DEPARTMENT OF STATE REVENUE

02-20130427.LOF

Letter of Findings: 02-20130427
Corporate Income Tax
For the Years 2007, 2008, and 2009

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUES

I. Corporate Income Tax – Combined Return.
Authority: IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-3-2-2(p); IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer argues that the Department's decision requiring it to file a combined return with its corporate subsidiaries is unwarranted.

II. Corporate Income Tax – Combined Return Alternative.
Authority: IC § 6-3-2-2(p); IC § 6-8.1-5-1(c); AE Outfitters Retail Co. v. Indiana Dept. of State Revenue, No. 49T10–1012–TA–66, 2011 WL 5059896 (Ind. Tax Ct. 2011).

Taxpayer maintains that the Department is required to consider and adopt Taxpayer's "less restrictive" combined return alternative.

STATEMENT OF FACTS

Taxpayer is a distribution and manufacturing division of a Parent Company. Parent Company makes tobacco and related products. Parent Company has various other subsidiaries which provide marketing, sales, warehousing, and manufacturing services.

Taxpayer has employees in Indiana. The employees act as representatives, work from their homes, and are provided with various equipment and supplies enabling them to conduct their work. Among other responsibilities, these representatives replace stale goods and organize retail displays.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's tax returns and business records. The audit resulted in an assessment of additional corporate income tax. Taxpayer disagreed with the assessment 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. Corporate Income Tax – Combined Return.

DISCUSSION

The Department's audit made an adjustment for 2008, 2009, and 2010 original returns to combine Taxpayer with its subsidiaries in order to "fairly reflect [Taxpayer's] income from Indiana sources."

According to the audit report, "Alternatives to computing the adjusted gross income tax liability using combination were explored and it was concluded that combination fairly reflects the [Taxpayer's] Indiana adjusted gross income tax liability."

Taxpayer argues that the Department failed to fully consider combined return alternatives, that the decision requiring it to file a combined return was unwarranted, and asks the Department to "set aside [the] erroneous and unsubstantiated audit findings and accept [its] returns prepared in accordance with Indiana law . . . ."

As a threshold issue, it is the Taxpayer's responsibility to establish that the 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." See Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The audit arrived at its decision requiring a "combined filing" based in part on authority found at IC § 6-3-2-2(l). IC § 6-3-2-2(l) 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:
>
> (1) separate accounting;
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> (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;
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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.

IC § 6-3-2-2(m) authorizes the department to resort to alternative methods of reporting income:

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.

IC § 6-3-2-2(p) states that requiring a taxpayer to file a combined return is warranted only if necessary to "fairly" reflect the taxpayer's Indiana income. The statute provides:

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).

The audit found that Taxpayer and its subsidiaries shared a "unitary relationship" thereby meeting the threshold issue found at IC § 6-3-2-2(m). Taxpayer readily agrees and does not dispute this portion of the audit's conclusion.

The audit concluded that the Taxpayer's income, as reported, did not reflect Taxpayer's Indiana source income because of the financial effects of a 700 million dollar inter-divisional loan between Parent Company and its United States affiliates.

Taxpayer pays 100 percent of all interest costs on the Parent Company's loan. However, the audit found that loan proceeds "flowed to all of the subsidiaries . . ." and that none of the subsidiaries were required to repay any portion of the Parent Company's loan. Portions of the loan were used to pay off a 98 million dollar loan owed by one of the subsidiaries. Portions of the loan were used to pay off a 234 million dollar loan owed by yet another of the subsidiaries.

In effect, Taxpayer was paying 48 million dollars a year in interest or a loan for which Taxpayer was not the sole beneficiary. As stated in the audit report, "Since [Taxpayer] is the only company of the group filing in Indiana its income is distorted because it bears all the expense of the other affiliates."

Thereafter, the audit considered various alternatives to combination as required under IC § 6-3-2-2(p). The audit concluded that (1) "separate accounting" did not apply because Taxpayer "and its affiliates are a single economic entity acting together toward a common goal" and because "most of the affiliates do not have an actual presence in Indiana . . . ." The audit concluded that (2) "[e]xcluding one or more factors" did not address the distortive effects of the inter-divisional loan because "the transactions of the affiliates do not have a direct impact on any of the apportionment factors." The audit found that (3) "disallowing or allocating expense deductions" did not address the distortive effect of the loan because "this option is applicable when the distortion can be traced directly to a specific expense" and because "this could result in a distortion to the detriment of [Taxpayer] since such a method does not provide factor relief . . . ."

