DEPARTMENT OF STATE REVENUE

02-20090446.LOF

Letter of Findings: 09-0446
Corporate Income Tax
For 2004, 2005, and 2006

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ISSUES

I. Royalty and Interest Expenses – Corporate Income Tax.

Authority: IC § 6-3-1-3.5(b); IC § 6-3-2-2; IC § 6-3-2-2(l); IC § 6-8.1-5-1(c); 45 IAC 3.1-1-8.

Taxpayer argues that the Department of Revenue erred when it disallowed royalty and related interest expenses.

II. Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks that the Department exercise its authority to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is in the business of owning and operating a chain of restaurants located in Indiana and other states. Taxpayer is the parent corporation and the holding company for an affiliated group of corporations. Taxpayer files a federal income tax return with members of the affiliated group and a separate Indiana income tax return. The activities of certain members of the affiliated group are outlined below.

A. Royalties / Intellectual Property: Franchisor LLC is an owner/operator of Taxpayer's restaurants and the franchisor to third party franchisees. In an earlier incarnation, Franchisor LLC owned certain intangible property such as trademarks, trade names, receipts, and "know-how."

In 2002, Franchisor LLC contributed the intellectual property to an intermediary named Enterprises Inc. in exchange for stock in a "1032 Exchange." Enterprises Inc. held the intellectual property briefly but then contributed the intellectual property to Associates LLC in exchange for a ninety-nine percent interest. Associates LLC is a partnership for federal purposes.

In summary, ownership of the intellectual property moved as follows: Franchisor LLC originally owed the intellectual property, "contributed" the property to Enterprises Inc., after which it was then contributed to Associates LLC.

Subsequent to the contribution of the intellectual property to Associates LLC, Enterprises Inc. sold its ninety-nine percent interest in Associates LLC to Franchisor LLC in exchange for a note in the amount of approximately $400 million.

However, Franchisor LLC continued in the business of licensing the intangibles to its franchisees. These franchisees paid royalties to Franchisor LLC for the privilege of using the same intangibles as well as for other services encompassed in the franchisor-franchisee relationship. However, because Associates LLC "owns" the intellectual property and pursuant to the terms of their internal licensing agreement, Franchisor LLC paid ninety percent of the royalty income to Associates LLC. Franchisor LLC kept ten percent of the royalties to cover its own fees and expenses attributable, according to Taxpayer, to the cost of protecting and managing the assets on behalf of Associates LLC.

Associates LLC's only income was its ninety percent share of the royalty income. According to the audit report, "[Associates LLC] amortized the intangibles over a 15-year period pursuant to an IRS Section 754 election to increase the basis of the assets to fair market value."

However, Associates LLC did not retain its ninety percent share. Ninety-nine percent of the Associates LLC's net income was returned to Franchisor LLC. That income appeared on the federal return as income from a passive investment company. The remaining one percent was paid to yet another entity which Taxpayer explains was created in 2002 to facilitate a corporate reorganization. As a result of Franchisor LLC owning ninety-nine percent of Associates LLC, Franchisor LLC – which elected to be treated as a partnership for federal income tax purposes – received a ninety-nine percent distributive share of Associate LLC's net income. According to Taxpayer, all income received by Franchisor LLC from Associates LLC is included in Franchisor LLC's Indiana adjusted gross income.

Taxpayer offers the following explanation:

> Associate LLC's only income was its 90 percent share of the royalty income received from franchisees. According to the audit report, "[Associates LLC] amortized the intangibles over a 15-year period pursuant to an IRS Section 754 election to increase the basis of the assets to fair market value." As a result of Franchisor LLC owning 99 [percent] distributive share of Associates LLC's net income in its federal taxable income. Thus, all income received by Franchisor LLC from Associates LLC is included in Franchisor LLC's Indiana

adjusted gross income.

