

**Letter of Findings: 02-20090879; 02-20100430**  
**Corporate Income Tax**  
**For the Years 2005, 2006, 2007, and 2008**

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**ISSUES**

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

**Authority:** IC § 6-3-1-3.5; IC § 6-3-2-2; P.L.162-2006, Sec. 53; IC § 6-3-2-20; IC § 6-8.1-5-1; [45 IAC 3.1-1-8](#); Lafayette Square Amoco, Inc. v. Indiana Dept of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Enterprise Leasing Co. of Chicago v. Indiana Dept. of State Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); In re B.J., 879 N.E.2d 7 (Ind. Ct. App. 2008); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992), aff'd 639 N.E.2d 264 (Ind. 1994); Surtees v. VFJ Ventures, Inc., 8 So.3d 950 (Ala. Civ. App. 2008); Webster's II New Riverside University Dictionary (2d ed. 1988); Black's Law Dictionary (2d pocket ed. 2001); Del. Code Ann. tit. 30, §1902.

Taxpayer and its subsidiaries/affiliates argue that the Department of Revenue erred in disallowing certain business expenses claimed on their income tax returns.

**II. Tax Administration – Underpayment Penalty and Negligence Penalty.**

**Authority:** IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#); IC § 6-3-4-4.1.

Taxpayers protest the imposition of the underpayment penalty and the negligence penalty.

**STATEMENT OF FACTS**

Taxpayer ("Parent") is a multinational corporation engaged in the manufacture and sales of commercial and consumer products. Through its multi-tiered corporate structure, Taxpayer wholly or partially owns, as well as directly or indirectly controls, its multi-tiered subsidiaries. Taxpayer and some of its subsidiaries (collectively, "Taxpayers") conduct business in Indiana and file Indiana consolidated returns.

In 1999, Parent embarked on a corporate restructuring and established two new wholly-owned subsidiaries, Sub F and Sub I, which both were incorporated in Delaware. Sub F is Parent's first-tier subsidiary and wholly-owned by Parent. Sub I, wholly-owned by Sub F, is Sub F's first-tier subsidiary and is a second-tier subsidiary of Parent. Sub F serves as a treasury function for Parent and its subsidiaries/affiliates, facilitating cash management and intracorporate lending between Parent and its subsidiaries/affiliates, including Taxpayers. Sub I serves as an intangible property holding company managing and licensing the intellectual property, such as patents and copyrights, which were created by and transferred from Parent since formation of Sub I.

In 2009, the Indiana Department of Revenue ("Department") performed an income tax audit of tax years 2005, 2006, and 2007 ("2009 Audit"). Pursuant to the audit, the Department disallowed certain business expenses which Taxpayers deducted from their returns. Those deductions include interest payments to Sub F on intercompany loans during tax years 2005 and 2006 as well as royalty payments to Sub I for the use of the intellectual property during tax year 2007. As a result, the Department's audit assessed Taxpayers additional income tax, interest, and penalties. Taxpayers timely protest the assessments. A hearing was held.

In 2010, Taxpayers timely filed an amended Indiana consolidated return for tax year 2008 and claimed that they were entitled to a refund. The Department, based upon an audit ("2010 Audit") review of Taxpayers' amended return and additional documentation submitted, made certain adjustments on Taxpayers' refund claim for the same reasons as stated in the 2009 Audit (collectively, "Audits"). Taxpayers also timely protest the 2010 Audit determination. Subsequently, Taxpayers agreed to consolidate these two protests because the issues are identical—disallowing Taxpayers' deductions on their royalty payments to Sub I and their interest payments to Sub F.

This Letter of Findings ensues addressing both protests. Additional facts will be provided as necessary.

**DISCUSSION**

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

The Department disallowed certain business expenses (which Taxpayers claimed and deducted as "ordinary and necessary" expenses in their returns) because the Department determined that Taxpayers' Indiana returns, as filed, did not fairly reflect their income derived from Indiana sources. Specifically, the Department disallowed Taxpayers' deductions on (1) interest payments to Sub F for intercompany loans during tax years 2005, 2006, and 2008, and (2) royalty payments to Sub I for the use of the intangible intellectual property during tax years 2007 and 2008. The Audits did so on the grounds that the claimed expenses "artificially" reduced Taxpayers' Indiana income, and, as a result, Taxpayers' Indiana returns, as filed, did not fairly reflect their income derived from

