**DEPARTMENT OF STATE REVENUE**

02-20090880.LOF

**Letter of Findings: 02-20090880**
**Corporate Income Tax**
**For the Years Ending 2/1/2004 through 1/29/2006**

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**ISSUES**

**I. Corporate Income Tax – Disallowance of Expenses.**

**Authority**: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-8; I.R.C. § 63; I.R.C. § 482; Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind.Tax,1992), aff'd 639 N.E.2d 264 (Ind. 1994); 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); Enterprise Leasing Co. of Chicago v. Indiana Dept. of State Revenue, 779 N.E.2d 1284 (Ind.Tax,2002).

Taxpayer argues that the Department of Revenue erred in disallowing certain business expenses claimed by Taxpayer on its income tax returns.

**II. Corporate Income Tax – Net Operating Loss ("NOL").**

**Authority:** 45 IAC 3.1-1-9; Letter of Findings 02-20050506 (March 30, 2006).

Taxpayer disagrees with the Department of Revenue's decision disallowing the carry-forward of a net operating loss attributable to the year 2004.

**III. Corporate Income Tax – Taxable Nexus.**

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

Taxpayer argues that its Subsidiary Company had sufficient contacts with Indiana such that the Subsidiary Company should have filed its own separate corporate income tax return.

**IV. Tax Administration – Negligence Penalty.**

**Authority**: IC § 6-8.1-5-1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer asks that the Department exercise its authority to abate the ten-percent negligence penalty on the grounds that Taxpayer had reasonable cause for claiming the expenses that it did.

**STATEMENT OF FACTS**

Taxpayer, a retail merchant and service provider, is incorporated in the state of Delaware and headquartered outside Indiana. Taxpayer operates business locations inside Indiana and outside Indiana. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional tax stemming – at least in part – from the disallowance of certain business expenses which Taxpayer paid to its wholly owned subsidiary company ("Subsidiary Company") for the tax years ending February 1, 2004, January 30, 2005, and January 29, 2006 ("Tax Years").

Taxpayer disagreed with the audit conclusions and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results. Additional facts will be provided as necessary.

**I. Corporate Income Tax – Disallowance of Expenses.**

**DISCUSSION**

The Department's audit disallowed certain business expenses. Specifically, the audit disallowed the royalty expenses, interest expenses, and the "mark-up" on "Intercompany Expense Reimbursements" which Taxpayer claimed as "ordinary and necessary" expenses. The audit did so on the grounds that the claimed expenses "artificially distort[ed] the taxpayer's Indiana income."

The expense issue stemmed from Taxpayer's 1999 decision to form Subsidiary Company incorporated in Delaware and headquartered outside Indiana. As described in Taxpayer's corporate minutes, this "holding company" was organized in 1999 "to undertake certain activities currently conducted by [Taxpayer]."

When Subsidiary Company was formed, Taxpayer transferred certain assets and liabilities to Subsidiary Company. Subsidiary Company recorded those assets and liabilities on its books accordingly. The amount of assets on its books totaled approximately $652,000,000, including, but not limited to, "cash, an SAP Accounting System, fixed assets, equipment, trademarks and leases." Subsidiary Company also claimed as an asset a promissory note, executed on the same date that Subsidiary Company was formed, in the amount of $575,000,000. This promissory note represented a loan in which Taxpayer was the borrower and Subsidiary Company was the lender.

The $575,000,000 loan – together with the other above named assets – was then used to purchase 100 percent of the Subsidiary Company's stock. In other words, in order to purchase Subsidiary Company, Taxpayer contributed assets and $575,000,000 which it borrowed from Subsidiary Company.

The entire $652,000,000 was then recorded on Taxpayer's books as an "investment" in Subsidiary Company.

