**DEPARTMENT OF STATE REVENUE**

02-20130641.LOF

**Letter of Findings: 02-20130641**
**Indiana Corporate Income Tax**
**For the Years 2009, 2010, and 2011**

**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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Reporting.

**Authority:** IC § 6-3-2-2(l); IC § 6-3-2-2(l), (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); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992).

Taxpayer argues that that *[sic]* Department erred when the Department required that Taxpayer, its Risk-Free Distributor, and its Parent Company file combined corporate income tax returns.

### II. Corporate Income Tax - Underpayment Penalty.

**Authority:** IC § 6-3-4-4.1(d); IC § 6-8.1-10-2.1(b); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(c).

Taxpayer asks that the Department exercise its discretion to abate a ten-percent underpayment penalty on the ground that Taxpayer was not negligent in reporting its income tax liability as it originally did.

## STATEMENT OF FACTS

Taxpayer is a member of a federal consolidated group of companies in the business of manufacturing, distributing, and selling consumer goods.

Taxpayer owns a single-member disregarded entity, which distributes the consolidated group's consumer goods. The Taxpayer identified this entity as a risk-free distributor (hereinafter "Risk-Free Distributor") based on the fact that the entity had a guaranteed profit/return in excess of costs because it operates with little to no market risk. The Risk-Free Distributor makes wholesale sales of the consolidated group's products, which are produced by the group's risk-free contract manufacturers (referred to as such because the entities having a guaranteed profit/return in excess of costs due to the fact that they operate with little to no market risk).

The Indiana Department of Revenue ("Department") conducted an Indiana income tax audit of Taxpayer's business records and tax returns for the years 2009, 2010, and 2011. The audit resulted in an assessment of additional income tax based upon combining Taxpayer - with its disregarded entity Risk-Free Distributor - and Parent Company. 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 Reporting.

## DISCUSSION

Taxpayer argues that the Department's audit failed to meet its statutory burden of establishing that Taxpayer's originally filed corporate income tax returns did not "fairly reflect" its Indiana source income and that - as a result and as permitted under Indiana law - it was necessary for Taxpayer (along with its disregarded entity Risk-Free Distributor) and its Parent Company to file combined income tax returns and report their income on a combined basis.

The issue is whether the Department was justified in requiring that Taxpayer - with disregarded Risk-Free

Distributor - and Parent Company file a combined return under IC § 6-3-2-2 on the ground that the originally filed returns did not fairly reflect the parties' adjusted gross income for the years at issue. Resolution of this issue requires review of the parties' business organization and relationship, the parties' "cost of goods sold," the parties' transfer pricing study, the parties' distribution agreements, whether the parties' shared a "unitary relationship," and whether the Department or Taxpayer met their burden of proof in establishing their respective positions.

**A. Consolidated Group's Organization**.

Taxpayer holds, controls, and owns the single-member disregarded entity (Risk-Free Distributor) which distributes the consolidated group's consumer goods in Indiana and elsewhere. Taxpayer reports the income of the disregarded Risk-Free Distributor. Risk-Free Distributor makes wholesale sales of consumer products produced by the Parent Company's manufacturing subsidiaries.

Risk-Free Distributor is paid less than $1.00 commission for each case of consumer goods it sells to Indiana customers. The less than $1.00 commission was reported as Taxpayer's sole Indiana source income.

Parent Company owns and operates various U.S. manufacturing facilities located in numerous states and U.S. territories.

The Risk-Free Distributor has Indiana employees such as account managers and field service technicians but does not operate an Indiana sales office.

Neither Taxpayer nor the Risk-Free Distributor takes possession of or physically delivers the consumer goods; unrelated companies transport the goods to Indiana wholesale customers.

**(1) The Parties' Business Relationship.**

The audit report outlined the duties, responsibilities, and functions of the related companies:

• [Parent Company] purchases goods from its manufacturing affiliates and sells those goods to [Risk-Free Distributor].

• [Parent Company] makes all decisions pertaining to [Parent Company's] brands including product functionality and attributes, packaging, positioning, advertising, and product pricing.

• [Parent Company] is responsible for product liability claims.

• [Parent Company] bears risks associated with unfavorable market conditions.

• [Parent Company] provides corporate strategy, legal oversight for all affiliates.

• [Parent Company] provides compensation arrangements for [the] bad debts of [Risk-Free Distributor].

• [Parent Company] assigns customer-specific teams of [Risk-Free Distributor's] sales force; [Risk-Free Distributor] is responsible for the day-to-day management of the client relationships.

• [Risk-Free Distributor] is responsible for all freight-related activities.

• [Risk-Free Distributor] is responsible for booking orders.

• [Risk-Free Distributor] manages customer credit function and Accounts Receivable. Bad debts are recovered through compensation arrangements with [Parent Company].

Briefly described, (1) Parent Company's manufacturing subsidiaries produce consumer products and sell those products to Parent Company. (2) Immediately prior to the sale to Risk-Free Distributor, title transfers to the Parent by means of a "flash title" transaction. (3) Risk-Free Distributor buys the products from the Parent Company and sells the products to local retailers.

