DEPARTMENT OF STATE REVENUE

02-20140385.SLOF

Supplemental Letter of Findings: 02-20140385
Corporate Income Tax
For the Years 2009, 2011, and 2012

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HOLDING

Food manufacturer was entitled to include a related company in its consolidated return because the related company earned Indiana source income. However, interest income earned from "payment in kind" notes constituted business income because the notes were acquired as an integral part of the food manufacturer's business.

ISSUES

I. Corporate Income Tax - Consolidated Filing.

Authority: IC § 6-3-4-14; IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); 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); 45 IAC 3.1-1-111.

Taxpayer maintains that it is entitled to include a related entity in its consolidated income tax filings and that the Department's audit and administrative decisions removing the entity from the return were incorrect.

II. Corporate Income Tax - Business and Non-Business Income.

Authority: IC § 6-8.1-5-1(c); MTC Regs. IV.1.(c)(3); Letter of Findings 02-20140385 (October 20, 2014).

Taxpayer states that interest income earned on "payment in kind" notes, received as partial proceeds from the sale of its grain elevator operation, is non-business income and that the audit and administrative decisions to the contrary were both wrong.

STATEMENT OF FACTS

Taxpayer is in the business of producing and packaging food products. Taxpayer operates multiple business locations within Indiana and outside Indiana. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional corporate income tax for the years 2009, 2011, and 2012. No assessment was made for the year 2010.

Taxpayer disagreed with a portion of the audit assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. Letter of Findings 02-20140385 (October 20, 2014), 20141231 Ind. Rev. 045140487NRA ("LOF"), was issued in which Taxpayer's protest was sustained in part and denied in part. Taxpayer disagreed with that portion of the LOF denying its protest and requested a rehearing on the remaining disputed issues. An administrative rehearing was conducted during which Taxpayer's representatives further explained Taxpayer's arguments. This Supplemental Letter of Findings ("SLOF") results and incorporates by reference the applicable statement of facts and law established in the LOF.

I. Corporate Income Tax - Consolidated Filing.

DISCUSSION

The LOF determined that one of Taxpayer's related companies - here designated as "Food Entity" - should not be included in Taxpayer's consolidated Indiana income tax return. The issue is whether the LOF erred and that the

Food Entity should have been included in the tax return.

As in the original LOF, it remains the Taxpayer's responsibility to establish that the existing tax assessment is "wrong." 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). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, in the original LOF as well as the preceding audit, are entitled to deference.

Taxpayer filed consolidated income tax returns. In those returns, Taxpayer included Food Entity. According to the audit report:

> Following the sales of the trading and merchandising operations in FY 2009, [Food Entity] no longer has Indiana property, payroll or sales for the fiscal years 2011 and 2012. Because of this [Food Entity] can no longer be included in the Indiana consolidated IT20 return as it no longer has "adjusted gross income derived from sources within the state."

The audit report also stated:

> The Taxpayer in an effort to show that [Food Entity] does business in Indiana provided documentation to show its employees visiting the Indiana plants providing services to affiliates doing business in Indiana. It appears that such services are part of its oversight as the parent company. It is noted that such oversight duties are mostly performed at its head office [outside Indiana]. It is the opinion of this audit that the oversight activities performed in Indiana are d[e] minimus and would not be enough to create an income tax-filing requirement in Indiana.

As authority for its decision, the audit report cited to the Department's regulation, 45 IAC 3.1-1-111 which states:

> The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state, as that phrase is defined in IC 6-3-2-2. For purposes of this subsection, "Adjusted Gross Income derived from sources within the state" means either income or losses derived from activities within the state. (Emphasis in original report).

The relevant statute is IC § 6-3-4-14 which provides in part:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.
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> (b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana. (Emphasis added).

During the administrative rehearing, Taxpayer restated its argument that Food Entity performs services in Indiana, that Food Entity is paid revenue attributable to those services, and that Food Entity's activities "create nexus with Indiana for income tax reporting purposes . . . ."

Taxpayer pointed out that Food Entity performs management services at business locations in Indiana and in other states and that Food Entity earned in excess of 10 million dollars during 2011 and 2012 for performing those services throughout the country. Taxpayer calculated that Food Entity earned a portion of that income attributable to work performed in Indiana and has submitted calculations detailing the means by which it attributed a portion of that service income to Indiana. Taxpayer's explanation follows:

> There were documented a total of 129 work days in Indiana during the 5/2011 tax year, and 123 work days in Indiana during the 5/2012 tax year. Considering that there are only 250 total potential work days in a calendar year . . . 129 and 123 work days respectively equates to 51.6[percent] and 49.2[percent] of the total potential work days in a year - if each Indiana work day occurred on a separate calendar day.
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> Alternatively, sourcing service revenues based on the respective 129 and 123 days worked in Indiana divided by the total potential work days of all employees in each year, results in management fees earned . . . in Indiana of $334,520 in 5/2011 and $308,168 in 5/2012.

However as to the Indiana management fees earned by Food Entity, and as explained in its original protest letter, "intercompany revenues are ultimately eliminated in consolidation for apportionment calculation purposes."

Based on the documentation Taxpayer provided at the time the rehearing was requested, on Taxpayer's explanation of the documentation, and on the detailed and reasonable apportionment of the service income to Indiana, and on the fact that Food Entity's Indiana activities exceeded the de minimis standard, Taxpayer has met its burden of establishing that Food Entity should have been included in the consolidated return.

