

**Letter of Findings: 02-20200004  
Indiana Corporate Income Tax  
For the Year 2018**

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

The Department agreed with Out-of-State S Corporation that it was not required to pay additional Indiana corporate income tax on behalf of its majority shareholder which was organized as a nonresident Employee Stock Ownership Trust; the trust was an employee profit sharing plan qualifying under the federal regulations as exempt from federal and state income tax.

### **ISSUE**

#### **I. Corporate Income Tax - Employee Stock Ownership Trust.**

**Authority:** IC § 6-8.1-5-1(c); *Dep't. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *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); I.R.C. § 401(a); I.R.C. § 501(a); I.R.C. § 502(a); I.R.C. § 503(a); *Employee Stock Ownership Trusts*, 84 Yale L.J. 1519 (1975); Revenue Ruling IT 98-06 (October 20, 1998); Investopedia; <https://www.investopedia.com/terms/e/esop.asp> (last visited February 14, 2020); Investopedia; <https://www.investopedia.com/terms/e/employeeshareownershiptrust.asp> (last visited February 14, 2020).

Taxpayer argues that one of its shareholders - a nonresident Employee Stock Ownership Trust - is not subject to Indiana corporate income tax.

### **STATEMENT OF FACTS**

Taxpayer is an out-of-state company in the business of providing telecommunication services. Taxpayer provides its services to customers in Indiana. Taxpayer submitted a 2018 Indiana S Corporation Income Tax Return reporting income earned in Indiana.

The Department subsequently issued a proposed assessment explaining as follows.

A review of your Indiana S corporation tax for the tax period ending December 31, 2018 indicates you may owe an additional [≈\$25,000]. This amount represents the full liability due including all assessed penalties and interest to date.

Taxpayer disagreed with the assessment and submitted a protest to that effect indicating that one of its majority shareholder/owners - an Employee Stock Ownership Trust - "is a tax-exempt shareholder."

In its written protest, Taxpayer asked for a "[f]inal determination without a hearing" in the apparent belief that the documentation and explanation provided was sufficient to resolve the dispute. This Letter of Findings results.

#### **I. Corporate Income Tax - Employee Stock Ownership Trust.**

### **DISCUSSION**

The issue is whether Taxpayer can establish that its majority shareholder is exempt from Indiana corporate income tax on the ground that this shareholder is a tax-exempt Employee Stock Ownership Trust ("ESOT").

As a threshold issue, it is the Taxpayer's responsibility to establish that the 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).

Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. The Department points out that, "[W]hen [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.'" *Dep't. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

In support of its argument, Taxpayer provided a copy of Revenue Ruling IT 98-06 (October 20, 1998). In that ruling, The Department addressed whether a taxpayer, organized as an S Corporation and owned entirely by an Employees' Stock Ownership Plan ("ESOP") was subject to Indiana income tax. In its original ruling request, the taxpayer explained its reasoning.

The ESOP (a "qualified trust" under Section 401(a) of the IRC) is generally exempt from federal income tax (IRC Section 501(a)). The ESOP is subject to federal income tax only on its "unrelated business taxable income" as defined in Internal Revenue Code Section 512. It is presently contemplated that the ESOP will not have any "unrelated business taxable income", there will have no income that is subject to federal or Indiana income tax.

After reviewing the relevant law, the Department came to a conclusion agreeing with the taxpayer's conclusion.

The Department rules that the taxpayer is not required to withhold adjusted gross income tax from amounts it pays or credits to the nonresident ESOP as dividends or its share of the undistributed taxable income.

In this case, Taxpayer argues that the Department's 1998 ruling is equally applicable to its own case. An ESOP is described as follows:

An employee stock ownership plan (ESOP) is an employee benefit plan that gives workers ownership interest in the company. ESOPs give the sponsoring company, the selling shareholder, and participants receive various tax benefits, making them qualified plans. Companies often use ESOPs as a corporate-finance strategy and to align the interests of their employees with those of their shareholders. Investopedia; <https://www.investopedia.com/terms/e/esop.asp> (last visited February 14, 2020).

In this case, Taxpayer's majority shareholder is an Employee Stock Ownership Trust ("ESOT") which is defined as follows:

An ESOT (employee share ownership trust) is a program that facilitates the acquisition and distribution of a company's shares to its employees. ESOTs are trust accounts through which a company can sell its shares to employees. Employee share ownership is supposed to boost employee morale and improve employee incentives to work hard and make decisions that are in the company's best interests. Such an arrangement thus helps to align the interests of company employees with those of other shareholders. Investopedia; <https://www.investopedia.com/terms/e/employeeshareownershiptrust.asp> (last visited February 14, 2020).

An ESOP and an ESOT are *not* identical. "An employee share ownership trust is comparable to (but differs from) an employee stock ownership plan, which often serves as a form of retirement benefit to employees." *Id.* Specifically, an ESOT is the asset holder and administrator of a stock ownership plan. *Employee Stock Ownership Trusts*, 84 Yale L.J. 1519, 1520 (1975).

The basic ESOT purchase arrangement proceeds as follows: the corporation establishes a stock bonus or employee stock ownership plan for its employees, and makes tax-deductible cash contributions to the ESOT which administers the plan. The ESOT purchases stock from the existing shareholder or shareholders at an arm's length price (as determined by outside appraisal), and allocates the purchased shares among the accounts of the covered employees. The interests of the individual employees vest in accordance with a specific schedule, and upon an employee's retirement, death, or other events specified in the plan, the ESOT distributes the vested shares to the employee or his beneficiary, at which time the recipient is taxed with respect to the stock received. *Id.* at 1523.

Nonetheless, the issue is whether it is required to pay Indiana income tax on behalf of its majority shareholder which in this case is an ESOT. I.R.C. § 401(a) provides in part as follows:

A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section.

In turn, I.R.C. § 501(a) provides in part:

Exemption from taxation.--An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

In this instance, Taxpayer's ESOT shareholder is a trust "forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees" under I.R.C. § 401(a) and is "exempt from taxation under" I.R.C. § 501(a). There is nothing to indicate that the ESOT is an entity excluded under I.R.C. § 502(a) because it is "carrying on a trade or business for profit . . ." or that it is excluded as an entity which has "engaged in a prohibited transaction" under I.R.C. § 503(a). Therefore, Taxpayer is not required to withhold or pay Indiana corporate income tax on behalf of its ESOT shareholder.

### **FINDING**

Taxpayer's protest is sustained.

February 19, 2020

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