DEPARTMENT OF STATE REVENUE

02-20140024.LOF

Letter of Findings: 02-20140024
Corporate Income Tax
For the Years 2008 through and including 2010

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Multinational corporation was allowed bonus depreciation modifications to taxable income in the tax year under statute, but was not allowed to reclassify the bio-fuel credit without statutory permission. Multinational corporation was required to include its foreign disregarded entities to apportion its business income, but its income received from non-unitary partnerships was business income properly apportioned at the partnership's level.

ISSUE

I. Corporate Income Tax - Imposition.

Authority: I.R.C. § 63; I.R.C. § 87; Treas. Reg. § 301.7701-2; IC § 6-3-1-3.5; IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-12; IC § 6-8.1-5-1; Sherwin-Williams Co. v. Indiana Dep't of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax 1999); 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); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Indiana Dep't of State Rev. v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); 45 IAC 3.1-1-62; 45 IAC 3.1-1-153; Black's Law Dictionary (7th ed. 1999).

Taxpayer protests the Department's proposed assessments.

STATEMENT OF FACTS

Taxpayer is an out-of-state multinational corporation doing business in Indiana and outside of Indiana. In addition to manufacturing activities, Taxpayer owns and licenses its intellectual property ("IP"), including patents, trade names, and trademarks, to various affiliates. Taxpayer also directly or indirectly owns various subsidiary corporations. Taxpayer and its subsidiary corporations owned some foreign companies operating outside of the United States that were treated as disregarded entities operating as "divisions" of Taxpayer in its federal income filings. Additionally, Taxpayer is a corporate partner of several domestic and foreign partnerships.

Prior to 2008, Taxpayer and its subsidiaries did not file Indiana corporate income tax returns (Form IT-20). Beginning with the 2008 tax year, Taxpayer determined that it received income derived from Indiana sources. From then on, Taxpayer and its subsidiary corporations filed and reported their Indiana income on IT-20 returns. Taxpayer and its subsidiary corporations reported their Indiana income on a separate return basis (including each of the corporation's disregarded subsidiaries operating as divisions on that corporation's separate return). Taxpayer's parent and other affiliates filed their own IT-20 returns on a separate return basis.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer's business records for tax years 2008, 2009, and 2010. Pursuant to the audit, the Department made various adjustments which resulted in additional tax. Taxpayer protested. An administrative hearing was held. This Letter of Findings ("LOF") ensues. Additional facts will be provided as necessary.

I. Corporate Income Tax - Imposition.

DISCUSSION

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its 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); see also Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "all statutes are presumptively constitutional." Indiana Dep't of State Rev. v. Caterpillar, Inc., 15 N.E.3d 579, 587 (Ind. 2014) (citing UACC Midwest, Inc. v. Indiana Dep't of State Rev. 629 N.E.2d 1295, 1299 (Ind. Tax Ct. 1994)). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." Caterpillar, Inc., 15 N.E.3d at 583.

Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b). In cases where a corporation derives business income from sources both within and without Indiana, Indiana may only tax a certain part of that multi-state income derived from sources within Indiana. Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax 1999). To that end, when "a corporation derives business income from sources both within and without Indiana the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996).

To compute the income subject to Indiana corporate income tax, Indiana adopts a multistep process to calculate a corporate taxpayer's taxable Indiana adjusted gross income. Indiana Dep't. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 581 (Ind. 2014). The federal law requires taxpayers to report and pay their federal income tax when their gross income exceeds a certain amount. For state income tax purposes, the presumption is that the taxpayers properly and correctly file their federal income tax returns. The Indiana statute refers to the Internal Revenue Code to efficiently and effectively compute what is considered the taxpayers' Indiana income tax. That is, IC § 6-3-1-3.5(b) simply provides the starting point to determine a corporate taxpayer's taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows . . . ." In determining the taxpayer's Indiana adjusted gross income, Indiana first refers to I.R.C. § 63 as the beginning point. From there, the taxpayer must follow various enumerated adjustments–additions and/or subtractions–under IC § 6-3-1-3.5(b). Then, the taxpayer makes additional adjustments based on provisions outside IC § 6-3-1-3.5(b), such as the foreign source dividend deduction offered under IC § 6-3-2-12(b). After making the above mentioned adjustments, the taxpayer determines how much of its income is apportioned (i.e., business income) or allocated (nonbusiness income) to Indiana, based on provisions outlined in IC § 6-3-2-2. Business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." IC § 6-3-1-20. Nonbusiness income is "all income other than business income." IC § 6-3-1-21.

