DEPARTMENT OF STATE REVENUE

02-20080749.LOF

Letter of Findings: 08-0749
Indiana Corporate Income Tax
For the Years 2005 and 2006

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ISSUES

I. Corporate Income Tax – Imposition – Business Expense Deduction.

Authority: IC § 6-3-2-2; IC § 6-3-2-20; 45 IAC 3.1-1-62; IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758 (Mass. 2002); Home Depot USA Inc. v. Arizona State Dep't of Revenue, TX 2006-000240 (AZ Tax Ct. 2009); I.R.C. § 162; I.R.C.§ 243.

Taxpayer protests the disallowance deductions of its royalty payments to its wholly-owned subsidiary, incorporated in Delaware.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2; IC § 6-3-4-4.1.

Taxpayer protests the imposition of the underpayment penalty and negligence penalty.

STATEMENT OF FACTS

Taxpayer, a large out-of-state multistate retailer, operates several retail stores in Indiana. In 2008, the Indiana Department of Revenue (Department) conducted an audit of Taxpayer's corporate income tax returns and business records for 2005 and 2006. In addition to interest payments, the Department's audit discovered that, Taxpayer paid royalties to its wholly-owned subsidiary, incorporated in Delaware (Delaware Subsidiary), based on four percent of its gross sales, in exchange for the "exclusive right, license, and privilege" to use all of its trademarks. Taxpayer then deducted the royalty and interest payments as ordinary and necessary business expenses.

The Department's audit disallowed Taxpayer's deductions of the royalty and interest payments in order to fairly reflect Taxpayer's Indiana income, which resulted in additional income tax, interest, and penalty. Taxpayer disagreed and protested the Department's disallowance of its royalty and interest deductions. Taxpayer, however, subsequently withdrew its protest of the disallowance of the interest deduction. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

DISCUSSION

I. Corporate Income Tax – Imposition – Business Expense Deduction.

Pursuant to IC § 6-3-2-2, the Department's audit disallowed Taxpayer's claimed deduction on its royalty payments to its Delaware Subsidiary in order to fairly reflect Taxpayer's income derived from sources within Indiana. Taxpayer, to the contrary, claimed that it was entitled to deduct the royalty payments it paid to its Delaware Subsidiary because the royalties were ordinary and necessary business expenses to protect, maintain, manage, and enhance its trademarks. Alternatively, Taxpayer asserted that the Department did not have the authority to add back its royalty payments because the add-back requirement, outlined in H.B. 1001 (P.L. 162-2006, Sec. 26), codified as IC § 6-3-2-20, applies only to taxable years beginning after June 30, 2006. Therefore, Taxpayer claimed that the add-back was not available for the years at issue during this audit.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3-2-2, in pertinent part, states:

(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.

45 IAC 3.1-1-62 further provides:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37 - 45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that

these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

The Department's audit noted that since the Delaware Subsidiary is wholly-owned by Taxpayer, the Delaware Subsidiary is controlled by the same interests. The Department's audit also noted that while Taxpayer recorded royalty deduction, the Delaware Subsidiary reported royalty income which was not subject to state income tax because Taxpayer excluded the Delaware Subsidiary from its Indiana income tax filings. Delaware did not tax the Delaware Subsidiary's royalty income. The Department's audit further noted that Taxpayer's royalty payments ($2,532,057,401 for 2005 and $2,786,346,726 for 2006) to its Delaware Subsidiary constituted 94.03 percent of its Delaware Subsidiary's total income for tax year 2005, and 93.80 percent of its Delaware Subsidiary's total income for 2006 tax year. While the Delaware Subsidiary's principal functions are to protect, maintain, manage, and enhance Taxpayer's trademarks, it only incurred expenses of $27,837,739 (1.03 percent of its total income) for tax year 2005 and $11,950,187 (0.40 percent of its total income) for tax year 2006. Additionally, the Department's audit noted that, as the sole shareholder of its Delaware Subsidiary, Taxpayer periodically received dividends from its Delaware Subsidiary, $2,186,000,000 for 2005 and $1,561,000,000 for 2006.

