THOUGHTS ON TAX SIMPLICITY

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"Tax simplicity" means different things to different constituents. For individuals, it may mean the ease of filling out return forms and remitting the correct amount of tax due. For businesses, tax simplicity is less focused on return preparation and more focused on predictability and clarity.

Businesses need predictability when it comes to taxes so they can plan, hire, price and invest with a reasonably certain expectation of what their resulting tax liabilities will be. A tax that is not predictable creates undue complexity and discourages investment. It also undermines trust in the government.

Businesses also want clarity on how taxes will be computed, what the position of the taxing authority is, and what to expect from the taxing authority. Without clarity, a business does not have the knowledge it needs to comply with the tax laws.

Below are several suggestions to bring predictability, clarity and simplicity to key aspects of the Indiana tax system.

PREDICTABILITY:

Currently, a great deal of discretionary authority is claimed by the Indiana Department of Revenue (the "Department") with respect to the filing and payment of business taxes. But the breadth of the purported discretion claimed by the Department far exceeds that actually bestowed by the General Assembly and Indiana courts.

In the case of the Indiana adjusted gross income tax ("AGIT"), the Department claims it has almost unfettered authority under Ind. Code § 6-3-2-2(l) to modify the method, deductions, and income calculations of a business taxpayer on the grounds that the Department thinks that the tax calculation by that taxpayer is somehow "unfair." Ind. Code § 6-3-2-2(l), a provision based on Section 18 of UDITPA, was originally intended to be only occasionally invoked by the Department when the standard, statutorily prescribed reporting method did not fairly reflect income to the state in a demonstrable way. It was intended to be used only in unusual and nonrecurring situations – a rarely invoked exception to the standard rules. Instead, it is regularly invoked on audits to justify deficiency assessments for any number of reasons.

For example, it is invoked to argue that a return methodology allowed by statute (a consolidated return) should not be available to a particular taxpayer, even though the taxpayer has a statutory right to file on that basis. It often is used to compel combined (unitary) filing even though by law, Indiana is not a combined (unitary) return state. It is also used to deny bona fide deductions that are allowed by law, when the auditor "feels" that the deductions are "too large."

As a result of the Department's expansive assertion of this authority beyond what was originally intended, there is little certainty for business taxpayers. They are essentially at the mercy of auditors who will often run calculations to prove that if the tax return was filed in another manner (other than the standard manner set forth in the statute), or if deductions were not taken, more tax would be owed. And owing more tax is often in the auditor's mind, a "fairer" way to reflect income derived from Indiana sources.

At a minimum, the General Assembly needs to reinforce the limited nature of the powers of the Department and/or require the Department to adopt regulations that clearly specify when and how its limited powers will be used. Certainty can only exist when taxpayers are advised of the standards that are to be imposed, and the agency abides by them.

Another area that would improve certainty is the ability of taxpayers to rely upon prior interpretations of the taxing authorities, including prior audits. In Ind. Code § 6-8.1-3-3(b), the General Assembly wisely provided that the Department could not change its interpretation of a listed tax (income, sales, financial institutions tax, *etc*.) unless that change was promulgated and published in the *Indiana Register*, and even then, that change would only apply prospectively. The Department has construed this provision so narrowly that if its construction were to prevail, this limitation would be construed out of existence. Predictability requires that a taxpayer be able to rely year-to-year on the same position (absent a change in fact or law). That doesn't happen as much as it should in Indiana.

<u>CLARITY</u>:

It has been argued that the Department should limit the scope and number of the new regulations it promulgates. I would recommend that the Department consider having <u>more</u> regulations and updating current regulations so that taxpayers have more clarity.

Currently, the Department's policies and positions can only be ferretted out by examining a large number of Letters of Findings and Revenue Rulings that are published every month in the *Indiana Register* by the Department. While larger businesses, law firms and accounting firms have the time to study the Department's Letters of Findings and Rulings every month to try to determine what is going on, small and medium sized businesses do not have that luxury. Smaller businesses are often surprised by liabilities based on a Letter of Findings issued several years ago.

Even if a taxpayer is lucky enough to find the guidance it needs in these documents, it will sometimes be told that those Letters of Findings and Revenue Rulings are not binding on the Department and/or do not constitute precedent on which the taxpayer may rely, creating a great deal of frustration in the business community. Furthermore, Letters of Findings and Revenue Rulings in which the taxpayer prevails often obscure the reason why by a statement that the taxpayer provided sufficient documentation to support its protest – which is entirely uninformative. The Department should be required to state with specificity the reasons for the decision and the types of evidence presented by the prevailing taxpayer so that other taxpayers have a clear understanding of what is required of them.

SIMPLICITY:

Simplicity requires that something be easy to follow and make sense. Since it was enacted in 1963, the AGIT has morphed into something that does not meet those requirements. The AGIT was originally enacted to "piggyback" on the federal Internal Revenue Code and it incorporated many of the Internal Revenue Code concepts so that there would be relative ease of compliance. However, over many years, that tie-in to the Internal Revenue Code has greatly eroded. In many instances, that erosion came as the result of Indiana opting out of deductions enacted at the federal level. Today we have eighteen (18) modifications to federal taxable income to arrive at adjusted gross income for corporations. (There are 32 such modifications for individuals!) The General Assembly should review these modifications to make sure that in each instance "decoupling" from the federal tax scheme really makes sense and is justifiable. The more the AGIT differs from the federal income tax base, the less simple the system is for compliance purposes.

