DEPARTMENT OF STATE REVENUE

02-20160014.LOF

Letter of Findings: 02-20160014
Corporate Income Tax
For the Tax Year 2013

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Tobacco Manufacturer was not permitted to utilize an alternative income apportionment formula; the statutory single-factor sales apportionment formula fairly reflected business's Indiana source income.

ISSUE

I. Corporate Income Tax–Fairly Reflect Indiana Source Income.

Authority: IC 6-3-2-2; IC § 6-8.1-5-1; Hans Rees' Sons v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931); Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978); Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980); 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); Dep't of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); 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); Bd. of Comm. of Howard County v. Kokomo City Plan Comm., 263 Ind. 282, 286-87 (Ind. 1975); 45 IAC 3.1-1-62; Letter of Findings 76-20060230 (January 2007); Frank H. Easterbrook, Presidential Review, 40 Case W. Res. L. Rev. 905 (1989).

Taxpayer protests the Department's denial of its request to apply an alternative, three-factor apportionment formula in order to determine its Indiana source income.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation that manufactures and sells tobacco products across the United States, including Indiana. Taxpayer's manufacturing, distribution facility and personnel are located almost entirely in another state. Taxpayer utilizes independent third-party shippers to transport its products to public warehouses throughout the country, but Taxpayer maintains ownership of the inventory stored in the public warehouses. One such warehouse is located in Indiana, and the inventory in this warehouse represents a small percentage of Taxpayer's total property. Taxpayer has no employees located in the state of Indiana.

In October 2014, during the course of an audit conducted by the Indiana Department of Revenue ("Department") for tax years 2011, 2012 and 2013, Taxpayer petitioned the Department to apportion its business income using an alternative to the statutory single-factor sales apportionment formula for the tax year ending December 31, 2013. Taxpayer requested permission to use a three-factor, equally weighted property, payroll and sales apportionment formula. Taxpayer's rationale for the request is due to the fact that Taxpayer has no employees and minimal property in Indiana, thus it argues that the majority of its income-generating activity occurs primarily outside of Indiana in one state.

The Department denied Taxpayer's request for alternative apportionment in a letter dated January 7, 2015. Nevertheless, on January 16, 2015, Taxpayer filed an amended 2013 Indiana Corporate Adjusted Gross Income Tax Return utilizing the alternative apportionment method previously denied by the Department, and requested a refund of $11,826,420. As part of the October 2014 audit, the Department again denied Taxpayer's request to utilize an alternative apportionment formula and the related claim for refund.

Taxpayer filed the instant protest challenging the audit's adjustment to Taxpayer's 2013 amended corporate income tax return to apply the statutory income apportionment formula. An administrative hearing was held at which Taxpayer explained the basis of its protest. This Letter of Finding results addressing Taxpayer's argument

that it should be entitled to utilize an alternative apportionment method. Additional facts will be addressed below as necessary.

I. Corporate Income Tax–Fairly Reflect Indiana Source Income.

DISCUSSION

As a threshold issue, it is the 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). Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Ind. Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Ind. Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

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.'" Dep't 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, as well as the preceding audit, shall be entitled to deference.

There are two relevant measures for determining the appropriateness of a state's income apportionment formula, one that looks to the state apportionment statute itself and the other that applies a U.S. Constitutional standard. In Indiana, Taxpayer must utilize the statutory single-factor sales formula unless the Department or Taxpayer can show that the standard formula does not fairly reflect the taxpayer's income apportioned to the state.

A. Indiana Statutory Standard

The first standard for determining whether a taxpayer is entitled to use an alternative apportionment formula is that adopted by the Indiana legislature, which is whether application of the statutory apportionment formula "fairly represents" taxpayer's income derived from the state.

IC 6-3-2-2(l) provides:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (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.

(**Emphasis added**).

45 IAC 3.1-1-62 further provides:

> All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37--45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the 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. **It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results**. (**Emphasis added**).

The Supreme Court has repeatedly held that a single-factor apportionment formula is presumptively valid, and has specifically held that a single-factor sales formula is valid. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273-282

(1978). The Supreme Court further acknowledged,

> States have wide latitude in the selection of apportionment formulas and that a formula-produced assessment will only be disturbed when the taxpayer has proved by "clear and cogent evidence" that the income attributed to the State is in fact "out of all appropriate proportion to the business transacted . . . in that State," [Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,] 283 U.S. at 135, or has "led to a grossly distorted result," [Norfolk & W. Ry. Co. v. Mo. State Tax Comm.,] 390 U.S. at 326. Moorman, 437 U.S. at 274.

Thus, there is a presumption that Indiana's apportionment statute is valid, and Taxpayer is required to prove that Indiana's statutory apportionment formula does not fairly represent the extent of Taxpayer's level of activity in this state in order to justify applying an alternative, multi-factor formula under IC § 6-3-2-2(l)(3).

The Supreme Court in Moorman recognized that use of an apportionment formula, as opposed to separate accounting, "does not purport to identify the precise geographical sources of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State. The single-factor formula . . . generally will not produce a figure that represents the actual profits earned within the State." 437 U.S. at 273. The Court went on to acknowledge that this fact is also true of three-factor formulas, and that both single-factor and multi-factor formulas "will occasionally over-reflect or under-reflect income attributable to the taxing State." Id. The Court concluded that this imprecision does not invalidate the use of a single-factor formula. Id.

