DEPARTMENT OF STATE REVENUE

02-20120140.LOF

Letter of Findings: 02-20120140
Adjusted Gross Income Tax
For the Years 2005, 2006, 2007

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ISSUES

I. Adjusted Gross Income Tax – Business/Non-Business Income Classification.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-8.1-5-1; May Dep't Stores Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16 (2008); Dept. of Treasury of Ind. v. Dietzen's Estate, 21 N.E.2d 137 (Ind. 1939); Fell v. West, 73 N.E. 719 (Ind. App. 1905); 45 IAC 3.1-1-30.

Taxpayer protests the apportionment to Indiana of what it claims is non-business income allocable to the state where Taxpayer is domiciled; not Indiana.

II. Adjusted Gross Income Tax – Imposition – Disallowance of Interest Expense Deduction.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-8.1-5-1; Gregory v. Helvering, 293 U.S. 465 (1935); Lee v. Comm'r, 155 F.3d 584 (2d Cir. 1998); Horn v. Comm'r, 968 F.2d 1229 (D.C. Cir. 1992); Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 3.1-1-8; Black's Law Dictionary (7th ed. 1999).

Taxpayer protests the Department's disallowance of certain claimed interest expenses.

III. Adjusted Gross Income Tax – Disallowance of 2007 Research and Development ("R & D") expenses deduction.

Authority: IC § 6-3-1-3.5; I.R.C. § 63.

Taxpayer protests the disallowance of an R & D expenses deduction on its 2007 return.

IV. Tax Administration – Underpayment of Tax – Ten Percent Penalty.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the imposition of the ten percent penalty for underpayment of tax for the year 2007.

STATEMENT OF FACTS

Taxpayer is a multinational corporation incorporated in Delaware. Taxpayer specializes in science and technology disciplines including high-performance materials, specialty chemicals, and products in certain specialized industries.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer for the years 2005 through 2007. As a result of the audit, the Department adjusted Taxpayer's corporate income tax returns for the years 1999 through 2007 which resulted in proposed assessments of tax for 2006 and 2007. Taxpayer protested most of the adjustments. An administrative hearing was held and this final determination ensues. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax – Business/Non-Business Income Classification.

DISCUSSION

For the years audited by the Department, Taxpayer reported carry-forward net operating losses ("NOLs") on its returns. These NOLs were created in 2001 as a result of Taxpayer's treatment of income from the sale of a specialized industry subsidiary ("SUB") as non-business income on its Indiana corporate income tax return for that year. Taxpayer's treatment of the revenue as non-business income meant that Taxpayer allocated the income to its domiciliary state. This classification removed the revenue from the sale of SUB's assets from the income apportionable to Indiana and therefore created Indiana NOLs.

Pursuant to the audit of the years 2005 through 2007, the Department reclassified the revenue from the sale of these assets as business income. As a result of the Department's reclassification of the income, Taxpayer no longer had the benefit of the NOLs resulting from the subtraction of this gain from Taxpayer's 2001 federal taxable income. This reduction of gain in 2001 affected Taxpayer's remaining NOLs for several years, including the audit years, resulting in taxable income for two of the audit years, 2006 and 2007.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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." Lafayette Square Amoco, Inc. v. Indiana Dept of State Revenue, 867 N.E.2d 289,292 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012). As Indiana courts have long held, "In construing tax statutes a liberal rule

of interpretation must be indulged in order to aid the taxing power of the state." Dept. of Treasury of Ind. v. Dietzen's Estate, 21 N.E.2d 137, 139 (Ind. 1939). "The statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers." Fell v. West, 73 N.E. 719, 722 (Ind. App. 1905).

IC § 6-3-2-1(b) states:

Except as provided in section 1.5 of this chapter, each taxable year, a tax at the rate of eight and five-tenths percent (8.5[percent]) of adjusted gross income is imposed on that part of the adjusted gross income derived from sources within Indiana of every corporation.