Thereafter, Taxpayer began to pay Subsidiary Company royalties, interest, management expenses as follows:

**Royalty Expenses:** As noted above, Subsidiary Company acquired from Taxpayer the licensed trademarks previously owned by Taxpayer. In order for Taxpayer to continue exploiting the trademarks' value, Subsidiary Company charged Taxpayer a licensing fee equal to one percent of Taxpayer's gross sales. As described in the audit report, "The [trademarks'] value attaches to the trademarks solely upon use by [Taxpayer] at [its] retail locations including the twenty-one [retail] locations in Indiana."

**Mark-up Expenses:** The audit report explained that Subsidiary Company existed in part to provide "Corporate headquarters, strategic management services, general accounting, finance, legal, tax, treasury, cash management, investor relations, data processing, human resources and benefit services, advertising and marketing [services]" to Taxpayer. All the expenses incurred by Subsidiary Company in providing these services to Taxpayer are reimbursed by Taxpayer. In addition to the reimbursement of the actual expenses, Taxpayer pays Subsidiary Company an "override" consisting of a "mark-up" on the actual expenses. The "mark-up" charge varies between one and four percent of Taxpayer's gross sales revenue.

**Interest Expenses:** In addition to the "mark-up" expenses and royalty expenses, Taxpayer also paid Subsidiary Company interest on two loans. The first loan is the $575,000,000 loan noted above; the second loan stems from a line-of-credit with a maximum limit of one billion dollars. During the three years at issue, Taxpayer paid Subsidiary Company approximately $176,000,000 in interest payments.

Accordingly, on the ground that the claimed royalty expenses, "mark-up" expenses, and interest expenses, "artificially distort[ed] taxpayer's Indiana income," the audit proceeded to disallow three of Taxpayer's claimed expenses: (1) the audit disallowed the royalty payments; (2) the audit disallowed the one to four percent "override" or "mark-up" on the management expense charges; (3) the audit disallowed the interest expenses attributable to loans between Taxpayer and Subsidiary Company.

The Department's audit arrived at its adjustment under authority of IC § 6-3-2-2(l) and (m).

(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) 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.

**A. Statutory Authority**.

Taxpayer argues that the audit's reliance on IC § 6-3-2-2(l) and (m) is misplaced because these two provisions "are exclusively related to how income is to be attributed to Indiana after federal taxable income modified by additions and subtractions under IC 6-3-1-3.5(b) are applied."

As a threshold issue, it is 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."

The Internal Revenue Code requires taxpayers to report and pay their federal income tax when their gross income exceeds certain amount. For state income tax purposes, the presumption is that the taxpayers properly and correctly file their federal income tax returns and, thus, to efficiently and effectively compute what is considered the taxpayers' Indiana income tax, the Indiana statute refers to the Internal Revenue Code. Thus, IC § 6-3-1-3.5(b) simply 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) adjusted as follows...." 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) with three adjustments...." Thus, the taxpayers' federal "adjusted gross income" is merely the starting point to calculate what would be their Indiana income tax; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point.

IC § 6-3-2-2 addresses issues of "adjusted gross income derived from sources within Indiana." Specifically, section (l) and (m) allow the Department or a taxpayer to employ a different method, if necessary, to fairly reflect and report the taxpayer's income derived from sources within Indiana. IC § 6-3-2-2(l)(4) clearly contemplates the use of "any other method [intended] to effectuate an equitable allocation and apportionment of the taxpayer's income." In addition, IC § 6-3-2-2(l)(1) allows for a "separate accounting" which counters Taxpayer's argument that the statute allows only for an adjustment to the manner in which "income is to be attributed to Indiana after federal taxable income...." If Taxpayer's contention were correct, IC § 6-3-2-2(l) and (m) would render a nullity. Enterprise Leasing Co. of Chicago v. Indiana Dept. of State Revenue, 779 N.E.2d 1284, 1294 (Ind.Tax,2002). ("The Court will avoid an interpretation that renders any part of the statute meaningless or superfluous.")

Accordingly, the Department is not able to agree with Taxpayer's assertion that section (l) and (m) "are exclusively related to how income is to be attributed to Indiana after federal taxable income modified by additions and subtractions under IC 6-3-1-3.5(b) are applied."