FINDING

Taxpayer's protest is sustained.

II. Corporate Income Tax - Business and Non-Business Income.

DISCUSSION

Taxpayer continues to argue that interest income derived from Payment in Kind ("PIK") notes received from the voluntary divestiture of Taxpayer's grain operation constitutes non-business income. As noted above, IC § 6-8.1-5-1(c) requires Taxpayer to establish that the proposed assessment was wrong.

Taxpayer does not disagree with the legal standard set out in the October LOF but disagrees with the interpretation and application of that standard.

The underlying transactions are explained in the October 20, 2014, LOF.

> Taxpayer operated three major business segments. Included in one of the three business segments was a business here referred to as "Merchandising Business." Merchandising Business was previously engaged in domestic and international grain merchandising, fertilizer distribution, agricultural and energy commodity trading and services, and grain, animal and oil seed byproduct merchandising and distribution. Merchandising Business was also involved in the natural gas and crude oil business.
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> In fiscal year 2009, Taxpayer sold its Merchandising Business which was accomplished in a series of stock transactions treated as the sale of assets. Taxpayer received cash, four year "payment in kind" (PIK) notes, a short term note, and a four year warrant to acquire equity of the Merchandising Business buyer. The PIK notes were issued to Taxpayer as partial compensation for the sale of grain elevators included in the overall 2009 divestiture.
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> Taxpayer earned interest income from the PIK notes. In its original tax return, Taxpayer declared the PIK interest income as non-business income on the ground that it is not in the business of investing in PIK notes or of selling interests in grain elevators. According to the audit report, Taxpayer argued that the acquisition of the PIK notes is a non-business activity under the functional test.
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> Taxpayer also asserts that the interest from the PIK notes is entitled to non-business income treatment under the transactional test because the sale of the grain elevators and the acquisition of notes receivable were not in the regular course of Taxpayer's food production and food packaging business.

As noted in the LOF, Taxpayer continues to maintain that the "original divestiture of the grain elevators was an extraordinary event - outside of normal business operations." Taxpayer concedes that because its grain elevator business had been operated as a part of its business up until the divestiture, "[T]he gain on the grain elevators was considered business income under the functional test" but that the "PIK Notes that were received as sales proceeds - in an extraordinary transaction - were assets a step further removed from the grain elevator operations."

Taxpayer concludes that "[t]he PIK notes were only held as investments and had no operational connection to the normal ongoing business operations" and that interest earned on the PIK notes "is nonbusiness income under both the transactional and functional test." As Taxpayer explains:

> The Taxpayer's frustrations regarding this issue relate to the auditor and the hearing officer affirmatively conflating the sale of the trading business with income received from the [PIK] notes which constituted consideration for the sale of the trading business.

Taxpayer challenges the LOF's statement that "[t]he Taxpayer buys and sells businesses all the time and therefore, under the functional test, they should be considered business income." In addition, Taxpayer states that the PIK notes were received as partial sales proceeds from the disposition of the grain elevator business and that "the activities of the parent have no relevance to [Merchandising Business] especially when the parent company has been removed from the consolidated Indiana return."

Taxpayer concludes that "[s]ubsequent to the consummation of the divestiture, the prior grain elevator business is **not unitary** with the ongoing operations in Indiana, and therefore the subsequent interest earned on the [PIK] Notes is not apportionable by Indiana." (**Emphasis in original**). However, the Department questions whether the unitary principle is relevant in determining whether or not the money earned from the PIK notes constitutes business or non-business income.

Taxpayer points to the relatively complex nature of the series of transactions which disposed of its grain elevator business and by which it acquired the PIK notes. Taxpayer attempts to distance the original sales transaction from the money earned from the PIK notes. However, the Department continues to agree with the analysis set out in the audit report:

> The exchange of the PIK notes and the [Merchandising Business assets] should be viewed under the overall package of the sales of the [Merchandising Business]. The Taxpayer buys and sells businesses all the time and therefore, under the functional test, [the exchange of PIK notes] should be considered business income. Since the PIK notes were acquired in the regular course of the Taxpayer's trade or business, it is considered a business asset whose income would be considered business income . . . It appears that when a business asset that produces business income when exchanged for another income-producing asset such as a note receivable, such asset and the income it produces should also be considered business income.

Although concededly not dispositive of the issue because Indiana is not a member of the Multistate Tax Commission ("MTC"), the Department again cites as "squarely on point" an MTC regulation which provides:

> Interest income is business income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business operations or where the acquiring and holding the intangible is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations. MTC Regs. IV.1.(c)(3).

This SLOF will not repeat the analysis set out in the October LOF but - for purposes of this SLOF - adopts the reasoning, facts, and analysis contained in that document. The Department continues to disagree with Taxpayer's reasoning that the money earned from the sale of the grain elevator business is substantively distinguishable from money earned as a result of investing those proceeds. The Department repeats its decision that the PIK interest income is properly classified as business income because the "underlying intangible was acquired, maintained, and disposed of as an integral part of Taxpayer's trade or business."

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer met its burden of establishing that Food Entity should have been included in the Taxpayer's consolidated return. Interest income derived from Taxpayer's PIK notes was properly classified as business income.

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