Under the provisions of IC § 6-3-2-2(a), business income of a corporation is subject to apportionment to Indiana, while nonbusiness income is generally allocable to the state from which the gain arises. Non-business gains from real property and tangible personal property are allocated to the state in which the real property or tangible personal property is located. IC § 6-3-2-2(g)-(k). Non-business intangible income is generally sourced to the corporation's state of commercial domicile.

IC § 6-3-1-20 defines "business income":

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business.

Conversely, IC § 6-3-1-21 provides that "nonbusiness income" means "all income other than business income."

The determination of whether the income from Taxpayer's sale of SUB's assets is classified as business or non-business income makes a difference because of the way in which a corporate taxpayer's adjusted gross income is calculated. For purposes of determining a taxpayer's Indiana adjusted gross income tax liability for the years at issue, business income is apportioned between Indiana and other states using a three-factor formula. IC § 6-3-2-2(b). In contrast, non-business income is either fully allocated to Indiana or is fully allocated to another state. IC § 6-3-2-2(g)-(k). "[W]hether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dep't. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

The Indiana Tax Court in May addressed the statutory and regulatory language cited above, and outlined the transactional and functional tests the Department and each taxpayer must apply to distinguish business from nonbusiness income. The court found that, "[I]n passing IND. CODE § 6-3-1-20, the General Assembly provided two tests for defining business income . . . the 'transactional' and 'functional' tests." Id. at 662.

The court goes on to say that IC § 6-3-1-20 "requires that not only the property's disposition but also its acquisition and management must be integral parts of the taxpayer's regular trade or business." Id. at 663 n.10.

The first clause of IC § 6-3-1-20 is commonly referred to as the "transactional test." Income is taxable as business income under this test when the income arises from transactions that occur in the regular course of a taxpayer's trade or business. Under the "transactional test," the nature of the particular transaction generating the income is the controlling factor the Department uses to identify business income pursuant to May. Three considerations enter into the Department's identification of whether the income arises from activities that occur in the regular course of a taxpayer's business:

1. The frequency and regularity of similar transactions
2. The former practices of the business; and
3. Taxpayer's subsequent use of the income.

In May, the tax court found that since May Department Stores was not in the business of buying and selling divisions, the income generated from the sale of its division did not meet the "transactional test" requirement that the transaction be in the regular course of the taxpayer's business. However, the court stated in May, for the first time, that the inquiry does not stop with the "transactional test." The court determined that the Indiana "business income" statute, IC § 6-3-1-20, offered alternative tests. While the "transactional test" focuses on the transaction itself, under the " functional test," gain from the disposition of a capital asset is considered business income if the asset disposed of was in its regular trade or business operations. May 749 N.E.2d at 664. According to the court in May, the regulation found at 45 IAC 3.1-1-30 requires the Department to consider the following in determining the scope of a taxpayer's trade or business:

1. The nature of taxpayer's trade or business.
2. The substantiality of the income derived from activities and transactions and the percentage of that income which forms taxpayer's total income for a given tax period.
3. The length of time the property producing income was owned by taxpayer.
4. The taxpayer's purpose in acquiring and holding the property producing income.

May 749 N.E.2d at 664 n.13.

Under the "functional test," the Department must focus on the property being disposed of and the relationship between the property at issue and taxpayer's business operations. May 749 N.E.2d at 664. The question is

whether the property, its use and disposition, constitutes an integral part of Taxpayer's business. Under its "functional test" analysis, the court stated that in the case of the disposition of property "it is not enough that the property was used to generate business income for the taxpayer prior to disposition . . . [t]he disposition, too, must be an integral part of the taxpayer's regular trade or business operations." Id. The court also clarified that under the "functional test" the frequency of the transaction is not dispositive, but rather what is dispositive is whether the transaction is considered "necessary or essential" to the taxpayer's regular trade or business operations. Id. at 665. To restate, both the use and disposition of the asset have to be in the taxpayer's regular trade or business.