In short, Taxpayer's protest is respectfully denied.

**B. Income Distortion**.

Alternatively, Taxpayer asserts that the audit did not establish a level of "distortion" necessary to justify resorting to the remedies found at IC § 6-3-2-2(l) and (m). Taxpayer argues that the addback of interest, royalties, and "mark-up" payments "requires reasonable analytical evidence to demonstrate distortion in fact exists under the statutory method and then requires that any adjustment or 'remedy' in fact fairly reflects Indiana source income." Taxpayer maintains that the audit "used implication and innuendo to suggest, using flat statements without showing cause and effect, that [Taxpayer's] use of the statutory method did not fairly reflect its Indiana source income."

**(1) Interest Expenses**.

At the outset of this relationship, Subsidiary Company was the beneficiary of assets previously held by Taxpayer but which were then "invested" in Subsidiary Company.

Included among those assets was a "note" valued at $575,000,000; in effect, Taxpayer gave Subsidiary Company an I.O.U. for $575,000,000 after which a loan was established in which Taxpayer borrowed the I.O.U. back from Subsidiary Company. Taxpayer then used the I.O.U. together with its assets to purchase 100 percent of Subsidiary Company's stock upon the formation of Subsidiary Company. Taxpayer then claimed the interest payments as "ordinary and necessary" business expenses and deducted them from its income for Tax Years. However, because Taxpayer had "borrowed" a large part of the stock's purchase price from Subsidiary Company, Taxpayer became obligated to pay 8.75 percent in interest each year.

The audit found that this intercompany transaction created a purported business expense deduction, which reduced Taxpayer's income derived from sources within Indiana. Thus, the audit determined that Taxpayer's Indiana income, as filed, did not fairly reflect income derived from sources within Indiana.

Taxpayer, to the contrary, stated that the $575,000,000 constituted the "necessary funding for [Subsidiary Company] for the seven year [loan] term – as determined at the time of incorporation." Taxpayer also stated that the audit's conclusion is "out of touch with the cash flow needs of a corporation."

The Department takes no stance on what is or should be the cash flow concerns of either Taxpayer or Subsidiary Company. However, the multiple transfers of the $575,000,000 between two closely related parties–from Subsidiary Company to Taxpayer and, then, from Taxpayer to the very same Subsidiary Company on the same date which Subsidiary Company was formed–makes it difficult to discern which party is the "borrower" and which is the "lender." Thus, the multiple transfers of the $575,000,000 bring into question the financial realities necessary to justify claiming the 8.75 percent interest payments as "ordinary and necessary" business expenses.

Accordingly, given the totality of the circumstances, the Department is not able to agree that Taxpayer has met its burden demonstrating that the 8.75 percent interest payments were "ordinary and necessary" business expenses. Because the claimed deductions of the interest payments distorted its income, Taxpayer's returns, as filed, did not fairly represent its income derived from sources within Indiana. Thus, the audit properly disallows Taxpayer's claimed deductions of interest payments for Tax Years.

**(2) Royalty Expenses**.

Taxpayer transferred its trademarks to its wholly owned Subsidiary Company upon the formation of Subsidiary Company and, immediately, leased back those trademarks to be used in its retail stores. In this instance, Taxpayer paid – and claimed as ordinary and necessary business expenses – approximately $99,000,000 to Subsidiary Company.

The audit report noted that these "trademarks were developed by the parent [Taxpayer]. [The trademarks'] value is heightened by the services provided in the [Taxpayer's] retail locations." The report further noted that, "There is no apparent business purpose for this move. The marks serve exactly the same purpose as they did before. No new markets were entered, no new business was created. Only the parent [Taxpayer] is making use of the marks." The report concluded, "The only thing that has changed in this move is the allocation of profits." In disallowing the royalty expenses claimed by Taxpayer, the report noted that "the total value of licensed marks are valued somewhere below 1.6 million – yet when [Taxpayer] uses them – they pay an annual fee in excess of $30 million per year to [Subsidiary Company]."

