DEPARTMENT OF STATE REVENUE

02-20150326.LOF

Letter of Findings: 02-20150326
Corporate Income Tax
For Years 7/31/2011, 7/31/2012, and 7/31/2013

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Companies consented to file on a consolidated basis for both federal and Indiana income tax purposes were liable for additional income tax because Companies were not entitled to deduct gains recognized by members of the group for the years 7/31/2011, 7/31/2012, and 7/31/2013.

ISSUE

I. Corporate Income Tax - Imposition.

Authority: I.R.C. § 63; I.R.C. § 1502; I.R.C. § 1504; Treas. Reg. § 1.1502-13; IC § 6-3-1-3.5; IC § 6-3-1-11; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); 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 Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Miller Brewing Co. v. Indiana Dep't of State Revenue, 903 N.E.2d 64 (Ind. 2009); Cooper Indus., Inc. v. Indiana Dep't of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-110; 45 IAC 3.1-1-111; 45 IAC 3.1-1-112.

Taxpayer claimed that the Indiana Department of Revenue erred in disallowing the deductions attributable to its intercompany transactions.

STATEMENT OF FACTS

Parent and its subsidiaries, which includes Taxpayer, are companies in the business of renting and leasing vehicles. For federal corporate income tax purposes, Parent and its subsidiaries file the federal income tax returns on a consolidated basis ("federal consolidated group"). The federal consolidated group filed a federal Form 3115 ("Application for Change in Accounting Method"), effective August 1, 2008, for intercompany transactions that occurred among the federal consolidated group.

Taxpayer, a wholly-owned subsidiary of Parent, began doing business in Indiana in August 2008. Taxpayer elected to file its Indiana corporate income tax return on a separate single entity basis until July 31, 2010. Similarly, some of its affiliates also conducted business in Indiana during those years and each elected to file its own separate Indiana corporate income tax return reporting its Indiana income tax separately until July 31, 2010, at which time a merger resulted in corporate restructuring.

After the merger, beginning August 1, 2010 (FYE 7/31/2011), Taxpayer and three of its wholly owned subsidiaries ("Sub A," "Sub B," and "Sub C"; collectively "Subs") that conducted business in Indiana elected to file the Indiana corporate income tax return on a nexus consolidated basis for Indiana corporate income tax purposes. Sub A is a management company. Sub B is an insurance company. Sub C is a service company.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer's corporate income tax returns and business records for FYE 7/31/2011, FYE 7/31/2012, and FYE 7/31/2013 ("Tax Years at Issue"). Pursuant to the audit, the Department made various adjustments on the consolidated returns for Tax Years at Issue, which resulted in an additional Indiana corporate income tax.

Taxpayer timely protested the audit assessment. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Corporate Income Tax - Imposition.

DISCUSSION

After reviewing Taxpayer's Indiana consolidated returns and business records for the Tax Years at Issue, the Department determined that Taxpayer erroneously claimed several deductions under "foreign source dividends/other deductions." One of the deductions was denoted by Taxpayer as a deduction for "deferred intercompany transactions adjustment." The Department's audit report noted, in relevant part, as follows:

> [T]axpayer had made adjustments to gross receipts under "foreign source dividends/other deductions" to reduce Indiana income in all three years of the audit period. One of the adjustments on this line was for "deferred intercompany transactions adjustment." This adjustment relates to a change in accounting method for intercompany transactions among the Parent Company and its Subsidiaries and reported on Federal Form 3115, "Application for Change in Accounting Method." This change in accounting method became effective after [T]axpayer's year ended July 31, 2008. [T]axpayer made this adjustment under the assumption that Indiana did not adopt the Federal Regulation (Treas. Reg. [§] 1.1502-13) to recognize the change in accounting method. [T]axpayer's assumption was incorrect because Indiana's Corporate Adjusted Gross Income Tax Return begins with Federal Taxable Income before the Federal NOL and special deductions with adjustments made in accordance with the guidelines prescribed under IC [§] 6-3-1-3.5 (b)(1) through (18), taxable income of corporations. The guidelines for adjustments to Indiana income under (1) through (18) does not mention the disallowance of accounting change for intercompany transactions. Therefore, the deduction has been disallowed . . . .