In May, May Department Stores ("May") purchased a rival department store chain. As a result of the purchase, an antitrust case was launched against May. In settlement of the antitrust claim, May sold the assets of one of its divisions, Horne. As a result of Horne's asset sale, May realized a gain that it treated as nonbusiness income, allocable to May's domicile; however, the Department determined that the income was business income apportionable to Indiana and other states.

The court held that, because selling entire divisions was not a regular business practice of the taxpayer, the sale failed to meet the "transactional test" for business income. Id. at 664. The court further held that, although Horne was "unquestionably an integral part of [May's] business operation," the "divestiture of Horne's assets was for the benefit of a competitor and not for the benefit of [May];" therefore "[u]nder these circumstances, this divestiture (the disposition of assets) could not have constituted an integral part of [May's] regular trade or business operations." Id. at 665. In other words, while the use of the asset was clearly a part of May's regular business, because the disposition was not in the regular course of business (it was forced and benefitted a competitor), the revenue generated by the sale of the asset did not qualify as business income.

Taxpayer protested the reclassification of the income from the sale of SUB. Taxpayer argues the sale of SUB was unrelated to Taxpayer's primary business purpose, SUB was merely an investment, and Taxpayer's interest in the subsidiary was merely an "oversight interest."

However, Taxpayer's own Securities and Exchange Commission ("SEC") records, its website, and public statements over the years by its top executives, document Taxpayer's history of developing its specialized industry business over a period of decades. This history includes a joint venture with an experienced specialized industry company – a predecessor to SUB – which began in the early 1990s. At that time Taxpayer was implementing a strategy to expand its sciences division. The joint venture developed several important products over the years. Taxpayer acquired its venture partner's interest in the late 1990s and operated as SUB. SUB continued its predecessor's research track record and developed several revolutionary products. In 2001, SUB was acquired by an unrelated specialized industry company when Taxpayer decided that it could no longer carry the research and development costs of SUB (at the time SUB represented 5 percent of Taxpayer's revenue but used up just under 30 percent of its research and development budget). As stated in Taxpayer's SEC records leading up to the sale of SUB, Taxpayer would use the proceeds to pay down debt, buy back shares, and make acquisitions – all decisions directly related to Taxpayer's business operations.

Under the application of the "functional test," as illustrated by May, the income generated from the sale of SUB therefore unquestionably qualifies as business income. As in May, the acquisition and management of the assets in this case were integral to Taxpayer's business operations in its specialized industry line of business since the assets of SUB were essential to the creation of this line of business dating back to the 1990s and before. And, unlike the forced disposition of assets in May, the disposition of the SUB assets in this case was an unforced, voluntary business decision on the part of Taxpayer, therefore integral to Taxpayer's business operations.

Arguably, Taxpayer's revenue from the sale of SUB also qualifies as business income under the "transactional test" – as the audit proposes. As a conglomerate with several lines of business, Taxpayer regularly engages in the acquisition and sale of divisions and subsidiaries as it seeks to consolidate or divest a particular line of business. However, having met the "functional test" there is no need to reach the "transactional test."

Taxpayer also appears to make the argument that because SUB was not unitary with Taxpayer. In support of this argument, Taxpayer makes extensive reference and comparisons to MeadWestvaco Corp. v. Illinois Department of Revenue, 553 U.S. 16 (2008) (" Mead") for the proposition that the unitary business principal is the key factor in determining whether a state may tax a portion of the gain from the sale of a business enterprise. Taxpayer argues, for example, that Taxpayer did not assume any day-to-day management of SUB, that SUB operated as a "discrete business unit responsible for the development and marketing of [specialized industry] products . . . It maintained it own sales and marketing division. It did not share its facilities, customer lists or research and development with other [Taxpayer] entities. There were few intercompany transactions between [SUB] and [Taxpayer]."

