DEPARTMENT OF STATE REVENUE

02-20120690.LOF

Letter of Findings: 02-20120690
Corporate Income Tax
For the Years Ending January 28, 2007, through February 01, 2009

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ISSUES

I. Corporate Income Tax–Subsidiary Corporation Filing Separate Return.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-4-1; IC § 6-8.1-5-1.

Taxpayer argues that the proper filing method requires Taxpayer and Subsidiary Corporation to file separate corporate income tax returns.

II. Corporate Income Tax–Disallowance of Expenses.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-20; IC § 6-3-4-1; IC § 6-8.1-5-1; 45 IAC 3.1-1-8; I.R.C. § 63; 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); Treas. Reg. § 1.482-1(b).

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

III. Tax Administration–Underpayment of Estimated Tax Penalty.

Authority: IC § 6-3-4-4.1.

Taxpayer asks that the Department abate the underpayment of estimated tax penalty.

STATEMENT OF FACTS

Taxpayer, a retail merchant and service provider, is incorporated in the state of Delaware, and is 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 for the tax years ending January 28, 2007, February 3, 2008, and February 1, 2009 ("Tax Years"). The audit resulted in the assessment of additional adjusted gross income tax. The Department determined that certain business expenses which Taxpayer paid to its wholly owned subsidiary corporation ("Subsidiary Corporation") should be disallowed in order to fairly reflect Taxpayer's Indiana income. Taxpayer protested. An administrative hearing was conducted, and this Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax–Subsidiary Corporation Filing Separate Return.

DISCUSSION

Taxpayer argues that "the proper method of reporting and apportioning income for Indiana requires filing separate company tax returns for both [Taxpayer] and [Subsidiary Corporation]." Taxpayer maintains, "The current audit assessment overlooks the nexus and taxation of [Subsidiary Corporation]."

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."

During the hearing, the Department requested that Taxpayer provide the returns for Subsidiary Corporation for the Tax Years in question. Taxpayer did not provide them. Instead, Taxpayer provided a self-prepared spreadsheet that demonstrated that Taxpayer did not have an Indiana apportionment factor or Indiana nonbusiness income for the Tax Years in question. In fact, the spreadsheet indicated that the fiscal year ended January 1, 2012, was the first year that Subsidiary Corporation had an Indiana apportionment factor. Taxpayer also provided a return that Subsidiary Corporation filed for the tax year ended January 1, 2012.

Corporations that have taxable nexus in Indiana are those corporations that have "adjusted gross income from sources within the state of Indiana." IC § 6-3-2-1(b); IC § 6-3-4-1(3). For a corporation to have "adjusted gross income from sources within the state of Indiana," the corporation must have either Indiana apportionment factors to have deemed Indiana business income or nonbusiness income that is allocated to Indiana. IC § IC 6-3-2-2. Since the evidence presented by Taxpayer demonstrates that Subsidiary Corporation has neither of these for the Tax Years, Subsidiary Corporation does not have taxable nexus with Indiana for the Tax Years.

Upon reviewing Taxpayer's and Subsidiary Corporation's information during the audit, the fact that the Department neither wrote an audit report for Subsidiary Corporation nor involved Subsidiary Corporation in Taxpayer's audit report presumes that the Department's audit's made the same determination that Subsidiary Corporation lacked taxable nexus in Indiana. The Department's audit report for a particular taxpayer addresses audit adjustments made to that particular taxpayer's income tax returns as filed and would not mention the tax filing status of a separate entity that was neither included in a consolidated return with that particular taxpayer nor found to have a filing duty in Indiana.

Taxpayer asserts that Subsidiary Corporation filing a separate return is the proper alternative to the Department disallowing the disputed expenses of Subsidiary Corporation. However, other than its bare assertions, Taxpayer has not provided documentation supporting Subsidiary Corporation's being allowed to file separate Indiana returns for the Tax Years. Neither, has Taxpayer provided a detailed analysis with supporting documentation that demonstrates how Taxpayer's chosen method addresses the concerns raised in the audit and more fairly reflects Taxpayer's Indiana income. In fact, the documentation Taxpayer presented demonstrates that Subsidiary Corporation cannot file a separate Indiana income tax return for the Tax Years. Since Taxpayer has not provided documentation to support its assertions, Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

