

Letters of Findings: 07-0597, 07-0598, 07-0599, 07-0600
Corporate Income Tax
For the Years 2003, 2004, 2005

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ISSUES

I. Adjusted Gross Income Tax – Royalty Fee & Interest Deductions.

Authority: IC § 6-3-1-3.5(b); IC § 6-3-2-2; IC § 6-8.1-5-1; [45 IAC 3.1-1-8](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); I.R.C. § 351.

Taxpayers protest the addback of royalty and interest expenses in calculating its income tax due to Indiana.

II. Tax Administration – Negligence Penalty.

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

Taxpayers protest the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

An affiliated group of companies ("Group") constructed and sold single family houses nationwide. Several related entities operated in Indiana. The Indiana group provided home construction and mortgage assistance. Two of the Indiana group members ("Corp 1" and "Corp 2") and one limited liability company ("LLC 1") were involved in home construction. Corp 1 and Corp 2 each owned fifty percent of LLC 1. This ownership was Corp 1's and Corp 2's only Indiana activity. LLC 1 developed several subdivisions in Indiana. LLC 1 filed as a partnership for federal and Indiana income tax purposes. LLC 1 ceased business operations in June 2005 and distributed all of its assets and liabilities to Corp 1 and Corp 2.

Another Indiana group member ("Corp 3") and a limited liability company ("LLC 2") provided mortgage assistance. Corp 3 began filing returns in Indiana in 2003. Its only tie to Indiana resulted from being the single member of LLC 2 which is a disregarded entity for federal and Indiana income tax purposes. As a result, all assets, income and expense items reverted to Corp 3. LLC 2 is a mortgage broker with locations in multiple states, including Indiana.

As a result of an audit, the Indiana Department of Revenue ("Department") determined that LLC 1, Corp 1, Corp 2, and Corp 3 (referred to either separately or as "Taxpayers" collectively) owed additional income tax, negligence penalty and interest for the tax years 2003, 2004, and 2005. This Letter of Findings addresses a combined protest by Taxpayers. Specifically, Taxpayers protest the Department's determination to add back, first, royalty payments made from Taxpayers to a related corporation for the rights to use certain intellectual property, and, second, a portion of interest payments made from Taxpayers to the same related corporation in 2003 and 2004, and another related corporation in 2005 for loans extended to Taxpayers by Related to cover the operating companies' daily payables (both related companies are referred to as "Related").

LLC 1 filed its Indiana IT-65 partnership returns in all audit years apportioning one-hundred percent of its distributable income to Indiana since it had no locations outside Indiana. LLC 1's IT-65 showed equal distributions to Corp 1 and Corp 2, its only members. Corp 1 and Corp 2 filed their Indiana income tax returns for all the audit years on a separate return basis. Corp 1's and Corp 2's only income consisted of distributions received from their fifty-percent membership in LLC 1. The Department's audit of LLC 1 increased the amount of distributable income for the years in question which then made upward adjustments to Corp 1's and Corp 2's income.

Corp 3 filed its Indiana income tax return for the audit years in question on a separate return basis. The Department's audit increased Corp 3's Indiana taxable income.

An administrative hearing was held on Taxpayers' protest and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax - Royalty Fee & Interest Deductions.

DISCUSSION

The Department, acting under the authority of IC § 6-3-2-2(l), concluded that the royalties and interest deductions taken by Taxpayers on their 2003, 2004, and 2005, Indiana returns distorted Taxpayers' Indiana taxable income so as not to fairly reflect Taxpayers' income derived from sources within Indiana. The Department, therefore, acting under the authority of IC § 6-3-2-2(l), disallowed the royalty and interest deductions. Taxpayers protest the Department's addback of royalty and interest expense to their Indiana adjusted gross income for those years because the deductions, Taxpayers argue, were valid business expenses and therefore properly deductible under federal and Indiana law.

The Department notes that all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3-1-3.5(b) provides the starting point for determining taxpayer's taxable income stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code...." The Department's Administrative Rules repeats the basic principle at [45 IAC 3.1-1-8](#) stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code – section 63)...." However, the taxpayer's federal "adjusted gross income" is merely the starting point; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point, the details of which are not relevant here.

The audit disallowed Taxpayers' royalty and interest deductions under IC § 6-3-2-2(l).

IC § 6-3-2-2 states in relevant part:

(l) 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) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
- (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.

(m) In 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

....

(p) Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

According to the Department's audit summary, LLC 1 had essentially assigned to another state a substantial portion of its distributable income via royalties being paid to Related. The Department proposed not to recognize the deductions taken for royalties and to reduce the amount of the interest deduction taken on Line 15 on page 1 of the federal 1065 partnership return for LLC 1 in all the audit years by amounts that represent interest that would not have had to been paid if the royalties had not been paid to the trademark holding companies.

