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EXTERNAL ALERT

Indiana Supreme Court Rules Manufacturer Cannot Deduct Foreign Source Dividend Income to Calculate State NOLs

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Overview

In *Indiana Department of Revenue v. Caterpillar, Inc.*, the Indiana Supreme Court recently reversed the Indiana Tax Court's 2013 ruling involving the deductibility of foreign source dividend ("FSD") income in the calculation of Indiana net operating loss ("NOL") available for carryover for corporate income tax purposes. The Indiana Tax Court had ruled that Caterpillar, Inc. (the "taxpayer") could deduct its FSD income in calculating Indiana NOLs. Reversing the Tax Court's decision, the Indiana Supreme Court determined that although the FSD deduction applies in calculating Indiana adjusted gross income ("AGI"), use of the deduction to calculate Indiana NOLs is inconsistent with the plain meaning of the NOL statute and is therefore not permissible.[1]

In this Tax Alert we explain the statutory and factual/procedural background of the case, summarize the Indiana Supreme Court's decision, and highlight some taxpayer considerations.

Background

Statutory Background

Indiana AGI begins with federal taxable income, which is then adjusted under Ind. Code § 6-3-1-3.5(b) and then further adjusted for a deduction of a percentage of FSD income pursuant to Ind. Code § 6-3-2-12(b). After making these adjustments, the taxpayer then apportions or allocates income to Indiana under Ind. Code § 6-3-2-2. The resulting number is Indiana AGI before the NOL deduction.

Allowable NOL deductions are calculated using a three-step process as specified in Ind. Code § 6-3-2-2.6(c):

1. Calculate the federal NOL under I.R.C. § 172
2. Adjust the federal NOL by applying the modifications required by Ind. Code § 6-3-1-3.5
3. Determine the portion derived from sources within Indiana

Factual Background and Proceedings in the Case

From 2000 to 2003 (the "Loss Years"), the taxpayer deducted its FSD income when calculating its Indiana NOL carryovers. In taking this deduction, the taxpayer joined Indiana's FSD deduction statute with the Indiana NOL calculation, manually writing the deduction into its tax return and thereby increasing its Indiana NOLs. The taxpayer also filed amended returns for 1996 through 1999 (the "Carryback Years"), which included a modified AGI reduced by the NOLs carried back from the Loss Years, and sought refunds based on the amended returns. The Indiana Department of Revenue ("Department") partially denied the refund after it audited the taxpayer's returns for the Carryback and Loss Years, rejected the taxpayer's insertion of the foreign source dividend deduction into the NOL calculation, and reduced the taxpayer's usable Indiana NOLs.

The taxpayer protested the Department's NOL recalculation and partial denial of the refund claims. Following a hearing, the Department denied the protest. The taxpayer appealed the matter to the Indiana Tax Court. As part its appeal, the taxpayer did not pursue the denied refunds but contested the Department's reduction of Indiana NOLs available for carryforward. The taxpayer also asserted that the

[1] *Indiana Department of State Revenue v. Caterpillar, Inc.*, Indiana Supreme Court (Docket No. 49S10-1402-TA-79, Aug. 25, 2014), slip op. at 9, 11; *available at:* **http://www.in.gov/judiciary/opinions/pdf/08251401LHR.pdf.**

Indiana tax statutes discriminated against foreign commerce by disallowing the FSD deduction in the Indiana NOL calculation but incorporating the federal domestic source dividend deduction in the same calculation.

The parties filed cross-motions for summary judgment with the Tax Court. On March 28, 2013, the Tax Court granted the taxpayer's motion and denied the Department's motion, thus finding in favor of the taxpayer. The Department petitioned the Indiana Supreme Court for review, which was granted by that court.

The Indiana Supreme Court's Summary of the Tax Court Decision

As described by the Indiana Supreme Court, the Tax Court's holding:

> treats an Indiana NOL as the mirror image of Indiana AGI by finding that the Indiana NOL incorporates the foreign source dividend deduction. . . . [The Tax Court's] decision superimposed all adjustments to Indiana AGI---including the foreign source dividend deduction---onto the NOL calculation. By the Tax Court's opinion, the term "modifications required by IC 6-3-1-3.5" found in the NOL statute is shorthand for every adjustment to AGI scattered throughout the Indiana tax statute.[2]

The Indiana Supreme Court noted further that the Tax Court "attempted to reinforce its conclusion when it looked at the legislative history of the Indiana NOL statute."[3]

The Indiana Supreme Court's Decision

The Indiana Supreme Court rejected the Tax Court's analysis and conclusion first by finding that "the Indiana NOL statute is unambiguous[, thus requiring the application of the plain meaning of] the statutory terms as written without resorting to canons of [statutory] construction."[4] The Supreme Court then found that the Tax Court's interpretation "is not consistent with the plain meaning of the Indiana NOL statute," which does not reference or incorporate the FSD deduction.[5] As explained by the Supreme Court.

> The phrase 'modifications required by IC 6-3-1-3.5' [as specified in the NOL statute] does not incorporate by reference every modification to Indiana AGI or anywhere in the Indiana tax statutes. Rather, that phrase means what is says---the modifications [by Section 3.5].[6]

Accordingly, the Indiana Supreme Court held that the Tax Court "clearly erred when it adopted a false symmetry between Indiana AGI and Indiana NOLs" and thus the Supreme Court denied the taxpayer's effort to apply the FSD deduction to its Indiana NOL calculations.[7] The Supreme Court also rejected the taxpayer's Foreign Commerce Clause claim.[8]

Based on the foregoing, the Supreme Court reversed the Tax Court's judgment and remanded the case with instructions that the Tax Court grant summary judgment in favor of the Department and deny summary judgment to the taxpayer.[9]

The time period for filing a motion for re-hearing with the Indiana Supreme Court has expired and no such motion was filed by the taxpayer.[10] However, the period for filing a petition for a writ of certiorari with the U.S. Supreme Court is still open.[11] Thus, this case is not yet final.

Taxpayer Considerations

Although the *Caterpillar* decision is not yet final, corporations that are contemplating the deduction of FSD income when they have NOL carryforwards should consider whether the Indiana Supreme Court's analysis and decision may be applicable to their particular factual situation.

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[2] *Id.* at 8.
[3] *Id*. at 9.
[4] *Id*. at 5.
[5] *Id*. at 9.
[6] *Id*.
[7] *Id*. at 10.
[8] *Id*.
[9] *Id*. at 11.
[10] Ind. Rules of Appellate Proc., Rule 54.
[11] Sup. Ct. R. 13.

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