The Department's audit observed that both Taxpayer and its Delaware Subsidiary's records reflected "a circular flow of intercompany funds between the Taxpayer and [its Delaware Subsidiary]" for these years. The Department's audit, thus, concluded that while Taxpayer deducted the royalties to reduce its income derived from sources within Indiana, the money flowed through the Delaware Subsidiary and returned to Taxpayer in the form of dividends. In order to fairly reflect Taxpayer's income derived from sources within Indiana, the Department's audit disallowed Taxpayer's royalty deductions pursuant to IC § 6-3-2-2(m) and 45 IAC 3.1-1-62.

Taxpayer maintained that it was entitled to the royalty deductions because its royalty payments were based on a reasonable license agreement with an "arm's-length" price that was established by an independent appraisal of the intangible property. To support its protest, Taxpayer submitted additional documentation, including, but not limited to, Taxpayer's Indiana corporate income tax returns, its Delaware Subsidiary's Form 1120 Federal Proformas, its Delaware Subsidiary's monthly invoices for royalty to Taxpayer, three license agreements, and two transfer pricing studies.

Taxpayer argued that expenses incurred by its Delaware Subsidiary to protect and defend its trademarks were reasonable and should have no bearing on the amount of income its Delaware Subsidiary earned. Taxpayer also claimed that the rate of four percent of Taxpayer's gross sales for the royalty charge was established on an "arm's-length" basis, which was determined by an independent appraisal of the intangible property. Taxpayer further claimed that its Delaware Subsidiary licensed the trademarks to both related and unrelated companies. Thus, Taxpayer believed that it was entitled to the royalty deductions.

In Syms Corp. v. Comm'r of Revenue, 765 N.E.2d 758 (Mass. 2002), the Supreme Judicial Court of Massachusetts addressed the very same issue and very same arguments which Taxpayer here offered.

In Syms, the taxpayer, Syms Corp., a New Jersey corporation, operated two retail stores in Massachusetts and was subject to Massachusetts corporate excise tax (corporate income tax). Syms owned several trademarks as the result of its business operation. Pursuant to a plan proposed by a financial consulting company to reduce its state income tax, Syms formed a wholly-owned Delaware subsidiary, SYL. According to the plan, Syms transferred its trademarks to SYL and then "executed a license agreement under which Syms would continue to use the trademarks as it had before the transfer." Id. at 761. Syms' trademark attorneys also validated the plan affirming that whether or not SYL is an active entity, its assets (consisting of Sym's trademarks) belong to Syms, the parent company. Id. Syms continued to stand behind the goods and services identified by the trademarks. Id.

Under the license agreement, Syms would pay a large royalty, "equal to four percent of Sym's annual net sales," to SYL. Id. at 762. This arrangement generated a deduction for Syms on its State excise tax, but SYL would not pay any State tax on the royalty income because, under Delaware law, corporations that hold intangible assets are exempt from income tax. Id. Additionally, SYL paid the money back to Syms as a non-taxable dividend under I.R.C. §243 and applicable state law.

The Supreme Judicial Court of Massachusetts agreed with the Massachusetts Commissioner of Revenue and the Massachusetts Appellate Tax Board that Syms' transfer and license back transaction "had no practical economic effect on Syms other than the creation of tax benefits and that tax avoidance was the clear motivating factor and its only business purpose." Id. at 764. The Supreme Judicial Court of Massachusetts also addressed Syms' argument that, "having validly transferred the trademarks to SYL in consideration for receipt of SYL stock, it was required to pay royalty fees, and, therefore, they were necessary business expenses" since the royalty rate was established on an "arm's-length" basis. Id. The Supreme Judicial Court of Massachusetts, upheld the Massachusetts Commissioner of Revenue and the Massachusetts Appellate Tax Board's disallowance of Syms' royalty expense, and stated that:

> It was irrelevant that the measure of royalty payments might have been equivalent to what would have been paid in an arm's-length transaction where, as here, the payments were not for services provided by SYL but rather part of a contrived mechanism by which affiliated entities shifted income, tax free, between themselves in a circular transaction for the benefit of Syms. Id. at 765.

