**DEPARTMENT OF STATE REVENUE**

02-20180638.SLOF

**Supplemental Letter of Findings: 02-20180638**
**Corporate Income Tax**
**For the Years 2011 through 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Supplemental Letter of Findings.

## HOLDING

On rehearing, Indiana Manufacturing Company again failed to demonstrate that it was entitled to deduct interest expenses from income earned in Indiana because the underlying loan transactions with its parent company did not constitute bona fide debt for Indiana income tax purposes.

## ISSUE

### I. Corporate Income Tax - Interest Expense Deduction.

**Authority**: IC § 6-3-2-2(m); IC § 6-8.1-5-1(c); *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Miller Brewing Co. v. Indiana Department of State Revenue*, 903 N.E.2d 64 (Ind. 2009); *E.I. DuPont De Nemours and Company v. Indiana Department of State Revenue*, 79 N.E.3d 1016 (Ind. Tax Ct. 2017); *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); *Bethlehem Steel Corp. v. Ind. Dept. of State Revenue*, 597 N.E.2d 1327 (Ind. Tax Ct. 1992);*Winn-Dixie Stores, Inc. v. C.I.R.*, 254 F.3d 1313 (11th Cir. 2001); *Lewis v. C. I. R.*, 328 F.2d 634 (7th Cir. 1964); *Gillespie v. C.I.R.,* 151 F.2d 903 (10th Cir. 1945); Letter of Findings 02-20160417 (December 29, 2017).

Taxpayer protests the Department's proposed assessments on the ground that it was entitled to deduct, on its Indiana income tax returns, interest expenses paid to its foreign affiliate.

## STATEMENT OF FACTS

Taxpayer is an out-of-state multinational corporation doing business both in Indiana and outside of Indiana. Taxpayer is a specialty-packaging manufacturer of paper tableware including plates, bowls, and cups. Taxpayer operates two Indiana manufacturing locations.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's separately filed 2011, 2012, and 2013 IT-20 corporate income tax returns and business records.

In reviewing Taxpayer's documentation, the Department noted that on December 21, 2011, Taxpayer had declared a dividend of approximately $435,000,000 paid to its sole shareholder parent company ("Parent").

The dividend was payable on or before December 21, 2011. The dividend was not paid in cash, but was in the form of three separate credit agreements consisting of five promissory notes executed by Taxpayer as maker to Parent as lender. In effect, Taxpayer did not have cash assets to pay Parent the dividend and Taxpayer "borrowed" the money from Parent enabling Taxpayer to declare that dividend.

The five promissory notes were signed on behalf of Taxpayer and Parent by the same individual officers of both companies.

On the same day the promissory notes were executed, Parent assigned the notes to a foreign affiliate of Taxpayer ("Foreign Finance Affiliate"). As a result, Taxpayer began making 2012 and 2013 principal and interest payments to Foreign Finance Affiliate.

Taxpayer, Parent, and Foreign Finance Affiliate all have the same ultimate Foreign Parent.

Taxpayer deducted the interest expenses paid to Foreign Finance Affiliate on its income tax returns, effectively reducing Taxpayer's taxable Indiana income.

The Department's audit found that the $435 million dollar dividend was "a transaction with no business or economic purpose" and that the interest payments were not "ordinary business expense[s] under IRC section 63." The Department exercised what it determined was its statutory authority to disallow the 2012 and 2013 interest expenses. The decision to disallow the interest expenses resulted in an assessment of additional Indiana income tax.

Taxpayer protested the decision disallowing the interest expenses and protested the decision imposing additional tax assessments. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. Letter of Findings 02-20160417 (December 29, 2017), 20180228-IR-045180082NRA, ("2017 LOF") was issued denying Taxpayer's protest. Taxpayer disagreed with the Department's 2017 LOF and timely requested a rehearing.

The Department granted Taxpayer's request. An administrative rehearing was conducted during which Taxpayer's representatives again explained the basis for its continued objections to the Department's audit and the 2017 LOF results. This Supplemental Letter of Findings results.

**I. Corporate Income Tax - Interest Expense Deduction.**

**DISCUSSION**

The issue is whether Taxpayer has met its statutory burden of establishing that it was entitled to deduct interest expenses paid to the Foreign Finance Affiliate because Taxpayer's originally reported 2012 and 2013 returns "fairly reflected and report[ed] the income [Taxpayer] derived from sources with the state of Indiana . . . ." IC § 6-3-2-2(m).

**A. Taxpayer's Burden of Proof.**

As a threshold issue, it is the Taxpayer's responsibility in this Supplemental Decision to establish that the assessment of additional tax, the original audit report's conclusions, and the analysis and decisions set out in the 2017 LOF are 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 position 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, fn. 9 (Ind. Tax Ct. 2012).