Taxpayer disagreed stating that "there is no evil in segregating activities in separate entities within an affiliated group while still deriving benefit to the whole from the interrelationship." Taxpayer pointed out that it has obtained a transfer pricing study justifying the royalty payments and the steps governing the valuation contained within the transfer pricing study are "strictly governed by IRC § 482." Taxpayer maintained that the audit "just makes statements without tying them to any analysis of why [the royalties] might be distortive."

Taxpayer essentially argued that it had good and sufficient reasons for "spinning off" employees, responsibilities, operations, and assets to the newly formed Subsidiary Company. Taxpayer points to its corporate minutes which states:

> WHEREAS, the [Taxpayer] and [Subsidiary Company] will each operate as distinct legal entities and business units, to more accurately measure the true economic performance of each entity, and in order to appropriate allocate, through the use of intercompany charges, profits and expenses.

Taxpayer explained that the Subsidiary Company was "spun off" to allow Taxpayer to "better focus on its activities while having back-office share services be done in another entity to measure profits and expenses of each separately." Taxpayer also mentioned other advantages, such as segregating potential liability, achieving economies of scale, and conducting its various functions "more efficiently and effectively...."

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 a transfer pricing study, 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.

Taxpayer is, of course, entitled to structure its business affairs in any manner its sees fit and to pursue any tax advantage attendant upon the management of its business affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind.Tax,1992), aff'd 639 N.E.2d 264 (Ind. 1994). In transferring the trademarks to Subsidiary Company, developing a business structure, and financial plan, Taxpayer sought for a variety of reasons to make the decisions it did and – for purposes of this discussion – the Department has no quarrel with any of the particulars of its business plan. What is incontrovertible is the fact that Taxpayer paid approximately $100,000,000 in royalties for trademarks which it once owned. When one considers the "substance" of the royalty payment, the Department was legitimately concerned that Taxpayer had shifted a substantial portion of its Indiana source income outside the state, that Taxpayer's Indiana income did not match its claimed Indiana expenses, and that it was appropriate to take steps to assure that Taxpayer's taxable income fairly reflected the income attributable to Indiana sources.

In short, Taxpayer needed to establish that it made economic sense to make payment of $100,000,000 to use its own trademarks, that the payment was "ordinary and necessary," that the payment was grounded in simple economic reality, and that its income, as filed, fairly represented the income derived from sources within Indiana. Taxpayer, however, has failed to establish that the audit was unjustified in its finding that the royalty payments simply shifted money from one corporate pocket into another and that effect of that shift was to distort Taxpayer's Indiana income.

**(3) "Mark-up" on Intercompany Expense Reimbursements**.

Similar to its trademark arrangement, Taxpayer transferred responsibility for "Corporate headquarters, strategic management services, general accounting, finance, legal, tax, treasury, cash management, investor relations, data processing, human resources and benefit services, advertising and marketing [services]" to its wholly owned Subsidiary Company and, subsequently, subscribed those services from Subsidiary Company. Subsidiary Company performed these "back office" functions and Taxpayer paid Subsidiary Company for doing so. Taxpayer also added to the reimbursement a "mark-up" referred also in the audit report as an "override." The amount of "mark-up" varies having increased from approximately one to four percent of Taxpayer's total sales revenue. Taxpayer's documentation revealed, in relevant part, that:

> In fiscal 2005 [tax year ending January 29, 2006], [Taxpayer] paid [Subsidiary Company] approximately $191 million as a reimbursement of costs incurred by [Subsidiary Company] and approximately $157 million as a service fee (i.e. approximately 4.3 percent of taxpayer's gross sales revenues).

Taxpayer then deducted the "mark-up" payments and reimbursement of actual expenses as "ordinary and necessary" business expenses.

