

Letter of Findings Number: 07-0357
Corporate Income Tax
For the Tax Years 1997-2003

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ISSUES

I. Adjusted Gross Income Tax—Disallowance of Royalty and Interest Expenses.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; *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 Department of Revenue's decision to disallow Taxpayer's expense deductions for royalty fees and interest that it paid to a related entity.

II. Tax Administration—Negligence Penalty.

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

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a company that manufactures and sells wood veneers in Indiana. Taxpayer's parent ("Parent") owns, manages, and markets Taxpayer's trade names, trademarks, patents, and intellectual property. The Parent's responsibilities include maintaining, managing, marketing, and protecting the existing intangible property. The Parent allows Taxpayer to use the various trademarks and other intangible property in its manufacturing and sales operations. Taxpayer pays the Parent a five percent royalty on its 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.

After an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for additional adjusted gross income tax for the 1997 through 2003 tax years. The Department found that Taxpayer had failed to report certain adjustments that it received from the Internal Revenue Service. In addition, the Department found that the level of Taxpayer's intercompany royalties and interest transactions significantly distorted Taxpayer's reported Indiana adjusted gross income and disallowed the deductions. Taxpayer protested the imposition of the tax and penalties resulting from the disallowance of the deductions for intercompany royalty and interest expense. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax—Disallowance of Royalty and Interest Expenses.

DISCUSSION

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

The Department found that the level of Taxpayer's intercompany royalties and interest transactions significantly distorted Taxpayer's reported Indiana adjusted gross income and disallowed the deductions.

The Department refers to IC § 6-3-2-2(l) which provides 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).

In addition, the Department also refers to IC § 6-3-2-2(m), which provides 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).

During the course of the protest, Taxpayer provided additional documents in support of Taxpayer's protest. Those documents included copies of Taxpayer's income tax form 1120's, balance sheets, the license agreement between Taxpayer and the Parent, a royalty rate valuation study, the loan agreements and payment schedules for the two loans between Taxpayer and the Parent, and a loan agreement and payment schedule for one of Taxpayer's loans between Taxpayer and an unrelated entity. Taxpayer offered these documents in support of its assertions that, while there were small amounts of loans made by the Parent, the Parent did not make excessive amounts of loans to the Taxpayer, nor did the Parent pay any dividends to Taxpayer with monies originating from the royalty fees or interest paid to the Parent. Upon further review of these documents coupled with Taxpayer's statements during the hearing, the Department cannot find any data or evidence to contradict Taxpayer's assertions. The Department cannot ascertain any activity that would suggest a mere circular flow of monies concerning the royalty and interest payments made between Taxpayer and the Parent.

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect. Based upon the additional information that Taxpayer submitted to the Department, Taxpayer has met its statutory burden of demonstrating that the Department's decision disallowing the royalty and interest expenses is incorrect. While the audit correctly noted that the claimed expenses significantly reduce the amount of income subject to tax in Indiana, there is little to indicate that the royalty payments constituted an abusive tax avoidance scheme such that the claimed expenses did not "fairly reflect" Taxpayer's Indiana source income.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides, "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty.

The Department may waive a negligence penalty as provided in [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.

In this case, since Taxpayer has established that it does not owe the proposed assessments as discussed in Issue I, Taxpayer has affirmatively established that there was not a failure to pay deficiencies and accordingly that it exercised ordinary business care, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest to the imposition of the penalty is sustained.

CONCLUSION

In summary, Taxpayer's protest is sustained.

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