DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 01-0063SLOF
ADJUSTED GROSS INCOME TAX
For the Tax Periods Ending in 1996, 1997, and 1998

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ISSUE

I. Disallowance of Royalty and Interest Expense Deductions – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); Horn v. Commissioner of Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Park 100 Dev. Co. v. Indiana Dept. of State Revenue, 429 N.E.2d 220 (Ind. 1981).

Taxpayer argues that the conclusion reached in the original Letter of Findings – whereby the Department disallowed the deduction of certain interest and royalty payments – was erroneous because it was based upon a misunderstanding of the parties' business relationships.

STATEMENT OF FACTS

There are three parties relevant to this Supplemental Letter of Findings; taxpayer, parent company, and Delaware holding company. The taxpayer is an out-of-state company in the business of selling industrial, medical, and specialty gases.

The parent company is an out-of-state entity which owns both the taxpayer and Delaware holding company. The parent company is not an Indiana taxpayer. Over a period of time, the parent company had acquired taxpayer and a number of entities all of which were engaged in a similar business. At some point, the parent company realized that – along with taxpayer and the other related entities – it had also acquired and developed certain intellectual property. The intellectual property consisted of trademarks, trade names, trade dress, and the like. It is not disputed the taxpayer and parent company's other affiliated members had unrestrained access to and use of the intellectual property before the intellectual property was transferred to Delaware holding company.

In 1996, the parent company formed Delaware holding company. The parent company exchanged the intellectual property for Delaware holding company's stock in an I.R.C. § 351 exchange. According to taxpayer, Delaware holding company is governed by a board of directors consisting of two parent company officers and two independent officers.

Thereafter, Delaware holding company arranged for an independent appraisal of the value of the intellectual property. Having made a determination of the value of the intellectual property, Delaware holding company entered into a series of 17 licensing agreements which permitted taxpayer – along with 16 other similarly situated entities owned by the parent company – continued use of the intellectual property. In exchange for the right to use of the intellectual property, taxpayer made royalty payments to Delaware holding company. In certain circumstances, pursuant to the terms of the royalty agreement, taxpayer also made interest payments to Delaware holding company.

Having received taxpayer's royalty and interest payments, Delaware holding company, together with similar payments received from the 16 different other affiliated entities, loaned those amounts to the parent company. The loans were made to the parent at the market rate of 8.75%. There is no indication that these loans have been repaid to Delaware holding company.

Taxpayer points out that Delaware holding company incurred certain expenses related to the maintenance of the intellectual property. Delaware holding company had a full-time employee. Delaware holding company employed a specialized law firm to assist in the management and protection of the intellectual property assets.

On their face, the state tax consequences of this three-way arrangement are as follows; taxpayer claims a deduction for the royalty and interest payments from its Indiana Adjusted Gross Income; Delaware holding company has no state tax liability because Delaware does not tax income attributable to intellectual property; parent company does not pay state income tax on those amounts received as loans from Delaware holding company.

The original Letter of Findings found that taxpayer was not entitled to deduct from its Indiana adjusted gross income the royalty and interest payments made to Delaware holding company. Taxpayer challenges that conclusion arguing that the original Letter of Findings misstated the factual circumstances surrounding the payments. A rehearing was granted, and this Supplemental Letter of Findings results.

DISCUSSION

I. Disallowance of Royalty and Interest Expense Deductions – Adjusted Gross Income Tax.

The original Letter of Findings agreed with the audit that taxpayer should not be permitted to deduct the royalty and interest payments from its Indiana source income. It arrived at the conclusion pursuant to IC 6-3-2-2(l). The statutory provision states that "[i]f 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 department may require in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

The original Letter of Findings concluded that permitting the taxpayer to deduct the royalty and interest expenses distorted taxpayer's Indiana income. Disallowance of the deductions would more "fairly represent" the amount of taxpayer's income apportioned to Indiana and would effectuate a more equitable apportionment of the taxpayer's Indiana income.

In addition, the original Letter of Findings justified its conclusion on the basis of the "sham transaction" doctrine based on a determination that the transfer of the intellectual property to Delaware holding company and taxpayer's consequent royalty payment lacked a legitimate business purpose.

