DEPARTMENT OF STATE REVENUE

02-20200419.SLOF

Supplemental Letter of Findings 02-20200419
Corporate Income Tax
For the Years 2015, 2016, and 2017

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

HOLDING

The Department disagreed with Retailer that - in reviewing Retailer's Indiana corporate tax returns - the Department erred in adjusting Retailer's federal adjusted gross income based on the addback of inter-company, intangible interest expenses.

ISSUE

II. Indiana Corporate Income Tax - Calculating Intangible Interest Expenses Added Back to Indiana Income.

Authority: IC § 6-3-1-3.5; IC 6-3-2-20: IC § 6-8.1-5-1; *Dept. of State Revenue v. Caterpillar, Inc.,* 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.,* 963 N.E.2d 463 (Ind. 2012); *Wendt LLP v. Indiana Dep't of State Revenue,* 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Scopelite v. Indiana Dep't of Local Gov't Fin.,* 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue,* 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer argues that the Department's audit overstated the amount of inter-company interest expenses added back for the purpose of calculating Taxpayer's Indiana taxable income.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of selling at retail. Taxpayer sells goods to its customers over the Internet and in brick-and-mortar stores. Taxpayer conducts business in Indiana and other states.

On its federal consolidated income tax return, Taxpayer is listed as the parent of an affiliated group of businesses.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's income tax returns and its related business records. The audit resulted in an assessment of additional Indiana corporate income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. A Letter of Findings ("LOF") was issued in August 2021.

The LOF sustained Taxpayer in part and denied it in part finding that Taxpayer did not meet "its burden of establishing that the audit erroneously adjusted the 2016 interest expense amount."

Taxpayer disagreed with that portion of the LOF denying its original protest. Taxpayer submitted a protest to that effect. An administrative hearing was conducted by video conference during which Taxpayer's representatives explained the basis for the protest. This Supplemental Letter of Findings ("SLOF") results.

I. Indiana Corporate Income Tax - Calculating Intangible Interest Expenses Added Back to Indiana Income.

DISCUSSION

The issue is whether Taxpayer has met its burden of proof necessary to establish that the Department's adjustment to its reported federal income, increasing the amount of inter-company interest claimed on that return, was wrong. According to Taxpayer, the LOF managed to misunderstand and mischaracterize the issue and that the Department's original adjustment remained erroneous.

At the outset, both the Department and Taxpayer recognize what this SLOF is *not* about. The issue is not whether Taxpayer is required under Indiana law to add back inter-company interest expenses claimed on its federal return.

The issue is simply whether or not the Department adjusted Indiana return by adding back *more* inter-company interest than the inter-company interest expense claimed on its federal return. Simply stated, the audit found that the interest expense amount was "X" while Taxpayer argues that the number should be "Y." The Department found that the "X" amount was a large number while Taxpayer explains that the "Y" number is a small number. The Department's decision adding back the larger number resulted in an assessment of additional Indiana corporate income tax because Taxpayer now has additional income taxable in Indiana.

Taxpayer explains what the Department purportedly did wrong. The Department's audit erred in finding that Taxpayer had failed to addback approximately $18,000,000 in 2016 interest expenses. As explained in the audit report:

> The audit determined that the Taxpayer correctly added-back interest expenses paid to [related companies] for the period 1/30/2015 in the amount of [approximately $18,000,000] because it does not meet the exception to the addback under IC § 6-3-2-20(c). However, no add-back was made for the periods 1/29/2016 - 1/27/2017 for [related companies] per the Taxpayer's loan schedules is [approximately $24,000,000] respectfully.

Taxpayer states that its "loan schedules do not support the [approximately $18,000,000] reference by the Department of Revenue." Taxpayer concludes that the expense should be changed to reflect the original draft audit report which - according to Taxpayer - was "originally agreed to by the [T]axpayer." Taxpayer points out what it argues were the flaws in the audit's conclusions.

> • The DOR used incorrect and ultimately superseded loan schedules in their October Additional Audit Report.
> • The [loan] schedule the DOR relied upon failed to include the modification entries. As a result, the schedule incorrectly calculated the principal amount of the loan.
> • The principal loan amount relied upon by the DOR is unsupported by the companies' federal return amount and, when properly adjusted does not tie to an amount supported by any documentation.
> • [Taxpayer] provided the DOR with the correct and sufficiently adjusted Loan Schedule account for the company's true position for the Interest Expense Add-back, expressed in the [audit report].