The audit report made the following analysis of Taxpayer's overall business operation.

This audit examines the operation of [Risk-Free Distributor], the single member disregarded entity held by

> [Taxpayer]. The business operations of [Risk-Free Distributor] are analyzed to determine whether the results reported by [Taxpayer] fairly reflect the income generated from the distribution function in Indiana. Business transactions are also evaluated to consider substance as well as form.
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> Product is transferred to [Risk-Free Distributor]; however, title transfers first to [Parent Company]. [Risk-Free Distributor] is the wholesale distributor for the consumer products manufactured by subsidiaries of the [Parent Company]. Neither [Parent Company] nor the manufacturing subsidiaries regularly sell product to domestic third parties. ([Parent Company] does sell directly to a Canadian distributor.) According to both the Transfer Pricing Study and the Distribution Agreements, [Risk-Free Distributor] receives product directly from affiliates' manufacturing plants, all of which are outside of Indiana.
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> In an apparent discrepancy the Distribution Agreements state that title and possession of product are transferred directly from the manufacturing company to the [Risk-Free Distributor]; however, the Transfer [Pricing] Study states that [Parent Company] purchases the product from the manufacturing subsidiaries at the same time that the product is transferred to [Risk-Free Distributor]. The [T]axpayer's statement [contained in the audit report] explains the transfer of product and title as follows:
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>> [Parent Company] does not directly manufacture or directly sell to the trade. However, as the owner of the intellectual property . . . of the brands sold in the U.S., it records both sales and Cost of Product Sold in a flash title legal transaction. It buys from the U.S. manufacturing entities and sells to the [Risk-Free Distributor]. (Emphasis in original).

It should be noted that the information provided by Taxpayer regarding this "flash title" transaction is inconsistent. While the Parent Company asserts that it takes title to the products from the manufacturing entities before selling the products to the Risk-Free Distributor, Taxpayer's own documentation contradicts this assertion. According to the contract between Parent Company and Risk-Free Distributor, "[D]elivery of title and possession shall be made by the [manufacturing] company directly to [Risk-Free Distributor]."

The audit asked Taxpayer the question; "Why is it necessary for [Risk-Free Distributor] to buy the product from [Parent Company] to perform the distribution function?" Taxpayer responded as follows:

> While [Parent Company] never takes physical possession of the product sold to [Risk-Free Distributor], legal title transfers from the manufacturing entity to [Parent Company] (and then subsequently to [Risk-Free Distributor]) in all cases where the brand intangibles of the underlying product is owned, maintained, and controlled by [Parent Company]. As the U.S. entrepreneur, [Parent Company] authorizes volume produced and distributed in the U.S. In this capacity, legal title passes to it in the buy-sell intercompany flow.

**(2) Distribution Agreements**.

According to the audit report, Risk-Free Distributor and Parent Company entered into Distribution Agreements in 1983 which were revised in 1987, 1992, and 2001. The Distribution Agreements contractually governed the flow of goods, income, and apportioned costs. According to the audit report, the Distribution Agreements provide as follows:

> • Consumer products produced by [Parent Company] will be sold to the [Risk-Free Distributor], a wholesale distributor with a sales organization throughout the United States.
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> • Place of delivery of all products sold shall be the respective [manufacturing] plants of the producing company.
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> • Delivery of title and possession shall be made by the producing company directly to [Risk-Free Distributor].
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> • [Risk-Free Distributor] will not be required to advertise or promote the various products but is not prevented from doing so providing that any advertising or promotion is approved.
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> • [Risk-Free Distributor] will return monies received to [Parent Company] after deducting costs and expenses.
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> • [Risk-Free Distributor] will receive [less than $1.00] for each unit of finished products sold.

Pursuant to the Distribution Agreements and briefly stated, the products and cash flow is as follows: (1) Parent Company's manufacturing subsidiaries transfer their products to Risk-Free Distributor; (2) Risk-Free Distributor sells the products to retailers on the basis of prices set by Parent Company; (3) Risk-Free Distributor pays the net income to Parent Company; and (4) Parent Company pays less than $1.00 per unit to Risk-Free Distributor.

The Agreements guaranteed Risk-Free Distributor a specified amount of income. Parent Company guaranteed that it would sell Risk-Free Distributor a minimum of [Redacted] units of consumer goods earning Risk-Free Distributor a commission of [Redacted] each year. The Agreements specified that a "unit" was one case of consumer goods. The Agreements stipulated that the goods would be delivered at Parent Company's manufacturing facilities.

**(3) Cost of Goods Sold Issue**.

The audit found that Parent Company increased the cost of the goods sold to Risk-Free Distributor by 80 percent. The audit stated:

> Review of federal consolidated returns finds that [Parent Company] increases the cost of the product 80[percent] before transferring title to the U.S. and Canada distributing entities in simultaneous transactions. On average the parent acquires products at a cost of [Redacted] Billion and sells that same product for [Redacted] Billion without having possession of the product and without adding value to the product.