Taxpayer provided a third-party economic analysis that purports to show that Indiana's statutory apportionment formula, which considers only sales to customers in Indiana, does not fairly represent Taxpayer's Indiana income. However, the expert report essentially states that, because Taxpayer's property, payroll, and manufacturing are located outside of Indiana, the single-factor sales formula does not reflect Taxpayer's income-generating activities in Indiana. In 2006, the Indiana General Assembly amended its statutory apportionment formula to gradually phase out its equally-weighted three-factor property, payroll, and sales formula to a single-factor sales formula that fully went into effect in 2011. This shift to a single-factor sales formula is a recognition that sales, and where those sales occur, is now a better representation of a taxpayer's net income from a particular state. Inherent in this change is the fact that Indiana would no longer consider the property and payroll factors for any multi-state taxpayer, and that it would result in an increase in tax liability for some taxpayers and a decrease for others. This does not, by itself, show that Indiana's apportionment formula does not fairly represent Taxpayer's Indiana income.

Taxpayer attempts to show that application of the single-factor sales formula overstates its Indiana income by comparing the results to an "economically appropriate" apportionment formula. Upon review, Taxpayer's report only shows that a different, lower apportionment percentage would result from a multi-factor formula as compared to a single-factor formula, not that the formula it considers "economically appropriate" would more accurately reflect Taxpayer's Indiana income. As stated in Moorman, the use of apportionment formulas, by their nature, provide only a "rough approximation" of income related to activities in the taxing state, and comparing the results of different formulas is not sufficient to prove that the single-factor sales formula does not fairly attribute Taxpayer's income to this state.

Taxpayer provides a "separate accounting" analysis to purportedly show that the single-factor sales formula overstates its Indiana income. Taxpayer starts with the premise that the Indiana apportionment formula, applied to Taxpayer's overall taxable income, results in an amount equal to 29 percent of its sales in Indiana. Taxpayer refers to a transfer pricing analysis in its expert report in an attempt to show that this figure is equivalent to the "rate of return on sales from [Taxpayer's] income-generating activities in Indiana" and argues that "[t]his percentage accurately and fairly reflects income from activities in Indiana only if an arms-length agreement between [Taxpayer] and a third party would result in a commission of 29 percent of sales."

Taxpayer refers to the use of the Comparable Uncontrolled Services Price method to do its separate accounting analysis. However, the Comparable Uncontrolled Services Price method is not applicable to this analysis, as this is not an issue involving combined reporting. Consideration of a "hypothetical transfer pricing agreement" and an "arm's length royalty rate" are irrelevant, as the Department is not seeking to allocate income from an affiliate to Taxpayer. The analysis provided by Taxpayer is not a separate accounting analysis, which would identify the precise geographical source of Taxpayer's profits. Even if Taxpayer had made such a showing, it does not necessarily follow that income should be allocated to the states Taxpayer identifies as the geographic source of its profits, and Taxpayer's income would still be subject to fair apportionment in accordance with Indiana statute. See Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 229-230 (1980).

Taxpayer has not proven that the Indiana statutory apportionment formula does not fairly represent Taxpayer's income derived from sources within the state of Indiana. Because of the state's "wide latitude in the selection of apportionment formulas," the Department concludes that Indiana's statutory apportionment formula fairly represents Taxpayer's Indiana income.

B. U.S. Constitutional Standard

The second, higher standard for determining the validity of a state's apportionment formula under the Commerce Clause and the Due Process Clause is whether that formula yields a result that is "out of all appropriate proportion to the business transacted by the [taxpayer] in that State." Moorman, 437 U.S. at 274 (quoting Hans Rees' Sons v. North Carolina ex rel. Maxwell, 283 U.S. 123, 135 (1931)).

With respect to Taxpayer's argument that application of the statutory single-factor sales formula does not meet U.S. Constitutional standards, the Department once again declines to make this determination. In general, the Department of Revenue is not the best forum in which to evaluate a constitutional question. Of course, every departmental employee, and every member of the executive branch, has an inherent responsibility to construe and interpret the constitution as it bears on the exercise of his responsibilities. See generally Frank H. Easterbrook, Presidential Review, 40 Case W. Res. L. Rev. 905 (1989).

Nevertheless, "all statutes are presumptively rational and constitutional." Bd. of Comm. of Howard County v. Kokomo City Plan Comm., 263 Ind. 282, 286-87 (Ind. 1975). As a result, as a practical matter, the Department of Revenue usually denies challenges to a statute's constitutionality. In one typical decision, the Department concluded the following: "The Department takes note of Taxpayers' constitutional and statutory protests. However, Taxpayers raise issues which are beyond the purview of administrative review by the Department. Taxpayers' constitutional challenges will not be addressed here because the Department will not overturn a tax scheme enacted by the Indiana General Assembly based upon Taxpayers' facial constitutional and statutory challenges." Letter of Findings 76-20060230 (January 10, 2007), 20070328 Ind. Reg. 045070178NRA.

FINDING

Taxpayer's protest is respectfully denied.

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