Taxpayer suggests that in Mead the U.S. Supreme Court determined that Lexis lacked a unitary relationship with Mead and therefore the income resulting from the sale of Lexis was non-business income. Taxpayer argues that the sale of SUB by Taxpayer tracks comparable facts and history to Mead's sale of Lexis.

The Department cannot agree with Taxpayer's proposition because Taxpayer fundamentally misreads the Mead decision. A correct understanding of the Mead decision requires an understanding of the procedural history

of that case. The Illinois Circuit Court of Cook County concluded that Lexis and Mead were not a unitary business, but nevertheless concluded that Illinois could tax an apportioned share of Mead's capital gain because Lexis served an "operational function" in Mead's business. Mead 553 U.S. at 23. The Illinois Appellate Court affirmed the trial court's "operational function" analysis and did not address the question of whether Mead and Lexis formed a unitary enterprise. Id. Again, the Illinois Appellate Court did not address the trial court's finding that the companies were not unitary. Instead the Illinois Appellate Court found that Lexis did indeed serve an operational purpose in Mead's business and therefore the revenue from the sales of Lexis was business income to Mead. The Illinois Appellate Court relied on Allied-Signal v. Director of Taxation, 504 U.S. 768 (1992) to arrive at its conclusion. The U.S. Supreme Court, in its Mead decision, clarified that the "operational function" test for apportionable income articulated in Allied-Signal must be applied narrowly to assets used in the taxpayer's business, but not to the relationship between business entities or businesses. The U.S. Supreme Court found that it was a "fundamental error" for the Illinois Appellate Court to consider whether Lexis served an operational purpose in Mead's business without determining that Lexis and Mead were unitary and therefore vacated the Illinois Appellate Court's decision. Mead 553 U.S. at 24. However, the U.S. Supreme Court noted that, on remand, the Illinois Appellate Court could take up the question of whether Mead and Lexis should be considered a unitary business, contrary to the Illinois trial judge's factual findings. Also, the U.S. Supreme Court noted that the lower court could also revisit the issue of whether a distinction exists between a sale of separate subsidiary and a sale of a division.

The question, therefore, of whether Lexis and Mead were unitary is not one addressed by the Mead decision as Taxpayer suggests.

Therefore, based on the above, the Department's audit correctly recharacterized the income from the sale of SUB from non-business to business income.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Imposition – Disallowance of Interest Expense Deduction.

DISCUSSION

The Department made adjustments for the audit years disallowing a deduction for interest expense payments made by Taxpayer to a subsidiary ("LOAN SUB"). The Department found that these intercompany transactions among a controlled group of affiliated companies did not "fairly reflect" Taxpayer's Indiana source income and should therefore be disallowed.

According to the Department's audit summary, allowing Taxpayer to claim the interest expense deduction did not fairly reflect Taxpayer's Indiana source income for several reasons:

- No payments were ever made on the loan. At the end of the year [Taxpayer] records interest expense for this loan as an account payable. [LOAN SUB] records interest income as an account receivable. No money ever changes hands. The balance on the loan grows each year as interest is piled on top of principal increasing the balance due each year.
- [LOAN SUB] has no employees. They only hold the notes and record a paper transaction with no real business purpose to the corporation. As such, their only activity is to hold a master note for a line of credit between [Taxpayer] and [LOAN SUB]. Taxpayer explained that [LOAN SUB] borrowed cash to send estimated payments to the IRS as required on their income. However, when returns are filed, all of the income of [LOAN SUB] is eliminated on the consolidated return and as a result do not pay any federal tax on their income.
- The interest rate on the loans does not reflect true market rates. If these were true loans, during the period of 2002 and 2003 when the rate was 4.25[percent] to 4.00[percent] the taxpayer could have easily refinanced them to obtain a favorable market rate instead of continuing to accrue interest at 8.5[percent] (over two times the going rate). This would have saved several hundred million dollars in interest. Any prudent financial person would have refinanced a true loan in this instance. However, since this was an internal paper transaction with no money changing hands, no effort to refinance was ever made.
- At the end of the term the loan is rolled over into a new loan. The new loan includes all of the interest accrued over the last 10 years. The same terms exist on the new loan as no money ever changes hands. Taxpayer's interest expense deducted on its federal return will grow for another 10 years. Even though the loan is due at the end of 10 years, it's never actually paid off.
- On the consolidated federal return this deduction is eliminated and has no effect on federal taxable income reported to the IRS and therefore [Taxpayer] would have no interest in adjusting it.
- This adjustment only [a]ffects state taxable income as [LOAN SUB] (the company which records the interest income) has no nexus with Indiana.
- The huge interest expense has eliminated most of taxpayer's Indiana taxable income for the past 10 years and severely distorted income from operations.