The audit's disallowance of the above deduction resulted in additional income subject to Indiana income tax for the Tax Years at Issue.

Taxpayer stated that it agrees that Indiana follows federal Treas. Reg. § 1.1502-13. Taxpayer however disagrees with the above-mentioned audit adjustment, arguing that it was entitled to deduct the gains from the intercompany transactions under Treas. Reg. § 1.1502-13(c)(7)(ii), matching rule, for the Tax Years at Issue. Taxpayer claimed that the audit's disallowance of that deduction resulted in taxing the same income which was previously reported in Indiana returns which it filed on the separate single entity basis. Taxpayer therefore objected to the audit's disallowance of that deduction, claiming the disallowance is double taxation.

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). "Each assessment and each tax year stands alone." Miller Brewing Co. v. Indiana Dep't of State Revenue, 903 N.E.2d 64, 69 (Ind. 2009). 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); 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 to 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 the adjusted gross income tax of every corporation that conducts business in Indiana or has income derived from Indiana. IC § 6-3-2-1(b); IC § 6-3-2-2. 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. Caterpillar, Inc., 15 N.E.3d at 581. Specifically, Indiana follows the cardinal tax principles established in the federal law. IC § 6-3-1-11. Indiana statutes refer to the Internal Revenue Code to efficiently and effectively compute what is considered the taxpayer's Indiana income tax. IC § 6-3-1-3.5(b) 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.

A corporate taxpayer, in general, files its Indiana corporate income tax return reporting its apportionable income to Indiana pursuant to IC § 6-3-2-2, also known as standard apportionment based on a single entity return. If the taxpayer and also its affiliates all have income derived from sources within Indiana, they may elect to report their apportionable income as a group on a consolidated basis pursuant to IC § 6-3-4-14(a), which in relevant part provides "[a]n affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3." Indiana adopts the definition of "affiliated group" outlined in I.R.C. § 1504 with one condition that the entities (namely, members of the affiliated group) must have "adjusted gross income derived from sources within Indiana" under IC § 6-3-2-2. IC § 6-3-4-14(b). That is, only when all entities have "either income or losses derived from activities within" Indiana, are they eligible to exercise the privilege to make such an election. IC § 6-3-4-14(a); 45 IAC 3.1-1-111.

To exercise the privilege of filing as a consolidated group, IC § 6-3-4-14(a) further requires that all "members of the affiliated group [must] consent . . . 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 . . . ." Thus, when a consolidated return is filed prior to the last day prescribed by law for the filing of such return, all members of that affiliated group in that consolidated return are deemed to consent to file on a consolidated basis. 45 IAC 3.1-1-110. "Once an election is made to file consolidated, a taxpayer must obtain written permission from the Department to change from this method of reporting." Id. When members of an affiliate group choose to file separately on one type of tax but not the other, the burden will be on each of the taxpayers to demonstrate that they correctly report and remit the taxes. 45 IAC 3.1-1-112.

When an Indiana consolidated return is filed, IC § 6-3-4-14(c) states:

> For purposes of IC 6-3-1-3.5(b), the determination of "**taxable income**," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, **both during and after the period of affiliation**, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code. (**Emphasis added** and footnote omitted).

Accordingly, a corporate taxpayer may file with its parent and affiliates on a consolidated basis for federal income tax purposes. For Indiana income tax purpose, however, each member of the federal consolidated group may choose to file its own return separately (on a single entity basis) for the same tax year regardless of their eligibility to file as a consolidated group. When they are eligible and consent to file an Indiana corporate income tax return on a consolidated basis, Indiana follows the applicable federal rules to determine taxable income concerning the consolidated group - both during and after the period of affiliation - subject to Indiana corporate income tax. Notably, one of the tax advantages of filing on a consolidated basis is the ability to defer the recognition of certain gain (or loss), and therefore defer the recognition of taxable income, attributable to intercompany transactions among members of the consolidated group pursuant to Treas. Reg. § 1.1502-13. "An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction." Treas. Reg. § 1.1502-13(b)(1)(i). The regulation emphasizes single-entity treatment. Treas. Reg. § 1.1502-13(a)(2). Each transaction is generally required to be analyzed separately. Treas. Reg. § 1.1502-13(b)(1)(iii). Additionally, if a transaction occurs between two related entities which are members in part and non-members in part, some adjustments are required, which include dividing the transaction into two separate transactions to reflect the transactions between the two entities pursuant to Treas. Reg. § 1.1502-13(b)(1)(ii).

