DEPARTMENT OF STATE REVENUE

02-20211071.LOF

Letter of Findings: 02-20211071
Indiana Corporate Income Tax
For the Years 2017 and 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Paper Manufacturer that its intra-company sales and cancelled sales should be removed from both the numerator and the denominator of the sales factor in order to conform with the Department's multi-factor calculation of Paper Manufacturer's corporate income tax.

ISSUE

I. Indiana Corporate Income Tax - Intercompany Transactions and Sales Factor Adjustments.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; *Dept. of State Revenue v. Caterpillar, Inc*., 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *State Bd. of Tax Comm'rs v. Jewell Grain Co*., 556 N.E.2d 920 (Ind. 1990); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Mynsberge v. Indiana Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999); *Tri-States Double Cola Bottling Co. v. Department of State Revenue*, 706 N.E.2d 282 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-38; Income Tax Information Bulletin 12 (February 2020); Income Tax Information Bulletin 12 (October 2015); FASB ASC 845-10-30-3.

Taxpayer argues that the Department erred in adjusting its federal taxable income.

STATEMENT OF FACTS

Taxpayer is a company, headquartered outside Indiana, in the business of manufacturing and selling paper products. Taxpayer's business operations are organized as two "divisions." The first division consists of Taxpayer's cardboard manufacturing mills. The second division consists of the manufacturing facilities which produce cardboard boxes, paper boxes, and displays.

In addition, Taxpayer manufactures white duplicator paper, protective packaging, specialized commodity paper, and a variety of other specialized paper products.

Taxpayer operates three Indiana manufacturing facilities.

For the years 2017 and 2018, Taxpayer filed a federal consolidated income tax return. For the years 2017 and 2018, Taxpayer filed an Indiana income tax return (Form IT-20) on a separate basis. Those Indiana returns included five "disregarded entities" whose income was reported on Taxpayer's returns.

One of the five disregarded entities was acquired in 2013 but not fully merged with Taxpayer until July 2017.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's 2017 and 2018 tax returns and business records. That audit resulted in an assessment of additional Indiana corporate income tax. Taxpayer disagreed with the audit "adjustments" which led to the additional proposed assessment and submitted a protest to that effect. An administrative hearing was conducted by video conference during which Taxpayer's representatives explained the basis for its protest. This Letter of Findings results.

I. Indiana Corporate Income Tax - Intercompany Transactions and Sales Factor Adjustments.

DISCUSSION

The issue is whether Taxpayer has met its burden of proof necessary to establish that the Department's adjustment of its reported Indiana income was wrong, inconsistent, and/or incomplete. In particular, Taxpayer challenges the Department's decision increasing Taxpayer's reported taxable income resulting in an additional total assessment of approximately $275,000.

A. Indiana's Corporate Income Tax Calculation.

1. Taxpayer's Indiana Income.

Pursuant to IC § 6-3-2-2(a)(2), Taxpayer's income from doing business in Indiana was subject to Indiana corporate income. 45 IAC 3.1-1-38 explains:

> For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
> (4) Rendering services to customers in the state
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.
>
> As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).

2. Apportioning Taxpayer's Indiana Income and Everywhere Income.

Indiana imposes a tax on each corporation's adjusted gross income derived from "sources within Indiana." IC § 6-3-2-2(a). The statute provides in relevant part:

> With regard to corporations . . . "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;

Where a corporation receives income from both Indiana and out-of-state sources, the amount of tax is determined by a single-factor sales apportionment calculation as defined in IC § 6-3-2-2(b).

The "sales factor" consists of a fraction, "[T]he numerator of which is the total sales of the taxpayer in [Indiana] during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e).

Income Tax Information Bulletin 12 (October 2015), 20151125 Ind. Reg. 045150409NRA, summarizes:

> F. Apportionment of Business Income
>
> A corporation, other than a domestic insurance company, that has business income from both within and outside Indiana must apportion its income by means of the single-factor receipts formula under IC 6-3-2-2. . . .
>
> The apportionment factor to be applied to a corporation's business income to determine the amount taxable by Indiana is a single factor based on receipts. The sales factor is determined by dividing the taxpayer's total Indiana sales by the taxpayer's total sales everywhere. The numerator of the sales factor includes all sales made in Indiana and sales made from Indiana to the U.S. Government. . . . Income Tax Information Bulletin 12 (October 2015), 20151125 Ind. Reg. 045150409NRA

The most current version of Income Tax Information Bulletin 12 (February 2020), 20200226 Ind. Reg. 045200064NRA, summarizes:

> Receipts from the sale of goods are apportioned based on a single-factor sales approach. The sales factor is determined by dividing the taxpayer's total Indiana receipts by the taxpayer's total receipts everywhere. The numerator of the sales factor includes all sales made in Indiana . . . .

Taxpayer falls squarely within the category of businesses which are required to calculate their income tax liability utilizing Indiana's apportionment regime. In this case, the Department made a series of sales factor adjustments to conform with those requirements. However, it is those adjustments to which - in one manner or another - Taxpayer objects.

B. "Broken Items," Credits, Rebates, and the Department's Audit Adjustments.

1. Broken Items.

Taxpayer provided the Department a download of its "sales data" which "represented [all] total sales made by [Taxpayer]." However, that data represented only Taxpayer's sales and not the disregarded entities' sales. The Department found fault with Taxpayer's method of accounting for "broken items." The audit explains what "broken items" means.