The Supreme Judicial Court of Massachusetts concluded that Sym's royalty expense was not an "ordinary

and necessary expense" under I.R.C. §162 and, therefore, was not deductable *[sic]*.

Taxpayer's situation and its arguments are also similar to the taxpayer's in Home Depot USA Inc. v. Arizona State Dep't of Revenue, TX 2006-000240 (AZ Tax Ct. 2009). In Home Depot, the taxpayer, Home Depot, transferred its trademarks to its wholly-owned subsidiary, Homer, which was incorporated in Delaware. Upon transferring its trademarks to Homer, Home Depot then leased back its trademarks from Homer and paid Homer royalties to use its trademarks exclusively. While Home Depot deducted the royalty expenses in its Arizona income tax filings, Homer's income was not subject to Arizona tax since Home Depot excluded Homer from its Arizona income tax filings. Homer's income was not subject to Delaware income tax because Delaware did not tax corporate income from intangible assets.

Asserting the royalty rate under its license agreement was established and supported by an independent appraisal of intangible property, Home Depot challenged the Arizona State Department of Revenue's authority to require combined returns when necessary to accurately determine Arizona source income. The Arizona tax court recognized that Home Depot "obtained an independent appraisal which it asserts constitutes the equivalent of an arm's-length price." Id. The Arizona tax court, however, observed that Home Depot and Homer "are interdependent to the extent that Homer has essentially no existence at all beyond its licensing of the Home Depot trademarks to Home Depot, the only entity to which it legally can license them." Id. Ruling in favor of the Arizona State Department of Revenue, the Arizona tax court stated that:

> Trademarks are unique. It has been recognized from the infancy of trademark law that a trademark has no cognizable existence distinct from the product to which it is attached. It is an identifier of property rather than property in its own right. A trademark symbolizes the public's confidence or "goodwill" in a particular product. However, it is no more than that, and is insignificant if separated from that confidence. Therefore, a trademark is not the subject of property except in connection with an existing business. In a very real sense, the trademark is the product and the product is the trademark.... [T]he core function of a seller of goods and services is indivisible from the core function of the formal owner of the trademarks associated with those goods and services: neither core function can be achieved in the absence of the other. This conclusion is strengthened by the absence of a free market in which a trademark can be bought and sold at an arm's-length price. By the very nature of a trademark, there is a monopsony: there can be only one buyer, who ultimately determines the price. Id.

The Arizona tax court, thus, opined that the case law does not require the Arizona State Department of Revenue "to accept the appraiser's estimate of what the market transfer price would be in an imaginary market in which such a transfer could be priced." Id. Accordingly, the Arizona tax court concluded that the Arizona State Department has the statutory authority to require combined returns when necessary to accurately determine Arizona source income.

Like Syms Corp. and Home Depot, in this instance, Taxpayer provided 2006 and 2008 transfer pricing studies and claimed the transfer pricing analyses established an "arm's-length price" to lease its trademarks (the Trademarks) from its Delaware Subsidiary. Taxpayer maintained that the Department must recognize that Taxpayer was entitled to the deduction because Taxpayer's royalty expenses were ordinary and necessary business expenses.

Notably, prior to 1991, as part of its business operation, Taxpayer owned the Trademarks. In 1991, the Delaware Subsidiary was created, wholly owned by Taxpayer, to protect, maintain, manage, and enhance the Trademarks. Upon the creation of the Delaware Subsidiary, Taxpayer transferred all the Trademarks to the Delaware Subsidiary in consideration for receipt of the Delaware Subsidiary stock. Meanwhile, Taxpayer licensed the Trademarks back from the Delaware Subsidiary and the Delaware Subsidiary granted to Taxpayer "the exclusive right, license, and privilege to use all of the Trademarks" in exchange for the royalties, based on four percent of Taxpayer's gross sales.