In response to an audit query questioning the increase, Taxpayer explained:

> Every product code in the company . . . has a specific sales and "cost of product sold" amount associated with it. The basis of all these COPS accounts are GAAP principles which include items such as material and finished product variances. In order to present separate company financial statements, and to show that net outside sales (NOS) has associated cost of products sold (COPS or COGS), the COPS that originate on the manufacturers flow through the system to the distributor. Essentially, product that [Risk-Free Distributor] purchases intercompany becomes its COPS. In consolidation, there is an offsetting NOS/COPS elimination.

In particular, audit noted "large manual entries" adjusting Risk-Free Distributor's cost of goods sold during 2011. The first adjustment was for approximately [Redacted] billion dollars and the second adjustment was for approximately [Redacted] billion dollars.

The audit apparently found the explanation insufficient stating that:

> Neither the sources nor the explanations have been provided for the large manual Cost of Goods Sold charges. Without additional information this audit will assume that the manual adjustments are introduced into the accounting system to increase Cost of Goods Sold in order to manage the bottom line - taxable income.

**(4) Risk-Free Distributor's Function and Income**.

Taxpayer was asked to explain on what basis the Risk-Free Distributor was reporting its Indiana source income. The question posed stated, "Does the taxable income reported each year reflect the less than $1.00/unit earned by [Risk-Free Distributor] under the Distribution Agreements plus other income of [Taxpayer]?" Taxpayer responded:

> Yes, any other income of [Taxpayer] is in addition to the [less than $1.00]/unit earned by [Risk-Free Distributor].

The audit concluded that Risk-Free Distributor shouldered only limited transactional risks.

> A statement provided by [T]axpayer describes the activities of [Taxpayer] as the employer of a nationwide sales force which operates with limited risk and earns a guaranteed profit. A distributor which is independent of a manufacturing operation bears all risks and burdens of the property acquired. Among the risks assumed by [an] independent distributor is the potential of incurring losses.

The audit asked whether any money was exchanged between Risk-Free Distributor and Parent Company. Taxpayer responded as follows:

> There is no direct exchange of money. [Risk-Free Distributor] collects all third party accounts receivables (i.e. cash) from its customers and deposits daily into the global cash pool. [Risk-Free Distributor] is the global

> cash pool member, and the "pay on behalf" entity for the U.S. As such, bank accounts are only in the name of [Risk-Free Distributor], with authorization for use by U.S. affiliates. For intercompany cash management, transfers are legally between the cash pool and the specific legal entity, but this indirectly involved [Risk-Free Distributor] as the pay on behalf conduit.

The audit found that Risk-Free Distributor returned to Parent Company the income it received after deducting costs and expenses, but that Risk-Free Distributor was the holder of an offshore account of money received from its customers and from which cash transactions were made on behalf of the consolidated group.

**(5) Transfer Pricing Study**.

The audit found that Parent Company is responsible for directing marketing efforts to retailers as well as the final household consumers. As the audit report states:

> According to the Transfer Pricing Study, [Parent Company] makes all decisions pertaining to [Parent Company] product advertising and pricing. [Parent Company] also assigns customer-specific teams of the [Risk-Free Distributor's] sales force. [Parent Company] controls the [Risk-Free Distributor's] marketing program to mass merchandisers.
>
> In addition, [Parent Company] controls the marketing to the final customer. [Parent Company] develops and controls marketing to the household consumers through newspaper supplements and magazine advertising, radio and television advertising, and television programming.

**B. Audit's Analysis**.

The audit found that Taxpayer's business operation was inconsistent with "independent operation" thereby justifying - in part - the conclusion that Taxpayer (with disregarded entity Risk-Free Distributor) and Parent Company should be required to report their income on a combined basis.

> [Parent Company's] consolidated group includes a vertical integration of manufacturing subsidiaries and a distribution entity. [Parent Company] has burdened [Risk-Free Distributor] with an average 80[percent] intercompany markup . . . . [Risk-Free Distributor] is responsible for arranging transportation of the products of the consolidated group into the state of Indiana and selling the products to retailers. [Parent Company] controls product pricing and consumer marketing as well as [Risk-Free Distributor's] sales efforts. [Risk-Free Distributor] reports taxable income which is not the net profit after expenses but rather a commission of [less than $1.00] . . . per unit (defined as a case). Although [Risk-Free Distributor] returns all monies after expenses to [Parent Company] (and receives a commission), [Risk-Free Distributor] is identified as the accountholder of an offshore account of all cash received from customers. It is from this account that cash transactions are made for the consolidated group. (Emphasis in original).

The audit compared the results reported by consolidated group, the Parent Company, and Taxpayer with its disregarded entity, Risk-Free Distributor. The audit found that Taxpayer, with its disregarded entity Risk-Free Distributor, accounted for 92 percent of the consolidated group's sales but reports its Cost of Sales at almost three times the Cost of Sales reported by the entire consolidated group.