Treas. Reg. § 1.1502-13(a)(2) further explains in relevant part as follows:

> Under this section, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The amount and location of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The timing, and the character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

"S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items." Treas. Reg. § 1.1502-13(b)(2)(i). "B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items." Treas. Reg. § 1.1502-13(b)(3)(i). The timing rules are considered as "a method of accounting for intercompany transactions . . . ." Treas. Reg. § 1.1502-13(a)(3).

During the protest process, Taxpayer in this instance argued that it was entitled to deduct gains recognized from the intercompany transactions (as deferred taxable income) for the Tax Years at Issue on the ground that those gains were previously reported in their Indiana returns - although reported as separate return basis - when they filed their Indiana corporate income tax returns for FYE 7/31/2008, FYE 7/31/2009, and FYE 7/31/2010. Taxpayer argued that it "is being double taxed on certain intercompany income items in the state of Indiana because it switched from filing separate Indiana returns to a consolidated Indiana return." Taxpayer referenced Cooper Indus., Inc. v. Indiana Dep't of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct. 1996), to support its protest, explaining in part, as follows:

> [Taxpayer and its affiliates which conducted business in] Indiana filed separate Indiana returns in prior years. In these prior years [Taxpayer and its affiliates which conducted business in Indiana] correctly adjusted its federal taxable income to include income items that were deferred for federal income tax purposes because a consolidated return was filed for federal tax purposes.
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> Once [Taxpayer and its affiliates which conducted business in Indiana] elected to file an Indiana consolidated return, income items that were previously reported in the separate returns filed in earlier years should be excluded to arrive at federal taxable income in consolidated return years when applying the federal consolidated return regulations. As the auditor points out, Indiana follows the federal consolidated return regulations. Those very regulations only require that prior year income items be recognized ONLY IF THEY WERE DEFERRED IN PRIOR YEARS. Thus, for Indiana consolidated return purposes, income items that were NOT deferred in prior years do NOT have to be recognized in a consolidated return year in applying the federal consolidated return regulations. . . .

(EMPHASIS in original).

Taxpayer further offered the merger documents and an example to illustrate the accounting method which it used to support the amount of the "income" that it claimed should be the "deferred income in reverse" for the Tax Years at Issue. Taxpayer further stated that "[d]ue to software limitations and the sheer volume of units involved, the tracking of individual units already recognized for Indiana purposes is not practical. [Taxpayer] proposes reversing the net [] of income already recognized for state purposes over 5 years MACRS depreciation rates. . . ."

Upon review, however, Taxpayer is mistaken. This Letter of Findings first notes that without the source documentation to support Taxpayer's "deferred income in reverse," the following discussion only addresses Taxpayer's arguments in theory. Similar to federal income tax scheme, Indiana establishes various filing statuses which taxpayers may elect in reporting Indiana income. Each filing status, such as separate single entity, consolidated, or combined, affords different tax advantages pursuant to policy considerations. When a taxpayer elects to file one status over the other, the taxpayer must adhere to the statutorily required steps to compute taxable income for that status. Corporate taxpayers which have Indiana source income may choose to file on separate single entity basis, on a consolidated basis, or on a combined basis to claim certain benefits. When taxpayers make elections, rules apply to that tax year when the election was made and going forward.