The expense issue stemmed from a series of business arrangements which occurred in 1999 among Parent, Sub F, and Sub I. Both Sub F and Sub I were formed and incorporated in Delaware and headquartered outside Indiana in 1999. The 1999 arrangements can be summarized as follows:

**Sub I:** Parent first transferred certain of its intellectual property (including copyrights and patents) to Sub I in exchange for one-hundred (100) percent of Sub I's shares. From then on, Sub I acquired the exclusive rights to license and to sublicense the intellectual property to generate income from those intangibles. Parent also assigned to Sub I its existing license agreements with its subsidiaries/affiliates and unrelated third parties. Parent has been collecting the royalty payments from its subsidiaries/affiliates and unrelated third parties for their use of the licensed intellectual property prior to the assignment. Parent then leased back those intellectual property rights to be used in Parent's manufacturing process.

**Sub F:** Immediately following the formation of Sub I, Parent transferred all of Sub I's issued and outstanding shares (which it had just acquired) to Sub F, and in return, Parent acquired one-hundred (100) percent of Sub F's shares. Sub F was formed to centralize control and to manage the cash flow of Parent and its subsidiaries/affiliates. Parent provides Sub F the necessary funding to make intercompany loans when necessary.

Pursuant to the company's cash management policy, Taxpayers borrow from and pay interest to Sub F. Taxpayers then deduct those interest payments as "ordinary and necessary" expenses in their returns. Additionally, pursuant to the assigned license agreements, Taxpayers pay royalties to Sub I for the use of the intellectual property. Taxpayers then deduct those royalty payments as "ordinary and necessary" expenses in their returns. Because Indiana, like most of states, use the federal taxable income as the starting point to calculate state taxable income, the deductions of those royalty payments to Sub I and interest payments to Sub F as business expenses reduce Taxpayers' taxable income in Indiana. At the end of each year, both Sub I and Sub F have substantial amount of profits and, as a result, Sub I paid dividends to Sub F and Sub F paid dividends to Parent.

The Audits noted that both Sub I and Sub F incur nominal expenses to carry out their business activities. The Audits also noted that Taxpayers claim that they placed all cash management functions in Sub F "for the purpose of cost savings and efficiency." These "cost saving" strategies resulted in large amounts of intercompany interest being paid to Sub F which reduced Indiana income. Thus, the Audits concluded that both intercompany transactions shifted Taxpayers' deemed Indiana income outside of Indiana, and, as a result, their Indiana returns failed to fairly reflect their Indiana income for the years at issue. Thus, the Audits proceeded to disallow certain of Taxpayers' claimed expenses: (1) the Audits disallowed Taxpayers' royalty payments to Sub I for tax years 2007 and 2008; and (2) the Audits disallowed Taxpayers' interest payments to Sub F for tax years 2005, 2006, and 2008.

The Audits arrived at the adjustments under authority of IC § 6-3-2-2(l)(4).

(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. (Emphasis added).**

#### **A. Statutory Authority.**

Taxpayers argue that the Department's reliance on IC § 6-3-2-2(l) is misplaced. Taxpayers state, in pertinent part, that:

IC § 6-3-2-2(l) only permits the Department to adjust a taxpayer's apportionment formula, not its taxable income. The Department has not excluded or included one or more factors or required separate accounting, which are the first three options in IC § 6-3-2-2(l). Instead, the Department adjusted Taxpayers' income base by disallowing certain deductions reported by Taxpayers on their pro forma federal return. Indiana law is clear. Adjusted gross income is determined by using federal taxable income as a base and then modifying that base with Indiana adjustments.

Taxpayers also claim that the Department may not rely on IC § 6-3-2-2(m) to disallow Taxpayers' claimed "ordinary and necessary" expenses. Taxpayers state, in pertinent part, that:

Neither the Indiana statutes, regulations nor case law set forth a standard by which the Department may exercise its authority under IC § 6-3-2-2(m). In the absence of such a standard,... the Department may not rely on IC § 6-3-2-2(m) to disallow [Taxpayers'] interest and royalty deductions. Even if the Department may rely on IC § 6-3-2-2(m) in certain circumstances, the Department may not rely on such provision in this case because the income as originally reported by [Taxpayers] fairly reflects [their] activities within Indiana.