Accordingly, the Department determined that Taxpayer's income as reported did not fairly reflect Taxpayer's income derived from sources within Indiana. The Department determined that Taxpayer's payments of interest, royalties, and a "mark up on intercompany expense reimbursements" to Subsidiary Corporation artificially distorted Taxpayer's Indiana income. In order to fairly reflect Taxpayer's income, the Department disallowed these expenses and made adjustments to Taxpayer's income. 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 . . . ." The issue presented is whether the Taxpayer has – by merely suggesting an alternative filing methodology – proven that the original assessment was wrong. Taxpayer has not.

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax – Disallowance of Expenses.

DISCUSSION

As a result of an audit, the Department adjusted Taxpayer's adjusted gross income by disallowing certain business expenses. Specifically, the Department disallowed royalty expenses, interest expenses, and the "mark-up on intercompany expense reimbursements" which Taxpayer claimed as "ordinary and necessary" expenses. The Department determined that the claimed expenses "artificially distort[ed] the taxpayer's Indiana income."

The expense issues stemmed from Taxpayer's 1999 decision to form Subsidiary Corporation 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 Corporation was formed, Taxpayer transferred certain assets and liabilities to Subsidiary Corporation. Subsidiary Corporation recorded those assets and liabilities on its books. The amount of assets on its books totaled approximately $652,000,000, including, but not limited to, cash, an accounting system, fixed assets, equipment, and "trademarks and leases." The "trademarks and leases" were valued collectively at approximately $1,600,000. Subsidiary Corporation also claimed as an asset a $575,000,000 promissory note, executed on the same date that Subsidiary Corporation was formed. This promissory note represented a loan in which Taxpayer was the borrower and Subsidiary Corporation 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 Corporation's stock. In other words, in order to purchase Subsidiary Corporation, Taxpayer contributed assets and $575,000,000 which it had borrowed from Subsidiary Corporation that same day. The entire $652,000,000 was then recorded on Taxpayer's books as an "investment" in Subsidiary Corporation. Thereafter, Taxpayer began to pay Subsidiary Corporation royalties, interest, management expenses as follows:

Royalty Expenses: As noted above, Subsidiary Corporation acquired from Taxpayer the licensed trademarks previously owned by Taxpayer. In order for Taxpayer to continue exploiting the trademarks' value, Subsidiary Corporation charged Taxpayer a licensing fee equal to one percent of Taxpayer's gross sales until tax year ending February 3, 2008, when the fee increased to two percent of Taxpayer's gross sales. As noted in the audit report, this licensing fee resulted in Taxpayer paying an annual fee in excess of $41 million, $90 million, and $97 million in the respective Tax Year to Subsidiary Corporation for use of trademarks that Taxpayer had valued at less than $1.6 million (as noted previously in the agreement setting up Subsidiary Corporation the leases and trademarks were jointly valued at $1.6 million). 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 Corporation 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. As noted in the audit report, prior to the formation of Subsidiary Corporation, these expenses were paid directly by Taxpayer. The audit report also notes that all of the officers' compensation expense continues to be recorded solely on the books of Taxpayer and not on the books of the Subsidiary Corporation whom Taxpayer is paying to perform the management services. The service agreement provides that Taxpayer will reimburse Subsidiary Corporation for all the expenses incurred by Subsidiary Corporation in providing these services. In addition to the reimbursement of the actual expenses, the agreement provides for

Taxpayer to pay Subsidiary Corporation "a certain percentage" consisting of a "mark-up" on the actual expenses. The "mark-up" charge is based upon Taxpayer's sales revenue. For example, for the fiscal year ending February 1, 2009, the "mark-up" charge was approximately 4.6 percent of Taxpayer's sales revenue. For the Tax Years, the "mark-up" on the actual expenses that Taxpayer paid to Subsidiary Corporation exceeded $143 million, $123 million, and $222 million, respectively.

Interest Expenses: In addition to the above expenses, Taxpayer also paid Subsidiary Corporation interest on two loans. The first is the loan, noted above, in the amount of the $575,000,000 IOU that Taxpayer entered into with Subsidiary Corporation at its formation. Taxpayer paid off the first $575,000,000 IOU in October 2006 and "refinanced" it by entering into a second $575,000,000 IOU with Subsidiary Corporation. 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 Corporation approximately $270,000,000 in interest payments.

