DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 02-20120047
Adjusted Gross Income Tax
For Tax Years 2007-08

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ISSUE

I. Adjusted Gross Income Tax–Net Operating Losses.

Authority: Alemasov v. Comm'r, T.C. Memo. 2007-130, 2007 WL 1484527 (U.S. Tax Ct. 2007); Specialty Restaurants Corp. & Subs v. Comm'r of Internal Revenue, T.C. Memo 1992-22, 1992 WL 73543 (U.S. Tax Ct. 1992); I.R.C. § 162; IC § 6-3-1-3.5; IC § 6-3-2-2.6; 45 IAC 3.1-1-8; Black's Law Dictionary (6th ed. 1990)

Taxpayer protests the reduction of claimed net operating losses.

STATEMENT OF FACTS

Taxpayer is an Indiana business in the medical industry. As the result of an Indiana adjusted gross income tax ("AGIT") audit covering the tax years 2007 and 2008 ("Audit Years"), the Indiana Department of Revenue ("Department") determined that Taxpayer had over-reported its net operating losses ("NOLs") dating back to 1994. This determination resulted in a reduction of available NOLs but did not result in assessments of additional AGIT for the Audit Years. Taxpayer protested the reduction of NOLs in their entirety. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Net Operating Losses.

DISCUSSION

Taxpayer protests the Department's reduction of NOLs as Taxpayer claimed them for the tax years 1994-2008. The Department based its determination on the fact that Taxpayer included lease payments which it had not actually made in its loss calculations. Taxpayer was and is a wholly-owned subsidiary of a hospital ("Parent"). Parent leased physicians to Taxpayer, but Taxpayer could not provide documentation to establish that it had actually paid the lease amounts to Parent. The fact that Parent paid the physicians without being paid by Taxpayer formed the basis of the Department's adjustments. Taxpayer protests that Parent "contributed" the amount of lease payments not made by Taxpayer to Taxpayer's business, thereby constituting capital contributions to Taxpayer. Taxpayer cites to several federal court cases in support of its position.

The first relevant statute is IC § 6-3-1-3.5, which provides in relevant part:

. . .

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

(1) Subtract income that is exempt from taxation under this article by the Constitution and statutes of the United States.

(2) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 170 of the Internal Revenue Code.

(3) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States.

(4) Subtract an amount equal to the amount included in the corporation's taxable income under Section 78 of the Internal Revenue Code.

. . ..

Also, 45 IAC 3.1-1-8 provides:

"Adjusted Gross Income" with respect to corporate taxpayers is "taxable income" as defined in Internal Revenue Code–section 63 with three adjustments:

(1) Subtract income exempt from tax under the Constitution and Statutes of the United States. [See Regulation 6-3-1-3.5(a)(050)(a) [45 IAC 3.1-1-5(a)].]

(2) Add back deductions taken pursuant to Interanl *[sic.]* Revenue Code-section 170 (Charitable contributions);

(3) Add back deductions taken pursuant to Internal Revenue Code-section 63 for:

(a) Taxes based on or measured by income and levied at the state level. For purposes of this subsection, the Indiana Gross Income Tax is a state tax measured by income and must be added back (see Miles v. Department of Treasury, 209 Ind. 172 (1935));

(b) Property taxes levied by a political subdivision of any state; and

(c) Indiana motor vehicle excise taxes, except for that portion of the tax not considered an ad valorem tax.

Also, IC § 6-3-2-2.6 states:

(a) This section applies to a corporation or a nonresident person.

(b) Corporations and nonresident persons are entitled to a net operating loss deduction. The amount of the deduction taken in a taxable year may not exceed the taxpayer's unused Indiana net operating losses carried over to that year. A taxpayer is not entitled to carryback any net operating losses after December 31, 2011.

(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.

(e) Subject to the limitations contained in subsection (g), an Indiana net operating loss carryover shall be available as a deduction from the taxpayer's adjusted gross income derived from sources within Indiana (as defined in section 2 of this chapter) in the carryover year provided in subsection (f).

(f) Carryovers shall be determined under this subsection as follows:

(1) An Indiana net operating loss shall be an Indiana net operating loss carryover to each of the carryover years following the taxable year of the loss.

(2) Carryover years shall be determined by reference to the number of years allowed for carrying over net operating losses under Section 172(b) of the Internal Revenue Code.

(g) The entire amount of the Indiana net operating loss for any taxable year shall be carried to the earliest of the taxable years to which (as determined under subsection (f)) the loss may be carried. The amount of the Indiana net operating loss remaining after the deduction is taken under this section in a taxable year may be carried over as provided in subsection (f). The amount of the Indiana net operating loss carried over from year to year shall be reduced to the extent that the Indiana net operating loss carryover is used by the taxpayer to obtain a deduction in a taxable year until the occurrence of the earlier of the following:

(1) The entire amount of the Indiana net operating loss has been used as a deduction.

(2) The Indiana net operating loss has been carried over to each of the carryover years provided by subsection (f).

....

Next, I.R.C. § 162 provides in relevant part:

(a) In general

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including–

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000. For purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. The preceding sentence shall not apply to any Federal employee during any period for which such employee is certified by the Attorney General (or the designee thereof) as traveling on behalf of the United States in temporary duty status to investigate or prosecute, or provide support services for the investigation or prosecution of, a Federal crime.

(Emphasis added).