During the course of the audit, Taxpayer was notified of the audit's preliminary conclusions and "asked to provide any alternative methods." The audit report indicates that Taxpayer "did not present any alternatives to the combination."

Nonetheless, Taxpayer argues that the audit's conclusion was "erroneous and unsubstantiated" and that "the auditor . . . failed to support his contention that Indiana income is distorted by any means other than saying 'we determined.'"

Taxpayer objects to the audit's characterization of the inter-divisional loan. Taxpayer notes that the loan agreement names Taxpayer as the "sole party legally responsible for its repayment. The subsidiaries have no such responsibility, and therefore there is no legal basis for requiring them to pay."

Taxpayer explains "having all of the debt at the parent company . . . level simplifies its administration as well" and that the purpose of the loan was "to balance [Parent Company's] investment in [Taxpayer] between debt and equity."

Taxpayer further explains that the loan "was not created haphazardly" and that [s]tudies were performed by outside consultants" before structuring the loan as Parent Company did.

In addition, Taxpayer argues that "[n]one of the other subsidiaries have any activities in, or tax nexus with Indiana" and that it has "fully supported [its] separate company filing position, which is in accordance with Indiana law . . . ."

The Department is unable to agree with Taxpayer's argument that the audit's conclusion was unwarranted. The audit raised legitimate and quantifiable concerns over the distortive effects of the inter-divisional loan when Taxpayer assumed responsibility for payment of 100 percent of the Parent Company's loan and when the proceeds of that loan clearly benefited the outlying affiliates. As a result, the audit was correct when it required that Taxpayer file a combined return with its corporate subsidiaries.

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax – Combined Return Alternative.

DISCUSSION

Having found that Department's audit was fully justified in requiring that Taxpayer and its corporate affiliates file a combined return because of the distortive effects of the inter-divisional loan, Taxpayer nonetheless questions whether the Department resorted to a "combined return" without considering a more measured response.

IC § 6-3-2-2(p) clearly requires that the Department consider various alternatives before requiring that a taxpayer report its income "in a combined income tax return for any taxable year . . . ."

> 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).

In support of its argument, Taxpayer cites to, AE Outfitters Retail Co. v. Indiana Dept. of State Revenue, No. 49T10–1012–TA–66, 2011 WL 5059896 at *2 (Ind. Tax Ct. 2011), "[B]efore the Department issues a combined return mandate, it must ascertain whether application of each of the following [IC § 6-3-2-2(l)] methodologies would result in an equitable allocation and apportionment of the taxpayer's income . . . ." (Emphasis in original).

As explained by its representative, Taxpayer proposes an alternative to the audit's conclusion that Taxpayer file a combined return with its subsidiaries. As explained by Taxpayer, its alternative is "a better and more accurate test . . . ." In effect, Taxpayer proposes to reallocate Taxpayer's interest expense based "upon the subsidiaries pre-existing loan balances." According to Taxpayer:

> By reallocating the interest expense pro-rata based upon the subsidiaries' pre-existing loan balances, the subsidiaries (which do not file in Indiana) would have greater expenses and lower income while [Taxpayer] (which files in Indiana and would now be deducting 68 [percent] rather than 100[percent] of the interest) would have lower expenses and, therefore, greater income (by approximately $16 million per year) to report in Indiana.

Taxpayer concludes that its alternative proposal – reallocating interest expense – is "a less restrictive alternative to combined return . . . ."

As noted in Part I above, IC § 6-8.1-5-1(c), places upon Taxpayer the burden of establishing that the proposed assessment is "wrong." The Department is not prepared to agree that Taxpayer has necessarily established that it has met this burden. Nonetheless, the Department is well aware of its statutory responsibility to fully explore reporting alternatives before requiring a combined return. Therefore, the Audit Division is requested to review Taxpayer's interest expense allocation methodology in order to determine whether this alternative fully addresses the audit's original concerns while arriving at a conclusion which "fairly reflect the taxpayer's adjusted gross income for the taxable year[s] . . . ." IC § 6-3-2-2(p).

FINDING

Taxpayer has provided a reporting alternative which warrants review. The Audit Division is instructed to review the Taxpayer's suggested alternative to combination.

SUMMARY

Taxpayer is denied in part and sustained in part; the audit was justified in its conclusion that the Taxpayer's assumption of all responsibility for paying the inter-divisional loan interest expenses resulted in a distortion of Taxpayer's Indiana source income; The Audit Division is instructed to review the Taxpayer's suggested alternative to combination and to make whatever adjustment if any to the original assessment it finds warranted.

Posted: 04/30/2014 by Legislative Services Agency
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