

Letter of Findings Number: 10-0130
Income Tax
For Tax Years 2005-07

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ISSUE

I. Adjusted Gross Income Tax–Net Operating Losses.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-2.6; IC § 6-3-2-20; IC § 6-8.1-5-1.

Taxpayer protests the reduction of claimed net operating losses and the resulting imposition of adjusted gross income tax.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation with Indiana operations. As the result of an audit of the tax years 2005, 2006, and 2007, the Indiana Department of Revenue ("Department") determined that Taxpayer had incorrectly deducted royalties paid to a related company and that Taxpayer's claimed net operating losses ("NOLs") were therefore overstated for the tax years 2003, 2004, 2005, 2006, and 2007. The Department then determined that Taxpayer had additional Indiana adjusted gross income tax ("AGIT") due for the tax year 2007. The remaining NOLs were sufficient to result in no tax due for 2005 and 2006. The Department therefore issued proposed assessments for AGIT and interest for 2007. The Department did not impose assessments for 2003 or 2004, but only adjusted the NOL calculations for those years to determine the amount of NOLs available to be applied to the tax years at issue. Taxpayer protests that the royalties in question should not be added back, that its NOLs should not be reduced, and that it does not owe any tax or interest for this tax period. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Net Operating Losses.

DISCUSSION

Taxpayer protests the adjustment of NOLs for 2003-07 and the imposition of AGIT for the tax year 2007. Taxpayer states that the royalties in question were properly paid to a related company which actively administered the trademarks and other intellectual property for which Taxpayer paid arm's-length royalty rates. The Department determined that the payment of the royalties distorted Taxpayer's Indiana income and added the royalties back to Taxpayer's Indiana income. Adding those royalties back to Taxpayer's income increased that income and reduced the amounts of available NOLs. The Department noted that, effective July 1, 2006, IC § 6-3-2-20 was enacted requiring the addback of such royalties and that Taxpayer properly added the royalties back for 2007. Therefore, the Department did not addback any royalties for 2007.

Taxpayer protests that it properly deducted those royalties and that its original NOL calculations were correct. Taxpayer therefore protests the Department's recalculation of NOLs and protests that it had sufficient NOLs available to eliminate the Department's proposed assessment of AGIT for 2007. 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 adjusted gross income tax is imposed under IC § 6-3-2-1, which states:

(a) Each taxable year, a tax at the rate of three and four-tenths percent (3.4 [percent]) of adjusted gross income is imposed upon the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every nonresident person.

(b) Except as provided in section 1.5 of this chapter, each taxable year, a tax at the rate of eight and five-tenths percent (8.5 [percent]) of adjusted gross income is imposed on that part of the adjusted gross income derived from sources within Indiana of every corporation.

Also of relevance 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.

....

Also, IC § 6-3-2-2.6 provides:

- (a) This section applies to a corporation or a nonresident person.
- (b) Corporations and nonresident persons are entitled to a net operating loss deduction. The amount of the deduction taken in a taxable year may not exceed the taxpayer's unused Indiana net operating losses carried back or carried over to that year.
- (c) An Indiana net operating loss equals the taxpayer's federal net operating loss for a taxable year as calculated under Section 172 of the Internal Revenue Code, derived from sources within Indiana and adjusted for the modifications required by [IC 6-3-1-3.5](#).
- (d) The following provisions apply for purposes of subsection (c):
 - (1) The modifications that are to be applied are those modifications required under [IC 6-3-1-3.5](#) for the same taxable year in which each net operating loss was incurred.
 - (2) The amount of the taxpayer's net operating loss that is derived from sources within Indiana shall be determined in the same manner that the amount of the taxpayer's adjusted income derived from sources within Indiana is determined under section 2 of this chapter for the same taxable year during which each loss was incurred.
 - (3) An Indiana net operating loss includes a net operating loss that arises when the modifications required by [IC 6-3-1-3.5](#) exceed the taxpayer's federal taxable income (as defined in Section 63 of the Internal Revenue Code), if the taxpayer is a corporation, or when the modifications required by [IC 6-3-1-3.5](#) exceed the taxpayer's federal adjusted gross income (as defined by Section 62 of the Internal Revenue Code), if the taxpayer is a nonresident person, for the taxable year in which the Indiana net operating loss is determined.
- (e) Subject to the limitations contained in subsection (g), an Indiana net operating loss carryback or carryover shall be available as a deduction from the taxpayer's adjusted gross income derived from sources within Indiana (as defined in section 2 of this chapter) in the carryback or carryover year provided in subsection (f).
- (f) Carrybacks and carryovers shall be determined under this subsection as follows:
 - (1) An Indiana net operating loss shall be an Indiana net operating loss carryback to each of the carryback years preceding the taxable year of the loss.
 - (2) An Indiana net operating loss shall be an Indiana net operating loss carryover to each of the carryover years following the taxable year of the loss.
 - (3) Carryback years shall be determined by reference to the number of years allowed for carrying back a net operating loss under Section 172(b) of the Internal Revenue Code. However, with respect to the carryback period for a net operating loss:
 - (A) for which a taxpayer made an election to use five (5) years instead of two (2) years under Section 172(b)(1)(H) of the Internal Revenue Code, two (2) years shall be used instead of five (5) years; or
 - (B) that is a qualified disaster loss for which the taxpayer elected to have the net operating loss carryback period with respect to the loss year determined without regard to Section 172(b)(1)(J) of the Internal Revenue Code, five (5) years shall be used.
 - (4) Carryover years shall be determined by reference to the number of years allowed for carrying over net operating losses under Section 172(b) of the Internal Revenue Code.
 - (5) A taxpayer who makes an election under Section 172(b)(3) of the Internal Revenue Code to relinquish the carryback period with respect to a net operating loss for any taxable year shall be considered to have also relinquished the carryback of the Indiana net operating loss for purposes of this section.
- (g) The entire amount of the Indiana net operating loss for any taxable year shall be carried to the earliest of the taxable years to which (as determined under subsection (f)) the loss may be carried. The amount of the Indiana net operating loss remaining after the deduction is taken under this section in a taxable year may be carried back or carried over as provided in subsection (f). The amount of the Indiana net operating loss carried back or carried over from year to year shall be reduced to the extent that the Indiana net operating loss carryback or carryover is used by the taxpayer to obtain a deduction in a taxable year until the occurrence of the earlier of the following:
 - (1) The entire amount of the Indiana net operating loss has been used as a deduction.
 - (2) The Indiana net operating loss has been carried over to each of the carryover years provided by subsection (f).