The audit disallowed the "mark-up" expenses of $250,162,138 for Tax Years although it should be noted that the audit did not disallow the underlying expense reimbursements.

Taxpayer objected stating that the "mark-up" expenses were justified by a transfer pricing study. Taxpayer asserted that the audit's decision insofar as these expenses "indicate a lack of understanding of the methodology used to determine the proper profit on the services provided by Subsidiary Company.

As discussed above, the issue is whether Taxpayer has met its burden of demonstrating that the "mark-up" expenses were "ordinary and necessary" and that claiming – as an expense deduction – the approximately $250,000,000 in "mark-up" expenses accurately, correctly, and fairly represented "taxpayer's income derived from sources within the state of Indiana...." IC § 6-3-2-2(l).

In this instance, Taxpayer itself had handled the "back office" functions before the "spinning off." Taxpayer paid Subsidiary Company the reimbursement of the actual expenses and a "mark-up" for the same "back office" services after Subsidiary Company was formed. Taxpayer's documentation showed that Taxpayer shares the headquarters with Subsidiary Company. Its documentation, after the "spinning off," further showed that Taxpayer bears most of the risks, including market risk, inventory risk, product liability risk, credit risk, as well as "general operation and managerial risk," but Subsidiary Company only bears the risks related to the intangible assets. Additionally, Taxpayer's documentation also showed that Taxpayer reported and claimed approximately

$75,000,000 deductions for the compensation it paid to its corporate officers for Tax Years but, in Subsidiary Company's federal returns, there was no (zero) compensation paid to the corporate officers for Tax Years.

Accordingly, given the totality of the circumstances, in the absence of other documentation, the Department is not able to agree that Taxpayer has demonstrated that its returns, as filed, which deducted its $250,000,000 in "mark-up" expenses accurately, correctly, and fairly represented Taxpayer's "income derived from sources within the state of Indiana."

In summary, Taxpayer failed to provide sufficient documentation to substantiate its claim that its interest, royalty, and "mark-up" payments to its wholly-owned Subsidiary Company were "ordinary and necessary" business expenses, and that it was entitled to the deductions, which reduced its income for Tax Years. Rather, Taxpayer's documentation demonstrated that ninety-nine percent of Subsidiary Company's revenue was from Taxpayer's claimed interest, royalty, service payments. Since its formation, Subsidiary Company only has had one client–Taxpayer–and is almost non-existent without Taxpayer. Taxpayer's documentation demonstrated that the circumstances surrounding the formation of the wholly-owned Subsidiary Company in Delaware together with (1) the purported loans and payments of interest, (2) the purported transfer of trademarks and subsequent licenses in exchange for payments of royalty, as well as (3) the transfer of "back office" functions and payments for those services, artificially created "expenses" for Taxpayer and, at the same time, shift its income to its wholly-owned Subsidiary Company which has no state income tax under Delaware law. Therefore, Taxpayer's income, as filed, did not fairly represent its income derived from sources within the state of Indiana and the audit properly disallowed those "expenses" pursuant to IC § 6-3-2-2 (l) and (m).

**FINDING**

Taxpayer's protest of the Department's disallowance of the interest, royalty, and "mark-up" expenses is respectfully denied.

**II. Corporate Income Tax – Net Operating Loss ("NOL").**

**DISCUSSION**

On its originally filed income tax return, Taxpayer claimed an approximately 1.5 million dollar net operating loss for the year ending February 1, 2004. The audit determined that this particular loss "originated from years when the taxpayer would have been paying royalties, mark up of expenses and intercompany interest (which should have been disallowed as deductions) the disallowance of these expense deductions would have resulted in the elimination of the taxpayer's Net Operating Loss." The audit denied Taxpayer the benefit of the net operating loss pursuant to 45 IAC 3.1-1-9 and Letter of Findings 02-20050506 (March 30, 2006).