In seeking to correct the purported error, it is Taxpayer's responsibility to establish that the assessment of additional tax, and the original audit report's conclusions regarding the interest expenses, were "wrong."

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).

Because it carries the burden of making its argument, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.,* 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue,* 977 N.E.2d 480, 486, fn. 9 (Ind. Tax Ct. 2012).

In considering Taxpayer's argument, the Department bears in mind that "when [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 the audit and this Letter of Findings are entitled to deference.

What is the significance of Taxpayer's claim that the Department overstated the amount of inter-company interest claimed on its federal return? The Department's audit correctly cited to IC § 6-3-1-3.5(b) which provides that, in determining *Indiana* corporate adjusted gross income, Taxpayer must addback certain expenses claimed on the federal return as follows:

> In the case of corporations, [Indiana adjusted gross income is] the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

. . . .

Add to the extent required by IC 6-3-2-20:
(A) the amount of intangible 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; and
(B) any directly related interest expenses (as defined in IC 6-3-2-20) that reduced the corporation's adjusted gross income (determined without regard to this subdivision). For purposes of this clause, any directly related interest expense that constitutes business interest within the meaning of Section 163(j) of the Internal Revenue Code shall be considered to have reduced the taxpayer's federal taxable income only in the first taxable year in which the deduction otherwise would have been allowable under Section 163 of the Internal Revenue Code if the limitation under Section 163(j)(1) of the Internal Revenue Code did not exist.

If a business claimed inter-company interest expenses on its federal corporate income tax return, those expenses are added back to calculate *Indiana* adjusted gross income. In Taxpayer's case, the addback of an additional 18 million dollars of inter-company interest expenses increased the amount of income reported on its return. If Taxpayer is correct that the Department's addback of the 18 million should be corrected, and then the amount of income reported on its Indiana return should be decreased.

In its protest letter, Taxpayer summarizes its claim that the Department is wrong explaining that the "increase to the intangible interest expense adjustment made by the Department of Revenue does not reflect the amounts paid in calculation of its federal taxable income."

As noted above, it is Taxpayer's statutory responsibility under IC § 6-8.1-5-1(c) to establish that the assessment was wrong, and that Taxpayer must present clear and cogent evidence supporting that position. *Scopelite,* 939 N.E.2d at 1145; *Wendt LLP,* 977 N.E.2d at fn. 9.

In this instance, Taxpayer is incorrect for the following reasons. In preparing for a transition to a new accounting system, Taxpayer made three prior year "model" adjustments to loan balances that resulted in modifications to inter-company interest expenses. The first adjustment was made to adjust the principal loan balance that reduced federal taxable income for January 2016 in the amount of approximately 2.5 million dollars. The second and third adjustments were made to correct a principal loan balance through January 2016 that reduced federal taxable income for the period January 2016 in the amount of approximately 3.5 million dollars and to adjust for the compounding of interest for the period January 2017 which decreased federal taxable income in the amount of approximately 1.5 million dollars. Therefore, the total federal taxable income adjustments for January 2016 through January 2017 were approximately 6.1 million dollars and 1.5 million dollars.

Taxpayer added back interest on the 2015 return but did not do so on the 2016 or 2017 returns. Instead of reporting the full amount of interest expense on the 2016 and 2017 returns as filed, Taxpayer adjusted its interest expense amounts based on clean up entries from the prior years. For IRS purposes, if an expense in an earlier year - later determined to be incorrect - the taxpayer reports the amount as "income" in the year in which the error is discovered.

In this case, Taxpayer erred in lowering the interest expense in those earlier years instead of reporting the full interest expense and the interest income attributable to the earlier year's reporting errors. As a result, what the Taxpayer reported on then current federal return was incorrect as it incorrectly "netted" these errors on that return. Therefore, Taxpayer has not proven the Department's adjustments under IC § 6-3-1-3.5(b) were incorrect and has not met the burden imposed under IC § 6-8-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

February 8, 2021

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