In considering Taxpayer's argument, the Department bears in mind that "when [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the 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, interpretations of Indiana tax law contained within the audit and the 2017 LOF decision are entitled to deference.

**B. The Department's Audit and June 2017 Letter of Findings' Position.**

This Supplemental Letter of Findings incorporates the detailed statements of law and findings of facts set out in the 2017 LOF.

Briefly stated, the Department's audit and the 2017 LOF came to the conclusion that: (1) Taxpayer's issuance of the dividend; (2) the decision to borrow money to fund the dividend payment; and (3) the payment of interest on the borrowed money lacked economic substance. In coming to that conclusion, both the audit and the 2017 LOF made the following points.

- Taxpayer did not have the financial means to declare the $435 million dollar dividend. Both the audit and

2017 LOF found that Taxpayer did not have the accumulated profits and earnings necessary to pay the dividend. The Department instead found that the $435 million payment constituted a non-taxable "return of capital" to Parent.

• Parent had previously declared a capital contribution of approximately $230 million in the form of "forgiveness of [Taxpayer's] debt and discharge of an existing loan." According to the 2017 LOF, the debt was forgiven "because there were not sufficient earnings for Taxpayer to pay the interest and/or principal." According to the Department's audit report, "This is another example of the loans' failure to meet the arm's length standard as no reasonable unrelated lender would issue new loans following the forgiveness and discharge of such a large [$230 million dollar] debt."

• Taxpayer's declared dividend did "not meet the arms' length standard as it [was] not likely that an uncontrolled taxpayer would declare a dividend without having earnings and profits from which to pay the dividend."

• Taxpayer's declared dividend and the decision to borrow money to pay that dividend "weakened [T]axpayer's financial structure by increasing its debt and expenses without getting anything in return." The audit reported that Taxpayer increased its "debt ratio" from approximately 70 percent to over 100 percent after declaring the dividend and borrowing Parent's money to pay the dividend.

• The Department rejected Taxpayer's reliance on a 2011 transfer pricing study to support Taxpayer's position that the promissory notes reflected "arm's length transactions under Treas. Reg. § 1-482-2." As explained in the 2017 LOF:

> [T]he transfer pricing study provided is inapplicable to support Taxpayer's position because Taxpayer is not a party to the loans analyzed in the transfer pricing study; rather, the study analyzes transactions between Parent and a related third party. The transfer pricing study is based upon the critical assumption that Parent is the borrower, while the loan agreements at issue have Parent as the lender.

• In effect, Taxpayer and its various affiliates structured the arrangement in order to "reduce income subject tax in Indiana."

The audit concluded that the loan agreement - entered into in order to allow Taxpayer to fund the $435 million dividend - did not "meet the arm's-length standard under Treasury Regulation 1.482-1(b)." As a result, the Department disallowed the interest expense deductions claimed as a result of the loans underlying Taxpayer's dividend.

Both the 2017 LOF and audit report cited to IC § 6-3-2-2(m) as authority for disallowing the claimed interest expenses. The statute provides:

> 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.

**C. Reasons for Taxpayer's Rehearing Request.**

Taxpayer argues that the Department's conclusions are not supported by the facts or the law for four primary reasons.

**i. Federal Audit Supports the Claimed Interest Expenses.**

Taxpayer points out that the Internal Revenue Service ("IRS") conducted an audit review of Taxpayer's and Parent's 2014 federal income tax returns. According to the IRS's Form 4564 Information Document Request, one of the reasons for the federal review was to determine "[w]hether interest expenses deduction [are] ordinary and necessary business expenses under IRC Section 162 and whether it meets the all events test requirements of IRC Section 461." The IRS sought from Taxpayer information to: (1) "confirm that the interest expense was accrued under terms of a formal note (bona fide debt);" (2) "whether [the] transactions were reflected as debt in the books and records of the parties;" (3) "whether there [was] a fixed schedule for repayment, including the maturity date;" and (4) "whether the interest expense is being charged on the outstanding debt."

As an apparent reply to the IRS's concerns, the IRS responded that "[w]e've completed the review of the examination of your tax return for the year(s) shown above [2014]. We made no changes to your reported tax."

As Taxpayer explains, "[T]he Internal Revenue Service has audited 2014, which included the interest[] related to all three of the years addressed in this [Indiana] audit, and has issued a No-Change order."