Pursuant to the audit, the Department made several adjustments to Taxpayer's reported Indiana income. First, the audit adjusted Taxpayer's 2008 "bonus depreciation subtraction." Second, the audit reclassified income Taxpayer received from various partnerships ("Partnerships") as nonbusiness income. Third, the audit proposed to exclude three (3) foreign disregarded entities from Taxpayer's Indiana returns. Finally, the audit declined Taxpayer's request to reclassify a federal bio-fuel credit it claimed in its 2009 federal return as an Indiana business expense deduction. Consequently, the audit proposed to recalculate Taxpayer's taxable income and apportionment factors, which resulted in additional adjusted gross income tax due. Taxpayer, to the contrary, asserted that the audit's proposed assessments were erroneous.

After reviewing the additional documentation provided by Taxpayer, this LOF finds that Taxpayer's supporting documentation demonstrated that the audit erred in (1) adjusting the 2008 bonus depreciation subtraction, and (2) excluding Taxpayer's three foreign disregarded entities operating as divisions of Taxpayer. This LOF also finds that Taxpayer's supporting documentation failed to demonstrate that the audit erred in reclassifying income it received from the non-unitary partnerships as nonbusiness income. However, Taxpayer's documentation demonstrated that the audit workpapers may contain errors in calculating the tax (apportionment factors). Finally, this LOF concludes that the audit properly declined Taxpayer's request to reclassify the bio-fuel credit claimed on its federal return as an Indiana business expense deduction. As explained in detail below, this LOF addresses each of the adjustments as follows:

A. 2008 Bonus Depreciation Subtraction.

The audit adjusted Taxpayer's 2008 bonus depreciation subtraction. The bonus depreciation subtraction is one of the modifications to Taxpayer's federal "taxable income" outlined in IC § 6-3-1-3.5. IC § 6-3-1-3.5 (b)(5), in relevant part provides:

> In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:
>
> . . .
>
>> (5) Add or subtract the amount necessary to make the adjusted gross income of any taxpayer that owns property for which bonus depreciation was allowed in the current taxable year or in an earlier taxable year **equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168(k) of the Internal Revenue Code to apply bonus depreciation to the property in the year that it was placed in service**. (**Emphasis added**).

The audit found that Taxpayer "reported a subtraction bonus depreciation adjustment" in its 2008 IT-20. The audit further noted that "2008 year was the initial year [Taxpayer] began filing an Indiana tax return. . . . [Taxpayer] did not previously make an addback adjustment to its Indiana adjusted gross income for which it now seeks to claim a subtraction adjustment." The audit explained that because Taxpayer did not file "an Indiana adjusted gross income tax return during the year in which bonus depreciation was first claimed for federal tax purposes. . . . [N]o bonus depreciation adjustment is possible for any asset which was first placed into service prior to the filing of the initial Indiana adjusted gross income tax return."

Taxpayer argued, in its December 19, 2013, protest letter, in relevant part, that:

> The code simply states that an adjustment should be made to adjusted gross income so that depreciation claimed would be on the basis as if bonus depreciation had never been claimed. In making this adjustment, the depreciation claimed on the Indiana return is something other than "equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168([k]) of the Internal Revenue Code to apply bonus depreciation to the property in the year that it was first placed in service."
>
> The calculation used to compute the amount of the Bonus Depreciation adjustment in the filed return for all three years was the same. The calculation started with depreciation as claimed on the Federal return and then adjusted for the effects of current year bonus depreciation and any adjustments required for prior year bonus depreciation to come up with the amount of depreciation that would have been claimed had bonus never been claimed. The difference between the filed return depreciation and the adjusted depreciation was entered as the Bonus Depreciation Adjustment for Indiana purposes. If we follow the auditor's logic, we would be precluded from any depreciation adjustment relating to assets placed in service prior to 2008. . . .