After conducting an audit of Taxpayer's tax returns as filed, which included a review of Taxpayer's books and records, the Department made adjustments to Taxpayer's report Indiana adjusted gross income. Upon reviewing the documented facts and circumstances, the Department determined that these claimed royalty expenses, "mark-up" expenses, and interest expenses "artificially distort[ed] taxpayer's Indiana income." Therefore, the Department, in order to fairly reflect Taxpayer's Indiana income, under authority of IC § 6-3-2-2(l) and (m) disallowed the expense deductions. Additionally, the Department's audit noted that the royalties and interest expense would also qualify as "intangible expense add backs" that each taxpayer is required to disclose on its returns and add back under IC § 6-3-2-20.

IC § 6-3-2-2(l)-(m), provide as follows:

(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.

Accordingly, 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 an alternate 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."

Taxpayer argues that since these payments to its wholly owned subsidiary are equivalent to that of an arm's length transaction based upon its transfer pricings studies, the Department has failed to meet its required burden of proof that the interest, royalty, and "mark up on intercompany expense reimbursements" are distortive. Therefore, Taxpayer asserts that the Department's inclusion of these expenses fails to fairly reflect its Indiana adjusted gross income under IC § 6-3-2-2(l) and (m). Moreover, Taxpayer argues that there is "no basis for disallowing" the interest, royalty, and "mark up on intercompany expense reimbursements" under IC § 6-3-2-2(l) and (m). Taxpayer maintains that since the interest and "mark up on intercompany expense reimbursements" are not one of the "mandatory add backs" listed in IC § 6-3-2-20 and the royalty expenses meet an exemption to the "mandatory add back" provision in IC § 6-3-2-20, the Department cannot add back the expenses under IC § 6-3-2-2(l) and (m).

The law provides that 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 federal income tax when their gross income exceeds a certain amount. For state income tax purposes, the presumption is that taxpayers properly and correctly file their federal income tax returns. Thus, to efficiently and effectively compute what is considered the taxpayers' Indiana income tax, the Indiana statute refers to the Internal Revenue Code. 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 repeat this 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, a taxpayers' federal "adjusted gross income" is merely the starting point to calculate what would be the taxpayer's 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.

Without reverting to the "intangibles expense add backs" listed in IC § 6-3-2-20–that a taxpayer is required to disclose and add back to properly compute "Indiana adjusted gross income" under IC § 6-3-1-3.5(b)–IC § 6-3-2-2(l) and (m) specifically provide for the "employment of any other method to effectuate an equitable apportionment of the taxpayers income . . ." if the normal allocation and apportionment provisions "do not fairly represent the taxpayer's income." Taxpayer, in arguing that only those "intangible expenses listed in IC § 6-3-2-20 can be added back, places too stringent an interpretation on the authority granted the Department under IC § 6-3-2-2(l) and (m). The plain language of the law states that "[i]f 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 department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." While IC § 6-3-2-20 requires that a taxpayer disclose and add back certain "intangible expenses" in computing its Indiana adjusted gross income, there is nothing in the statute which states that the Department does not have the authority to add back those same intangible expenses or any other expenses. To the contrary, IC § 6-3-2-2(p) reinforces the proposition cautioning the Department not to include other "income, deductions, and credits" unless "the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m)."

The Department, in finding distortion of reported income, made adjustments to Taxpayer's report income under the authority of IC § 6-3-2-2(l) and (m). Additionally, the Department noted that the royalty and interest expenses qualify for add back under IC § 6-3-2-20. In making this determination, the Department was, in effect, putting Taxpayer on notice that Taxpayer would be required, in future years, to add back these types of expenses on its returns to compute its Indiana adjusted gross income as provided under IC § 6-3-1-3.5(b)(9). Accordingly, the Department chose to put Taxpayer on notice that in the future these intangible expenses should be added back by Taxpayer on its Indiana returns.