> [T]here were times that [Taxpayer] would issue a credit or rebate to the customer. For example, a customer would return a product to [Taxpayer] because it was broken or defective, and the customer was unable to utilize the product. Therefore, a credit was issued to the customer for the **broken or faulty product**. In addition, there were times that [Taxpayer] would discount or provide a **rebate** to the customer. (**Emphasis added**).

The audit explained how Taxpayer accounted for all these credits, discounts, and rebates.

> [Taxpayer] booked these credits, discounts, and rebates to a cost of goods sold [] account instead of to a sales account. Consequently, the sales data download that was obtained from [T]axpayer did not reflect these sales reductions.

As pointed out above, the Department reviewed Taxpayer's Indiana return and adjusted the sales factor utilized in that return. It made those adjustments because the Department concluded that the credits, rebates, and discounts should not have been included in the sales factor.

> [T]he transactions classified as broken items for credit should not be included in the Indiana sales apportionment computation. Therefore, these transactions have been removed from the computation of the numerator sales . . . .

2. Intra-Company Sales.

The Department's audit again found fault in the manner in which Taxpayer calculated its sales factor and, again, the Department cited to Taxpayer's initial "download" of Taxpayer's sales data. The audit report explained the Department's objections.

> The sales download included sales made by one [Taxpayer] and sold to another [Taxpayer] location. For example, during the audit period an Illinois [Taxpayer] location made a sale to the [Indiana] location of [Taxpayer]. This transaction was included in the download; however, intra-company sales should not be included in the Indiana sales apportionment computation.
> . . . .
>
> These sales were included in the mills downloads as a transaction in which the bill to name includes [Taxpayer].
> . . . .
>
> [T]hese transactions have been removed from the computation of the sales numerator per the [T]axpayer's sales data download.

3. Intra-Company Sales and Taxpayer's Disregarded Entities.

The Taxpayer's initial sales "download" included sales by one Taxpayer location to another Taxpayer location.

The audit report provided a specific example:

> [D]uring the audit period, an Illinois [Taxpayer] location made a sale to the [Indiana location] of [Taxpayer]. This transaction was included in the download; however, intra-company sales should not be included in the Indiana sales apportionment computation. These sales were identified in the [manufacturing] downloads as transactions in which the bill to name included [Taxpayer].

The Department's audit concluded that these intra-company sales to disregarded entities should not be included in Taxpayer's sales factor.

In each of three adjustments listed above, the audit concluded that pursuant to Accounting Standards Codification ("ASC") 845 of the United States Generally Accepted Accounting Principles ("GAAP"), these transactions are not revenue and do not represent sales. As the audit report explains;

> The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange . . . lacks commercial substance. FASB ASC 845-10-30-3(b).

C. Taxpayer's Objections.

As to each of the three categories listed above (1, 2, 3), Taxpayer agrees; the audit correctly removed "broken sales" and intra-company sales from the sales factor. Taxpayer essentially maintains that the audit did not go far enough in implementing those adjustments. As to the category of "broken sales," Taxpayer argues that all broken sales - and not simply one facility's broken sales - should also have been removed from sales factor.

As to the audit's treatment of intra-company sales, Taxpayer again agrees that intra-company sales should be eliminated from the sales factor because intra-company sales "lack commercial substance." However, Taxpayer points to two instances in which the Department missed the mark. In particular, Taxpayer maintains that intra-company sales between one of its separate entities with one of its disregarded entities should also be eliminated from the sales factor.

Taxpayer argues that its audited financial statements and the information it provided to the SEC all tie to its original federal income tax return and that the adjustments made during the audit should be implemented consistently across all the reporting entities.

D. Taxpayer's Burden in Challenging the Department's Calculation.

It is the Taxpayer's responsibility to establish that the corporate tax assessments are incorrect because the audit's calculations were incomplete. 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 Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

With that threshold burden in mind, 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 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 this decision, as well as the preceding audit, shall be entitled to deference.

Nevertheless, in determining whether a taxpayer has met that burden of proof, the Department bears in mind its own responsibility. [A] tax imposition statutory provision . . . is to be strictly construed against the imposition of tax. See *State Bd. of Tax Comm'rs v. Jewell Grain Co*., 556 N.E.2d 920, 921 (Ind. 1990); *Tri-States Double Cola Bottling Co. v. Department of State Revenue*, 706 N.E.2d 282, 285 n.9 (Ind. Tax Ct. 1999). However, the policy of strict construction will not override the plain language of a tax imposition provision. *Mynsberge v. Indiana Dep't of State Revenue*, 716 N.E.2d 629, 632-33 (Ind. Tax Ct. 1999).

E. Analysis, Application, and Conclusion.

Taxpayer agrees with the principles underlying the Department's adjustments to its sales factor but argues that

the adjustments were either wrongly applied or simply incomplete. A "plain reading" of the facts and law leads the Department to agree and, to the extent specified in this Letter of Findings, the Department concludes that the results of the original audit should be reviewed by the audit division in a manner consistent with accepted principles of calculating Indiana sales factor.

FINDING

As specified in this Letter of Findings, Taxpayer's protest is sustained, and the Department's audit division is requested to review the original calculation of Taxpayer's 2017 and 2018 corporate income tax and to make any adjustments consistent with the findings listed above.

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