In this instance, although Taxpayer and its Indiana affiliates were members of the federal consolidated group and had been filing their federal returns with Parent on a consolidated basis as of August 2008, Taxpayer chose to file its own Indiana income tax returns separately for the years 7/31/2008, 7/31/2009, and 7/31/2010 for Indiana corporate income tax purposes; as did each of its affiliates conducting business in Indiana. By doing so, each entity claimed its deductions, exemptions, and credits separately when filing its Indiana return pursuant to IC § 6-3-2-2. In other words, Taxpayer elected to file Indiana returns separately for the prior non-audited years. Since Taxpayer did not "consent" to file on a consolidated basis for the prior non-audited years, it was not a member of a consolidated group for Indiana corporate income tax purposes. Even assuming that the federal rules of change of accounting method govern prior filings, Taxpayer here must amend its prior Indiana filings to properly apply the applicable federal rule because each tax year stands alone. Taxpayer is not allowed to reverse its computation of the "deferred income" which it claimed it added back in its Indiana filings previously. For the Tax Years at Issue, when Taxpayer and Subs met the statutory requirements and consented to file their Indiana corporate income tax return on a consolidated basis beginning August 2010, the federal rules regarding consolidated group, which include Treas. Reg. § 1.1502-13, became applicable going forward. Pursuant to IC § 6-3-4-14(c), the relevant federal rules apply to Taxpayer and Subs as a consolidated group to determine their taxable income, the rules do not apply in reverse to arrive at the result which Taxpayer now desired. Thus, the audit properly disallowed Taxpayer's claim of the deferral in reverse.

Taxpayer's reliance on Cooper Indus., Inc. v. Indiana Dep't of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct.

1996), is also misplaced. In Cooper, the petitioners, Cooper Industries Inc. and affiliates, filed federal corporate income tax returns on a consolidated basis, and consistently filed their Indiana corporate income tax returns on a combined basis for the tax years (1985 through 1988) because they conducted their Indiana business operation as a unitary group. Id. at 1210. By filing on a combined basis, the petitioners aggregated "their earnings before apportionment." Id. The Department determined that the petitioners had "excess loss account" income stemmed from two subsidiaries, which was subject to Indiana income tax "for the purpose of their 1988 Indiana income taxes." Id. at 1211-12. The court explained that "the issue is not what number appears on line 28 of a taxpayer's federal income tax form 1120 but whether a particular item of income was included in taxable income pursuant to I.R.C. § 63." Id. at 1213. The court concluded that "Indiana refers to I.R.C. § 63 defined taxable income not as reported taxable income." Id. The court explained that the excess loss account adjustment was not an adjustment made at arriving at section 63 taxable income, but was instead an adjustment required in arriving at consolidated taxable income under Treas. Reg. § 1502. Id. The court concluded that the consolidated return regulations were not applicable to the petitioners because it had filed on a combined, not consolidated, basis. Id.

Notably, the petitioners in Cooper did not change their accounting method, nor did they have any issues of intercompany transactions pre-merger and post-merger. Rather, the petitioners in Cooper consistently filed their federal returns as a consolidated group and also consistently filed their Indiana corporate income tax returns on a combined basis. The court concluded that the rules governing consolidated groups thus did not apply. That is not the case here. As mentioned above, Taxpayer here conducted its business in Indiana since August 2008–the year it filed with the federal consolidated group for federal income tax purposes. Taxpayer however elected to file its Indiana corporate income tax returns on a separate entity filing basis for the same year until July 31, 2010. Not until after the merger, did Taxpayer and Subs consent to file on a nexus consolidated basis for Indiana corporate income tax purposes beginning August 2010. Thus, Taxpayer's reliance of Cooper is misplaced.

In short, the Department is not able to agree Taxpayer's interpretation of Treas. Reg. § 1.1502-13(c)(7)(ii), matching rule. Taxpayer consented to file the Indiana return on the consolidated basis beginning August 2010 and the federal rules of the consolidated group apply "during and after the period of affiliation." Thus, the audit correctly adjusted Taxpayer's returns for the Tax Years at Issue pursuant to IC § 6-3-1-3.5(b).

FINDING

Taxpayer's protest is respectfully denied.

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