**ii. Taxpayer's "Earnings-Price" (E&P) Ratio.**

Taxpayer disagrees with the audit's conclusion that it was not in a financial position to declare a $435,000,000 dividend and that the decision to do so - and then borrow the money to fund that dividend - placed Taxpayer into an untenable 100 percent debt to equity position. Taxpayer argues that Taxpayer was in a position to declare the dividend because Taxpayer had in excess of $130,000,000 of E&P before declaring the dividend and borrowing the money. According to Taxpayer, its transfer pricing study correctly considered "the appropriateness of a loan supported by the activity and assets of the entire consolidated U.S enterprise" and not simply Taxpayer's activity and assets.

**iii. Parties to the Transfer Pricing Study (TPS).**

Taxpayer disagrees with the Department's position that the results of the transfer pricing study are irrelevant because the TPS analyzed the financial and business relationship between Parent and - as the audit explained - a "related third party." Taxpayer explains that: (1) Parent is merely a holding company and that only significant asset on Parent's books was its investment in Taxpayer. (2) The TPS at issue "is analyzing the debt of the [Parent's] group. The amounts analyzed are reported on a consolidated basis." (3) According to Taxpayer, "The transfer pricing report reviewed comparable companies as part of a debt capacity analysis [concluding that Taxpayer's] financial performance ratios to be broadly comparable those in recently concluded transaction." In effect, because comparable companies could undertake similar loans, Taxpayer "should also be able to obtain financing and capitalize itself in a comparable manner."

Taxpayer concludes that the TPS buttresses its claim that it was "reasonable for [Taxpayer] to carry $435,000,000 in debt because it has the ability to repay" and because the TPS "was analyzing the appropriateness of a loan supported by the activity and assets of the entire consolidated U.S. enterprise."

**iv. Indiana Tax Court *DuPont* Decision.**

Taxpayer cites to the Indiana Tax Court's decision in *E.I. DuPont De Nemours and Company v. Indiana Department of State Revenue*, 79 N.E.3d 1016 (Ind. Tax Ct. 2017) as authority for its position Taxpayer's loans also constituted "bona fide" debt. The *DuPont* case stemmed from the Department's decision disallowing DuPont's interest expenses attributable to money DuPont borrowed from a related entity. *Id.* at 1024. The Department disallowed the interest expenses because the Department found "there can be neither a legitimate business purpose nor economic substance to a loan which is never repaid and whose sole effect was to 'wipe out' DuPont's Indiana income through the interest expense deductions" and because "the underlying loans lacked economic substance and were therefore sham transactions." *Id.* In that case, the Department pointed out that the related DuPont party had no assets or receipts other than interest paid by DuPont, DuPont never paid interest to the related party, and that the interest rates called for in the loan arrangement were excessive. *Id.* at 1025-26.

The court found that the Department failed to establish that the DuPont inter-company loan agreement "lack[ed] economic substance." *Id* at 1027. The court set aside the Department's decision disallowing DuPont's interest expense deductions. *Id.*

According to Taxpayer the Tax Court's decision in *DuPont* is relevant because "the facts in this matter are more fully documented and the economic transactions were more fully supported than in *DuPont.*"

**D. Legal Analysis.**

As noted, this supplemental decision incorporates the statements of fact and law as set out in the 2017 LOF. Nonetheless, the Department repeats the principle that, as a general rule, interest expenses are not deductible when attributable to transactions that have no purpose other than the securing of interest deductions. *Winn-Dixie Stores, Inc. v. C.I.R.*, 254 F.3d 1313, 1316 (11th Cir. 2001) (The court held that "a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose."); *Lewis v. C. I. R.*, 328 F.2d 634, 635 (7th Cir. 1964) (Stating that "[r]egardless of a taxpayer's motives, where a paper transaction lacks substance and no genuine indebtedness is created resulting in a bona fide debtor-creditor relationship, no interest can be said to have been paid for the use or forbearance of money actually loaned and no interest expense deduction may flow therefrom.") The Department finds the reasoning in these cases sound.

The Department relied on IC § 6-3-2-2(m) as authority for taking the steps to disallow the interest expenses and issue the proposed assessments. The statute provides:

> 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.

**i. Taxpayer's Federal Audit.**

During the course of the federal audit, the IRS sought to determine whether Taxpayer's loan arrangement met the three-pronged "All-Events" test under I.R.C. § 461(h). That test is met when: (1) all the events which occurred establish that the liability was incurred; (2) the amount of the liability can be determined with reasonable accuracy; (3) the payment transactions called for in the agreement have occurred. As to Taxpayer's federal audit, the IRS sought to discover whether the loan agreement was documented with a "formal note," whether the debt was recorded on Taxpayer's books, whether the underlying loan called for scheduled repayments, and whether the interest expenses were charged on the remaining debt.