Taxpayer asserted that the audit erred in stating that the "[s]ubtraction adjustment can only be made when an addition adjustment was previously made in determining Indiana adjusted gross income during the year in which the asset was first placed into service."

Upon review, Taxpayer's point is well taken. For income tax purposes, similar to the federal rule, Indiana allows a corporate taxpayer to claim a deduction on property subject to depreciation. However, in adopting a straight-line depreciation rule, Indiana does not follow (or recognize) federal bonus depreciation deduction. As a result, a corporate taxpayer who filed a federal return and who is also required to file an Indiana return would have added back the "bonus depreciation" deduction in the year when the asset was first placed into service. Nonetheless, in computing the Indiana tax, IC § 6-3-1-3.5(b)(5) does not condition that this Indiana "depreciation deduction subtraction" is only performed when a taxpayer first made an addition modification to its federal taxable income for the bonus depreciation that was taken in the first year of service for the asset. This provision speaks for itself. Without specific statutory authority, the audit erred in making this adjustment.

Taxpayer's protest of the Department's adjustment to its 2008 bonus depreciation deduction subtraction is sustained. The Department will revise the audit adjustment in a supplemental audit review.

B. Income from Partnerships.

The audit noted that, for the tax years at issue, Taxpayer was a corporate partner of Partnerships. The audit also noted that Taxpayer included a proportionate share of income (or loss) it received from the Partnerships in the apportionment factors when it filed its Indiana returns for the tax years at issue. Upon further review, the audit determined that Taxpayer's business activities and the Partnerships' business activities were not unitary. Thus, the income (or loss) of the Partnerships is separately apportioned at the partnership's level and is not included with Taxpayer's other income activities pursuant to the Hunt decision and 45 IAC 3.1-1-153(c).

Throughout the protest, Taxpayer claimed that the audit erred in determining that no unitary relationship existed, but it provided no document to demonstrate otherwise. Without sufficient supporting documentation to show that Taxpayer's activities and the Partnerships' activities are unitary, the Department is unable to agree that the audit determination is incorrect.

Alternatively, Taxpayer also asserted that the Department's audit workpapers erred in calculating the Partnerships' apportionment factors. Taxpayer provided a summary sheet marked as "Exhibit B" with additional information contained in its "Dividend, Interest and Royalty Schedule" for the tax years at issue, to show the errors. The Department's Audit Division is requested to review this information and make any corrections it deems appropriate.

Taxpayer's protest of the audit's reclassification of its partnership income as income from non-unitary partnerships is denied. However, the Department's Audit Division is requested to review "Exhibit B" and correct any errors contained in the audit workpapers. Taxpayer's protest is sustained as to the Partnerships' apportionment factor calculations subject to the results of the supplemental audit determining that there were errors contained in the audit workpapers.

C. Foreign Disregarded Entities.

For the tax years at issue, Taxpayer's Indiana returns included the income/loss from three foreign entities. These three foreign entities have been treated as disregarded entities operating as divisions of Taxpayer for federal income tax purposes in Taxpayer's federal returns. For the tax years at issue, following its federal filings, Taxpayer reported these three entities as its three foreign branches ("Foreign Branches") in its Indiana returns; two of the Foreign Branches incurred substantial losses for the years at issue.

After reviewing Taxpayer's records, the audit proposed to exclude the business activities of the Foreign Branches from Taxpayer's federal taxable income and apportionment factors for the tax years at issue. The audit concluded that "the inclusion of the property, payroll, and sales data of the [F]oreign [B]ranches into the apportionment calculation results in [] unfair reflection of [Taxpayer's] activities within the State." The audit determined that including Foreign Branches in Taxpayer's Indiana returns distorts Taxpayer's income attributable to Indiana because the Foreign Branches' business activities were unrelated to Taxpayer's Indiana business activity.