The audit found that the consolidated group reports the results of Parent Company, the manufacturing entities, Risk-Free Distributor, and all other subsidiaries after the elimination of inter-company sales and expenses. The average taxable income each year for the consolidated group was [Redacted] billion; the average taxable income each year for Taxpayer was [Redacted] million (0.14 percent of the consolidated taxable income).

For apportionment purposes, Taxpayer reports wages in [Redacted] states plus the District of Columbia. Taxpayer explains that it reports its income in [Redacted] of those states in exactly the same manner as it reports its income in Indiana. For the years at issue, Taxpayer reports the results of Risk-Free Distributor and has no other sales activity other than Risk-Free Distributor.

**(1) Unitary Relationship**.

In arriving at its conclusion that Taxpayer (with its disregarded entity Risk-Free Distributor) should file a combined return with Parent Company, the audit found that a unitary relationship existed between these entities.

The audit found that there was "common ownership" of the entities on the ground that Taxpayer's pro forma federal return revealed that Taxpayer was 100 percent owned by Parent Company.

The audit found that there was "common management" of the different entities on the ground that, according to the Transfer Pricing Study, Parent Company made all decisions related to its goods including product, packaging, pricing, and advertising. In addition, the audit found that Parent Company was responsible for all product liability claims, that Parent Company provided overall product strategy, and that Parent Company exercised legal oversight of all its affiliates. The audit noted that the parties' distribution agreements required that Risk-Free Distributor was required to return to Parent Company all money received after deducting costs and expenses but was entitled to retain less than $1.00 for each case of product it sold.

The audit found that there was "common operation or use" between the different entities noting that Parent Company performed purchasing, financing, advertising, marketing, product research, tax compliance, insurance, and pension plan management on behalf of Taxpayer and, by extension, its disregarded entity Risk-Free Distributor.

The audit concluded that there existed a "unitary relationship" between Parent Company and the Taxpayer's disregarded entity Risk-Free Distributor.

**(2) Statutory Alternatives to Separate Reporting.**

As required under IC § 6-3-2-2(l), the audit considered various alternatives short of requiring that Parent Company and Taxpayer (with its disregarded entity Risk-Free Distributor) file a combined return. The audit considered the following:

- Exclude or add back the cost of goods sold reported by Risk-Free Distributor;
- Calculate Taxpayer's revised gross income by the following method: Multiply Parent Company's gross income percent times Taxpayer's net sales;
- Combine the results of Taxpayer with Parent;
- Report consolidated results to reach an estimated Indiana apportionment;
- Report Taxpayer's sales plus Parent Company's cost of goods sold.

The audit rejected the first alternative because the "option does not take into account the cost of production and the expenses associated with the organizations involved in the production of products."

The audit rejected the second alternative because "this option does not take into account expenses of [Parent Company] for marketing and advertising to Indiana retail customers. This option also does not allow [Parent Company's] expenses associated with product, market, and collection risks. This option should be rejected because [Parent Company's] expenses are not allowed."

As to the third alternative, the audit noted that "[t]he combination reports the costs of goods sold of the parent and the costs of goods sold to [Taxpayer] for product acquired from affiliates other than [Parent Company]. This option allows the expenses of [Parent Company] in addition to the expenses of [Taxpayer]."

As to the fourth alternative, the audit noted that "[r]eporting consolidated results would recognize that the [Parent Company's] consolidated group operates to manufacture products which are distributed and marketed to the retail Indiana consumer. Reporting consolidated results would include the taxable income of the manufacturing affiliates which file in those states in which the affiliates operate. There are several [Parent Company] subsidiaries which file in Indiana, and reporting the consolidated return taxable income would result in duplication. For this reason, this option should be rejected."

As to fifth alternative, the audit noted that "[r]eporting [Taxpayer] results with the [Parent Company's] Cost of Goods Sold eliminates the markup by [Parent Company] to [Risk-Free Distributor]. However, this option does not allow Cost of Goods Sold reported by [Taxpayer] for product acquired from other affiliates, and it does not allow expenses of [Parent Company]. This option should be rejected."

All five alternatives considered resulted in additional tax: (1) applying the first option would have resulted in additional tax liability approximately 700 percent greater than the combination option eventually chosen; (2)

applying the second option would have resulted in additional tax liability approximately 290 percent greater than the combination option eventually chosen; (3) applying the third option would have resulted in additional tax liability approximately equal to the combination option eventually chosen; (4) applying the fourth option would have resulted in additional tax liability approximately 240 percent greater than the combination option eventually chosen; (5) applying the fifth option would have resulted in additional tax liability approximately 360 percent greater than the combination option eventually chosen.

**(3) Audit's Conclusions**.

The audit concluded that the results - as reported by Taxpayer - did not reflect its Indiana source income for the following reasons.

• The Risk-Free Distributor was not a distinct and separate wholesale distributor.

• Parent Company chose to separately report the results of its manufacturing subsidiaries and Risk-Free Distributor while managing the operation of the Risk-Free Distributor, controlling product pricing, product liability, and product marketing including the redemption of coupons accepted by retailers and received from individual consumers.