The audit made its adjustment to the "Allocation of Net Income" under IC § 6-3-2-2(l) and (m) which states in relevant part:

(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 l, 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.

(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.

(Emphasis added).

In exercising the authority under IC § 6-3-2-2(l) and (m), IC § 6-3-2-2(p) provides additional guidance:

(p) 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).

(Emphasis added).

As noted in Part I above, it is Taxpayer's responsibility to establish that the existing tax assessment is incorrect. IC § 6-8.1-5-1(c) states that it is Taxpayer who has "[t]he burden of proving that the proposed assessment is wrong . . . ."

The authority to disallow the interest expenses to which Taxpayer points is found at IC § 6-3-1-3.5(b)(9) which states:

(b) In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

(9) Add to the extent required by IC 6-3-2-20 the amount of intangible expenses (as defined in IC 6-3-2-20) and any directly related intangible interest expenses (as defined in IC 6-3-2-20) for the taxable year that reduced the corporation's taxable income (as defined in Section 63 of the Internal Revenue Code) for federal income tax purposes. [amended by P.L. 162-2006 effective to taxable years beginning after June 30, 2006].

(Emphasis added)

Assuming for the moment that the Department had the authority to disallow the interest expense, did the audit correctly determine that Taxpayer's returns – as originally filed and as determined under I.R.C. § 63 – did not "fairly reflect" Taxpayer's Indiana source income? The question is not inconsequential; the audit disallowed approximately 3.1 billion dollars in interest expenses.

The Department's audit reasons that during the years at issue Taxpayer made substantial profits from its operations in Indiana, however the income apportioned to Indiana on Taxpayer's return was severely distorted by the intercompany interest deduction resulting from the intercompany loan transactions. According to the Department audit, Taxpayer and its related parties entered into loan transactions which led to interest expenses of several billion dollars. As quoted above, these were loans to which the parties agreed to an interest rate approximately twice that of the prime rate during the audit years, were loans for which there is no timely expectation of repayment, and were loans apparently structured in such a way as to gain a substantial and disproportionate state tax advantage.

For the reasons set out above by the Department's audit, the audit determined that the loan transactions lacked economic substance and should have been eliminated as an intercompany transaction as it was on Taxpayer's federal return.

Because the audit questioned whether the subject transactions lacked "economic substance," the Department must consider whether the interest payments were attributable to an intercompany transaction which had no other purpose than to avoid taxation; did the loans and the interest payments fall within the definition of a "sham transaction" which is defined as "[a]n agreement or exchange that has no independent economic benefit or business purpose and is entered into solely to create a tax advantage . . . ." Black's Law Dictionary 1380 (7th ed. 1999). The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for favorable tax

treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id. at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[T]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id. at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950). "[T]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Comm'r, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, ex ante, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1237. The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one . Lee v. Comm'r, 155 F.3d 584, 586 (2d Cir. 1998).

Taxpayer protests arguing that the transactions had "economic substance" because without the loans from LOAN SUB, Taxpayer would not, for example, have been able to purchase SUB's predecessor. Taxpayer argues it would have needed to obtain loans from other third party lenders. Accordingly, Taxpayer believes the transactions were entered into for a business purpose other than simply harvesting state tax benefits.