Taxpayer answered these questions to the IRS's satisfaction. However, the Department does not agree that the IRS's decision is dispositive in this manner. Hypothetically, even if the Department were to agree that Taxpayer's debt was reflected in a "formal note," that the debt was reflected in Taxpayer's books and records, that the note called for repayments, and the interest expenses were incurred, that does not necessarily answer the question of whether Taxpayer's claim to the expenses resulted in an Indiana tax liability which fairly represented Taxpayer's Indiana source income. IC § 6-3-2-2(m). In this case, the Department found that the interest expenses resulted in a substantial underreporting of that Indiana source income and made a decision to disallow the expenses.

**ii. Taxpayer's "Earnings-Price" (E&P) Ratio.**

Taxpayer criticizes the Department's conclusion that Taxpayer - given its financial circumstances - was not in a position to declare a $435,000,000 dividend in favor of the Parent. Taxpayer points out that it had $130,000,000 of E&P available at the time it declared the dividend.

Taxpayer here raises an interesting point but the analysis is irrelevant. On its face the underlying facts seem straightforward; Taxpayer declared a $435,000,000 dividend, Taxpayer did not have the wherewithal to pay the amount, and then simultaneously borrowed the $435,000,000 from the same party in whose favor Taxpayer had just declared the dividend. That same lender (Parent) recently forgave - or restructured out of economic existence - Taxpayer's $230 million dollar debt because, according to the audit report, there was no expectation that this amount could ever be repaid.

**iii. Indiana Tax Court *DuPont* Decision.**

Taxpayer maintains that the Department is required to allow Taxpayer the interest expenses under *DuPont.* In that case, the Indiana Tax Court found that the Department did not meet its burden of establishing that the loans at issue in *DuPont* did constitute "sham transactions." The Department agrees that the circumstances in *DuPont* are relevant and the Tax Court's ruling is instructional; the Department does not agree that the *DuPont* decision is dispositive. The Indiana Tax Court's decision does not permanently preclude the Department of exercising its statutory authority under IC § 6-3-2-2(m) of raising legitimate, well-founded questions concerning whether a loan such as this "lacks economic effects or substance other than the generation of tax benefits" and whether the original returns fairly reflect[ed] and report[ed] the income derived from sources within the state . . . ." *Lewis,* 328 F.2d at 635; IC § 6-3-2-2(m). ("[T]he Tax Court has stated that issue preclusion generally does not apply in tax appeals because 'each assessment and each tax year stands alone.'" *Miller Brewing Co. v. Indiana Department of State Revenue*, 903 N.E.2d 64, 69 (Ind. 2009.) See also *Gillespie v. C.I.R.,* 151 F.2d 903, 906 (10th Cir. 1945) ("[T]he doctrine [of estoppel] should be sparingly applied in tax cases involving liability for different years, and generally it is not applied where the taxable events and transactions are by their nature fluid and subject to change from year to year.")

**E. Conclusion.**

The Department is not in a position to second-guess the parties' willingness to engage in such transactions or to read the minds of the persons responsible. However, the Department's questions as to the simple economic reality of such a financial arrangement are not entirely unfounded, as Taxpayer maintains. In any routine arms-length lending arrangement, there is an obvious expectation that borrowed money will be repaid and that the lender has assurances that it will be repaid. A situation where a company declares a multimillion dollar dividend but then is forced to borrow capital from the same party it declared that dividend raises legitimate questions as to whether the parties involved are simply moving money from one pocket to another thereby generating interest expenses out of thin air.

Taxpayer is, of course, entitled to engage in lawful business arrangements in any manner its sees fit and then vigorously pursue any tax advantage attendant upon such an arrangement. Taxpayer is also free to enter into whatever loan transactions it desires whether those transactions are wise, careless, or even fanciful. However, in determining the nature of any business transaction and the resultant tax consequences, the Department is required to look at "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).

Following a review of the original audit report, the 2017 LOF, and Taxpayer's protest submission, the Department concludes that Taxpayer's deduction of the interest expense does not correspond to an actual expense incurred by Taxpayer. Instead, the effect of the interest deduction is that a substantial proportion of Taxpayer's income is untaxed. Consequently, Taxpayer's effective rate is significantly lower than the rate applicable to standalone companies which find themselves in a factually and legally comparable situation but who do not enter into such a like-kind loan arrangement. In such circumstances, the Department acted well within its authority and responsibility under IC § 6-3-2-2(m) in order to assure that Taxpayer's originally filed returns "fairly reflect[ed] and report[ed] the income derived from sources within the state of Indiana . . . ." Taxpayer has not met its burden under IC § 6-8.1-5-1(c) of proving that the Department's rationale and assessment were wrong.

**FINDING**

Taxpayer's protest is respectfully denied.

December 31, 2019

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