• Risk-Free Distributor did not report to Indiana the net income received from the sale of product after expenses but reported as taxable income only the [less than $1.00] commission received from the sale of each case of consumer goods, returning to Parent Company the balance.

• The inflated cost of goods sold resulted in unreported gross income by Taxpayer. Risk-Free Distributor is burdened with a cost of goods sold which allows only [Redacted] percent gross margin while the Parent Company averages [Redacted] percent gross margin. Parent Company adds no material or processing to the product but adds a markup that is "without economic substance" and is a strategy intended only "to reduce income subject to state taxation."

• Risk-Free Distributor reports a cost of goods sold for product in which it has no right or interest. Risk-Free Distributor cannot exercise any ownership right over the products, does not control the products, and cannot claim any benefit from the products. Risk-Free Distributor does not determine its product's customers or its selling price. Risk-Free Distributor returns to the Parent Company its net income but does not actually buy anything. According to the audit, "There is no purpose for the Cost of Goods Sold reported by [Risk-Free Distributor] other than to shift income."

The Department audited Taxpayer's Indiana tax returns and found that - as reported - the "results as reported do not fairly reflect Indiana income."

> [Taxpayer] purports to purchase from [Parent Company] product manufactured by its subsidiaries. Although the distribution operation has been organized to appear separate from the parent, [Risk-Free Distributor] is captive. The corporate parent controls product marketing and pricing and retains product liability. [Risk-Free Distributor] has limited risk. [Risk-Free Distributor has] no rights to the products for which it arranges distribution receiving only a small fee per unit rather than net income from sales of product.

The audit concluded that:

> An audit of [Taxpayer] was conducted for FYE 6/30/09, FYE 6/30/10, and FYE 6/30/11, finding that the results as reported do not fairly reflect Indiana income. [Taxpayer] reports the results of the disregarded entity [Risk-Free Distributor].

In arriving at its final determination, the audit took into consideration the following factors:

• [Taxpayer] reports the results of [Risk-Free Distributor];

• [Risk-Free Distributor] distributes products produced by [Parent Company's] manufacturing subsidiaries;

• Cost of Goods Sold reported by [Taxpayer] is inflated by the markup applied by the [Parent Company];

• Gross income is under-reported by the amount of the markup applied by [Parent Company];

- Taxable income reported by [Taxpayer] is commission rather than [the] net income from a sales operation;

- No money is exchanged between [Parent Company] and [Risk-Free Distributor];

- [Risk-Free Distributor] does not acquire right or interest in the product distributed to wholesalers;

- [Parent Company] controls the operation of [Risk-Free Distributor] and [Taxpayer].

The audit concluded that it was appropriate "to combine the results of [Parent Company] with the results of [Taxpayer] . . . in order to fairly represent the taxable income subject to Indiana apportionment . . . ."

The audit chose this alternative methodology for the following reasons:

> This adjustment allows the Cost of Goods Sold reported by [Parent Company], thereby eliminating the markup imposed by [Parent Company] on its sales to [Taxpayer]. This audit has determined that [Parent Company] not only controls [Risk-Free Distributor] but that [Parent Company] and [Risk-Free Distributor] are a single operation. [Parent Company] controls the marketing of the products both to the retailer and beyond to the ultimate household consumer. Expenses of both [Parent Company] and [Taxpayer] are allowed in the calculation of taxable income.

The audit concluded that "[t]his adjustment subjects the combined income of [Parent Company] and [Taxpayer] to Indiana apportionment, reflecting the economic reality of the taxpayer's activity in the state of Indiana. Applied uniformly, such an adjustment would result in taxation of no more and no less than 100[percent] of [T]axpayer's income."

**C. Statement of Law**.

As a threshold issue, it is a taxpayer's responsibility to establish that the existing 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." 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). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of state Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

The audit arrived at its decision requiring a "combined filing" based in part on authority found at IC § 6-3-2-2(l) and (m). IC § 6-3-2-2(l) states:

> (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:
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> (1) separate accounting;
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> (2) for a taxable year beginning before January l, 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 as follows:

> 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).

**D. Taxpayer's Objections**.

Taxpayer disagreed with the audit's decision stating that "the audit report fails to show that [Taxpayer's] separate company Indiana return fails to fairly reflect its Indiana source income as required by IC [§] 6-3-2-2(l) or (m). The audit report also fails to meet the requirement under IC [§] 6-3-2-2(p) that the Department exhaust all other methods to address the alleged distortion before it may require that a taxpayer file a combined return." Taxpayer continues:

> It appears the Department had one objective in this audit, to subject [Parent Company's] income to Indiana tax. Unable to do so by an assertion of nexus over [Parent Company], the Department relied upon combination. Given the lack of statutory or regulatory guidance on unitary combinations in Indiana, the Department appears to have resorted to an arbitrary combination to produce its desired result. The inference of a unitary relationship between [Parent Company] and [Taxpayer] in a separate filing state, such as Indiana demonstrates the Department's attempt to ignore operational and strategic structuring. Much of the audit report finds evidence of a unitary operation. The [Taxpayer] does not contest its unitary characteristics with [Parent Company] . . . . However, it appears the Department is asserting that the structuring of an organization with separate and distinct operational and legal purposes is by nature a sham, and not permitted for tax purposes, For a taxpayer such as [Parent Company] which has substantial operations in each legal entity and has been operating in essentially the same manner [for multiple] years, this provides an unfair and unsupported standard.

