DEPARTMENT OF STATE REVENUE

02-20120134.LOF

Letter of Findings: 02-20120134
Corporate Income Tax
For the Years 2007, 2008, and 2009

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ISSUE

I. Separate Accounting – Corporate Income Tax.

Authority: IC § 6-3-2-2(b); IC § 6-3-2-2 (l), (m); IC § 6-3-2-2 (l); IC § 6-3-2-2 (l)(1); IC § 6-3-4-14; IC § 6-3-4-14(a)-(b); IC § 6-8.1-5-1(c); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983); Dep't of Treasury of Ind. v. Dietzen's Estate, 21 N.E.2d 137 (Ind. 1939); Wabash, Inc. v. Department of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000); Sherwin-Williams Co. v. Dep't. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); Fell v. West, 73 N.E. 719 (Ind. App. 1905); Economy Oil Corp. v. Ind. Dep't of State Revenue, 321 N.E.2d 215 (Ind. Ct. App. 1974); 45 IAC 3.1-1-39.

Taxpayer argues that the Department of Revenue was not justified in requiring that the members of Taxpayer's consolidated group calculate their income tax liability under a "separate accounting" or "stacked method."

STATEMENT OF FACTS

Taxpayer is in the business of supplying medical implants, instruments, and cutting tools. The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer's business records and tax returns.

Taxpayer filed consolidated federal and Indiana income tax returns. According to Taxpayer, it used "the standard (traditional) method of apportionment" in filing those returns. The Department's audit concluded that Taxpayer's method of apportionment did not fairly represent Taxpayer's Indiana source income. As an alternative, the Department determined that Taxpayer's should calculate its adjusted gross income using a "stacked" or "separate accounting" method. The recalculation of Taxpayer's adjusted gross income resulted in an assessment of additional income tax. Taxpayer disagreed and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Separate Accounting – Corporate Income Tax.

DISCUSSION

The issue is whether the Department's audit was justified in resorting to an alternative method of apportioning Taxpayer's income and whether Taxpayer demonstrated that the resulting assessment is "wrong" as required by IC § 6-8.1-5-1(c).

The law states that under IC § 6-3-4-14, a corporate member of an affiliated group will be included in the consolidated gross income tax return 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.
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> (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.
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> (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.
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> (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).

Under normal conditions, IC § 6-3-2-2(b) calls for the apportionment of Indiana income by reference to and

calculation of Taxpayer's property, payroll, and sales factors. The tax due is determined by multiplying that income by the tax rate. This is termed the standard method. However, if the standard method fails to fairly reflect Indiana sourced income, the law directs the Department to use another method that effectuates a more equitable allocation and apportionment of a taxpayer's income. See 45 IAC 3.1-1-39. A taxpayer may also petition to use an alternate method of apportionment but must obtain a ruling from the Department before doing so. Id.

The United States Supreme Court, the Indiana Tax Court, and the Department all recognize that the standard method is the method most used by related corporations to compute their state income taxes. In Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 170 (1983), the United States Supreme Court not only affirmed the use of the standard formula but also stated that it has become a benchmark against which other apportionment formulas are judged.

The Indiana Tax Court recognizes Indiana's deference to the standard formula. See Wabash, Inc. v. Department of State Revenue, 729 N.E.2d 620, 625 (Ind. Tax Ct. 2000) and Sherwin-Williams Co. v. Dept. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996). The basic premise and intent of a consolidated income tax return is that the group is treated as a single corporation. Wabash. 729 N.E.2d at 626. In a consolidated return, the separate entities of the various member entities are disregarded; the consolidated income of the entire group is reported on a single return and a single tax is paid on the total income. Id. Based on the deference shown this model and the weight given the standard mode, and deviation must be justified.

Three of Taxpayer's entities exhibited factors which would not have raised concerns about using the standard apportionment. For illustrative purposes, the information for the 2009 tax years is provided as follows:

A. "Advantage" has 100 percent of its property in Indiana, 100 percent of its payroll in Indiana, and 86 percent of its sales in Indiana. The result is Indiana apportionment of 89 percent for this entity.

B. "Medical" has 55 percent of its property in Indiana, 46 percent of its payroll in Indiana, and 36 percent of its sales in Indiana. The result is Indiana apportionment of 39 percent for this second entity.

C. "Instruments" has 100 percent of its property in Indiana, 100 percent of its payroll in Indiana, and 62 percent of its sales in Indiana. The result is Indiana apportionment of 70 percent for this third entity.

However, the Department carefully considered the effect of including the following two entities in the consolidated return and whether or not the circumstances surrounding these two entities warranted consideration of an alternative method of apportioning the entire group's income.

D. "Technologies" has 0 percent of its property in Indiana, 5.31 percent of its payroll in Indiana, has "negative sales," and reports $9,700,000 in losses. The result is 0.53 percent Indiana apportionment for this fourth entity.

E. "Medical Instrument" has 0 percent of its property in Indiana and 0 percent of its payroll in Indiana. Medical Instrument has $106,000 in Indiana sales compared to $25,000,000 in sales everywhere. Taxpayer had approximately $1,500,000 in Indiana adjusted gross income. The result is 0.34 percent Indiana apportionment for this fifth entity.

Taxpayer explains the reason why Technologies was saddled with a large amount of debt. Technologies was created to be an integrated parent and marketer of different medical related products. In order to accomplish this, Technologies incurred debt in order to purchase the other entities found in the consolidated group. Taxpayer explains that – for accounting purposes – this debt simply resides on the book of Technologies. Cash receipts from the remaining companies is transferred to Technologies.