Taxpayers further assert that their intercompany transactions qualify for one of the exceptions established by IC § 6-3-2-20(c) which became effective and applicable to taxable years beginning after June 30, 2006.

Taxpayers thus assert that they were entitled to deduct interest payments and royalty payments as "ordinary and necessary" expenses pursuant to IC § 6-3-2-20.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dept of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The Internal Revenue Code requires taxpayers to report and pay their federal income tax when their gross income exceeds a certain amount. For state income tax purposes, the presumption is that the taxpayers properly and correctly filed their federal income tax returns and, thus, to efficiently and effectively compute 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 the taxpayers' 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 repeat 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, 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 Taxpayers' 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 Taxpayers' contentions were correct, IC § 6-3-2-2(l) and (m) would be rendered a nullity. Enterprise Leasing Co. of Chicago v. Indiana Dept. of State Revenue, 779 N.E.2d 1284, 1294 (Ind. Tax Ct. 2002). ("The Court will avoid an interpretation that renders any part of the statute meaningless or superfluous.")

Moreover, pursuant to IC § 6-3-2-2(l), "[i]f the allocation and apportionment provisions... do not fairly represent the taxpayer's income derived from sources within the state of Indiana," the Department may require, "if **reasonable**: (1) separate accounting... or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. The word "or" is defined, in relevant part, as follows:

1. **a.** An alternative, usu. only before the last term of a series... **b.** The second of two alternatives, the first being preceded by either or whether... **2. A synonymous or equivalent expression.... (Emphasis added).**

Webster's II New Riverside University Dictionary 826 (2d ed. 1988).

The Indiana Court of Appeals in *In re B.J.*, 879 N.E.2d 7 (Ind. Ct. App. 2008), in applying an Indiana statute, further explained, in pertinent part, that:

The words "and" and "or" as used in statutes are not interchangeable, being strictly of a conjunctive and disjunctive nature respectively. Moreover, "or" is defined as "a function word to indicate **an alternative, the equivalent or substitutive character of two words or phrases.**" *Id.* at 20. (Internal citations omitted). **(Emphasis added).**

Thus, the word "or" in IC § 6-3-2-2(l) intends to provide the Department or a taxpayer an alternative which can be considered to make adjustments in the event that the allocation and apportionment provisions do not fairly represent a taxpayer's income derived from sources within the state of Indiana. IC § 6-3-2-2(l) does not condition or dictate the manner with which the Department or the taxpayer shall apply the first three methods before they can apply IC § 6-3-2-2(l)(4). Rather, the statute only requires the application of IC § 6-3-2-2(l) to be "reasonable." Had the Indiana General Assembly intended to impose the order established in IC § 6-3-2-2(l), as Taxpayers claimed, the statutory language would have so reflected.

In early 2006, the Indiana General Assembly passed P.L.162-2006, Sec. 53 (codified as IC § 6-3-2-20), which requires taxpayers to add back expenses attributed to certain intercompany transactions involving intangibles. IC § 6-3-2-20 also affords the taxpayers with certain exemptions. However, it should be noted that a statute which provides a tax exemption is strictly construed against taxpayers. *Indiana Dept. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974). IC § 6-3-2-20, in relevant part, states:

(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.

The statutory notes referred to P.L.162-2006, Sec. 53, in relevant part, further provide that:

(b) [IC 6-3-2-20](#), as added by this act, **applies only to taxable years beginning after June 30, 2006.**

(c) The addition of [IC 6-3-2-20](#), as added by this act, **does not affect the legitimacy or illegitimacy of deductions claimed by taxpayers for taxable years beginning July 1, 2006.** Any determination of:

- (1) the department of state revenue; or
- (2) a court reviewing a department of state revenue determination;

of the legitimacy or illegitimacy of **deductions claimed by taxpayers for taxable years beginning before July 1, 2006, shall be made without regard to IC § 6-3-2-20**, as added by this act. **Id. (Emphasis added).**

Accordingly, for the taxable periods beginning before July 1, 2006, in the absence of IC § 6-3-2-20, IC § 6-3-2-2 (l) and (m) permit the Department to employ any other method to effectuate an equitable allocation and apportionment of a taxpayer's income to fairly reflect a taxpayer's income derived from sources within the state of Indiana. Therefore, the Department is unable to agree with Taxpayers' assertion that the Department cannot rely on IC § 6-3-2-2(l) and (m) to make any adjustments.