Taxpayer raises objections to the audit's conclusion requiring that Parent Company and Taxpayer - along with disregarded Risk-Free Distributor - file a combined return.

**(1) Department's Burden of Proof**.

Taxpayer claims that, at this administrative level, the burden is now on the Department to demonstrate that the Taxpayer's separate company calculative was distortive. To that end, Taxpayer cites to Rent-A-Center East, Inc., 963 N.E.2d at 466-67. Taxpayer explains in its November 5, 2013, protest letter that in Rent-A-Center:

> [T]he Department required that the taxpayer filed a combined return with other related corporations. The taxpayer filed a motion for summary judgment in the Tax Court alleging that the Department had not complied with IC 6-3-2-2(p). The Tax Court granted the taxpayer's motion because the Department had not designated any evidence that it had complied with subsection (p). The Department argued in its Petition for Review and in front of the Indiana Supreme Court that the proposed assessment served as prima facie evidence that the Department had not complied with all requirements to make the assessment, including subsection (p). The Indiana Supreme Court stated:
>
>> Rather, Section 6-3-2-2(p) reflects the Legislature's codification of a rule of decision with respect to when a combined income tax return may permissibly be required. It serves as the evidentiary bar that must be evaluated at the end of the summary judgment analysis (or trial process) not a threshold over which the Department must pass at the beginning.
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>> Thus viewed, we think the process in case like these proceeds along fairly straightforward lines . . . . [T]he Department's notice of proposed assessment constitutes a prima facie showing . . . [t]he burden then shifts to the taxpayer to come forward with sufficient evidence . . . demonstrating a factual dispute . . . the Department could then reply to the taxpayer's showing . . . . (Internal citations omitted).

The Department rejects Taxpayer's application and reliance on the Indiana Supreme Court's decision in Rent-A-Center. In that case, the issue was whether the Tax Court properly required the Department to meet its burden under Ind. Trial Rule 56(c) of demonstrating that it was entitled to summary judgment as a matter of law.

Id. at 466. The administrative protest is not governed by the Indiana Trial rules and the "burden of proof" does not shift once Taxpayer sets out its argument challenging the assessment. As noted in the supreme court's decision, "Significantly, the General Assembly has provided that '[t]he 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 is wrong rests with the person against whom the proposed assessment is made.'" Rent-A-Center East, Inc., 963 N.E.2d at 466. (Emphasis in original).

**(2) Common Ownership**.

Although Taxpayer admits that it is not independent of Parent Company, Taxpayer asserts that it has its own leadership in a separate business unit which it refers to as "Market Development Organization" which it describes as "one of [Redacted] separate and distinct business units comprising [Parent Company]."

**(3) Cost of Goods Sold**.

Taxpayer disagrees with the audit's finding that Parent Company inflated the cost of goods sold. Taxpayer explains that "[t]he costs of goods sold of [Risk-Free Distributor] are adjusted to reflect the appropriate level of income due [Risk-Free Distributor]." Taxpayer continues:

> The appropriate pricing cannot be achieved contemporaneous with the transactions due to changing costs and customer pricing. Thus manual adjustments are made to the cost of goods sold on a quarterly basis to effectuate the appropriate pricing per the transfer pricing study. There is nothing nefarious or mysterious about these adjustments.

**(4) Intercompany Ownership of Consumer Goods**.

Taxpayer challenges the audit's finding that Parent Company did not purchase the goods sold to Indiana consumers stating that the audit's conclusion "misses the point." Taxpayer explains:

> [Parent Company] does take title to the products in a flash title transaction. That is to say that immediately prior to the product being sold to [Risk-Free Distributor], it is sold to [Parent Company]. Thus [t]he [Parent Company] does have sales and cost of goods sold. Ultimately whether or not [Parent Company] ever takes title or possession of the products is irrelevant. Neither the manufacturing subsidiaries nor [Parent Company] owns the right to manufacture the products. [Parent Company] owns the rights to these products. Further, [Parent Company] contributes substantial value to the overall operations of [Parent Company] which would have to be compensated consistent with the transfer pricing study via these intercompany sales or similar intercompany transactions. Rather than record such consideration in the form of a sale of the products, it could just as reasonably have been paid directly to [Parent Company] in the form of a management fee. (Emphasis added).

**(5) Transfer Pricing Study**.

In addition, Taxpayer indicates that the Department's failure to understand the significance of its transfer pricing study "resulted in the Department improperly characterizing cost of goods sold as 'inflated.'" Taxpayer continues:

> A comparison between cost of goods sold on the consolidated federal income tax return to the cost of goods sold on separate company returns is entirely misleading. At the most basic level, it fails to account for the intercompany eliminations. But more importantly, [Taxpayer] also sells products for the other entrepreneur entities in the [Parent Company] group.

