

**Letter of Findings Number: 06-0169**  
**Adjusted Gross Income Tax**  
**For the Tax Period 2000-2001, 2004**

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**ISSUES**

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

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

The Taxpayer protests the disallowance of the royalty deduction.

**II. Tax Administration- Ten Percent Negligence Penalty**

**Authority:** IC § 6-8.1-10-2.1; [45 IAC 15-11-2\(b\)\(c\)](#).

The Taxpayer protests the imposition of the ten percent negligence penalty.

**STATEMENT OF FACTS**

The Taxpayer manufactures and produces tangible personal property. Pursuant to an audit, the Indiana Department of Revenue (Department) assessed additional adjusted gross income tax, interest, and penalty for the years 2001, 2002, and 2004. No additional adjusted gross income tax, interest, and penalty was assessed for the year 2003. The taxpayer protested and a hearing was held. This Letter of Findings results.

**I. Adjusted Gross Income Tax- Disallowance of Royalty Deduction**

**DISCUSSION**

In 1997, the Taxpayer's affiliated corporations reorganized their business operations. During this reorganization, a Delaware holding company was incorporated to own and manage intellectual property. The Taxpayer is the managing member of the holding company. The Taxpayer and its affiliates assigned ownership of all of their trade names, trademarks, and related intellectual property to this holding corporation. According to the audit report, the Taxpayer pays the holding company six per cent of its Indiana income to reimburse the holding company for its services on behalf of the Taxpayer. The Taxpayer deducted these payments from its Indiana gross income to determine its Indiana adjusted gross income. At the discretion of the managing member (the Taxpayer) the holding company distributes cash and property to the members of the corporation. The Department determined that the deduction of the royalty payments did not fairly reflect the Taxpayer's Indiana source income. Therefore, the Department disallowed this deduction of royalty expenses paid. The Taxpayer protested this disallowance.

Indiana Department of Revenue assessments are prima facie evidence that the tax assessment is correct. IC § 6-8.1-5-1(b). The Taxpayer bears the burden of proving that the assessment is incorrect. Id.

The department disallowed the royalty expense deductions 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).

This provision is bolstered by [45 IAC 3.1-1-1-62](#), which states in pertinent 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. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income.

The Taxpayer argued that this statute only allows the Department to use another method such as the disallowance or royalty deductions when the apportionment or allocation methods provided by statute did not fairly reflect the Taxpayer's income. The Taxpayer states that since the Department accepted the Taxpayer's apportionment method and it fairly reflected the Taxpayer's Indiana source income, the Department did not have the statutory authority to deny the royalty expense deductions.

The Department did accept the Taxpayer's apportionment method. However, the deduction of the royalty expenses from the Taxpayer's Indiana sales effectively lowered the Indiana sales factor. This modification of the sales factor distorted the Taxpayer's Indiana income to such an extent that the statutory sales factor no longer fairly reflected the Taxpayer's income received from selling tangible personal property to Indiana customers. In

order to remedy this distortion, the Department appropriately disallowed the Taxpayer's deduction of royalty expense payments to the holding corporation.

The Taxpayer further argued that the holding company was a viable, legitimate, and true corporation, not a "sham corporation." The Taxpayer presented substantial documentation to support that contention. That information does not, however, alter the Department's position that the Taxpayer's utilization of the royalty expense deduction distorted the Taxpayer's actual income received from Indiana sales of its tangible personal property.

The Taxpayer's deduction of royalty expenses paid to the related holding corporation did not fairly reflect the Taxpayer's income received from sales of its tangible personal property to Indiana consumers. Therefore, the Department properly disallowed the Taxpayer's royalty deductions.

Alternatively, the Taxpayer made the following argument:

If the Taxpayer is not entitled to deduct the royalty payments it made to the holding corporation, it should be entitled to deduct the operating expenses of the holding corporation.

The Department has insufficient information to address the Taxpayer's alternative argument at this time.

#### **FINDING**

The Taxpayer's protest is respectfully denied.

## **II. Tax Administration- Ten Percent Negligence Penalty**

### **DISCUSSION**

The Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation [45 IAC 15-11-2](#)(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at [45 IAC 15-11-2](#)(c) as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the assessed adjusted gross income tax was due to reasonable cause rather than negligence.

#### **FINDING**

The Taxpayer's protest is sustained.

*Posted: 01/24/2007 by Legislative Services Agency*

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