In what should have been a simplification of the AGIT, some years ago Indiana began the process of converting to a single sales factor for income apportionment purposes. However, apportionment has actually become more complicated. We do not argue over property and payroll factor issues anymore, but now we argue a lot more about the sales factor. In fact, there appear to be more apportionment issues today since Indiana converted to a single sales factor than there ever were before. For example, Indiana law says that we are a "cost of performance" state for sourcing income from services. However, the Department says we are a "market" sourcing state in many cases. In the end, this creates neither an acceptable nor simple way for a business to report its taxes.

Although I may be roundly criticized for this, I would urge the consideration of lessons learned from a tax that was in many respects a simple tax – the Indiana gross income tax. I am not talking about the Indiana gross income tax at the time of its repeal in 2002. I am talking about the original Indiana gross income tax, which had a broad base and a low rate. In fact, Indiana's original gross income tax was so simple it became the basis for the Indiana sales tax in 1963. It was only over time with the increased rates and the addition of numerous exemptions, exclusions and deductions, the Indiana gross income tax ended up being unfair and at the end it certainly was not simple.

Other states have enacted "modernized" gross income taxes that are worth studying. Ohio's CAT (Commercial Activities Tax) is an example. The CAT is imposed at a rate of $150 for the first $1,000,000 in gross receipts, and 0.26% for all gross receipts above $1,000,000. Gross receipts are the total amount realized by a person without deduction for the costs of goods sold or other expenses incurred.

I am not at all suggesting that Indiana enact a CAT-type tax; indeed, there are many negative aspects to Ohio's CAT. I am suggesting that alternative types of taxes (other than net income taxes) should be fully considered if Indiana is trying to achieve a simpler taxing scheme. The AGIT may not be a good platform for the future of Indiana business income tax. Innovative thinking – taking the best of other tax systems – whether those systems are net, gross, franchise, value added or other types of taxes would be a good starting point.

Another area where simplicity is lacking is in the real and personal property tax abatement area. Although property tax abatement is one of the key tools in Indiana's economic development tool kit, it is not a simple process for a taxpayer to navigate. Obtaining abatement is a difficult and time-consuming process and there are numerous traps for the unwary taxpayer that can cause the loss of the benefits of abatement. Because we need to attract and grow business, Indiana's property tax abatement process should be simplified.

One of the most controversial aspects of Indiana's personal property tax is the so-called "30% Floor." Regulation 50 I.A.C. 4.2 4 9(a) provides that "the total valuation of a taxpayer's assessable depreciable personal property in a single taxing district cannot be less than thirty percent (30%) of the adjusted cost of all such property of the taxpayer." Indiana actually applies <u>two</u> floors establishing lower limits for the true tax value on which personal property tax is based. First, as long as the property remains in use, it cannot be depreciated to zero by application of depreciation factors – the final-year depreciation percentage (or its inverse, the final "true tax value percentage") continues to apply. Thus, a floor is established at the lowest true tax value percentage assigned to each pool classification – which ranges from 5% to 20%. Second, if the sum of the total true tax values of all assets is less than 30% of the total adjusted cost, then the total valuation is adjusted upward to that 30% figure, effectively taking away depreciation otherwise granted. It is not unusual to preserve some value for property as long as it remains in use, even beyond the property's depreciable life; many states do that by establishing the first floor. But why does Indiana have the complication of an additional floor taking away depreciation, and is that approach conducive to business competiveness in Indiana?

Issues associated with the 30% floor also arise because of limitations placed by regulation and policies on abnormal obsolescence deductions. Indiana regulations provide for an abnormal obsolescence deduction, which can lower the total true tax value of a taxpayer's property below 30%. Historically, however, it has been extremely difficult for businesses to get this deduction. Even during the economic downturn beginning in 2008, many taxpayers have incurred substantial expense in unsuccessful efforts just trying to qualify and quantify abnormal obsolescence in accordance with guidance from the State. *See* Dep't of Local Gov't Finance, Memo to County Assessing Officials (Aug. 21, 2009). One reason asserted by assessing officials for denying abnormal obsolescence deductions is that all appropriate depreciation and obsolescence is afforded the taxpayer in the depreciation tables.

With the tendency of the 30% floor to frustrate economic development, over-burden older industries, and diminish the effects of otherwise permitted deductions under the law, it is time for Indiana to revisit the wisdom of the floor and determine whether it makes sense in the current business climate. Whether 30% truly is an appropriate minimum value for depreciable personal property today and whether it would make sense to eliminate the floor altogether are questions that should be considered.

Finally, on a procedural note, the General Assembly may want to consider returning to the longer appeal periods previously provided by law. More time may make resolution of tax disputes simpler. It would particularly be helpful to have more time after the issuance of a Letter of

Findings or Supplemental Letter of Findings by the Department to appeal to the Indiana Tax Court. Having a longer period to engage in more meaningful settlement discussions with the Department may benefit both the Department and taxpayers.

June 17, 2014