(h) An Indiana net operating loss deduction determined under this section shall be allowed notwithstanding the fact that in the year the taxpayer incurred the net operating loss the taxpayer was not subject to the tax imposed under section 1 of this chapter because the taxpayer was:

- (1) a life insurance company (as defined in Section 816(a) of the Internal Revenue Code); or
- (2) an insurance company subject to tax under Section 831 of the Internal Revenue Code.

(i) In the case of a life insurance company that claims an operations loss deduction under Section 810 of the Internal Revenue Code, this section shall be applied by:

- (1) substituting the corresponding provisions of Section 810 of the Internal Revenue Code in place of references to Section 172 of the Internal Revenue Code; and
- (2) substituting life insurance company taxable income (as defined in Section 801 the Internal Revenue Code) in place of references to taxable income (as defined in Section 63 of the Internal Revenue Code).

(j) For purposes of an amended return filed to carry back an Indiana net operating loss:

- (1) the term "due date of the return", as used in [IC 6-8.1-9-1\(a\)\(1\)](#), means the due date of the return for the taxable year in which the net operating loss was incurred; and
- (2) the term "date the payment was due", as used in [IC 6-8.1-9-2\(c\)](#), means the due date of the return for the taxable year in which the net operating loss was incurred.

(Emphasis added).

The Department determined that Taxpayer's deduction of the royalty payments in question resulted in an unfair representation of Taxpayer's Indiana income. The Department therefore added the amount of royalties back to Taxpayer's Indiana income. By adding back those royalties, the Department increased Taxpayer's Indiana income for the tax years 2003-2006. This in turn reduced Taxpayer's claimed NOLs for those years.

The Department recalculated the amount of Taxpayer's available NOLs and applied the resulting amounts to Taxpayer's Indiana income for the tax years 2005-07. Since the Department's addback of royalty payments increased Taxpayer's Indiana income for 2005 and 2006, and since the addback of royalty payments reduced the amounts of NOLs available to apply to the three audit years of 2005, 2006, and 2007, the Department determined that Taxpayer only had enough NOLs to result in no Indiana AGIT due for 2005 and 2006. NOLs reduced the amount of Indiana AGIT for 2007, but were insufficient to eliminate Taxpayer's 2007 Indiana AGIT.

Taxpayer protests that the royalties in question were properly deducted and that the Department should have neither added back those royalties nor reduced its NOLs. As part of the protest process, Taxpayer provided documentation and analysis in support of its position. That documentation is sufficient to establish that, while the royalties were paid to a related company, the royalties were paid pursuant to an arm's length agreement and the related company actually performed the duties for which the royalties were paid.

Since the royalties were at arm's-length and were for actual services, Taxpayer's deduction of those royalties prior to the statutory change which became effective on July 1, 2006, was proper. Therefore, the royalties were properly deducted and the Department's adjustments to Taxpayer's NOLs were unnecessary. Since there were other adjustments made in the audit, the Department will conduct a supplemental audit to reflect the findings discussed above.

FINDING

Taxpayer's protest is sustained.

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