The Department similarly found that Corp 3's method of allocation and apportionment does not fairly reflect Indiana sourced income. Again, according to the Department's audit summary, Corp 3 had essentially assigned to another state a substantial portion of their income via inter-company interest and royalty to Related in all audit years. The Department proposed not to recognize the royalty deduction and to reduce the amount of interest deduction taken on Line 18 on Page 1 of the federal 1120 by an amount that represents interest that would not have been paid had the royalties not been paid to the trademark companies.

The first point Taxpayer argues is that IC § 6-3-2-2(l) permits the Department to adjust only the allocation and apportionment of Taxpayers' I.R.C. § 63 adjusted gross income, and, except for the enumerated provisions contained within IC § 6-3-1-3.5(b), the Department is wholly without authority to disallow the royalty and interest deductions allowed under the federal tax scheme. Taxpayers place too formalistic an interpretation on the authority granted the Department under IC § 6-3-2-2(l). The plain language of the law states that "[i]f 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 department may require, in respect to all or any part of the taxpayer's business activity... the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (Emphasis added).

The audit indeed was without authority to contravene the royalty and interest expense deductions legitimately claimed on Taxpayers' federal return. However, if the auditor believed that the effect of those deductions was to misallocate Taxpayers' Indiana income, IC § 6-3-2-2(l) plainly granted the Department the authority to ignore the effect of the federal deductions and allocate that income to Indiana. Therefore, the Department's audit was plainly justified in determining that Taxpayers' royalty and interest federal deductions artificially distorted Taxpayers' Indiana income and in disallowing those expenses in order to "more fairly represent" the amount of Taxpayers' income apportioned to Indiana and to effectuate a more equitable apportionment of Taxpayers' Indiana income.

The second point Taxpayers argue is that the activities above all had "economic substance" and were for

"valid business purpose." Taxpayers argue that Group centralized all intellectual property within one legal entity, Related, to better manage Group's brands and to enhance Group's intellectual property. Furthermore, Taxpayer states in a pre-hearing request for information:

Moreover, the transfer also was necessary for the continuation but even more for the development of the overarching business imperative of appropriately and fairly funding [Group's] internal central bank to provide ready cash flow across all entities. The central bank earns royalty income, due to its ownership of the IP, that it redeploys for its own specific expenses, its expenses as the central banker... This transfer made it possible for [Group] as a whole to ensure sufficient cash flow without the need for outside borrowing for necessary expenses of each of the [Group] entities.

This "central banking" function is further explained in the Department's audit report which refers to comments by Taxpayers' director of state tax:

[T]he inter-company loans are essentially a revolver with cash swept on a daily basis against outstanding payables for the operating companies. The "Internal Bank" is merely a conduit to centralize the cash function within the group and push down debt from outside third party banks.

The value of Related's trademarks was determined by a study performed by a third party using transfer pricing studies according to the requirements of Section 482 of the IRC. The 2002 Transfer Pricing Study sought to compare royalty agreements in Group's industry, however, it did not locate royalty agreements that based the royalty rate on a percentage of sales among the cohorts, therefore the comparables for the study relied on sample agreements from other industries in addition to a profitability analysis of Group. The study recommended a royalty rate of two-percent of sales. The trademarks were transferred as tax-free capital contributions to the trademark holding companies pursuant to Section 351 of the IRC. The royalty rate established by the transfer pricing study was applied to the net sales of the entity using the trademarks.

According to Taxpayers, in response to a pre-hearing request for information by the Department, Related, in addition to holding existing intellectual property, also created new brands that it registered as trademarks/tradenames. Related also hired an expert in branding to fill a then-newly created vice president level position whose emphasis was on branding initiatives to execute Group's initiative to differentiate its brand from that of other home builders. This new vice president was responsible for national advertising, sponsoring a float in well-known parade, developing logos, commercials, etc. In addition to branding experts, Related hired other employees who had experience in dealing with the legal issues surrounding trademarks and tradenames. These employees worked with outside legal counsel to implement protective strategies. Therefore, among Related's trademark related expenses were: advertising, marketing, market studies, valuation, accounting, personnel, and legal expenses.