The audit made the adjustment pursuant to IC § 6-3-2-2(l) (as in effect for the tax years at issue), which provides "[i]f the allocation and apportionment provisions . . . do not fairly represent the taxpayer's income derived from sources within the state of Indiana, . . . the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;
(2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Taxpayer objected to the Department's adjustment of excluding the Foreign Branches, claiming that it properly included the Foreign Branches under IC § 6-3-2-2. Taxpayer protested the Department's determination that inclusion of its Foreign Branches' business activities distorted Taxpayer's income that is apportioned to Indiana.

When "a corporation derives business income from sources both within and without Indiana the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co., 673 N.E.2d at 851. In addition, 45 IAC 3.1-1-62 requires that a corporation "doing business in more than one state shall use the allocation and apportionment provisions described in [IC §] 6-3-2-2(b)-(k). . . ." The taxpayer is thus required to use the standard formula to determine its business income apportioned to Indiana regardless of the specific sources of business income within or without Indiana. "[T]he Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states." Id. In making any assessment or adjustment, the Department must abide by the "reasonable" standard pursuant to IC § 6-8.1-5-1(b) and IC § 6-3-2-2(l).

IC § 6-3-2-2(l) provides the Department with discretionary authority to adjust the allocation and apportionment provisions of Taxpayer's adjusted gross income tax in order to arrive at an equitable and accurate allocation of Taxpayer's Indiana income. The purpose of the adjustments is to "fairly reflect . . . the income derived from sources within the state of Indiana . . . ." IC § 6-3-2-2(m). It is clear from the language in IC § 6-3-2-2(l) that the preferred method of filing returns is the standard apportionment or separate company filing method of representing a taxpayer's income derived from Indiana sources. Other methods of income allocation and apportionment should only be allowed when those provided for by IC § 6-3-2-2 do not fairly reflect Taxpayer's Indiana income.

Hence, the Department is allowed to use a reasonable alternative pursuant to a specific reasonable adjustment to correct a distortion in order to fairly reflect income/loss derived from Indiana source under IC § 6-3-2-2(l). A reasonable alternative is not required to be the best one among all, but must be "[f]air, proper or moderate under the circumstances." Black's Law Dictionary 1272 (7th ed. 1999). To that end, careful considerations on a case by case basis must follow. Accordingly, the question now becomes whether the Department has shown that an alternative method other than the standard apportionment method used by Taxpayer is required to fairly reflect the income Taxpayer reported as Indiana sources income.

The audit found that "inclusion of the [Foreign Branches] property, payroll, and sales into the apportionment calculation reduced the Indiana apportionment factor" substantially and summarily concluded that this was "distortive." The audit failed to explain how its proposed alternative would correct the distortion and would have more fairly reflected the Taxpayer's Indiana income. The audit stated that it "does not challenge the entity classification election of the [Foreign Branches]," but its proposed adjustments simply ignored the existence of the "entity classification election."

When an entity elected to be treated as disregarded, "its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner" unless special rules apply. Treas. Reg. § 301.7701-2(a). In the years prior to and during the audit, Taxpayer had been consistently filing its federal returns to include the business activities of the Foreign Branches as divisions of Taxpayer for several years. The audit did not find any changes, either voluntary or otherwise, in these classification elections for the tax years at issue. Nor did the audit determine that these elections were inappropriate. Thus, the Foreign Branches' business activities were and should have been reported in the same manner as branch or division of Taxpayer. Consequently, in the absence of the applicable special rules or additional circumstances showing the elections were inappropriate, Taxpayer properly included Foreign Branches in filing its Indiana returns for income tax purposes pursuant to the Indiana statutes and regulations.