In determining the nature of a 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). While Taxpayer styled this transaction as a loan, in substance LOAN SUB was merely a paper company with no employees. In substance, for the years at issue the loan rate was twice that of the prime interest rate and the interest was never actually paid to LOAN SUB but simply accrued along with the original loan. In substance, not only was the loan not repaid, but at the end of the loan's term, the loan was rolled over into a new loan including all of the accrued interest. While, it may be true that Taxpayer would not have been able to purchase SUB without LOAN SUB's influx of money, the fact remains that the transaction was not in substance a loan. LOAN SUB's influx of money could be treated as a capital contribution or some relevant accounting of the money, but the form of the loan is a "sham." Taxpayer cannot, therefore, utilize the interest expense deduction to distort its Indiana income tax obligations by unfairly reducing its taxable Indiana income.

Under IC § 6-8.1-5-1(c), Taxpayer has failed to meet its burden of demonstrating that the Department lacked the authority under IC § 6-3-2-2(l), (m) to disallow the interest expenses. Under IC § 6-3-2-2(l), (m), the audit was authorized to resort to "any other method to effectuate an equitable allocation and apportionment of the [T]axpayer's income" in order to "fairly reflect and report the income derived from sources within the state of Indiana . . . ." IC § 6-3-2-2(p) circumscribes that power " unless the department is unable to fairly reflect the [T]axpayer's adjusted gross income for the taxable year . . . ."

Lastly, for the years 2006 and 2007, Taxpayer comes under the rubric of IC § 6-3-2-20, which states:

(a) The following definitions apply throughout this section:

(1) "Affiliated group" has the meaning provided in Section 1504 of the Internal Revenue Code, except that the ownership percentage in Section 1504(a)(2) of the Internal Revenue Code shall be determined using fifty percent (50%) instead of eighty percent (80%).

(2) "Directly related intangible interest expenses" means interest expenses that are paid to, or accrued or incurred as a liability to, a recipient if:

(A) the amounts represent, in the hands of the recipient, income from making one (1) or more loans; and

(B) the funds loaned were originally received by the recipient from the payment of intangible expenses by any of the following:

(i) The taxpayer.

(ii) A member of the same affiliated group as the taxpayer.

(iii) A foreign corporation.

(3) "Foreign corporation" means a corporation that is organized under the laws of a country other than the United States and would be a member of the same affiliated group as the taxpayer if the corporation were organized under the laws of the United States.

(4) "Intangible expenses" means the following amounts to the extent these amounts are allowed as deductions in determining taxable income under Section 63 of the Internal Revenue Code before the application of any net operating loss deduction and special deductions for the taxable year:

(A) Expenses, losses, and costs directly for, related to, or in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property.

(B) Royalty, patent, technical, and copyright fees.

(C) Licensing fees.

(D) Other substantially similar expenses and costs.

(5) "Intangible property" means patents, patent applications, trade names, trademarks, service marks, copyrights, trade secrets, and substantially similar types of intangible assets.

(6) "Interest expenses" means amounts that are allowed as deductions under Section 163 of the Internal Revenue Code in determining taxable income under Section 63 of the Internal Revenue Code before the application of any net operating loss deductions and special deductions for the taxable year.

(7) "Makes a disclosure" means a taxpayer provides the following information regarding a transaction with a member of the same affiliated group or a foreign corporation involving an intangible expense and any directly related intangible interest expense with the taxpayer's tax return on the forms prescribed by the department:

(A) The name of the recipient.

(B) The state or country of domicile of the recipient.

(C) The amount paid to the recipient.

(D) A copy of federal Form 851, Affiliation Schedule, as filed with the taxpayer's federal consolidated tax return.

(E) The information needed to determine the taxpayer's status under the exceptions listed in subsection (c).