Taxpayer disagrees. Taxpayer points out that the intellectual property/royalty payments were not the typical two-party circular transactions designed wholly to elude state tax liability; e.g. (1) original owner transfers its intellectual property to wholly-owned holding company, (2) wholly-owned holding company charges original owner royalties, (3) wholly-owned holding company promptly "loans" the royalties back to original owner.

Taxpayer is correct in pointing out that these are not "two-party" transactions. Rather, the transactions involve three distinct participants; parent company, taxpayer, and Delaware holding company. The taxpayer is also correct in pointing out that the parties have taken unto themselves certain trappings of business legitimacy. Delaware holding company arranged for an independent evaluation of the intellectual property's value; the amount of royalty payments was established by reference to the independent evaluation; Delaware holding company has an employee; Delaware holding company engaged a law firm to "police" the intellectual property; the corporate governance of Delaware holding company is at least partially independent.

In addition, taxpayer argues that the Department's conclusion was "entirely contrary" to Department's conclusion in an earlier Letter of Findings published June 1, 2002. According to taxpayer, the June 2002 Letter of Findings (*Hereinafter* June 2002 LOF) "recognize[d] that the licensing of the trademarks and corporate logos to affiliated subsidiaries was a bona fide transaction" and that to allow the deduction in the June 2002 LOF and thereafter to deny it to taxpayer "is arbitrary and discriminatory." However, taxpayer overlooks the particular circumstances surrounding the June 2002 LOF. In that particular Letter of Findings, the holding company performed substantive activities for the petitioning taxpayer other than simply "holding" the petitioning taxpayer's intellectual property. The holding company controlled the operation of the petitioning taxpayer's Indiana retail stores. The holding company performed the taxpayer's asset and inventory purchases, accounting, payroll, invoicing, payables, property tax payments. The holding company "charge[d] and administrative fee to each store based on sales volume; allocate[d] a charge for rent to each store; charge[d] a service fee for inventory items purchased by the stores from the [holding company]; and charge[d] a one percent (1%) royalty fee for use of the trademarks and logos." The June 2002 LOF concluded that the petitioning taxpayer, the parent company, and the holding company possessed a separate and distinct economic vitality; their existence was based on more than simple tax avoidance. Taxpayer's contention – that the relationship between itself, Delaware holding company, and parent company is analogous to the parties described in the June 2002 LOF – is unwarranted. There is little indication that the taxpayer's

own Delaware holding company performed services or possessed an economic substance similar to that of the holding company described within the June 2002 LOF.

The Department has no quarrel with and does not challenge the validity of the value placed on the intellectual property subsequent to the transfer of that property to Delaware holding company. The Department does not challenge the amount of royalties Delaware holding company charged taxpayer – along with the 16 other affiliates – for the right to use that intellectual property. Similarly, the Department does not challenge the propriety of the interest charges levied against taxpayer. The Department does not challenge Delaware holding company's unrestrained right to loan its assets to the parent company with, apparently, little or no expectation that those amounts will be repaid. The Department certainly does not quarrel with Delaware's decision not to tax holding companies' income derived from the management of intellectual property.

However, the Department does maintain that, under IC 6-3-2-2(l), allowing taxpayer to claim the royalty and interest expenses as a deduction from its Indiana adjusted gross income "do[es] not fairly represent the taxpayer's income derived from sources within the state of Indiana." Taxpayer's parent company is certainly free to transfer its intellectual property to whomever it wants. However, *for purposes of determining taxpayer's adjusted gross income,* there is little or no economic or business justification for the formation of the Delaware holding company other than for allowing taxpayer to obtain the attendant tax benefits. The parent's company's decision to transfer the intellectual property – previously freely accessible to taxpayer and the other affiliated companies – allowed the taxpayer to shift a portion of its Indiana income to Delaware for no other readily discernible reason than to allow that income shift. Taxpayer has not shown that the transfer of the intellectual property to Delaware holding company served any other significant purpose other than tax avoidance – circumstances falling squarely within the "sham transaction" doctrine. "Transactions 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. Commissioner of Internal Revenue, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). *See also* Park 100 Dev. Co. v. Indiana Dept. of State Revenue, 429 N.E.2d 220 (Ind. 1981). It was such circumstances that IC 6-3-2-2(l) was plainly intended to reach. The Department was entitled to ignore the effect of the federal royalty and interest deductions and to allocate the royalty and interest income to Indiana.

FINDING

Taxpayer's protest is respectfully denied.

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