DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 06-0067
Income Tax
For Tax Period 2000-2002

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ISSUES

I. Adjusted Gross Income Tax - Deductions

Authority: IC § 6-8.1-5-1(b); IC § 6-3-2-2(l).

The taxpayer protests the disallowance of deductions for certain expenses.

STATEMENT OF FACTS

The taxpayer is a corporation that manufactures and sells power tools. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "Department," assessed additional adjusted gross income tax, and interest against the taxpayer. The taxpayer protested a portion of the assessment of adjusted gross income tax. A hearing was held and this Letter of Findings results.

I. Adjusted Gross Income Tax - Deductions

DISCUSSION

There are three corporations involved in this audit. The taxpayer was created as a wholly owned subsidiary of Corporation A in 1978. Corporation A contributed all of its operating assets to the taxpayer in return for stock. Another wholly owned subsidiary, Corporation B, was created from Corporation A in 1978. In return for shares of Corporation B stock, Corporation A contributed its intellectual property (patents and technical know-how). Shortly thereafter, Corporation B granted a license to the taxpayer to utilize the patents owned by Corporation B and previously owned by Corporation A. In return, the taxpayer agreed to pay a license fee of 3.8 percent of its sales. Corporation B has entered into similar agreements with other domestic and foreign affiliated companies and has also entered into third-party licensing agreements. Corporation B then loaned the royalty proceeds at a market rate of interest to the taxpayer. In 1999, the taxpayer agreed to pay Corporation A three percent of the net sales of products sold under the trademarks and patents for the right to use the patents and trademarks in the United States.

The taxpayer deducted the royalty, trademark, and intercompany interest expenses generated by the payment of royalties and interest to Corporation B and license fees paid to Corporation A. The Department determined that the taxpayer's reporting method - including these deductions for intercompany payments – did not fairly reflect its Indiana net income. Therefore, the department disallowed these deductions. The taxpayer protested this disallowance.

Notices of proposed assessments are prima facie evidence that the department's claim for unpaid taxes is valid**.** IC § 6-8.1-5-1(b). The taxpayer has the burden of proving that the department incorrectly imposed the assessment. Id.

The department disallowed the deductions for the intercompany payments of license fees, royalties, and interest under authority of IC § 6-3-2-2(l) 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 *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 method to effectuate an equitable allocation and apportionment of the taxpayer's income. (emphasis added).

The taxpayer argues that the department improperly disallowed the deductions because its tax reporting method fairly reflected its Indiana adjusted gross income subject to Indiana tax. The taxpayer argues that it reorganized its corporate structure for valid business reasons. The taxpayer believes that the current structure allows immediate worldwide access to the patents and trademarks. Since it never owned the patents and trademarks, the taxpayer argues that it had to pay license fees and royalties to other corporations to obtain permission to use the patents and trademarks. Further, the taxpayer argues that it negotiated the leases for the use of the trademarks and patents in arms' length transactions. The fees paid pursuant to the terms of the agreements fairly reflected the fair market value of the patents and trade marks.

Corporation B, from which the taxpayer leases the intangible property and borrows money, is a fully functional corporation organized to hold the patents and trade marks and also operates facilities in Europe, Puerto

Rico, and Mexico. Corporation B was not set up merely to hold patents and trademarks. It also has extensive holdings and operations in other areas of the world. The fees paid by the taxpayer represented only about one third of the total receipts of Corporation B.

The taxpayer errs in its conclusion that its original Indiana Adjusted Gross Income Returns fairly and equitably reported its actual Indiana income. Originally the taxpayer, Corporation A, and Corporation B were all part of one corporation. Before reorganization, the patents and trademarks were immediately accessible throughout the world just as they are now. Before the reorganization, the taxpayer did not have the expenses and deductions created by interest and licensing fee payments to Corporations A and B. This seemingly arbitrary reduction in the taxpayer's adjusted gross income subject to Indiana Adjusted Gross Income Tax distorts the actual income taxpayer has subject to taxation in Indiana. Since Indiana is a "water's edge" state, the business operations in foreign lands are not included in an Indiana combined return, and that income is not subject to Indiana tax.

The taxpayer asserts that it paid income tax on a unitary basis in another state. The taxpayer did not demonstrate, however, that income taxes paid in the other state were on its receipts from Indiana sales.

The taxpayer also points out that the Internal Revenue Service accepted the current corporate structure and resulting tax filings. Internal Revenue Service acceptance of Corporation A's business reorganization is not germane to the issue of the fair reflection of the taxpayer's Indiana adjusted gross income. The related corporations file a federal consolidated return. On that return, all intercompany transactions disappear. Therefore, there is no issue of the appropriateness of the intercompany expense deductions as there is on the Indiana return.

The taxpayer also argues that the Department is precluded from disallowing the deductions in a subsequent audit for the 2000-2002 years because it accepted the taxpayer's use of the same deductions in an audit of the tax years 1994-1996. The taxpayer argues that the Department has inappropriately changed its administration of the tax without a change in the law or regulations. In the years since 1996, the Department has been consistently using its statutory authority to require related corporations to eliminate expenses paid for use of trademarks and patents and payments on loans that merely serve to pass money through related corporations in a circular manner to engender large expense deductions and artificially lower adjusted gross income subject to tax in Indiana. The Department is within its rights to audit the taxpayer and assess the tax at this time. The Department did not assess the negligence penalty against the taxpayer due to the treatment during the previous audit.

In an effort to fairly and equitably reflect the taxpayer's income from sales in Indiana, the Department properly disallowed the expenses in accordance with its authority under § 6-3-2-2(l)(4) to used any "method that method to effectuate an equitable allocation and apportionment of the taxpayer's income."

FINDING

The taxpayer's protest is respectfully denied.

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