For the taxable years beginning after June 30, 2006, as Taxpayers correctly refer to IC § 6-3-2-20(c), several exemptions are available. Pursuant to IC § 6-3-2-20, the general rule is that a taxpayer must add back its otherwise qualified deductions, unless the taxpayer can demonstrate its deductions satisfy at least one of the exemptions afforded by IC § 6-3-2-20(c). Thus, in this case, for the deductions claimed for tax years beginning after June 30, 2006, Taxpayers must add back the deductions unless they can demonstrate that their deductions qualify one of the exemptions outlined in IC § 6-3-2-20(c).

#### **B. Income Distortion.**

Alternatively, Taxpayers assert that their income, as originally reported, fairly reflects their activities within Indiana because the charges for the intercompany transactions between Taxpayers and Sub F as well as between Taxpayers and Sub I are based on "arm's-length" prices which were supported by an independent transfer pricing study. Taxpayers further claim that the intercompany transactions satisfy at least one of the eight exceptions pursuant to IC § 6-3-2-20(c). Thus, Taxpayers maintain that they are entitled to deduct the interest payments and royalty payments.

The Department, referring to IC § 6-3-2-2(l)(4), determined that both intercompany transactions created purported business expense deductions, which reduced Taxpayers' income derived from sources within Indiana. Thus, the Department concluded that Taxpayers' Indiana income, as filed, did not fairly reflect income derived from sources within Indiana. The Department thus disallowed Taxpayers' deductions on royalty payments (for tax years 2007 and 2008) and interest payments (for tax years 2005, 2006, and 2008).

As discussed in Part A, IC § 6-3-2-20 applies to tax years beginning after June 30, 2006. The royalty and interest expense deductions claimed for tax years before July 1, 2006 and the same deductions claimed for tax years beginning after June 30, 2006, therefore, are discussed separately, as follows:

#### **(1) Royalty Expenses.**

The Department disallowed Taxpayers' deductions on royalty payments to Sub I for tax years 2007 and 2008. The Department determined that the licensing arrangements and royalty payments created a purported business expense deduction, which reduced Taxpayers' income derived from sources within Indiana. Thus, the Department concluded that Taxpayers' Indiana income, as filed, did not fairly reflect income derived from sources within Indiana. The Department thus disallowed Taxpayers' deductions on their royalty payments to Sub I. Taxpayers, to the contrary, assert that the intercompany transactions satisfy at least one of the exceptions established in IC § 6-3-2-20(c). Specifically, Taxpayers maintain that the royalty payments qualify the exemptions pursuant to IC § 6-3-2-20(c)(3) and (6).

IC § 6-3-2-20(c), in pertinent part, provides:

(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.

...

(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.

"Tax avoidance" is defined as "[t]he act of taking advantage of legally available tax-planning opportunities in order to minimize one's tax liability." Black's Law Dictionary 694 (2d pocket ed. 2001). IC § 6-3-2-20(f) further explains:

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.

In this instance, upon reviewing Taxpayers' documentation, Taxpayers have provided sufficient documentation demonstrating that they qualify for one of the exemptions outlined in IC § 6-3-2-20(c) regarding their royalty payments for tax year 2007 and 2008. Thus, Taxpayers have met their burden pursuant to IC § 6-8.1-5-1(c).

## **(2) Interest Expenses.**

The Department, pursuant to IC § 6-3-2-2(l)(4), disallowed the interest expenses attributable to intercompany loans between Taxpayers and Sub F for tax years 2005, 2006, and 2008. The Department also determined that the intercompany loans and interest payments created a purported business expense deduction, which reduced Taxpayers' income derived from sources within Indiana. Thus, the Department concluded that Taxpayers' returns, as filed, did not fairly reflect their income derived from sources within Indiana. The Department thus disallowed Taxpayers' deductions on interest payments to Sub F for those years.

Taxpayers, to the contrary, assert that their Indiana returns, as filed, fairly reflect income derived from sources within Indiana because Sub F has a business purpose and economic substance. Taxpayers further maintain that, pursuant to IC § 6-3-2-20(c)(8), the interest payments are exempt from adding back their returns.