(8) "Recipient" means:

(A) a member of the same affiliated group as the taxpayer; or

(B) a foreign corporation;

to which is paid an item of income that corresponds to an intangible expense or any directly related intangible interest expense.

(9) "Unrelated party" means a person that, with respect to the taxpayer, is not a member of the same affiliated group or a foreign corporation.

(b) Except as provided in subsection (c), in determining its adjusted gross income under IC 6-3-1-3.5(b), a corporation subject to the tax imposed by IC 6-3-2-1 shall add to its taxable income under Section 63 of the Internal Revenue Code:

(1) intangible expenses; and

(2) any directly related intangible interest expenses;

paid, accrued, or incurred with one (1) or more members of the same affiliated group or with one (1) or more foreign corporations.

(c) The addition of intangible expenses or any directly related intangible interest expenses otherwise required in a taxable year under subsection (b) is not required if one (1) or more of the following apply to the taxable year:

(1) The taxpayer and the recipient are both included in the same consolidated tax return filed under IC 6-3-4-14 or in the same combined return filed under IC 6-3-2-2(q) for the taxable year.

(2) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the item of income corresponding to the intangible expenses and any directly related intangible interest expenses was included within the recipient's income that is subject to tax in:

(i) a state or possession of the United States; or

(ii) a country other than the United States;

that is the recipient's commercial domicile and that imposes a net income tax, a franchise tax measured, in whole or in part, by net income, or a value added tax;

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient was made at a commercially reasonable rate and at terms comparable to an arm's length transaction; and

(C) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(3) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient regularly engages in transactions involving intangible property with one (1) or more unrelated parties on terms substantially similar to those of the subject transaction; and

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(4) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the payment was received from a person or entity that is an unrelated party, and on behalf of that unrelated party, paid that amount to the recipient in an arm's length transaction; and

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest

expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(5) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient paid, accrued, or incurred a liability to an unrelated party during the taxable year for an equal or greater amount that was directly for, related to, or in connection with the same intangible property giving rise to the intangible expenses; and

(B) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(6) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient is engaged in:

(i) substantial business activities from the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property; or

(ii) other substantial business activities separate and apart from the business activities described in item (i);

as evidenced by the maintenance of a permanent office space and an adequate number of full-time, experienced employees;

(B) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose; and

(C) the transactions were made at a commercially reasonable rate and at terms comparable to an arm's length transaction.

(7) The taxpayer and the department agree, in writing, to the application or use of an alternative method of allocation or apportionment under section 2(l) or 2(m) of this chapter.

(8) Upon request by the taxpayer, the department determines that the adjustment otherwise required by this section is unreasonable.

(d) For purposes of this section, intangible expenses or directly related intangible interest expenses shall be considered to be at a commercially reasonable rate or at terms comparable to an arm's length transaction if the intangible expenses or directly related intangible interest expenses meet the arm's length standards of United States Treasury Regulation 1.482-1(b).

(e) If intangible expenses or directly related intangible expenses are determined not to be at a commercially reasonable rate or at terms comparable to an arm's length transaction for purposes of this section, the adjustment required by subsection (b) shall be made only to the extent necessary to cause the intangible expenses or directly related intangible interest expenses to be at a commercially reasonable rate and at terms comparable to an arm's length transaction.

(f) For purposes of this section, transactions giving rise to intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient shall be considered as having Indiana tax avoidance as the principal purpose if:

(1) there is not one (1) or more valid business purposes that independently sustain the transaction notwithstanding any tax benefits associated with the transaction; and

(2) the principal purpose of tax avoidance exceeds any other valid business purpose.

