l) and (m) as its reason for removal of Sub G.

In addition to the arguments presented at the original hearing, Taxpayer raised two additional arguments. First, Taxpayer argues that its assignment of the restated loan agreement was for federal tax planning purposes. According to Taxpayer, the assignment of the restated loan permitted resulted in the interest being taxable in a foreign country where Sub S was located. The payment of taxes by Sub S permitted Taxpayer to qualify for a foreign tax credit for federal tax purposes. Taxpayer has stated that the Internal Revenue Service reviewed the assignment of the restated loan and did not make any federal adjustments.

While the Department recognizes the federal tax reasons for the assignment of the restated loan, the Department cannot agree that the net effect of Sub G's transactions does not "fairly reflect" Taxpayer's Indiana-source income.

Taxpayer also asserts that the Department is treating its loan agreement in a different manner than if Sub G had borrowed the money from an unrelated third party. In this particular case, Sub G is domiciled in Indiana. Sub G paid interest to Sub S. If the interest had been paid to a third-party lender, the lender would have reported the interest income and would have attributed the interest paid by Sub G to Indiana under either IC § 6-3-2-2.2(c) or IC § 6-5.5-4-6. In this case, Sub S did not file an Indiana adjusted gross income tax or a financial institutions tax return. Thus, in this case, absent a return from Sub S reporting Indiana income and Indiana receipts, the Department's determination in the audit and the original Letter of Findings was proper.

Taxpayer raised additional issues related to the Department's determination in the audit and the original Letter of Findings. The Department restates its reasoning as set forth in the original Letter of Findings.

FINDING

Taxpayer's protest is denied with regard to the exclusion of Sub L. Taxpayer's protest is denied with regard to Sub G except as provided in the original Letter of Findings.

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