INDIANA DEPARTMENT OF REVENUE
LETTER OF FINDINGS: 03-0423
Indiana Corporate Income Tax
For the Years 1994 through 2000

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ISSUE

I. **Disallowance of Royalty Expenses** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); IC 6-8.1-5-1(b); 45 IAC 3.1-1-62.

Taxpayer challenges an audit decision to disallow royalty expenses paid to an affiliated company during 1994 through 1997.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of providing information technology. Taxpayer provides service and support to business corporations and government agencies within the United States and throughout the world. During 2003, the Department of Revenue (Department) conducted an audit review of taxpayer's income tax returns and business records. The audit review determined that taxpayer owed additional Indiana corporate income taxes. Accordingly, the Department sent taxpayer notices of "Proposed Assessment." Believing that the audit erred in the disallowance of certain royalty expenses, taxpayer submitted a protest challenging the additional assessments. An administrative hearing was conducted during which taxpayer's representative explained the basis for the protest. This Letter of Findings results.

DISCUSSION

I. **Disallowance of Royalty Expenses** – Adjusted Gross Income Tax.

Taxpayer challenges the audit's decision to disallow certain royalty expenses purportedly paid to an affiliated Bermuda company during 1994 through 1997.

The audit's decision to disallow the 1994/97 royalty expenses stems from its initial decision to disallow royalty expenses paid to an affiliated company during 1998 through 2000 which were the three years actually under audit. The 1998/2000 royalty expenses were paid to a foreign corporation, incorporated in Bermuda, which was formed for the purpose of holding certain of taxpayer's tradenames, trademarks, and service marks. This "intellectual property" had previously been directly owned by taxpayer.

The audit disallowed the claimed 1998/2000 royalties expenses because the audit found that the initial transfer of the intellectual property to the Bermuda company and the subsequent agreement to pay royalties to the Bermuda company were without "economic substance." The

audit found that the transfer of the intellectual property and the royalty agreements were "but sham transactions between [taxpayer] and some of the affiliated companies." The audit concluded that it could "not be considered a sound business transaction to transfer or sell a business asset to one self [sic], in order to make an expenditure to buy the same business back, from one self [sic], at a greater value than [taxpayer] transferred or sold it."

The audit disallowed the 1998/2000 royalty payments pursuant to IC 6-3-2-2(l) which states as follows:

> 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) the exclusion of any one (1) or more of the factors;
> >
> > (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 methods to effectuate an equitable allocation and apportionment of the taxpayer's income. (*Emphasis added*).

The audit also relied upon 45 IAC 3.1-1-62 which states in part that, "All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) . . . unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources."

Having concluded that the royalty expenses paid during 1998/2000 were without economic substance, the audit concluded that "The disallowance of royalty fee expenses from the federal tax return would correct the distortion of income and present a more fair[] representation of the company's income from Indiana sources."

Taxpayer agrees that the audit correctly disallowed the 1998/2000 royalty payments. "[Taxpayer] is in agreement with the proposed adjustments made to the reallocation of receipts for purposes of Gross Income Tax [sic] calculation for the tax years ending September 30, 1998 – September 30, 2000."

However, the audit did not confine itself to considering the royalty payments paid to the Bermuda company during 1998/2000. The audit also made adjustments effectively disallowing the royalty expenses paid during 1994/97 in order to correct the NOL (Net Operating Loss) deduction coming forward to the years actually under audit. Because the actual amount of royalty payments paid during 1994/97 was unavailable at the time of the audit, an "average royalty and commission" was employed as the "best information available."

It is these 1994/97 payments which are at the heart of taxpayer's protest. Taxpayer agrees that the 1998/2000 royalty payments were correctly disallowed. However, taxpayer points out that the royalty agreement between itself and the Bermuda company was not entered until 1998 and

that "no royalty expense was paid by [taxpayer] until that fiscal year ended." In other words, taxpayer states that the audit's 1994/97 adjustments were founded upon non-existent royalty payments.

Taxpayer has provided a copy of the royalty agreement between itself and its associated Bermuda company. As taxpayer maintains, the agreement was "made effective as of October 1, 1998." Nonetheless, taxpayer's principal assertion – that it paid no royalties during 1994/97 – is refuted by taxpayer's own federal income tax returns. Specifically, taxpayer's support schedule for its 1996 federal 1120 income tax return states that taxpayer claimed deductions of approximately $37,000,000 in "COMMISSIONS & ROYALTIES."

Taxpayer was asked to explain the discrepancy between its claim that it did not pay royalties during 1994/97 and the information contained on the federal support schedule. Taxpayer declined to comment.

The evidence provided is inconclusive. The royalty agreement with the Bermuda company was not in effect until 1998. The audit employed what it regarded as the "best information available" to determine the 1994/97 royalty payments and to recalculate the NOL. Taxpayer's federal return clearly demonstrates that taxpayer paid substantial amounts of money in the form of royalty payments during 1996. When asked subsequent to the hearing to provide an explanation for the 1996 royalty payments, taxpayer failed to respond.

The audit acted within its authority to calculate taxpayer's 1994/97 royalty payments. IC 6-8.1-5-1(a) provides in the part that "If the department reasonably believes that a person has not reported the proper amount of tax due, the department *shall* make a proposed assessment of the amount of the unpaid tax on the basis of the basis of the best information available to the department." (*Emphasis added*).

In the face of taxpayer's failure to explain the nature and substance of the 1996 royalty expenses, the Department is unable to agree that the audit's conclusion concerning the 1994/97 royalty payment was unwarranted. As set out in IC 6-8.1-5-1(b), "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." Taxpayer's bare assertion – that the agreement between itself and the Bermuda company was not in effect until 1998 – does not meet the burden of proving that the proposed assessments are wrong.

FINDING

Taxpayer's protest is respectfully denied.

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