DEPARTMENT OF STATE REVENUE

02-20120008.LOF

Letter of Findings: 02-20120008
Indiana Corporate Income Tax
For Tax Year 2007

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Corporate Income Tax–Combined Return.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-62; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc. 963 N.E.2d 463 (Ind. 2012).

Taxpayer objects to the Department's determination that its affiliated entities have a unitary relationship with one another.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation that does business in Indiana. Taxpayer is a manufacturer of products. Taxpayer files its Indiana adjusted gross income tax returns on a consolidated basis with its subsidiaries and affiliates. Taxpayer filed its 2007 Indiana corporate income tax return on a consolidated basis, including several related companies and subsidiaries.

The Indiana Department of Revenue ("Department") conducted an audit of Taxpayer for the 2007 tax year. The Department determined that Taxpayer's method of reporting was not accurately reflecting income sourced to Indiana. As a result of the audit, the Department made several proposed adjustments which resulted in the assessment of additional income tax as well as interest. Taxpayer protested these adjustments. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Corporate Income Tax–Combined Return.

As a threshold issue, it is the Taxpayer's responsibility to establish that the tax assessment is incorrect. Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). 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." Furthermore, with regards to a decision that the Department has made to require a taxpayer to file a combined return, the Indiana Supreme Court has determined that:

> [T]he Department's notice of proposed assessment constitutes a prima facie showing–sufficient to satisfy Trial Rule 56(C)–that there is no genuine issue of material fact with respect to the validity of the unpaid tax–including presuming the Department's compliance with subsection (p) and consideration of the Standard Sourcing Rules where required. The Department needs nothing more than this and its motion, as a starter. The burden then shifts to the taxpayer to come forward with sufficient evidence demonstrating that there is, in actuality, a genuine issue of material fact with respect to the unpaid tax–in the context of subsection (p), for example, perhaps by demonstrating a factual dispute as to whether the Department could actually fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department. Ind. Code § 6-3-2-2(p).
>
> Indiana Dep't of State Revenue v. Rent-A-Center East, Inc. 963 N.E.2d 463, 466-67 (Ind. 2012).

The Department's audit arrived at its adjustment under authority of IC § 6-3-2-2(l), (m).

> (l) 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.
>
> (m) 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.

IC § 6-3-2-2(p) states that requiring a taxpayer to file a combined return is warranted only if necessary to "fairly" reflect the taxpayer's Indiana income.

> Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

In addition, 45 IAC 3.1-1-62 states:

> 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---37--45 IAC 3.1-1-61] (45 IAC 3.1-1) 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.

Accordingly, when a taxpayer's method of filing individual Indiana adjusted gross income tax returns for related corporations distorts the taxpayer's Indiana source income, the Department may require that the related entities file a combined return. The purpose of the combined return would be to fairly reflect the taxpayer's and related entities' actual Indiana income and expenses. In order to do so, the Department must find the entities form a unitary group. The second step is that the Department must make a finding that the taxpayer's own method of filing the adjusted gross income tax distorts the taxpayer's Indiana income and/or expenses. Lastly, the Department must be unable to fairly reflect Indiana income using other methods before requiring the combined-filing method.

The auditor concluded that the amount reported as Indiana source income could not be accurately reflected utilizing Taxpayer's method of reporting. The Department based its determination on several factors, including, but not limited, to: (1) a circular flow of funds between the related companies; (2) the expenses for services performed by one related company for another were not allocated; (3) substantial intercompany "overriding royalties;" (4) among the different affiliates, there was little or no salary and wage deductions and associated expenses; (5) all sales of the affiliates involved in production related activities were intercompany; (6) the affiliates involved in production related activities accounted for over half of the reported federal taxable income, but derived only a little over five percent of the groups' total revenue; (7) and Taxpayer treated all partnerships and limited liability companies that elected partnership treatment as unitary with their respective partner and utilized factor relief.

In the audit reports, three methods were suggested for reflecting Indiana sourced income, and of the three, the combined reporting method resulted in the least amount of Indiana AGIT. The auditor noted that it allowed Taxpayer an opportunity to provide an alternative method as well, but one was not provided to the auditor.

