DEPARTMENT OF STATE REVENUE

02-20100494.LOF

Letter of Findings Number: 02-20100494
Income Tax
For Tax Years 2004-06

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ISSUES

I. Adjusted Gross Income Tax–Royalty Addback.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-20; IC § 6-8.1-5-1; IC § 6-8.1-9-1; P.L. 162-2006.

Taxpayer protests the addback of royalties to its Indiana adjusted gross income tax.

II. Adjusted Gross Income Tax–Net Operating Losses.

Authority: IC § 6-8.1-5-1; 45 IAC 15-5-7.

Taxpayer protests the Department's net operating loss adjustment.

III. Tax Administration–Negligence Penalty and Interest.

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

Taxpayer protests the imposition of ten percent negligence penalties and interest.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had incorrectly deducted certain royalty and interest payments from its Indiana adjusted gross income tax ("AGIT") for the tax years 2004, 2005, and 2006. The Department therefore issued proposed assessments for AGIT, ten percent negligence penalties, and interest for those years. Taxpayer protests that the royalties were properly deducted and that it does not owe any additional base tax, penalties, or interest for those years. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Royalty Addback.

DISCUSSION

Taxpayer protests the imposition of proposed assessments for AGIT for the tax years 2004-06. Taxpayer states that the royalties in question were paid to related entities, but were at arm's length rates as determined by third-party studies. 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.

....

As the result of its audit, the Department determined that the royalties and interest payments which Taxpayer removed from taxable income on its Indiana returns should be added back to Taxpayer's taxable Indiana income. In its audit report, the Department listed several factors which led to this conclusion.

The Department noted that: 1)Taxpayer formed a related entity ("Related") and assigned the intangible property in question to Related in exchange for all the shares of Related; 2) the royalty payments were for patents and trademarks being held within a controlled group and that Taxpayer had control of the trademarks before and after the transfer; 3) the licensing agreements resulted in royalty and interest payments which substantially reduced Taxpayer's Indiana income without any clear economic benefit; 4) Related showed no intangible assets on its balance sheet and that the expenses to advertise, market, maintain the brand name, as well as legal and administrative expenses, are recorded under the expenses of Taxpayer; 5) Taxpayer and Related have common officers showing common control; 6) the money Taxpayer paid in royalties and interest flowed in a circular manner since Taxpayer paid royalties to Related, Related transferred the money by investing in a related financing company ("Related Finance"), Related Finance loaned that money to Taxpayer; and, 7) Related Finance had no employees and had no economic substance. The Department added back the royalty and interest payments in order to bring Taxpayer even with the taxable income apportioned to other states in order to fairly reflect Taxpayer's Indiana income.

Taxpayer believes that it is not required to addback those royalties and indirectly refers to IC § 6-3-2-20, which states:

(a) The following definitions apply throughout this section:

(1) "Affiliated group" has the meaning provided in Section 1504 of the Internal Revenue Code, except that the ownership percentage in Section 1504(a)(2) of the Internal Revenue Code shall be determined using fifty percent (50[percent]) instead of eighty percent (80[percent]).

(2) "Directly related intangible interest expenses" means interest expenses that are paid to, or accrued or incurred as a liability to, a recipient if:

(A) the amounts represent, in the hands of the recipient, income from making one (1) or more loans; and

(B) the funds loaned were originally received by the recipient from the payment of intangible expenses by any of the following:

(i) The taxpayer.

(ii) A member of the same affiliated group as the taxpayer.

(iii) A foreign corporation.

(3) "Foreign corporation" means a corporation that is organized under the laws of a country other than the United States and would be a member of the same affiliated group as the taxpayer if the corporation were organized under the laws of the United States.

(4) "Intangible expenses" means the following amounts to the extent these amounts are allowed as deductions in determining taxable income under Section 63 of the Internal Revenue Code before the application of any net operating loss deduction and special deductions for the taxable year:

(A) Expenses, losses, and costs directly for, related to, or in connection with the acquisition, use, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property.

(B) Royalty, patent, technical, and copyright fees.

(C) Licensing fees.

(D) Other substantially similar expenses and costs.

(5) "Intangible property" means patents, patent applications, trade names, trademarks, service marks, copyrights, trade secrets, and substantially similar types of intangible assets.

(6) "Interest expenses" means amounts that are allowed as deductions under Section 163 of the Internal Revenue Code in determining taxable income under Section 63 of the Internal Revenue Code before the application of any net operating loss deductions and special deductions for the taxable year.

(7) "Makes a disclosure" means a taxpayer provides the following information regarding a transaction with a member of the same affiliated group or a foreign corporation involving an intangible expense and any directly related intangible interest expense with the taxpayer's tax return on the forms prescribed by the department:

(A) The name of the recipient.

(B) The state or country of domicile of the recipient.

(C) The amount paid to the recipient.

(D) A copy of federal Form 851, Affiliation Schedule, as filed with the taxpayer's federal consolidated tax return.