Taxpayer concludes that the audit failed to give the necessary weight to its transfer pricing study. Taxpayer asserts that the study "establishes the proper amount of income for [Parent Company]" and that "it appears that the Department does not understand [Parent Company's] intercompany pricing." Taxpayer finds this "perplexing" because Parent Company "provided a copy of the applicable pricing study and the intercompany pricing contracts to the auditor." Taxpayer explains:

> [Parent Company] updates its intercompany pricing periodically, via an independent third party. The "Berry Ratio," a commonly accepted profit level indicator defined as gross profit divided by operating expenses, is the basis used for determining the appropriate compensation for [Parent Company] and [Risk-Free Distributor]. Inherent in the Department's assessment is a theme that a separate legal entity is not purposeful beyond tax avoidance. This is simply untrue. A distributor with limited risk and only authorized to perform

certain distributing related activities should not be entitled to the same profit level of an entity with substantial risk . . . . After [Parent Company] compensates the distributor according to the terms set forth in the pricing study (in addition to other related entities), [Parent Company] bears the risk of making a profit or loss.

Regarding pricing and product promotion, the functional analysis in the transfer pricing study explains in detail the different roles and responsibilities of [Parent Company] and [Taxpayer]. The Department is using these facts to support its assertion that [Taxpayer] cannot operate independently. Instead it should be evidence of a clear division of roles and responsibilities with an integrated entity, each role with a different risk and reward profile. [Taxpayer] is the entity responsible for [Parent Company's] customers; i.e., the retailers. This contrasts with [Parent Company], which among numerous other activities . . . owns decisions on advertising campaigns and messaging directed to the ultimate consumers.

Separation of operational responsibilities among business units, which for [Parent Company] are organized by legal entity, allows for clear decision rights and priorities and has been the manner that the company has operated for [numerous] years. For example, [Taxpayer] is responsible for increasing outside sales, while [Parent Company] leads innovation. The pricing not only reflects this, but it is mandated by it.

**(6) Combined Filing Prerequisites**.

Taxpayer points out the statutory requirements before the Department may require it to file a combined return with Parent Company and Risk-Free Distributor. In order to meet that statutory threshold, the Department must: (1) show that the standard apportionment and allocation provisions do not fairly reflect a taxpayer's Indiana source income; (2) establish that the affected taxpayer is unitary with the corporation or corporations the Department seeks to include in the combined return with the taxpayer; (3) must show that it is unable to fairly reflect the taxpayer's Indiana source income using any other method allowable under IC § 6-3-2-2(l), (m). In addition, IC § 6-3-2-2(p) requires that the Department exhaust all other methods to address any alleged distortion before it may require that a taxpayer file a combined return.

Taxpayer asserts that the Department has failed to meet the IC § 6-3-2-2(p) requirements because the audit failed to adequately identify, consider, explain, or develop legitimate alternatives before resorting to a combined return. As explained by Taxpayer, the Department cannot meet the statutory requirement "by proposing, and immediately dismissing, fundamentally unsound alternatives to the filing of a combined return." In effect, Taxpayer asserts that the Department failed to demonstrate that the intercompany transactions between Taxpayer and Parent Company were distortive. According to Taxpayer, if the intercompany transactions were, in fact distortive, "[I]t would stand to reason that [the Department] could show what a non-distortive price would be."

**E. Conclusion**.

Taxpayer is a large, sophisticated company, entitled to structure its business affairs in any manner its sees fit, to enter into any internal financial arrangements it deems appropriate, determine its own internal risks and rewards, and to pursue any tax advantage attendant upon the management of its business affairs. However, in determining the nature of Taxpayer's business transaction and the resultant tax consequences, the Department considers "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992), aff'd 639 N.E.2d 264 (Ind. 1994). The issue is whether Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that the audit's decision and consequent assessment was "wrong."

The audit raised legitimate concerns that the Taxpayer's reporting of its Indiana income did not fairly reflect that Indiana income. Noteworthy is the fact that Parent Company acquires goods from its manufacturing entities and increases the cost of those goods by 80 percent before transferring those same goods to its Risk-Free Distributor. In addition, Taxpayer makes periodic billion dollar "manual entries" further adjusting its cost of goods sold which - as noted in the audit report - are entered to "manage the bottom-line taxable income."

Taxpayer maintains that the Department failed to give proper weight to its transfer pricing study and that its study fully justifies its reporting position. However, transfer pricing studies are not Indiana-approved vehicles for justifying tax expenses through controlled party profits. Recitation in the transfer pricing study of the "arm's length nature of its intercompany transactions" does not necessarily imbue the study with authority to justify profit margins because - as noted in its own study - an "analysis conducted in accordance with the Treasury Regulations issued under § 482 of the Internal Revenue Code ('Treas. Reg. § 1.482')" does not apply to Indiana's adjusted gross income tax. The federal "arm's length" rules pertaining to international controlled transfers are intended to discourage U.S. companies from diverting profits to off-shore tax havens by requiring those companies to charge their foreign affiliates the same "arm's length" prices economic competitors are charged.

