DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 08-0177
Adjusted Gross Income Tax
For Tax Years 2001-03

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ISSUE

I. Adjusted Gross Income Tax – Combined Return.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1.

Taxpayer protests the determination to require it to file a combined Indiana return with related entities.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer should file a combined Indiana adjusted gross income tax return with related corporations, in order to fairly reflect income earned in Indiana. This determination was based on the Department's finding that a related company ("Related") had no economic substance, yet received large royalty payments from Taxpayer for the use of intellectual property ("IP") which Taxpayer had contributed to Related upon Related's formation. Also, Related loaned a large amount to Taxpayer upon which Taxpayer only makes interest payments. The Department considered this to be a circular flow of money which resulted in Indiana-based income being "rotated" out of Indiana and therefore escaping valid Indiana income taxes. The Department determined that by requiring a combined return which included Taxpayer and Related, the circular flow of income would be negated and Taxpayer's Indiana income would be fairly reflected. Accordingly, the Department issued proposed assessments for adjusted gross income tax for the tax years 2001, 2002, and 2003. Taxpayer protests that its returns as originally filed for the tax years 2001-03 fairly reflect its Indiana income and that requiring a combined return is not necessary. An administrative hearing was conducted and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax – Combined Return.

DISCUSSION

Taxpayer protests the Department's decision to require Taxpayer and affiliated companies to file a combined Indiana adjusted gross income tax return. Taxpayer states that its returns do fairly reflect its Indiana income as they were filed for 2001, 2002, and 2003. Taxpayer states that Related, which the Department determined should be included, had no contacts with Indiana and offers several reasons why it should not be included in a combined return. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The Department based its determination on several factors. First, the Department determined that Taxpayer and Related were in a unitary business, having satisfied the three factor test of: 1) unity of ownership, 2) unity of use, and 3) unity of operations. Second, the Department noted that Taxpayer's employees provided many services for Related. Significantly, Taxpayer's legal department handled all legal functions regarding the IP owned by Related. Third, the Department noted that Related had no economic substance separate from Taxpayer, since Related's only income was from receipts of royalties and interest from Taxpayer and since Taxpayer continued to perform all the primary functions of managing and defending the IP. Fourth, the Department noted that Taxpayer's 1995 Securities and Exchange Commission Form 10-K ("10-K"), which explained Taxpayer's business reorganization, stated that the reason for the reorganization was to lower state taxes. Fifth, the Department noted that Related acquired the IP in a transaction without true economic substance. The Department noted that, before and after the transaction, Taxpayer had exclusive use of both the IP and the cash assets of Related. Sixth, the Department noted that Related made a loan for tens of millions of dollars to Taxpayer and its affiliates upon which Taxpayer makes interest-only payments. No principal has ever been repaid. There were also many other intercompany cross-functions with many intercompany payments or credits or lack of credits or payments. The Department considered that all of these factors resulted in a business relationship between Taxpayer and Related which was too close for Taxpayer to fairly reflect its Indiana-based income via a single-filer return.

The relevant statute is IC § 6-3-2-2, which states in relevant parts:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;

(2) income from doing business in this state;

(3) income from a trade or profession conducted in this state;

(4) compensation for labor or services rendered within this state; and

(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas,

good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

.....

(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) 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.

(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.

....

(o) Notwithstanding subsections (l) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is:

(1) a foreign corporation; or

(2) a corporation that is classified as a foreign operating corporation for the taxable year by section 2.4 of this chapter.

(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).

Taxpayer's first point of protest regards the Department's reference to its unitary status with Related. Taxpayer does not address whether or not it was in a unitary business relationship with Related. Taxpayer does protest that there was no distortion when it filed separately and that there is therefore no need to change its filing method. Taxpayer also notes that the Department did not provide analysis of its unitary status or of the claim that single filing creates distortion. Taxpayer protests that it cannot disprove what has not been proven by the Department.

The Department notes that there is no requirement in IC § 6-3-2-2 that it provide analysis of how it determined that other methods do not fairly reflect Indiana income. The Department must merely demonstrate that it is unable to use any other method to fairly reflect Indiana income. The Department understands that Taxpayer does not agree that its Indiana income is not fairly reflected by single filing. While the Department understands that Taxpayer believes single filing to be correct, the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made.

The Department explained in the audit report that it did not accept that the hundreds of millions of dollars in royalty and interest payments paid by Taxpayer to Related, and therefore deducted from Taxpayer's Indiana income, during these three years were a fair reflection of Taxpayer's Indiana adjusted gross income. The Department considered that this reduction in Taxpayer's Indiana adjusted gross income tax, while Related paid nothing to Indiana, did not fairly reflect Taxpayer's Indiana income. The audit report explained the reasons why the Department did not accept that the royalties and interest payments resulted in fair costs for the respective transactions.

The audit report also gave multiple examples of intercompany activities that illustrate the difficulty of determining which activities were attributable to which company, and what amounts were paid from which company to which company. While the audit report does not use the word "distortion," the Department's reasoning is clear. The Department's position in this portion of the audit report is what Taxpayer needs to disprove in order to prevail in this protest.