For the three years at issue, including all five entities, and using the standard three factor method of apportioning Taxpayer's adjusted gross income for Indiana, Taxpayer reported $4,720,290 in losses and – of course – owed zero Indiana taxes.

Given the facts surrounding the five entities under consideration, the audit concluded that the standard method of apportionment "does not fairly represent the affiliated group's [Adjusted Indiana Gross Income]." Specifically, the audit objected to the standard method of apportioning income as follows; "The computation of Indiana adjusted gross income using this [standard] method is distorted due to the inclusion of companies [Technologies and Medical Instrument]. Both [Technologies and Medical Instrument] have significant net federal taxable income/loss yet very little activity in Indiana – standing along either company would have virtually no Indiana adjusted gross income or loss."

The audit noted that "[Technologies] and [Medical Instrument] had very little connection to Indiana. Neither corporation had any Indiana property during the audit period. Medical Instrument had little or no Indiana payroll and less than one-half of one percent Indiana sales. Technologies had very minor Indiana payroll and actually reported "negative sales." If the Department had simply excluded from the consolidated return the two entities with "de minimis" contact with Indiana, the result would have been additional income tax of approximately $133,914. Instead of eliminating Technologies and Medical Instrument from the consolidated return on the ground that the contact with the state was marginal, the Department employed a "stacked" method

Instead of accepting Taxpayer's methodology which resulted in "zero" Indiana tax or simply eliminating Technologies and Medical Instrument from the return, the Department employed a "stacked" method of calculating the consolidated group's tax liability.

In searching for a more appropriate and accurate reporting methodology, the audit considered the statutory

provision set out in IC § 6-3-2-2 (l) and (m).

(l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

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

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers. (Emphasis added).

A business entity must have Indiana source income to be in the consolidated return. IC § 6-3-4-14(a)-(b). Given the absence of meaningful contacts with the state, one alternative – of course – would have been to simply remove the two entities with marginal Indiana contact. If the Department had simply eliminated Technologies and Medical Instrument from the return, Taxpayer would have owed $133,914 using the standard apportionment methodology to calculate tax liability for the consolidated group. However, eliminating Technologies and Medical Instrument from the consolidated group would have eliminated all their factors; instead, the audit chose a less "blunt" instrument to accomplish what it determined more closely reflected their Indiana source income.

IC § 6-3-2-2 (l) references "separate accounting" as an alternative method for calculating a taxpayer's adjusted gross income; the audit uses the term "stacking." For purposes of this discussion "separate accounting" and "stacking" have the same meaning and result in the same amount of adjusted gross income.

The audit report described the application of the "stacking" method as follows:

Under this method the [Indiana adjusted gross income] of each corporation is computed separately, as if separate returns were filed for each corporation. After each separate amount of IAGI is calculated, those amounts are then consolidated (or stacked) into one amount of IAGI for the tax year. This amount is then compared to the IAGI per return. For 2007, the stacking method actually increased the reported loss by nearly $1.2 million. For the other two years consolidated, the stacking method created a positive IAGI of nearly $3.6 million. The returns for those years reported a negative IAGI of nearly $3.4 million. [T]he 2007 net operating loss (NOL) is carried to the operating gains of 2008 and 2009. The 2008 gain is eliminated and a portion of the 2009 gain is also eliminated. The balance of the 2009 gain is then taxed at the corporate tax rate of 8.5 [percent]. This generates a tax liability of slightly more than $89,000.

It should be noted that the "stacking" method is specifically listed as an alternative method in IC § 6-3-2-2 (l)(1) where its identified as "separate accounting."

Was the audit justified in taking the course it did? In making that determination, the law states that the proposed assessment is presumed correct. 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." A long-settled body of law states that Indiana tax laws are construed in favor of reinforcing that state's taxing authority. "The statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers." Fell v. West, 73 N.E. 719, 722 (Ind. App. 1905). In construing tax statutes relating to assessment and collection, a liberal rule of construction must be indulged in order to secure their uniform implementation. Economy Oil Corp. v. Ind. Dep't of State Revenue, 162 Ind. App. 658, 664-65, 321 N.E.2d 215, 218 (1974). See also Dep't of Treasury of Indiana v. Dietzen's Estate, 215 Ind. 528, 532, 21 N.E.2d 137, 139 (Ind. 1939) ("In construing tax statutes a liberal rule of interpretation must be indulged in order to aid the taxing power of the state.")

Under the standard apportionment methodology, two companies – each of which have only minimal ties to this state – would placed the entire consolidated entity into a "loss" position. Taxpayer's original return had the effect of converting three combined companies – each of which had substantial ties with Indiana with over $1,000,000 in Indiana source income – into a consolidated entity with several million dollars in loss. That substantial amount of loss would have been on the inclusion of the entities each of which had only a few thousand dollars of actual Indiana losses. The net effect of Taxpayer's approach would have been to "import" substantial losses generated outside Indiana into Indiana. For instance, what would have been a 2009 $52,000 Indiana loss for Technologies would have become, in effect, a $6,000,000 Indiana loss as part of the consolidated group.

The Department is unable to agree that these results would "fairly represent the taxpayer's income derived from sources with the state of Indiana...." IC § 6-3-2-2(l). Given the alternatives, the audit chose an alternative method of apportioning Taxpayer's income specifically permitted under statute, and the decision to do so was

entirely reasonable.

FINDING

Taxpayer's protest is respectfully denied.

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