Taxpayer does not challenge the Department's authority to disallow the net operating loss. However, Taxpayer does request "a real review of the NOL s and how they were generated to determine their validity in a supplemental audit." Taxpayer suggests that the 1.5 million dollar loss was attributable to expenses unrelated to the interest, "mark-up," or royalty payments discussed in Part I above.

Taxpayer did not provide sufficient documentation substantiating its claim which would justify either arising at such a conclusion or directing that the audit division review the disallowed 2004 NOLs.

**FINDING**

Taxpayer's protest is respectfully denied.

**III. Corporate Income Tax – Taxable Nexus.**

**DISCUSSION**

Taxpayer maintains that its Subsidiary Company "had substantial nexus and a taxable presence in Indiana during the Tax Years." Taxpayer points to a number of factors which it believes establish Indiana nexus. For example, Taxpayer asserted that Subsidiary Company leased a corporate aircraft and had employees traveling to Indiana regularly for "new store openings, evaluating potential new retail sites, visiting retail stores, visiting vendors, assisting with training associates, examining infrastructure needs, and assisting in store remodeling in Indiana." Taxpayer states that Subsidiary Company's "connections to Indiana are exclusively non-solicitation." Based upon its belief that the Subsidiary Company had sufficient nexus with Indiana, Taxpayer concludes that "[Subsidiary Company] should file separate company Indiana returns for tax years since 2002. Thus, Taxpayer claimed that by filing a separate company return for [Subsidiary Company], the interest, royalty, and mark-up expenses added back to the income of [Taxpayer] under audit would be included in [Subsidiary Company's] filing." As a result, Taxpayer asserted that the challenged expenses "would therefore not be added back to [Taxpayer's] income as doing so would effectively count the income of [Subsidiary Company] twice for Indiana purposes."

As noted in Part I above, the burden of demonstrating that the assessment is wrong rests with the Taxpayer. IC § 6-8.1-5-1(c) provides that, "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."

In this case, Taxpayer suggests that an alternative to disallowing the disputed expenses would have been for Subsidiary Company to file a separate return. Presumably, this alternative would have addressed the Department's concerns and – based upon Taxpayer's representations during the protest – simultaneously been acceptable to both Taxpayer and Subsidiary Company.

Perhaps, IC § 6-3-2-2(l)(4) allows for "the employment of **any other method** to effectuate an equitable allocation and apportionment of the taxpayer's income" in order to "fairly represent the taxpayer's income derived from sources within the state of Indiana...." (**Emphasis added**). Taxpayer's suggestion may very well fall within the remedy contemplated within IC § 6-3-2-2(l)(4), but the administrative hearing process is not the venue in which to experiment with alternatives to the filing methodology first presented to the Department at the onset of the audit process. The issue presented is whether or not the Taxpayer has – by suggesting an alternative filing methodology – proven that the original assessment was wrong. Taxpayer has not.

**FINDING**

Taxpayer's protest is respectfully denied.

**IV. Tax Administration – Negligence Penalty.**

**DISCUSSION**

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because its decision not to add back the challenged expense deductions did not constitute willful neglect. Further, Taxpayer points out that it obtained and periodically updated "Transfer Pricing Studies" purportedly "to ensure its intercompany expenses were arms length, approximating third party transactions...." In addition, Taxpayer points its finger at the Department which allegedly misspent five years failing to resolve Taxpayer's income tax liability.

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 must decline Taxpayer's invitation to share the responsibility for the additional income tax assessment which it incurred. Instead, the Department believes the additional liabilities are more directly linked to an aggressive – if not wholly unique – tax planning strategies which the Department has addressed previously under other circumstances and with other taxpayers. Nonetheless, given the totality of the circumstances, Taxpayer's positions were not wholly outside the realm of "ordinary business care and prudence...."

**FINDING**

Taxpayer's protest is sustained.

**SUMMARY**

For the reasons discussed above, on Part IV, Taxpayer's protest of the imposition of negligence penalty is sustained. However, the remainder of Taxpayer's protest is respectfully denied.

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