The Department disagrees with Taxpayer's assertion that the Department has not given the Transfer Pricing Study the necessary weight it deserves. The Department has carefully considered the study and its supporting materials. As explained previously, the audit noted that the study demonstrated that the Parent Company exerted significant control over its affiliates, including Taxpayer and Risk-Free Distributor and concluded that the entities were unitary and should file on a combined basis. Further, the Transfer Pricing Study was responsible for reviewing the transactions between Parent Company, the risk-free contract manufacturers, and Risk-Free Distributor. Ultimately, the Transfer Pricing Study determined that the transactions were at arm's-length. In other words, the study found that the Parent Company's payment of less than $1.00 per unit to the Risk-Free Distributor and the less than $1.00 per unit to the risk-free contract manufacturers was commercially reasonable.

However, there are facts that the study or Taxpayer failed to acknowledge. First, the study relied on by Taxpayer pertains to tax years 2003 and 2004. Nevertheless, Taxpayer did not merge with the Parent Company until 2005. Thus, the study relied upon could not have taken into account Taxpayer's business when establishing arms-length transactions. Another fact not pointed out in the Transfer Pricing Study was that the less than $1.00 per unit price paid by Parent Company to Risk-Free Distributor was originally set by contract in 1983. Similarly, the less than $1.00 paid to the risk-free contract manufacturers was set by contract in 1975, though the "unit" definition was revised in 1981. In other words, the Transfer Pricing Study found that the prices paid by Parent Company to its affiliates were arms-length, despite the fact that the prices had not been revised in over 30 years. Such a conclusion, that the nature of Parent Company's business has not changed in 30 years, combined with the fact that the study predated Taxpayer's merger with Parent Company, leads the Department to conclude that the study is not controlling in this matter.

The audit found - and the Department here agrees - that Taxpayer's original reporting of its Indiana source income was inherently distortive noting, among other things, that Parent Company increases its cost of goods sold by 80 percent without ever taking possession of the goods and without adding readily identifiable value to those goods.

In addition, the Department notes that the standard by which Taxpayer determines cost of goods sold is apparently quite malleable evidenced by the periodic, multi-billion dollar "manual entries" adjusting that cost of goods sold. The result is that Risk-Free Distributor is subsequently burdened with a cost of goods sold which permits only an 8 percent gross margin while the parent averages 45 percent gross margin. The cost of goods sold by Risk-Free Distributor is almost three times the Parent Company's actual cost of goods. In addition, it should be noted that Risk-Free Distributor generates 92 percent of the federal consolidated group's sales yet reports less than one percent of the federal consolidated group's taxable income by means of a pricing structure in which Risk-Free Distributor reports taxable income based on receiving less than $1.00 for each case of consumer goods sold to Indiana customers.

The audit met the requirements set out at IC § 6-3-2-2(l), (m), (p) before determining that Taxpayer (with disregarded entity Risk-Free Distributor) and Parent Company should file a combined return. The audit found, and Taxpayer does not disagree, that the parties share a unitary relationship. As necessary under IC § 6-3-2-2(l)(4), the audit considered "other method(s) to effectuate an equitable allocation and apportionment of the taxpayer's income" before resorting to the combined reporting requirement. Each of "other methods" considered by the audit would have resulted in an assessment substantially greater than the assessment currently at issue.

Taxpayer challenged the audit's conclusion but has failed to meet its burden under IC § 6-8.1-5-1(c) of establishing that the assessment was "wrong." For these and other reasons cited in the audit report, the Department finds that the decision requiring that Taxpayer (with its disregarded entity Risk-Free Distributor) and Parent Company report their income on a combined basis fully justified.

**FINDING**

Taxpayer's protest is respectfully denied.

**II. Corporate Income Tax - Underpayment Penalty.**

**DISCUSSION**

Taxpayer objects to the imposition of the ten percent "underpayment penalty." The penalty is authorized under IC § 6-3-4-4.1(d):

> (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.

IC § 6-8.1-10-2.1(b) sets the amount of penalty as ten percent. However, IC § 6-8.1-10-2.1(d) provides:

> If a person subject to the penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

In particular, Taxpayer argues that it "filed its returns following the prescribed statutory requirement . . . ." and that it "could not have filed a combined return for the audit years without obtaining permission from the Department pursuant to IC § 6-3-2-2(q)."

As discussed in Part I above, the Department disagrees with Taxpayer's substantive argument. However, there is sufficient information to conclude that Taxpayer "exercised ordinary business care and prudence . . . ." and that the penalty should be abated.

**FINDING**

On the issue of the "underpayment penalty," Taxpayer's protest is sustained.

**SUMMARY**

The audit satisfied the requirements under IC § 6-3-2-2(l), (m), and (p) in concluding that Taxpayer (with disregarded Risk-Free Distributor) and Parent Company report their income on a combined basis. Taxpayer met its burden of establishing that the ten-percent underpayment penalty should be abated.

*Posted: 02/25/2015 by Legislative Services Agency*
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