B. Loan: Enterprises Inc. loaned money to Franchisor LLC. Franchisor LLC borrowed approximately $400,000,000 from Enterprise Inc. in exchange for Enterprises Inc.'s ninety-nine percent interest in Associate LLC. The audit noted that Franchisor LLC paid interest on the loan to Enterprises Inc. but, according to the audit report, Enterprises, Inc. did not seek repayment of the loan. However, Taxpayer asserts that both interest and principal were paid and are continuing to be paid on a quarterly basis pursuant to the terms of the note.

Franchisor LLC deducted the interest payments on its federal return. Enterprises Inc. also recognized a deferred "gain" each year which corresponded with a gain on the books of Associates LLC relating to the appraisal of the intangibles transferred to Associates LLC. This gain was amortized over 15 years with the income reported by Enterprises Inc. and the expense recognized by Associates LLC.

Neither Associates LLC nor Enterprises Inc. had nexus in Indiana. Neither filed Indiana income tax returns. The royalty and interest income received by Associates LLC and Enterprises Inc. – both of which are organized in Delaware – was not subject to any state tax. Taxpayer explains as follows:

> The income generated by Enterprises Inc. is subject to tax in those states requiring a combined or unitary return. The net income of Associates LLC is reportable by the partners which own this partnership, and such, Franchisor LLC's distributive share of the Associate LLC's income (99 [percent]) is included in the Indiana return of Franchisor LLC each year.

C. Audit: The Department of Revenue (Department) conducted an audit review of Taxpayer's business record and income tax returns. The audit found that Taxpayer had deducted royalty and related interest expenses attributable to the use of the intellectual property. The audit disallowed these expenses for Indiana income tax purposes for the years 2004, 2005, and 2006. However, the audit allow an adjustment for the income reported by the Taxpayer relative to its distributive share of Associate LLC's income. Taxpayer disagreed with that decision and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Royalty and Interest Expenses – Corporate Income Tax.

DISCUSSION

Taxpayer challenges the Department's decision to disallow certain of the royalty and interest expenses.

The Department's audit concluded that intercompany interest and income transactions between members of the affiliated group had the effect of distorting Taxpayer's Indiana income. These interest and income expenses were disallowed "in order to fairly reflect the income earned from Indiana sources on [Taxpayer's] IT-20 return." The audit report noted that the transactions which flowed through the disregarded entity – Franchisor LLC – created a circular flow of funds. The audit asserts that Taxpayer was able to deduct the royalty and interest expenses while having access to a $400,000,000 loan from one of the related entities.

As a threshold issue, it is the Taxpayer's responsibility to establish that the tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

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 Department's decision to disallow the expenses was done pursuant to the authority set out in IC § 6-3-2-2(l) which states in relevant part:

> 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.

Taxpayer argues that the disallowance of the interest and royalty expenses was unjustified and "views the auditor as having a lack of understanding of a disregarded legal entity." Taxpayer maintains that the royalty amount paid by Franchisor LLC to Associates LLC is comparable to the royalty being received from third-party franchisees. In addition, Taxpayer explains that having the intellectual property held by Associates LLC provides "a separation of valuable intangibles from the remainder of the [Taxpayer's] current operations and a vehicle to protect its intellectual property." In addition, Taxpayer states its efforts to "isolate" its intellectual property are "real and genuine, resulting in a viable business structure formed for substantial business purposes."

Taxpayer concludes that the inter-company transactions were "clearly at arm's length" and that "there was no basis for adjusting its Indiana income by requiring the addback of deductions for intercompany royalties and interest...." Taxpayer summarizes its argument as follows:

> Taxpayer... concludes that there is no circular flow of funds since the royalties originate from third party franchisees such that Franchisor LLC is simply a conduit of such funds. Additionally, the Taxpayer asserts that the "loan" from Enterprises Inc. is not [a] loan in the character of a recurring flow of funds. Rather, it represents a note given in consideration for the sale of Enterprises Inc.'s 99 [percent] interest in Associates LLC to Franchisor LLC, and is being repaid in periodic installments of both principal and interest.

