DEPARTMENT OF STATE REVENUE

02-20120310. LOF

Letter of Findings: 02-20120310
Corporate Income Tax
For Tax Years 2008-2010

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax – Fair Reflection of Income.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1.

Taxpayer protests the disallowance of a deduction for management fees paid to an affiliated company.

II. Adjusted Gross Income Tax – Apportionment.

Authority: IC § 6-3-2-2.

Taxpayer protests the disallowance of a refund based on a reattribution of receipts from Indiana to other jurisdictions.

III. Tax Administration – Estimated Tax Penalty.

Authority: IC § 6-3-4-4.1; IC § 6-8.1-5-1.

Taxpayer protests the imposition of a penalty for failure to remit sufficient estimated taxes.

STATEMENT OF FACTS

Taxpayer is a corporation domiciled outside Indiana. Prior to 2008, Taxpayer's executive and certain clerical functions were under Taxpayer's corporate control.

In 2008, Taxpayer formed a management company (Management Company) and placed certain clerical functions and management functions under the control of Management Company. As part of the creation of Management Company, Taxpayer and Management Company entered into an agreement. The agreement called for Taxpayer to reimburse Management Company for Management Company's actual expenses. In addition, each company was to receive or retain an amount equal to its respective operating costs plus a specified percentage for each company. Thus, Management Company was also paid an additional percentage of its actual operating costs. Further, the agreement called for the sharing of Taxpayer's profits between Taxpayer and Management Company. Taxpayer claimed a deduction for the portion of costs (including markup) and profits paid to Management Company.

The Indiana Department of Revenue ("Department") audited Taxpayer and determined that Taxpayer's deduction for the portion of profits paid to Management Company should be disallowed. The Department separately disallowed Taxpayer's claimed research expense credits for the tax years. As a result, the Department issued proposed assessments for tax and interest for the tax years, along with a penalty for failure to remit sufficient estimated taxes for one of the years. Taxpayer protested the disallowance of the deduction for fees paid to Management Company and the estimated tax penalty. At hearing, Taxpayer conceded the research expense credit issue.

At the time of the Department's audit, Taxpayer indicated that it had overreported its Indiana receipts for apportionment purposes. The effect of this overreporting was that Taxpayer's Indiana apportionment factor as originally reported was higher than the proper apportionment factor. Taxpayer first provided the revised apportionment factors to the Department's auditor, who did not act upon the information. Amended returns were then filed reflecting the amended apportionment factors and seeking a refund. The Department denied the refund claims. Taxpayer also protested the refund denial.

The Department conducted an administrative hearing and this Letter of Findings results. Additional facts will be supplied as necessary.

I. Adjusted Gross Income Tax – Fair Reflection of Income.

DISCUSSION

Taxpayer argues that the payment of a portion of Taxpayer's profits to Management Company was a properly allowable deduction. In particular, Taxpayer and Management Company entered into an agreement based on a transfer pricing study. The transfer pricing study determined that the best method of allocating costs and profits between Taxpayer and Management Company was the "residual profit method."

The residual profit method involves two levels of analysis. For example, assume two companies, Company A and Company B, have a combined $1,295,000,000 in revenues and had $1,000,000,000 in operating expenses resulting from Company A's business and Company B's activities on behalf of Company A. Of these expenses, $900,000,000 is Company A's operating expenses and $100,000,000 is Company B's operating expenses.

The first level of analysis requires review of the routine profits relating to each company's operations. For instance, if businesses in Company A's line of business averaged a profit of ten percent of their costs, Company A's "routine profit" would be ten percent of Company A's $900,000,000 costs, or $90,000,000. Similarly, if businesses in Company B's line of business averaged a profit of five percent of their costs, Company B's "routine profit" would be five percent of $100,000,000, or $5,000,000.

These "routine profits" of Company A and Company B are subtracted from the overall profits. Thus, in this example, the overall profits are $295,000,000, while the routine profits are $95,000,000. The $200,000,000 is the "residual profit." The "residual profit" is then allocated to the respective companies based on their overall contributions to the generation of the "residual profit." Thus, if Company A is considered to have contributed forty-five percent to the extraordinary profit and Company B fifty-five percent, Company A is required to pay Company B $110,000,000 for Company B's contributions. However, if the "residual profit" is somehow negative, Company B is required to pay Company A the negative "residual profit."

In Taxpayer's case, the Department allowed Taxpayer's deduction for Management Company's operating expenses plus the percentage markup specified in the transfer pricing study. However, the Department disallowed Taxpayer's deduction for the "residual profit" paid to Management Company. The issue is whether the Department's disallowance of the deduction for the "residual profits" was proper. Secondarily, if a disallowance of the deduction is proper, the issue is how much of a deduction for the "residual profits" is allowable.

Under IC § 6-8.1-5-1(c), a proposed assessment is presumed to be correct, and the taxpayer bears the burden of proving that the proposed assessment is incorrect.

Both Taxpayer and the Department cite to IC § 6-3-2-2(m), which states:

> 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.