### **(a) Interest Expenses Claimed for Taxable Years Before July 1, 2006.**

Taxpayers' documentation demonstrates that Sub F was created to serve a treasury function and to effectively and efficiently manage Taxpayer (Parent) and its affiliates/subsidiaries' financial affairs (e.g., cash management). Pursuant to the 1999 business arrangements, Taxpayer transferred its 100 percent shares of Sub F in exchange for the 100 percent shares of Sub F, and, thus, Sub F is wholly owned by Taxpayer.

Taxpayers' documentation also demonstrates that Sub F is funded by Taxpayer (Parent) if Sub F is "in a negative position and swept daily if it is in an excess position" because Sub F's bank account is a "Zero Balance Account." Sub F, in turns, provides intercompany loans (including loans through cash-pooling accounts and traditional loans) to Taxpayer (Parent) and its affiliates/subsidiaries, including Taxpayers. Taxpayers then paid interest to Sub F and deducted those payments as "ordinary and necessary" expenses in their returns. Because Indiana, as many states do, use federal taxable income as the starting point for the calculation of taxable income in Indiana, the interest payments which Taxpayers deduct as business expenses also reduce Taxpayers' taxable income attribute to Indiana.

Notably, the interest payments paid to Sub F are not taxed in the federal consolidated returns because the income is eliminated based as intercompany transactions. Sub F's interest income is also not taxed in most of the states in the United States where a combined-reporting is required because Sub F's income is also eliminated in the combined returns for the same reason. Moreover, Sub F's interest income is not subject to Delaware state income tax because the State of Delaware does not impose income tax on intangibles. Del. Code Ann. tit. 30, §1902(b). As a result, the interest income which Sub F receives from Taxpayers, is not subject to federal and state income tax and the money returns to Taxpayer (Parent) in the form of "dividend" as a result since Taxpayer (Parent) wholly owns Sub F. Taxpayers' documentation demonstrates that Parent has received more than one (1) billion dollars in dividends from Sub F for those years at issue.

Taxpayers are, of course, entitled to structure their business affairs in any manner they see fit and to pursue any tax advantage attendant upon the management of their business affairs. The Department takes no stance on

what is or should be the cash flow concerns of either Taxpayers or Sub F. Taxpayers maintain the interest rates for the intercompany loans are on an "arm's length" basis. 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 Ct. 1992), *aff'd* 639 N.E.2d 264 (Ind. 1994). In forming Sub F to serve as a treasury for Taxpayer (Parent) and its affiliates/subsidiaries and to manage the cash flow for Taxpayers, Taxpayers sought for a variety of reasons to make the decisions they did and – for purposes of this discussion – the Department has no quarrel with any of the particulars of their business plan. What is incontrovertible is the fact that Parent (Taxpayer) wholly owns Sub F and provides Sub F the necessary funding, the fact that Taxpayer (Parent) and its affiliates/subsidiaries (including Taxpayers) then borrow money from Sub F and deduct the interest payments in their return reducing their taxable income accordingly, and the fact that Taxpayer (Parent) receives dividend payments from Sub F as a result of that Sub F has substantial profits with little expenses to carry out its business operations. While the Department's Audits noted that Sub F only incurred less than one (1) percent of its total interest income for its operating expenses, the majority of Sub F's interest income is not taxed anywhere. In the end, the majority of Sub F's interest income returns to Parent in the form of dividend. When one considers the "substance" of the intercompany loans, the Department was legitimately concerned that Taxpayers shifted a substantial portion of their Indiana source income outside the state, that Taxpayers' Indiana income did not match their claimed Indiana expenses, and that it was appropriate to take steps to assure that Taxpayers' taxable income fairly reflected the income attributable to Indiana sources.

Accordingly, given the totality of the circumstances, the Department is not able to agree that Taxpayers have met their burden demonstrating that their 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 2009 Audit properly disallows Taxpayer's claimed deductions of interest payments for the tax period prior to July 1, 2006.

**(b) Interest Expenses Claimed for Taxable Years After June 30, 2006.**

As discussed in Part A, after June 30, 2006, pursuant to IC § 6-3-2-20(b), "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... 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." Thus, the general rule, after June 30, 2006, requires that a taxpayer must add back any directly related intangible interest expenses paid, accrued, or incurred with its affiliates unless the taxpayer demonstrates that the interest expenses satisfy at least one of the eight exemptions afforded by IC § 6-3-2-20(c).