Taxpayer believes that I.R.C. § 162(a) supports its position that the physicians' salaries are properly

deductible on the basis that those salaries were incurred during the years at issue even if Taxpayer did not pay them in those years. The Department does not agree with this conclusion since the expenses in question were never paid by Taxpayer. Parent paid the physicians and Taxpayer was supposed to pay Parent a leasing fee for the physicians' services. Taxpayer never paid parent those leasing fees.

The Department is not convinced Taxpayer may rely on I.R.C. § 162. As I.R.C. § 162(a) plainly states:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including–
>
> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered.

The Department refers to Black's Law Dictionary, 768 (6th ed. 1990), which defines "incur" as:

> To have liabilities cast upon one by act or operation of law, as distinguished from contract, where the party acts affirmatively. To become liable or subject to, to bring down upon oneself, as to incur debt, danger, displeasure and penalty, and to become through one's own action liable or subject to.

Next, the Department refers to Black's Law Dictionary, 577 (6th ed. 1990), which defines "expense" in relevant part as:

> That which is expended, laid out or consumed. An outlay; charge; cost; price. The expenditure of money, time, labor, resources, and thought. That which is expended in order to secure benefit or bring about a result.

After reviewing these two definitions, the Department concludes that Taxpayer does not qualify for the deduction found under I.R.C. § 162. Taxpayer did not "incur" or pay the amounts at issue since it neither had liabilities cast upon it by act of law nor became liable or subject to debt, etc., as provided by contract. While there was a physician services agreement between Taxpayer and Parent, that agreement does not provide for conversion of amounts due from Taxpayer to Parent into capital contributions. Taxpayer did not make physician lease payments to Parent, therefore Parent incurred a loss. Also, Taxpayer had neither an outlay, charge, cost, or price, nor did it have an expenditure of money, time, labor, resources, or thought. Taxpayer did not make physician lease payments, therefore Taxpayer had no "expense." I.R.C. § 162 requires that a taxpayer have expenses paid or incurred in order to claim a deduction. Taxpayer had neither.

Taxpayer also refers to several Federal-level sources in support of its position that it is entitled to include payments which it agreed to make to Parent, but which it did not actually make, in its NOL calculations. In Specialty Restaurants Corp. & Subs v. Comm'r of Internal Revenue, T.C. Memo 1992-221, 1992 WL 73543 (U.S. Tax Ct. 1992), the United States Tax Court considered the status of payments made by a parent entity to the pre-business opening operations of its subsidiaries. The court wrote:

> Furthermore, creation of the subsidiaries provided distinct advantages, including limited liability and compliance with State liquor laws. The choice of the advantages of incorporation to do business requires the acceptance of tax disadvantages. Commissioner v. National Alfalfa Dehydrating and Milling Co., 417 U.S. 134, 142 (1974); Moline Properties, Inc. v. Commissioner, supra. Consequently, the expenses in question were not properly deductible by the parent corporation, but represented a contribution to the capital of the subsidiaries. Accordingly, Specialty and its subsidiaries must be taxed as separate entities, and the expenses in question can only be deducted by the subsidiaries, if at all.
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> Id. 3-4.
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> (Emphasis added).

The court also wrote:

> In this case, the nine subsidiaries involved were formed and incorporated during the taxable years in question, 1984 and 1985. Their function, like the parent company, was to establish, open, and operate theme restaurants. Yet, the respective restaurants of the subsidiaries (see supra p. 3), were not opened for business during the years at issue. Thus, applying the rationale set forth in Richmond, the expenses in question were not properly deductible under section 162 until ACTUAL business operations of the restaurants had commenced.
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> Id. 4.
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> (Emphasis added).

Taxpayer believes that this supports its claim that its non-payments of physician licensing fees to Parent constitute capital contributions by Parent to Taxpayer. Taxpayer is incorrect. As the court explained, the only reason the parent entity's expenses were considered capital contributions was that its subsidiaries had not commenced business operations. If the subsidiaries had been open for business, the amounts in question would have been, ". . . deducted by the subsidiaries, if at all." Id. at 4.

In the instant case, Taxpayer is the subsidiary and was open for business. Therefore, the lease payments would have been expenses for Taxpayer. Parent leased physicians to Taxpayer, but Taxpayer did not pay the lease fees due to Parent. Since Taxpayer did not incur expenses, Taxpayer may not deduct those amounts as losses.

Finally, Taxpayer states that the Department may not adjust its NOLs beyond the federal provisions. In Alemasov v. Comm'r, T.C. Memo. 2007-130, 2007 WL 1484527 (U.S. Tax Ct., 2007), the court reviewed the petitioner's claim that business expenses shown on petitioner's tax return were paid or incurred during the taxable year and that the expenses were "ordinary and necessary" to the petitioner's business under I.R.C. § 162(a). Id.

at 2. In reviewing petitioner's claims, the court noted that any deductions are a matter of legislative grace, and the petitioner had the burden of proving entitlement to any claimed deduction including the burden of substantiation. Id. In the instant case, the Department reviewed the deductions taken by Taxpayer and determined that they were not "incurred" "expenses" for Taxpayer's business, as required by I.R.C § 162(a), thus those amounts were not properly deducted from Taxpayer's federal AGIT as provided by I.R.C. § 63(a).

Taxpayer refers to several other sources in support of its protest, but the Department finds them equally unpersuasive. The Department finds no provision in the Internal Revenue Code which provides for a party to claim payments which were never made as losses. Since Taxpayer was unable to refer to any source which states that a taxpayer is eligible to claim a loss on payments which were never made, the Department's original net operating loss adjustment was correct.

FINDING

Taxpayer's protest is denied.

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