Taxpayer maintains that the Department's audit report did not follow IC § 6-3-2-2(p) because it did not show how it applied every method described in IC § 6-3-2-2(l) & (m), and, therefore, the Department did not meet the prerequisite for a mandatory forced combination filing.

The Department notes that IC § 6-3-2-2(p) does not require that the Department provide explanations of why every other method does not fairly reflect Indiana income. IC § 6-3-2-2(l) and (m) permit the Department to employ "any other method to effectuate an equitable allocation and apportionment of" Taxpayer's income in order to fairly reflect and report the income derived from sources within the state of Indiana. Meanwhile, IC § 6-3-2-2(q) imposes a limitation which the Department "may not require that income, deductions, and credits attributable to a taxpayer and another entity... be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m)." The Indiana Supreme Court's recent decision in Indiana Dept. of State Revenue v. Rent-A-Center East, Inc. has confirmed that the Department does not carry such an evidentiary burden.

As mentioned above, the Department's audit considered potential alternatives to fairly reflect Taxpayer's income derived from sources within Indiana pursuant to IC § 6-3-2-2(l) and (m), and concluded, the "method[s] result[ed] in a greater Indiana adjusted gross income tax than utilizing the combined reporting method." Taxpayer did not offer any tenable alternatives after receiving the auditor's e-mail. Taxpayer has now come forward with a method that "reallocates" Head Office and general and administrative expenses. However, Taxpayer does not explain how this method more fairly reflects Taxpayer's income, nor does Taxpayer explain how its method addresses the Department's concerns regarding the factors that led the Department to conclude that Taxpayer is required to file combined returns and readjust Taxpayer's 2007 corporate income tax assessment.

IC § 6-3-2-2(p) does not require the Department to apply the provisions of IC § 6-3-2-2 in the order in which they are written. There is nothing on the face of IC § 6-3-2-2 that requires the Department to apply the subparts of

IC § 6-3-2-2 in the order in which they are written. The statute is clear on its face, and it is devoid of any step-by-step instructions on how or in what order to apply subparts (l), (m) and (p). IC § 6-3-2-2(l) provides that the Department may require "in respect to all or any part of the taxpayer's business activity, if reasonable," one of several methods to fairly represent the taxpayer's Indiana source income. The clause "if reasonable" qualifies the methodology used to fairly represent the taxpayer's income from Indiana business activities, but it does not impose any order on which methodology must be used first, or second, or third, and so on. This point is underscored by IC § 6-3-2-2(m), which speaks to an entirely different set of circumstances than is addressed under IC § 6-3-2-2(l) or (p).

Taxpayer further argues that forced combination is a last resort and distorts Taxpayer's Indiana source income. Taxpayer refers to the forced combination "as arbitrary, intrusive, and unfair," as well as "novel and highly controversial." Taxpayer maintains that its 2007 return was filed in the same manner in which it has filed its returns for decades, by only including in its consolidated return Taxpayer's companies that have nexus with Indiana. Taxpayer argues that the profits from its lucrative production related businesses that operate outside of Indiana are unfairly "pulled" into the calculation of Indiana sourced income.

IC § 6-3-2-2 requires that the Department be unable to fairly reflect Indiana income using other methods before requiring a combined filing. The Department provided an explanation in the audit report concerning the interwoven nature of the entities' activities and demonstrated at least three circular flows of monies. The Department requested that Taxpayer suggest alternative methods that could be used, and Taxpayer did not provide an alternative method until after the hearing. The Department explained that it tried alternatives methods and was unable to otherwise fairly reflect Taxpayer's Indiana income and required combined filing, as allowed under IC § 6-3-2-2(l). Thus, the Department considered combined filing as a last resort, as required by 45 IAC 3.1-1-62.

Pursuant to IC § 6-8.1-5-1(c), taxpayer has failed to meet its burden of rebutting the presumption that the original audit decision was correct. Taxpayer has failed to demonstrate that combined filing requirement would distort the amount of income taxpayer received from conducting business within this state.

FINDING

Taxpayer's protest is respectfully denied.

Posted: 10/31/2012 by Legislative Services Agency
An html version of this document.