(E) The information needed to determine the taxpayer's status under the exceptions listed in subsection (c).

(8) "Recipient" means:

(A) a member of the same affiliated group as the taxpayer; or

(B) a foreign corporation;

to which is paid an item of income that corresponds to an intangible expense or any directly related intangible interest expense.

(9) "Unrelated party" means a person that, with respect to the taxpayer, is not a member of the same affiliated group or a foreign corporation.

(b) 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.

(c) The addition of intangible expenses or any directly related intangible interest expenses otherwise required in a taxable year under subsection (b) is not required if one (1) or more of the following apply to the taxable year:

(1) The taxpayer and the recipient are both included in the same consolidated tax return filed under IC 6-3-4-14 or in the same combined return filed under IC 6-3-2-2(q) for the taxable year.

(2) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the item of income corresponding to the intangible expenses and any directly related intangible interest expenses was included within the recipient's income that is subject to tax in:

(i) a state or possession of the United States; or

(ii) a country other than the United States;

that is the recipient's commercial domicile and that imposes a net income tax, a franchise tax measured, in whole or in part, by net income, or a value added tax;

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient was made at a commercially reasonable rate and at terms comparable to an arm's length transaction; and

(C) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(3) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient regularly engages in transactions involving intangible property with one (1) or more unrelated parties on terms substantially similar to those of the subject transaction; and

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(4) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the payment was received from a person or entity that is an unrelated party, and on behalf of that unrelated party, paid that amount to the recipient in an arm's length transaction; and

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(5) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient paid, accrued, or incurred a liability to an unrelated party during the taxable year for an equal or greater amount that was directly for, related to, or in connection with the same intangible property giving rise to the intangible expenses; and

(B) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(6) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient is engaged in:

(i) substantial business activities from the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property; or

(ii) other substantial business activities separate and apart from the business activities described in item (i);

as evidenced by the maintenance of a permanent office space and an adequate number of full-time, experienced employees;

(B) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose; and

(C) the transactions were made at a commercially reasonable rate and at terms comparable to an arm's length transaction.

(7) The taxpayer and the department agree, in writing, to the application or use of an alternative method of allocation or apportionment under section 2(l) or 2(m) of this chapter.

(8) Upon request by the taxpayer, the department determines that the adjustment otherwise required by this section is unreasonable.

(d) For purposes of this section, intangible expenses or directly related intangible interest expenses shall be considered to be at a commercially reasonable rate or at terms comparable to an arm's length transaction if the intangible expenses or directly related intangible interest expenses meet the arm's length standards of United States Treasury Regulation 1.482-1(b).

(e) If intangible expenses or directly related intangible expenses are determined not to be at a commercially reasonable rate or at terms comparable to an arm's length transaction for purposes of this section, the adjustment required by subsection (b) shall be made only to the extent necessary to cause the intangible expenses or directly related intangible interest expenses to be at a commercially reasonable rate and at terms comparable to an arm's length transaction.

(f) For purposes of this section, transactions giving rise to intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient shall be considered as having Indiana tax avoidance as the principal purpose if:

(1) there is not one (1) or more valid business purposes that independently sustain the transaction notwithstanding any tax benefits associated with the transaction; and

(2) the principal purpose of tax avoidance exceeds any other valid business purpose.

(Emphasis added).

Specifically, Taxpayer believes that it meets the requirements of IC § 6-3-2-20(c)(2). The Department notes that IC § 6-3-2-20 was enacted by P.L. 162-2006, which provided that IC § 6-3-2-20 applies to tax years starting after June 30, 2006. Therefore, IC § 6-3-2-20 does not apply to any of the tax years at issue in this protest. Even if IC § 6-3-2-20 did apply to these years, Taxpayer does not meet the requirements to which it refers.

Taxpayer believes that it meets the requirements of IC § 6-3-2-20(c)(2) since Related paid income tax in its home state, the terms of the licensing agreement were at arm's-length as determined by a transfer pricing study, and the licensing arrangement had economic substance and was not for Indiana tax avoidance. Taxpayer also states that there was no financing agreement by which Related would loan funds back to Taxpayer. As explained in the audit report, the arrangement is between Taxpayer and Related Finance. Taxpayer has not addressed this arrangement.

Taxpayer provided documentation in support of its position. The first items provided are copies of Related's home state income tax returns for 2004, 2005, and 2006. While these are income tax returns for Related's home state, of relevance is the amount of wages, salaries, and rental costs which Related reported. For illustrative purposes of the scale of funds at issue only, Related reported less than $5,000 of salaries and wages for 2004 and 2005. Related reported that it paid zero wages or salaries for 2006. Related paid less than $20,000 in rents for all three years.