While Taxpayer claimed that its Delaware Subsidiary was free to and did license the Trademarks to unrelated third parties, Taxpayer's documentation demonstrated otherwise. Taxpayer has control, directly or indirectly, over its Delaware Subsidiary. Taxpayer's documentation showed that the Delaware Subsidiary was wholly owned by Taxpayer and, thus, like SYL in Syms, the Delaware Subsidiary's assets (consisting of the Trademarks) belong to Taxpayer, the parent company. Since Taxpayer has the "exclusive right, license, and privilege to use all of the Trademarks" per their lease agreement, its Delaware Subsidiary must include Taxpayer in every license agreement if the Delaware Subsidiary decided to license the Trademarks. In fact, Taxpayer continued to stand behind the goods and services identified by the Trademarks. All of the three license agreements which Taxpayer submitted to support its protest demonstrated that Taxpayer was also a party to these license agreements. Thus, Taxpayer and its Delaware Subsidiary, like Syms and SYL, as well as Home Depot and Homer, were interdependent to the extent that the Delaware Subsidiary had essentially no existence at all beyond its licensing of the Trademarks to Taxpayer, the only entity to which it legally can license them. In short, Taxpayer's alleged "arm's-length transaction" had no practical economic effect on Taxpayer "other than the creation of tax benefits and that tax avoidance was the clear motivating factor and its only business purpose."

Finally, Taxpayer asserted that the Department did not have the authority to add back its royalty deduction because the required add-back statute was not applicable in this instance. IC § 6-3-2-20 applies only to taxable

years beginning after June 30, 2006.

IC § 6-3-2-20(b) states:

Except as provided in subsection (c), in determining its adjusted gross income under IC 6-3-1-3.5(b), a corporation subject to the tax imposed by IC 6-3-2-1 shall add to its taxable income under Section 63 of the Internal Revenue Code:

(1) intangible expenses; and

(2) any directly related intangible interest expenses;

paid, accrued, or incurred with one (1) or more members of the same affiliated group or with one (1) or more foreign corporations.

Taxpayer is mistaken. The add-back statute specifically required an "add-back" of Taxpayer's "intangible expenses and any directly related intangible interest expenses paid, accrued, or incurred with one or more members of the same affiliated group." The Department's audit did not refer to the add-back statute mentioned above to add back Taxpayer's claimed royalty deduction. Rather, the Department's audit, referred to the general authority provided by IC § 6-3-2-2 and disallowed Taxpayer's royalty deduction to fairly reflect and report Taxpayer's income derived from sources within Indiana. Pursuant to IC § 6-3-2-2 and 45 IAC 3.1-1-62, the Department could implement any reasonable means to fairly reflect and report Taxpayer's income derived from sources within Indiana, including disallowing Taxpayer's deduction. The Department's audit disallowed Taxpayer's deduction which the Department believed Taxpayer should not have deducted when it filed its income tax returns in the first place. Disallowing Taxpayer's deduction, therefore, is different from adding back Taxpayer's expenses.

Given the totality of circumstances, in the absence of other documentation, the Department is not able to agree with Taxpayer that it has met its burden demonstrating the Department's proposed assessment is wrong.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

DISCUSSION

Taxpayer protests the imposition of the underpayment penalty and negligence penalty.

A. Underpayment Penalty

The Department imposed an underpayment penalty because Taxpayer failed to timely remit its estimated payments of adjusted gross income tax under IC § 6-3-4-4.1(d).

IC 6-3-4-4.1(d) states:

The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

(1) the annualized income installment calculated under subsection (c); or

(2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment is not appropriate.

B. Negligence Penalty

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a tax return;

(2) fails to pay the full amount of tax shown on the tax return;

(3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or

(4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

45 IAC 15-11-2(b) further 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), in part, 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. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has provided sufficient documentation to demonstrate that its failure to pay tax was not due to negligence.

FINDING

Taxpayer's protest on the underpayment and negligence penalty is sustained.

SUMMARY

For the reasons discussed above, Taxpayer's protest on the Department's disallowance of its royalty deduction is respectfully denied. However, Taxpayer's protest on the underpayment penalty and negligence penalty is sustained.

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