# PUBLICATION

## Spotlight on Indiana: Surprising Corporate Income Tax Audit Results

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The Indiana Department of Revenue (Department), like most state taxing agencies, is granted discretionary authority to modify the standard income apportionment formula if it does not "fairly reflect" a corporate taxpayer's business activity in the state. The Department's recent Letters of Findings indicate how this authority is evolving in Indiana in the context of taxpayers engaged in businesses such as retail and distribution, as well as home health care products and services.

#09-0918

In Letter of Findings 09-0918, dated March 12, 2010, the Department required an Indiana corporate taxpayer to file a "partial" unitary combined report with only some of its affiliates while excluding the taxpayer's parent corporation and another affiliate that did business in Indiana. Previous Letters of Finding involving other taxpayers have required full group unitary combination – all based on an Indiana unitary standard that is stricter than that applied in other traditional unitary states, notably California and Illinois.

Although this corporate structure in #09-0918 was (at least in part) tax motivated, the Department nevertheless recognized that a taxpayer has a right to structure its affairs in a manner that results in the lowest tax and further recognized that the structure was supported by business purpose, economic substance, and the group's intercompany transactions were at arm's length. Despite such recognitions, the Department in Letter of Findings 09-0918 reasoned that a partial unitary combined report was necessary to correct the resulting distortion if the taxpayer was allowed to file its Indiana adjusted income tax return on a separate company basis.

#s 09-0857 and 09-0862

Conversely, Letters of Finding 09-0857 and 09-0862, both dated September 1, 2010, are also instructive regarding the Department's application of its alternative apportionment authority. In these rulings, one Indiana corporate taxpayer paid royalties and management fees to its parent (09-0857) and another paid interest expenses to its parent corporation on loans received from the parent (09-0862). Surprisingly, the Department in their Letters of Finding rejected the findings and disallowance proposed by the state auditors of the royalty, management fee, and interest expense deductions. Both Letters of Finding found the intercompany arrangements were documented with valid arm's length transfer pricing studies and, although tax motivated, were supported by legitimate business purposes and economic substance. Further, both Letters emphasized that the intercompany royalties, management fees, and interest were not part of a circular flow of funds. As a result, the deductions were sustained and audit findings rejected. While these intercompany expense deductions are now subject to statutory disallowance under Indiana's related-party intangible and interest expense "add-back" statute (effective for tax years beginning after June 30, 2006), Letters of Finding 09-0857 and 09-0862 may reflect the Department's position on the application of certain exceptions to the "add-back" statute.

Summary

Why did the Department use partial unitary combination in Letter of Findings 09-0918, but not in Letters of Finding 09-0857 and 09-0862? Alternatively, why did the Department not apply full unitary combination in these rulings? One can only guess that unitary combination would have provided a tax benefit to the taxpayers under the fact patterns of the latter rulings. No guesswork is needed, however, in anticipating that more states will be flexing their discretionary authority in business income tax audits so as to protect state revenues from tax-sophisticated structures involving related parties.

If you would like to discuss how Indiana or other states are exercising their discretionary authority in regard to business income tax audits, please do not hesitate to contact one of the attorneys in the Firm's Tax Department.