Taxpayers, referring to IC § 6-3-2-20(c)(8), assert that their claimed interest expenses qualify for the exemption because Sub F has a business purpose and economic substance. Taxpayers, referring to the company's policy, maintain that the established interest rates are "arm's length" market rates. Taxpayers also claim that the transactions are not tax-motivated transactions and that they serve a legitimate purpose—to maximize the use of company's internal fund effectively and efficiently. Thus, Taxpayers believe that it would be unreasonable to disallow the claimed interest expenses.

IC § 6-3-2-20(c)(8) provides:

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

In the absence of statutory definition of "unreasonable," the courts and the state administrative agencies usually refer to dictionaries and apply general rules of statutory interpretation. In *Surtees v. VFJ Ventures, Inc.*, 8 So.3d 950 (Ala. Civ. App. 2008), the plaintiff, VFJ Ventures, Inc. ("VFJ"), manufacturing and selling jeanswear under the Lee and the Wrangler brand names, challenged the Alabama Department of Revenue's assessment based on an add-back statute. The Alabama add-back statute requires a corporation subject to Alabama state income tax to "add back otherwise deductible interest expenses and costs and intangible expenses and costs directly or indirectly paid, accrued, or incurred to, or in connection directly or indirectly with one or more direct or indirect transactions, with one or more related members." *Id.* at 959. Deducting the royalties paid to its Delaware affiliates as business expenses, VFJ argued that the add-back statute should not apply because it qualified certain exceptions contained in the statute. *Id.* Specifically, VFJ maintained that the add-back statute was unreasonable because its Delaware affiliates had "a legitimate business purpose and economic substance." The trial court agreed and ruled in favor of VFJ. *Id.* at 960.

The Court of Civil Appeals of Alabama ("VFJ court") disagreed. The VFJ court acknowledged that:

A state, subject to constitutional limitations, may fashion its own taxing scheme. In doing so, a state is not required to use the same deductions the federal-taxation scheme allows. A statutory tax deduction or exemption is a matter of legislative grace. In enacting the add-back statute, the Alabama Legislature elected not to extend its grace to deductions for transactions between related entities involving royalty payments for intangible assets. *Id.* at 970.

The VFJ court, upon reviewing the Alabama legislature history, opined that the add-back statute is "to eliminate, subject to certain exceptions, one type of deduction for ordinary and necessary business exceptions,"

and not to address "issue of sham or fraudulent transactions or deductions." Id. In responding to VFJ's argument that it was unreasonable to add back the royalty payments paid to its Delaware affiliates because its Delaware affiliates had "a legitimate business purpose and economic substance," the VFJ court applied the general rule of statutory interpretation, and first found that:

The term "unreasonable" has been defined as "[n]ot guided by reason; irrational or capricious," see Black's Law Dictionary 1574 (8th ed.2004), and as "not governed by or acting according to reason" or "exceeding the bounds of reason or moderation," Merriam-Webster's Collegiate Dictionary 1371 (11th ed.2003)." Id. at 967-68.

The VFJ court also found that the Department's regulation, although not in effect during the years at issue, specifies that "the application of the add-back statute will be deemed "unreasonable" when the tax resulting from the application of the statute has no 'fair relation' to or is out of proportion to the corporation's activities in Alabama." Id. at 970. The VFJ court opined that the Department's interpretation is "consistent with the common-usage definitions of the term 'unreasonable' as 'irrational,' 'capricious,' or 'exceeding the bounds of reason or moderation.'" Id. at 971. The VFJ court thus concluded that the trial court erred in its interpretation of the unreasonableness exception to the add-back statute by focusing on whether the VFJ's Delaware affiliates have legitimate business purposes and economic substance. Id. The VFJ court thus determined that "the trial court's interpretation of the unreasonableness exception found in § 40-18-35(b)(2) effectively nullifies another exception to the add-back statute, specifically the exception contained in subsection (b)(3)" and that "the trial court's interpretation of the unreasonableness exception renders the add-back statute itself ineffective by giving it no field of operation, or,... that the trial court's interpretation allows the exception to swallow the add-back rule." Id. at 967. As a result, the VFJ court, ruling in favor of the Alabama Department of Revenue, reversed and remanded the trial court's decision.

In this instance, similar to VFJ's circumstances and arguments, Taxpayers also argue that pursuant to IC § 6-3-2-20(c)(8), adding back the interest expenses is unreasonable because Sub F has a business purpose and economic substance. Specifically, Taxpayers stated that Sub F has seventeen (17) full-time employees handling necessary tasks under the well-established company policy and "the interest is charged monthly and rates are market-based."