Related has notes in place to support and document its loans. Taxpayers provided a sample note. Taxpayers argue that the debtor has legally enforceable obligations to pay. The ultimate source of repayment of loans by the operating entities was from proceeds from the sale of homes and land and other related financings. According to Taxpayers, the loans are both fixed and payable without regard to earnings. Taxpayers state that there was no fixed maturity date for the indebtedness because it was a revolving credit facility. Taxpayer further states that while there was no fixed maturity date, the interest payments in this instance are paid or accrued quarterly without exception and regardless of the profitability of the borrower. Interest rates are determined based on transfer pricing studies which set a base interest rate adjusted only partially due to various financial metrics of the borrower; thus, Taxpayers state that while the interest rate is set in part based on the borrower's economic condition, the rate is not "tied" to earnings alone.

The fact that Taxpayers have arguably demonstrated business purpose does not remove the question of the economic substance of the subject transactions. The economic-substance doctrine looks beyond whether a transaction is conducted at arm's length, and instead at the transaction's economic effects. Accordingly, a finding of business purpose does not preclude looking at the economic substance of financial transfers between related entities. The fact remains that Taxpayers' Group has a company, Related, that holds Group's trademarks and functions as Group's "central bank," and that has nexus in a tax haven state. This structure provides the operating affiliates in Indiana with deductions against Indiana income for royalty payments made to Related. Taxable Indiana income is thus reduced. The royalty income to Related is not taxed because Related is located in a tax haven state. Related also extends loans to the Indiana operating affiliates to help them meet their daily payables. The Indiana operating affiliates pay interest to Related on these loans. These interest payments are also deductible expenses to the Indiana operating affiliates. Taxable Indiana income is thus further reduced. Again, the income resulting from the payments to Related is not taxed to Related because it is located in a tax haven state.

It is noteworthy that the Ex-21 attachment to Group's 10-K reports for the audit years show that the overwhelming majority of Group's entities - the number of entities approaches 100 - are located in states where their incomes would be taxed, except for just a handful of entities located in tax haven states which include primarily the trademark and "banking" entities such as Related. As long as Related has nexus in its tax haven state, this structure provides the operating affiliates with royalty expense and interest expense deductions, while the corresponding royalty and interest income to Related is not subject to tax in any state. The inter-company efficiencies resulting from managing Group's trademark and trade names through one entity and from an "internal

bank" that acts as a "cash revolver" for Group are self-evident. However, the economic net-effect of the flow of the royalty fees from Taxpayers to Related, the loans from Related to Taxpayers, and the payment of interest by Taxpayers to Related, is to essentially remove to a tax haven state a significant portion of income sourced to Taxpayers' Indiana activities and, therefore, otherwise subject to taxation in Indiana.

Taxpayers have shown an apparent valid business purpose for their Group's trademark and loan entities and activities. However, notwithstanding this valid business purpose, the economic substance of these deductions does not fairly reflect Taxpayers' Indiana activities since they reduce Taxpayers' Indiana taxable income by approximately half

over the audit years while resulting in a double tax benefit to the Group. Such a significant distortion of Taxpayers' taxable Indiana income does not "fairly reflect" Taxpayers' income derived from sources within the state of Indiana during the audit years. Pursuant to IC § 6-3-2-2(l) and (m), the Department is authorized to employ a reasonable method that effectuates an equitable distribution, allocation, or apportionment of income to Indiana. Subject to the bar set by IC § 6-3-2-2(p), the Department chose to add back Taxpayers' royalty and interest deductions to its Indiana taxable income.

However, Taxpayers reasonably point out that the Department's audit report does not fully address the economic flow of the loans extended to Taxpayers by Related and their associated interest deductions with respect to the flow of royalty deductions and income. In other words, the Department's audit does not fully document the flow of royalty and loan related monies between Related and Taxpayers.

Therefore, given the above, but also given that the Department's audit has reasonably pointed to a significant distortion in Taxpayers' reported Indiana taxable income, this Letter of Findings reduces the Department's audit addback of the royalty deduction to the extent that Taxpayers' royalty expenses are measured by Related's expenses in support of its trademarks. The Department's audit methodology for calculating a proportionate addback of the interest expense is reasonable - the Department's audit had reduced the amount of interest deduction taken on the federal returns by an amount that represented interest that would not have been paid had the royalties not been paid to the trademark companies - but will be calculated based on the modified allowable royalty expense.

FINDING

Taxpayers are sustained in part and denied in part. Taxpayers are sustained to the extent that a supplemental audit does the following for Indiana purposes: (1) establishes Related's trademark-related expenses as a proportion of its royalty income for the audit years; (2) allows Taxpayers' royalty deduction in that same proportion; and (3) allows Taxpayers' interest deduction in that same proportion.

II. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and ten percent negligence penalties for the tax years in question. Taxpayers protest 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 refers to [45 IAC 15-11-2\(b\)](#), which states:

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 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.

Taxpayers have met their burden of proof to show that the deficiencies they incurred are due to reasonable cause and are therefore not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest is sustained.

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