The Department cited to this subsection as its authority for disallowing the deduction for the "residual profits" paid to Management Company. On the other hand, Taxpayer cites to IC § 6-3-2-2(m) for the proposition that the subsection is Indiana's version of I.R.C. § 482. In other words, Taxpayer asserts that, if the deduction is determined to be arms'-length under I.R.C. § 482, then the deduction is allowable.

In support of the proposition that the arrangement between Taxpayer and Management Company reflected an arms'-length transaction, Taxpayer received a "Transfer Pricing Analysis" dated December 16, 2008, (the "TPA") from a national accounting firm.

However, page eight of the TPA states "The tax advice set forth herein addresses specific U.S. federal income tax issues. [Taxpayer] has not requested us to consider, and we have not considered, any other U.S. federal income tax issue; any non-income tax issues; or any state, local or foreign income tax issues. Accordingly, we do not reach any conclusions regarding any other U.S. federal income tax; no-income tax; or state, local or foreign tax issues."

Aside from the limitations contained in the TPA, there are various issues with the TPA and its application. For instance, the Department's audit report raises the issues of whether the "residual profit" is determined before or after interest and taxes. In addition, the TPA uses various companies in Taxpayer's industry which exhibited increased percentage profitability based on size, yet the TPA used an arithmetic mean to determine the "routine profits" percentage for Taxpayer. However, such issues are not necessary for analysis under IC § 6-3-2-2(m).

In Taxpayer's case, Taxpayer paid over $250,000,000 to Management Company in "residual profits" for the audit period. Management Company had over 200 employees. During the protested years, no money was transferred from Management Company to Taxpayer as dividends. However, in periods after the protested periods, Management Company paid Taxpayer dividends.

The effect of these transactions is that Taxpayer claimed a $100,000,000 deduction for one year. A portion of the $100,000,000 may have been used for Management Company's expenses. Eventually, when Management Company had money in excess of its expenses, Management Company returned the excess to Taxpayer as a dividend. The dividend was not subject to Indiana tax. Assuming Management Company incurred $20,000,000 in expenses, with the remainder returned as a dividend, Taxpayer received a $100,000,000 net deduction yet had a real-world cost of less than $100,000,000.

The Department is led to the conclusion that Taxpayer's reporting did not reflect the economic realities of its operations or of Management Company's operations. Taxpayer is entitled to deductions for legitimate business expenses, and the Department does not dispute the legitimacy of Management Company's expenses on behalf of Taxpayer and Taxpayer's affiliated companies. However, to permit a deduction in excess of those expenses when that excess will be simply returned to Taxpayer does not reflect the real-world income of Taxpayer. Even though an actual circular flow did not exist until after the years in question, a circular flow of money resulting in a deduction and non-taxable dividend of any excess amounts deducted existed. Thus, Taxpayer's protest is denied with regard to the portion of the amount paid to Management Company and disallowed by the Department's audit.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Apportionment.

DISCUSSION

Taxpayer also protests the denial of a refund based on amended returns. In particular, Taxpayer asserts that it attributed certain receipts to Indiana that should have been attributed to other jurisdictions. The issue is whether the receipts in question are attributable to Indiana under IC § 6-3-2-2(e) and (f).

Taxpayer has not provided sufficient information to conclude that the receipts in question should be removed from its Indiana sales numerator. However, Taxpayer has provided sufficient legal and factual grounds to conclude that the inclusion of receipts should be reviewed. Thus, Taxpayer's protest is sustained subject to audit review of its Indiana sales numerator. Taxpayer has thirty (30) days after the issuance of this Letter of Findings to provide information substantiating that the receipts in question should not have been sourced to Indiana; however, the Department may permit additional time to provide the information if necessary.

FINDING

Taxpayer's protest is sustained subject to audit verification.

III. Tax Administration – Estimated Tax Penalty.

DISCUSSION

Taxpayer protests the imposition of the ten percent penalty imposed because of Taxpayer's failure to make sufficient estimated tax payments as required pursuant to IC § 6-3-4-4.1(d). The burden of proving a proposed assessment incorrect–including a penalty assessment–rests with the taxpayer, as provided under IC § 6-8.1-5-1(c).

IC § 6-3-4-4.1 provides in relevant part:

(c) Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:

(1) twenty-five percent (25 [percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year; or

(2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax.

A taxpayer who uses a taxable year that ends on December 31 shall file the taxpayer's estimated adjusted gross income tax returns and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year. If a taxpayer uses a taxable year that does not end on December 31, the due dates for filing estimated adjusted gross income tax returns and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year. The department shall prescribe the manner and forms for such reporting and payment.

(d) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

(1) the annualized income installment calculated under subsection (c); or

(2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

The Department is unwilling to agree that an audit assessment can never result in an estimated tax penalty under IC § 6-3-4-4.1. However, in this case, Taxpayer assumed a legally reasonable, good-faith position upon which the Department disagreed. Based on the reasonableness of its actions and its payment of estimated taxes based on its original, reasonable filing position, Taxpayer has provided sufficient legal and factual grounds to justify penalty waiver for any estimated tax penalties imposed for the years in question.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest is denied with regard to the disallowed deduction paid to Management Company. Taxpayer's protest is sustained with regard to the attribution of receipts to Indiana subject to audit verification. Taxpayer's protest is sustained with regard to the estimated tax penalty.

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