This leads to Taxpayer's second point of protest, which regards the Department's explanation in its audit report that Related had no economic substance and that the royalties paid by Taxpayer were for no legitimate business purpose. Taxpayer insists that Related's charges were legitimate and that Related was and is a functioning business. In support of this position, Taxpayer has provided documentation which shows that Related did have employees who performed business functions. Taxpayer also provided copies of transfer pricing studies it commissioned from an unrelated third party to verify that the royalty rates qualified as arm's-length. Taxpayer believes that these factors support its position that Taxpayer and Related conducted their business at arm's-length, which in turn supports its position that Taxpayer should not be required to file a combined return.

Taxpayer also states that the loan was for business reasons and that it makes interest payments on a regular basis.

A review of the documentation shows that Related does in fact have employees and legitimate business costs. What it also shows is that none of those employees have any duties regarding the protection and administration of the IP at issue. The legal duties regarding the IP are handled by Taxpayer's legal department. Related's employees are primarily marketing oriented, including photographers, graphic designers, ad specialists and several other similar areas of specialization. Taxpayer states that the costs of marketing are included along with royalties and partially account for the Department's concern regarding the hundreds of millions of dollars which Taxpayer paid to Related for this period.

Taxpayer also states that it had pricing studies done to establish the royalty rates and to ensure that they were conducted at arm's-length pricing. A review of the June 30, 2002, pricing study shows that the third party performing the study anticipated that Taxpayer's legal division would handle all legal matters concerning the IP which Related owned. Significantly, the pricing study states that Taxpayer's legal department licensed the IP to independent retailers as sub-licenses after Related licensed the IP to Taxpayer. Later, the study states that Related can be characterized as a marketer which owns IP and directs the marketing for all entities in Taxpayer's group of companies. In other words, Taxpayer still did all of the work an IP owner would do regarding the IP. Meanwhile, Related worked on advertising and marketing the product, rather than marketing the IP, and collecting royalties and interest from Taxpayer. The pricing study goes on to explain the many shared functions of the various companies as they cooperate with each other in their various endeavors. The pricing study does not support Taxpayer's claim that it should continue single filing.

Neither does the loan arrangement support Taxpayer's claim that single filing is appropriate. Taxpayer argues that the rate of interest was typical for the time when the loan was made and that it makes regular interest payments. Taxpayer pays Related almost nine million dollars of interest every year for a loan upon which principal is never repaid. The Department is not convinced that an arm's-length lender would never expect to have the principal repaid.

Taxpayer's third point of protest is the Department's reference to Taxpayer's 1995 Securities and Exchange Commission Form 10-K. The Department noted that, in the course of explaining the reasons for Taxpayer's business reorganization, the Form 10-K stated that the arrangement would have the effect of reducing aggregate state income liabilities. Taxpayer protests that the filing explains much more than a single aspect of the reorganization. A review of the filing shows that there were other stated advantages to the reorganization which Taxpayer would have legitimate business reasons for pursuing. However, this does not mean that the filing does not list state income tax reduction as one of the beneficial results of the reorganization. In fact, the filing states that the reorganization gives Taxpayer additional flexibility to permit it to reduce state income taxes by allocating income to the operations responsible for generating the income. The reduction of state income tax was therefore one of the motivating factors in the reorganization. Also, as previously explained, the Department does not agree that Related was the operation responsible for generating income from royalties since Taxpayer continued to perform the functions of IP ownership.

Taxpayer also refers to two Letters of Findings which the Department issued sustaining the protests of two unrelated third parties who had protested that they should not file combined returns. Taxpayer believes that its facts are similar and that it should be sustained for the same reasons listed in those Letters of Findings. After review, the Department finds that Taxpayer's facts are sufficiently different from the facts in the two referenced Letters of Findings to make their reasoning inapplicable here.

In conclusion, the Department agrees that Related was a functioning business with employees and facilities. The Department does not agree that those employees had anything to do with IP administration. Certainly they did not perform any activities which justified the amount of royalties paid by Taxpayer. Those activities were performed by Taxpayer's employees. The Department also agrees that the royalty rates charged by Related and paid by Taxpayer conform to the pricing transfer studies. The Department does not agree that the pricing transfer studies support the protest against combined filing. The many mutually supporting cross-activities listed confirm the Department's determination that combined filing and application of apportionment percentages is the only way to fairly account for the many mutually supporting activities and cross-payments between companies which were functionally intertwined. A strong example of this is the millions of dollars in interest payments, on a loan which is never repaid, which are removed from Taxpayer's Indiana adjusted gross income. Also, while the 1995 S.E.C. Form 10-K gives other reasons for the reorganization, it does list the reduction of state income liabilities as a reason. The Department does not agree that Taxpayer and Related should not file a combined return. Given the intertwined nature of the entities here, the only way to fairly reflect Taxpayer's Indiana adjusted gross income is to require a combined return and apply appropriate apportionment percentages. Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

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