While the audit report correctly noted that the inclusion of the Foreign Branches significantly reduced the amount of the income subject to tax in Indiana, based upon the facts presented there is little to indicate that the activities of the Foreign Branches constituted an abusive tax avoidance scheme such that the inclusion of the Foreign Branches did not "fairly reflect" Taxpayer's Indiana source income. Based upon the facts presented, the Foreign Branches incurs legitimate and reasonable expenses associated with its business activities. Based upon the facts presented, the Foreign Branches neither loan the money back to Taxpayer or its affiliates, nor return expenses back to Taxpayer or its affiliates in the form of dividends. Also, there is no indication that the Foreign Branches make unaccounted for "interest" or other payments to Taxpayer or its affiliates. Lastly, there is no indication that there are violations of the "matching principle" resulting from unrecognized streams of revenues and/or the expenses from the free use of the property developed by the Foreign Branches. Therefore, in this particular case, Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of demonstrating that the Department's decision excluding the Foreign Branches is incorrect.

Given the totality of the circumstances, the audit failed to demonstrate that an adjustment under IC § 6-3-2-2(l) was necessary to fairly reflect Taxpayer's income. Taxpayer's protest of this adjustment is sustained.

D. 2009 Bio-fuel Credit.

Taxpayer elected to claim a federal tax credit (bio-fuel production credit; the "Credit") against its federal tax liability in its 2009 federal income tax return. By electing to claim the Credit, Taxpayer was required to include the same amount of the Credit in its federal gross income pursuant to I.R.C. § 87. Consequently, Taxpayer's 2009 federal taxable income–the starting point to compute the Indiana income tax–increased.

During the audit, Taxpayer requested that the Department reclassify the Credit as an ordinary and necessary business expense. Taxpayer asserted that the Department should reclassify the Credit as an ordinary and necessary business expense to "fairly represent the income derived from source within . . . Indiana." The audit declined Taxpayer's request. Taxpayer protested the audit refusal.

Upon review, Taxpayer is mistaken. To compute a corporation's Indiana income tax "the term 'adjusted gross income' shall mean . . . the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted" by certain modifications. IC § 6-3-1-3.5(b). "[T]axable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction)." I.R.C. § 63. In this instance, when Taxpayer elected to claim the Credit in its 2009 federal return, it must include the same amount of the Credit claimed in its gross income under I.R.C. § 87. Without the statutory adjustments under IC § 6-3-1-3.5(b), Taxpayer's taxable income remained unchanged.

Taxpayer requested that the Department reclassify the Credit to fairly represent its income derived from Indiana. However, it failed to show that there were "distortive" circumstances which oblige the Department to do so. Taxpayer also referenced no statutory authority to reclassify the Credit as an allowable federal business expense deduction. Taxpayer neither offered supporting documentation to demonstrate that the Credit it claimed in its 2009 federal income tax return was inappropriate nor did it amend its 2009 return to correct any erroneous credits/deductions claimed or should have claimed. Pursuant to applicable statutes, Taxpayer must not include the expenses in its federal taxable income when it claimed the Credit and it must start with the federal taxable income to compute its Indiana tax. I.R.C. § 87; IC § 6-3-1-3.5(b). Given the totality of the circumstance, in the absence of other supporting documentation, the Department is not able to reclassify the Credit. The audit properly declined Taxpayer's request.

FINDING

Taxpayer's protest is sustained in part and is denied in part. Taxpayer's protest of Part I.A. regarding 2008 bonus depreciation modification is sustained. Taxpayer's protest of Part I.C. concerning the exclusion of its Foreign Branches is also sustained. Taxpayer's protest of Part I.B. regarding the audit reclassification of its income from the non-unitary partnerships is respectful denied. However, the audit may have erred in the calculation of the Partnerships' apportionment factors, and thus the Department's Audit Division will conduct a supplemental audit review of the calculations and make adjustments it deems appropriate. Finally, Taxpayer's protest of Part I.D. concerning the reclassification of the Credit is also respectfully denied.

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