Taxpayers' reliance on "business purposes and economic substance" is misplaced. Indiana, like Alabama, is one of several separate-entity states which adopted an add-back statute (IC § 6-3-2-20) in 2006. By adopting the add-back statute, the Indiana General Assembly, like the Alabama Legislature (as the VFJ court acknowledged), also elected not to follow the federal statutory deductions for transactions between related entities involving intangible interest expenses. The fact that Sub F has business purposes and economic substance does not eliminate an "unreasonableness" analysis under [IC 6-3-2-20\(c\)\(8\)](#).

The proper test of the "unreasonableness" exemption in IC § 6-3-2-20(c)(8) should be, consistent with the common-usage definition as the VFJ court explained, whether adding back the interest expenses has "fair relation" to or is out of proportion to Taxpayers' activities in Indiana. The Department thus is not able to agree with Taxpayers that their interest payments qualify the exemption afforded by IC § 6-3-2-20(c)(8). As discussed in Part B(2)(a), Taxpayers' documentation demonstrates that pursuant to the 1999 arrangements, Taxpayer (Parent) wholly owns Sub F and provides Sub F the necessary funding. Taxpayers then borrow money from Sub F to fund their business activities in Indiana. While Taxpayers deduct the interest payments in their return reducing their taxable income accordingly, the majority of Sub F's interest income is not taxed anywhere, and Sub F's interest income returns to Taxpayer (Parent) as a result. Thus, pursuant to IC § 6-3-2-20(b), Taxpayers must add back their interest payments when Sub F's interest income from Taxpayers has a "fair relation" to Taxpayers' business activities in Indiana and adding back the interest payments is not out of proportion or unreasonable.

In short, Taxpayers' protest of royalty payment deduction for 2007 and 2008 tax years is sustained. Taxpayers' protest of the Department's disallowance of interest payment deductions claimed for taxable years before July 1, 2006, is respectfully denied. Taxpayers' protest of their interest payment deductions claimed for taxable years after June 30, 2006, is also respectfully denied.

#### **FINDING**

Taxpayers' protest of royalty payment deduction for 2007 and 2008 tax years is sustained. Taxpayers' protest of the Department's disallowance of interest payment deductions claimed for taxable years before July 1, 2006, is respectfully denied. Taxpayers' protest of their interest payment deductions claimed for taxable years after June 30, 2006 is also respectfully denied. The Department will recalculate Taxpayers' tax liability in a supplemental audit review.

## **II. Tax Administration – Underpayment Penalty and Negligence Penalty.**

### **DISCUSSION**

Taxpayers protest the imposition of the underpayment penalty and negligence penalty.

#### **A. Underpayment Penalty.**

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

[IC 6-3-4-4.1\(d\)](#) states:



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

- (1) the annualized income installment calculated under subsection (c); or
- (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.

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

Taxpayers have provided sufficient documentation demonstrating that the imposition of the underpayment penalty is not appropriate.

#### **B. Negligence Penalty.**

Taxpayers also protest the imposition of the negligence penalty.

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

- (1) fails to file a return for any of the listed taxes;
- (2) 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;
- (3) incurs, upon examination by the department, a deficiency that is due to negligence;
- (4) fails to timely remit any tax held in trust for the state; or
- (5) is required to make a payment by electronic funds transfer (as defined in [IC 4-8.1-2-7](#)), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

[45 IAC 15-11-2\(b\)](#) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in [45 IAC 15-11-2\(c\)](#), in part, as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

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

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

Taxpayers have provided sufficient documentation demonstrating that the imposition of the negligence penalty is not appropriate.

#### **FINDING**

Taxpayers' protest of the underpayment penalty and negligence penalty is sustained.

#### **SUMMARY**

For the reasons discussed above, on the Issue I, Taxpayers' protest of the Department's disallowance of business expenses is sustained in part and respectfully denied in part. Taxpayers' protest of the disallowance of deductions on royalty payments for tax years 2007 and 2008 is sustained. However, Taxpayers' protest of the disallowance of deductions on interest payments for tax years 2005, 2006, and 2007 is respectfully denied. On the Issue II, Taxpayers' protest of the underpayment penalty and negligence penalty is sustained. The Department will recalculate Taxpayers' tax liability in a supplemental audit review.

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