Based on the above, under IC § 6-3-2-20(b), a taxpayer who is subject to Indiana AGIT, is required to add back its federal deductions relating to intangible expenses and any directly related intangible interest expenses which are paid, accrued, or incurred with one or more members of the same affiliated group or with one or more foreign corporations. IC § 6-3-2-20(c) allows for certain exceptions from this requirement, but Taxpayer has not argued and/or substantiated any of these requirements. Furthermore, under IC § 6-3-2-20(f), as demonstrated above, Taxpayer's state tax avoidance exceeds any other valid business purpose.

Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c). The Department must conclude that the transactions were "motivated by nothing other than the [T]axpayer's desire to secure the attached tax benefit." Horn, 968 F.2d 1326.

FINDING

Taxpayer's protest of the Department's disallowance of the interest expense deduction is respectfully denied.

III. Adjusted Gross Income Tax – Disallowance of 2007 Research and Development Expenses Deduction.

DISCUSSION

The Department's audit added back research and development ("R & D") expense deductions Taxpayer had taken for the 2007 year on its Indiana return. The disallowance of this deduction increased Taxpayer's taxable income. The audit's summary report explained that in calculating its Indiana adjusted gross income, Taxpayer must begin with federal taxable income as defined under I.R.C. § 63. Taxpayer's federal taxable income as defined under I.R.C. § 63 did not include a federal deduction for qualifying R & D expenses. Therefore, Taxpayer

could not then deduct those R & D expenses from Indiana adjusted gross income. Taxpayer did not take a federal deduction for those expenses because Taxpayer had instead taken a federal credit for the expenses. Because Taxpayer had taken a credit for the R & D expenses, a deduction was therefore not available at the federal level.

Taxpayer protests as follows:

Since Indiana does not allow the federal R & D tax credit as part of its corporate income tax starting point, Taxpayer's actual R & D expenses of $30,748,141, which would otherwise be deductible for Federal income tax purposes, should be deductible in calculating Taxpayer's IN corporate income tax base. Therefore Taxpayer respectfully requests that the Department adjust the assessment for the 2007 tax year by reversing the auditor's add-back of $43,776,706 and permitting Taxpayer's deduction of $30,748,141.

Under IC § 6-3-1-3.5(b), the starting point of Indiana taxable income is I.R.C. § 63 with then a number of Indiana-specific enumerated adjustments. None of the Indiana adjustments include a deduction for federal R & D expenses taken at the federal level as credit instead of a deduction. Accordingly, the Department's audit correctly disallowed the deduction Taxpayer took on its 2007 return for R & D expenses.

FINDING

Taxpayer's protest of the disallowance of the R & D expenses deduction on the 2007 return is respectfully denied.

IV. Tax Administration – Underpayment of Tax – Ten Percent Penalty.

DISCUSSION

The Department assessed Taxpayer a ten percent penalty for underpayment of tax by the original due date of Taxpayer's 2007 corporate income tax return. Taxpayer timely protested the assessment of penalty.

The Department imposed a ten percent penalty on Taxpayer because the Department found that Taxpayer failed to remit ninety percent of the full amount of corporate income tax on or before the original due date for payment.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Under IC § 6-8.1-10-2.1, penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1 further states in relevant part:

(d) If a person subject to the penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

(e) A person who wishes to avoid the penalty imposed under this section must make an affirmative showing of all facts alleged as a reasonable cause for the person's failure to file the return, pay the amount of tax shown on the person's return, pay the deficiency, or timely remit tax held in trust, in a written statement containing a declaration that the statement is made under penalty of perjury. The statement must be filed with the return or payment within the time prescribed for protesting departmental assessments. A taxpayer may also avoid the penalty imposed under this section by obtaining a ruling from the department before the end of a particular tax period on the amount of tax due for that tax period.

The Department also notes that 45 IAC 15-11-2 further provides in relevant part:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Of the three substantive issues contested in Taxpayer's protest, the loan interest expense issue represents the lion's share of the proposed assessment. Taxpayer's treatment of the loan interest expense issue does not demonstrate "reasonable cause" and therefore the underpayment penalty is not waived.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer is denied on all elements of its protest.

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