DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 07-0062
Corporate Income Tax
Tax Period: 2002 - 2004

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ISSUES

I. Adjusted Gross Income Tax – Disallowance of Royalty Expense.

Authority: IC § 6-8.1-5-1(b); IC § 6-3-2-2(l); IC § 6-3-2-2(m); *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S.Ct. 1132 (1943); *Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal.Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer protests the disallowance of deductions for business expenses related to royalty payments made to an affiliated company.

STATEMENT OF FACTS

Taxpayer and its affiliates engage in manufacturing, distribution, and restaurant operations. Taxpayer has established limited liability companies ("LLCs") to run its restaurant affiliates in Indiana, Kentucky and Michigan. Taxpayer is a holding company, holding ninety-nine percent interest in each of the LLCs. The LLCs are taxed as partnerships for federal tax purposes, with the income or loss flowing up to the Taxpayer. The LLCs have boards of directors different from that of the main operating company.

Taxpayer transferred Taxpayer's registered trademarks to a management company ("Management Company") in an I.R.C. § 351 tax-free exchange for one hundred percent of Management Company's stock. Taxpayer alleges that the Management Company owns, manages, and markets the Taxpayer's trademarks, as well as provides centrally located administrative functions, including accounting, finance, marketing, data processing and numerous other functions. Management Company also establishes the overall corporate strategy for the Taxpayer and its affiliates. Further, Management Company owns proprietary and distinctive business formats, confidential restaurant and food manufacturing information, know-how in restaurant operations, proprietary operations and policy information, and other Taxpayer information. Management Company's responsibilities include maintaining, managing, marketing, and protecting the existing intangible property.

Management Company allows the LLCs to use the various trademarks and other intangible property in their manufacturing, sales, and restaurant operations. The LLCs pay Management Company a five percent royalty on their respective gross sales representing licensing fees for use of the intangible property. Taxpayer asserts that the granting of the license represents an arms-length transaction with economic substance. During the three audit years, as well as in 2005, Management Company also charged marketing and other corporate fees to the LLCs, resulting in the allocation of all of Management Company's operating expenses to the LLCs. Taxpayer asserts that the marketing fee covers promotional, advertising, and other marketing-related expenses; the corporate fee goes towards "headquarter-related" expenses, including accounting, document collection and retrieval, and other administrative services performed by Management Company. But Taxpayer also avers that the three fees cover employee salaries, office supplies, advertising expenditures; those expenses typical in the corporate setting. According to Taxpayer, the royalties provide a profit stream; the royalties are "straight profit."

After auditing the 2002, 2003, and 2004 tax years, the Department concluded that the level of intercompany royalties and related transactions significantly distorted Taxpayer's reported Indiana adjusted gross income. The payment of royalty fees to Management Company in addition to the corporate and marketing fees does not fairly reflect the LLCs' operating income derived from Indiana sources. The Department provided the following reasons for its assessment:

1. The value of the trademarks is dependent on continuing research, development and marketing activities. Management Company has charged the cost of engaging in the activities and services that enhance or ensure the continued value of the trademark to the restaurant operating affiliates [the LLCs]. The payment of royalty fees to use these trademarks results in the same expenses being allocated to the restaurant operating facilities twice;
2. The profitability of the restaurant operating facilities declined as a direct result of the transfer of the trademarks and related royalties. An agreement so detrimental to the restaurant operating affiliates' income without any clear economic benefit other than avoiding state income tax does not fairly reflect the income derived by the affiliates in Indiana;
3. Management Company acquired the trademarks in a transaction without true economic substance. Before and after the execution of the royalty agreement, the Taxpayer had exclusive use of both the trademarks and the cash assets held by Management Company; and
4. The transactions involving the royalty expenses reflected on the Taxpayer's return are also without true

economic substance.

As a result of that audit examination, a number of adjustments were made which increased Taxpayer's tax liabilities. Taxpayer disagreed with certain of those adjustments and submitted a protest to the Department. Pursuant to that protest, the Department conducted an administrative hearing which afforded Taxpayer an opportunity to substantiate the basis for its protest. As a result of that hearing, this Letter of Findings was prepared.

I. Adjusted Gross Income Tax – Disallowance of Royalty Expense

DISCUSSION

The Taxpayer and Management Company entered into a license agreement in January 2002 ("License Agreement"). The License Agreement provided that Taxpayer, as licensee, was granted "the nonexclusive right to use the Licensed Rights to operate [restaurants] in the [United States and Canada]." The Licensed Rights included the various trade-, service, and other proprietary marks associated with Taxpayer's restaurant business. Those Rights also included all confidential information and data collected, compiled, and created by the Management Company ultimately disclosed to or otherwise obtained by the Taxpayer. The LLCs pay Management Company a five percent royalty on their respective gross sales representing licensing fees for use of the Licensed Rights. The Taxpayer and Management Company entered into a similar license agreement in January 2003.

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*.

In support of the Department's position, the audit report cited to IC § 6-3-2-2(l) which states that:

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 report also cited to IC § 6-3-2-2(m) which states that "[i]n the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." *Id*. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." *See Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal.Rptr. 432 (Cal. Ct. App. 1961).

In the hearing, the Taxpayer provided additional documents in support of Taxpayer's protest. Those documents included copies of the Taxpayer's profit and loss statements, federal forms 1065 and 1120, and the license agreement between the Taxpayer and the Management Company. The Taxpayer offered these documents in support of its assertions that the Management Company did not make any loans to the Taxpayer, nor did Management Company pay any dividends to the Taxpayer with monies originating from the royalty and management fees paid to the Management Company. Upon further review of these documents coupled with the Taxpayer's statements during the hearing, the Department cannot find any data or evidence to contradict the Taxpayer's assertions. The Department cannot ascertain any activity that would suggest a circular flow of monies concerning the royalty payments made by Taxpayer to Management Company.

Based upon Taxpayer's additional information as reviewed by the Department, the Taxpayer has met its burden of supporting its argument against the Department's assessment that the Taxpayer's payment of royalty fees to Management Company in addition to the corporate and marketing fees does not fairly reflect the LLCs' operating income derived from Indiana sources. Taxpayer has met its statutory burden of demonstrating that the Department's decision disallowing the royalty expenses is incorrect.

FINDING

The taxpayer's protest is sustained.

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