The issue is whether Taxpayer filed 2004, 2005, and 2006 income tax returns in a manner which accurately reflected its taxable income or did the various inter-company deductions – an issue irrelevant for federal income tax purposes – have the effect of not "fairly representing" Taxpayer's Indiana source income.

The audit concluded that "the taxpayer deducted royalty and related interest expense for the use of trademarks, trade names, and recipes under "Other Deductions" and that a "circular flow of funds exists" which deducts the royalty and interest expenses paid to related entities while having access to loans.... from a related entity. The audit concluded that it was necessary to disallow a "substantial amount of intercompany income/expense transactions between the affiliated groups" in order to " fairly reflect the income earned from Indiana sources on [Taxpayer's] IT-20 return." (Emphasis added) As authority, the audit relied on IC § 6-3-2-2 which the audit explained as requiring that "if the allocation and apportionment provisions do not fairly represent the taxpayer's income derived from sources within the state of Indiana the Department can distribute, apportion, or allocate the income between and among the organizations or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana...."

Taxpayer maintains that the intercompany royalty and interest expenses are justified and supported by federal tax law, that the royalty payments are properly classified as "ordinary and necessary business expenses," that there is no direct relationship between the intercompany royalties and the interest payments, that the royalty payments "are not [merely] creating a benefit for Indiana income tax purposes, and that the "amortization of the partnership interest is made in accordance with "federal statutes and regulations." In addition, the intercompany royalty rates are "based upon the royalty rates currently being charged to third party franchisees, that transferring the intangible assets "provides a separation of valuable intangibles... and a vehicle to protest its intellectual property." In sum, Taxpayer believes that its company structure is "entirely based on a valid business purpose[] and the amounts charged are clearly at arms length." Taxpayer believes that there simply "is no basis for adjusting taxpayer's Indiana income by requiring an addback of deductions for intercompany royalties and interest pursuant to IC [§] 6-3-2-2(l) and/or (m)."

As noted above, IC § 6-8.1-5-1(c) requires that the Taxpayer carry the burden of " proving that the proposed assessment is wrong." (Emphasis added). In this case, Taxpayer has set out various rationale explaining and justifying the intercompany transactions. The Department has little quarrel with these explanations but concludes that they do satisfy the audit's concern that Taxpayer's income – as reported on its Indiana returns – did not reflect Taxpayer's Indiana source income. In effect, Taxpayer's royalty payments reflect payments for intellectual property which it once owned but which it transferred in a three-step transaction from Franchisor LLC to Enterprise Inc. to Associates LLC. The Department must disagree with Taxpayer's assertion that recognizing these intercompany royalty payments as legitimate, substantive "business expenses" would more fairly recognize the parties' Indiana source income. The Department is prepared to agree that Taxpayer's business structure is more than an empty business shell created simply as an imaginative – if overly complex – business structure. However the Department is unable to attach the same economic substance to the royalty payments and underlying interest payments as Taxpayer does.

The audit concluded that Taxpayer's licensing agreement royalty payments, and interest obligations represented Taxpayer's attempt to cultivate tax benefits but which had the result of not accurately reflecting Taxpayer's Indiana source income. The audit's concerns were justified, the decision to disallow the expenses was narrowly tailored to address those concerns, and the disallowance of the expenses is supported under Indiana law. Taxpayer has failed to meet its burden of overcoming the "prima facie evidence that the department's claim for the unpaid tax is valid." IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

II. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer maintains that it is entitled to abatement of the ten-percent negligence penalty.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

The Department continues to believe that Taxpayer's intercompany interest and royalty payments did not fairly reflect Taxpayer's Indiana source income. However, there is insufficient information to establish that Taxpayer's position was so adventurous or egregious as to constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest is denied as to Issue I but sustained as to the ten-percent negligence penalty.

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