DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 09-0857
Corporate Income Tax
Tax Period: 2005 - 2007

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ISSUES

I. Adjusted Gross Income Tax – Disallowance of Royalty Expense.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2; IC § 6-3-2-20; 45 IAC 3.1-1-62.

Taxpayer protests the disallowance of deductions for business expenses related to royalty payments made to an affiliated company.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

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

Taxpayer protests the imposition of a ten percent underpayment penalty, and a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer engages in the business of providing integrated home healthcare products and services through a network of healthcare professionals across the nation. Taxpayer operates branch locations throughout the United States to deliver these products and services to third party "payors," including both private and national insurance providers, Medicare, Medicaid, HMOs, and other managed health care organizations. Taxpayer realizes income in all fifty states.

Taxpayer is a wholly owned subsidiary of a company (Parent Company) that provides management services and administers loans generated from third parties. Taxpayer asserts that the Parent Company provides various management services, including corporate sales and marketing, clinical, business development, human resources, legal, corporate information, purchasing, intellectual property management, finance, and other corporate administration services. Taxpayer alleges that the Parent Company owns, manages, and markets its trade names and trademarks, and licenses use of this intellectual property to its subsidiaries, including Taxpayer. Taxpayer further alleges that the Parent Company collects management fees and royalties in exchange for its services and use of its intellectual property, respectively.

During the 2005, 2006, and 2007 tax years (Tax Years), Taxpayer paid Parent Company a percentage of Taxpayer's gross receipts representing royalty payments for use of the intellectual property under terms of a license agreement. Taxpayer also paid management fees to Parent Company under the terms of a management and administrative services agreement. Taxpayer further benefited from loans made by the Parent Company, which taxpayer asserts represents third party debt allocated by the Parent Company. Taxpayer deducted the royalty payments, management fees, and interest on loads paid from its Indiana gross income.

After auditing Taxpayer for the Tax Years, the Department concluded that the royalty payments, management fees, and interest income received from subsidiaries represented the Parent Company's sole source of revenue. The Department further determined that the aforementioned transactions between Taxpayer and Parent Company significantly distorted Taxpayer's reported Indiana adjusted gross income. As an alternative to combining the Parent Company and Taxpayer, the Department disallowed Taxpayer's deductions for royalty payments to fairly reflect Taxpayer's income earned in Indiana.

As a result of that audit examination, the Department made a number of adjustments which increased Taxpayer's tax liabilities. Taxpayer disagreed with certain of those adjustments and submitted a protest to the Department. Pursuant to that protest, the Department conducted an administrative hearing which afforded Taxpayer an opportunity to substantiate the basis for its protest. This Letter of Findings results from that hearing.

I. Adjusted Gross Income Tax – Disallowance of Royalty Expense.

DISCUSSION

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.

In support of the Department's position, the audit report cited to IC § 6-3-2-2(l) which states 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:
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> (1) separate accounting;
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> (2) the exclusion of any one (1) or more of the factors;
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> (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**).

The audit report also cited to IC § 6-3-2-2(m) which states 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."

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.

In its protest, 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. Specifically, Taxpayer asserts that the aforementioned statutory provisions do not authorize the add-back of deductions; that those provisions only concern the apportionment or allocation of Indiana taxable income.

Addressing Taxpayer's statutory authority argument first, 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(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 mistakenly applies the aforementioned statute to Taxpayer's specific circumstances. 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 aforementioned add-back statute 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.

Taxpayer further argues that it made the royalty payments in an arm's length transaction for valid business purposes. Taxpayer states that the Parent Company provided intellectual property protection and management services to its subsidiaries, including Taxpayer. In exchange, Taxpayer paid royalty fees to the Parent Company pursuant to a license agreement pertaining to the intellectual property; and management fees to the Parent Company pursuant to a management and administrative services agreement.

As part of this protest, Taxpayer has provided documentation, explanations, and analyses. The documentation and analyses demonstrate that Taxpayer's treatment of the royalty payments in its original return fairly reflect Taxpayer's Indiana income for the Tax Years. Further, Taxpayer provided arguments and supporting documents to assert that the Parent Company did not pay any dividends to Taxpayer with monies originating from the royalty and management fees Taxpayer paid to the Parent Company. 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 circular flow of monies concerning the royalty fee payments made by Taxpayer to the Parent Company. The documentation and analysis is sufficient to meet the requirements of IC § 6-8.1-5-1(c).

Based upon Taxpayer's additional information, Taxpayer has met its burden in arguing against the Department's assessment that Taxpayer's payment of royalty fees to the Parent Company in addition to the management fees does not fairly reflect Taxpayer's income derived from Indiana sources. Taxpayer has met its

statutory burden of demonstrating that the Department should not have disallowed Taxpayer's royalty expense deductions.

A determination that the Department incorrectly disallowed business expense deductions for royalty payments also necessarily supports Taxpayer's argument that the Department improperly recalculated Taxpayer's net operating losses carry-forward.

FINDING

The Taxpayer's protest with respect to improper disallowance of royalty payments as a business expense deduction is sustained. As a result, the Department should conduct a supplemental audit to determine net operating losses carry-forward.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

DISCUSSION

Taxpayer protests the imposition of an 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:
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> (1) the annualized income installment calculated under subsection (c); or
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> (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.
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> 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 documents and explanation to demonstrate 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 § 6-8.1-10-2.1] 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:
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> (1) the nature of the tax involved;
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> (2) judicial precedents set by Indiana courts;
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> (3) judicial precedents established in jurisdictions outside Indiana;
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> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
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> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> 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 documents and explanation 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 royalty payments as a business expense deduction is sustained. The Department should conduct a supplemental audit to determine net operating losses carry-forward, where applicable. Taxpayer's protest on the underpayment penalty and negligence penalty is sustained.

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