Taxpayer states that the third-party pricing study set the range of royalties. While Taxpayer is correct that the royalty rate it paid to Related is slightly below the low end of the range of royalties provided in the pricing study, that study explains on page one that the third-party preparer of the study was taking into account such factors as heightened brand awareness and marketing, synergies, laboratory testing methodologies, information systems, and billing technologies. As explained in the Department's audit report, and as confirmed by Related's home state income tax returns, Related did not perform any of the activities described in the pricing study. The $5,000 or less in wages or salaries which Taxpayer paid in 2004 and 2005 and $0 in 2006 could not possibly pay for a single full-time employee, let alone a sufficient work force to administer the intellectual property in question and the approximately $400,000,000 in income Related reported for each of the three years. Plainly, Taxpayer was still performing or paying for the performance of the activities for which Related was receiving royalties. Therefore, the royalties paid by Taxpayer to Related were not for any commercial business purpose. Taxpayer has not met the requirements of IC § 6-3-2-20(c)(2)(B).

At hearing, Taxpayer raised a second issue which was not part of the audit process or audit report. Taxpayer states that it reviewed its costs of performance and that it over-reported its Indiana income. Taxpayer has several locations in Indiana where Indiana employees begin the process of providing services to Taxpayer's Indiana customers. Taxpayer originally reported the income from these services on the Indiana income tax returns it filed. Now, Taxpayer states that it takes samples from its customers in Indiana, but that it sends the samples to another state for laboratory testing. Taxpayer believes that the greater costs of performance occur in the other state, and that it therefore over-reported income to Indiana.

The Department disagrees with Taxpayer's conclusion. The Department refers to IC § 6-8.1-9-1(a), which states:

> If a person has paid more tax than the person determines is legally due for a particular taxable period, the person may file a claim for a refund with the department. Except as provided in subsections (f) and (g), in order to obtain the refund, the person must file the claim with the department within three (3) years after the latter of the following:
> (1) The due date of the return.
> (2) The date of payment.
> For purposes of this section, the due date for a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax is the end of the calendar year which contains the taxable period for which the return is filed. The claim must set forth the amount of the refund to which the person is entitled and the reasons that the person is entitled to the refund.

Rather than waiting for the Department to conduct an audit and protesting the resulting proposed assessments, Taxpayer should have diligently reviewed its filing methods and filed refund claims for those years. A protest of an audit is not the appropriate forum for Taxpayer's argument. Amended returns and claims for refund are the appropriate forum for Taxpayer's argument.

In conclusion, the royalties which Taxpayer paid to Related were properly added back to Taxpayer's 2004, 2005, and 2006 Indiana AGIT. IC § 6-3-2-20 does not apply to the tax years at issue and, even if it did, Taxpayer does not meet the requirements found in IC § 6-3-2-20(c)(2)(B). Taxpayer's statements regarding cost of performance are properly addressed by filing amended returns and claiming refunds. Cost of performance was not an issue raised in the audit, and a protest hearing is not the appropriate venue for review.

FINDING

Taxpayer's protest is denied regarding the addback of royalties and the cost of performance issues.

II. Adjusted Gross Income Tax–Net Operating Losses.

DISCUSSION

Taxpayer protests the Department's determination that, as a result of the addback of royalty and interest payments, Taxpayer had sufficient income to eliminate net operating losses ("NOLs") in 2006. Taxpayer states that the Department did not respect Taxpayer's NOLs generated in tax years prior to 2004 and that the Department has effectively redetermined Taxpayer's taxable income for years which were barred by the three-year statute of limitations.

45 IAC 15-5-7(a) provides:

> Except as otherwise provided in IC 6-8.1-5-2, the statute of limitations for the assessment of a listed tax liability is three (3) years from the due date of the annual return (including extensions of time granted by the department) or the date on which the annual return is filed for the tax year, whichever is later. If an extension of time is granted by the department, the statute of limitations shall begin to run on the day after the last day of the extension period.

After review of the audit report, it is clear that the Department determined that the adjustment's to Taxpayer's 2004, 2005, and 2006 adjusted gross income resulted additional taxable income which exhausted all available NOLs which Taxpayer had carried forward into those years on the returns it filed. The Department did not redetermine Taxpayer's income for prior years, but rather adjusted Taxpayer's income and NOLs for the years at issue. Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

III. Tax Administration–Negligence Penalty and Interest.

DISCUSSION

The Department issued a proposed assessment and the ten percent negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty and interest. The Department notes that it is not permitted to waive interest, as provided by IC § 6-8.1-10-1(e). The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> . . .
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> . . .
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which 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.

(Emphasis added.)

45 IAC 15-11-2(c) provides in pertinent part:

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.

In this case, Taxpayer incurred an assessment which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer states that it did act reasonably and that it should not be subject to penalty. After review of the circumstances in this protest, Taxpayer has not established that the assessment arose due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

SUMMARY

Taxpayer is denied in Issue I regarding the addback of royalties. Taxpayer is denied in Issue I regarding its cost of performance argument. Taxpayer is denied in Issue II regarding net operating losses. Taxpayer is denied in Issue III regarding the imposition of negligence penalty and interest.

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