First, Taxpayer disputes that its interest expense deductions qualify for automatic add back under IC § 6-3-2-20. Taxpayer maintains that its interest expense deductions do not relate to loans made from the lender's receipts associated with royalty payments as required in IC § 6-3-2-20(a)(2). However, since the Department made adjustments to the interest expense deductions under IC § 6-3-2-2(l) and (m), a determination of the interest expense deductions under IC § 6-3-2-20 is a moot point and, therefore, not relevant for the Tax Years in question. Therefore, the Department will not address this issue in this Letter of Findings.

Second, while Taxpayer does not dispute that its royalty expenses must be disclosed under IC § 6-3-2-20(c)(6), Taxpayer claims that the royalty expenses meet the requirements of the exception provided in IC § 6-3-2-20(c)(6) and would not have to be added back by Taxpayer. As a threshold issue, Taxpayer, other than its bare assertions of meeting the elements for the exception under at IC § 6-3-2-20(c)(6), has not provided documentation that substantiates it assertions. The only documentation offered was a transfer pricing study performed by a major accounting firm which contained the limitation that the study's "analysis is limited to the reasonable application of the comparable profits method and does not include an analysis of any other potentially applicable transfer pricing method or the determination of the best method in accordance with the applicable principals of the regulations under section 482 of the Internal Revenue Code." (Emphasis added). Since IC § 6-3-2-20(d) provides that a transfer pricing study offered to determine an amount "at terms comparable to an arm's length transaction" must "meet the arm's length standards of United States Treasury Regulation 1.482-1(b)" which requires a determination under the best method, the study provided by Taxpayer issued with this limitation would not meet such standards. See Treas. Reg. § 1.482-1(b).

Notwithstanding this lack of supporting documentation, since the Department made its adjustments to the royalty expense deductions under IC § 6-3-2-2(l) and (m), a determination under IC § 6-3-2-20 is not relevant for the Tax Years in question. Further, since Taxpayer invites the Department to apply a statutory exception for which Taxpayer has not met the statutory prerequisites listed in IC § 6-3-2-20(c)(6) to invoke the exception, any determination under IC § 6-3-2-20(c)(6) is not relevant for the Tax Years in question . See IC § 6-3-2-20(a)(7), (c)(6) (enacting an exception for a taxpayer that makes a disclosure on its tax return, provides the information needed to determine the taxpayer's status under the exceptions with its tax return, and establishes by a preponderance of the evidence that the taxpayer meets the requirements of the exception). Accordingly, since this is a matter not relevant to the Tax Years in question and is relevant for Taxpayer's future tax years, the Department will not address it specifically in this Letter of Findings.

Nonetheless, regardless of which statute the royalty add backs fall under, the Department when considering the elements of distortion and unfair reflection under IC § 6-3-2-2(l) and (m) will necessarily demonstrate that the elements for the exception under IC § 6-3-2-20(c)(6) would not be met by that taxpayer. Pursuant to IC § 6-3-2-20(b), a taxpayer subject to Indiana adjusted gross income tax, is required to add back its federal deductions relating to intangible expenses and any directly related intangible interest expenses which are paid, accrued, or incurred with one or more members of the same affiliated group or with one or more foreign corporations. IC § 6-3-2-20(c) allows for certain exceptions from this requirement. Under IC § 6-3-2-20(c)(6), a taxpayer that makes the disclosure of the exception on its return, files the information necessary to substantiated the requirements with its return, and can establish by a preponderance of the evidence that it has met the requirements will not have to add back the intangible expense. Two of those requirements are that the taxpayer demonstrate by a preponderance of the evidence that its intangible company has "substantial business activities" and that the "the principal purpose of tax avoidance [does not] exceed[] any other valid business purpose." IC § 6-3-2-20(c), (f). The Department when establishing the elements of distortion and unfair reflection under IC § 6-3-2-2(l) and (m) will necessarily demonstrate that the taxpayer's transactions that caused the distortion/income shifting 1) do not have a valid business purpose that exceeds the avoidance of state taxes and 2) do not have substance as the transactions were made with a company set up only to handles these intercompany transactions.

Upon reviewing the documented facts and circumstances, the Department determined that Taxpayer's claimed interest expenses, royalty expenses, and "mark-up" expenses "artificially distort[ed] Taxpayer's Indiana income." Therefore, the Department, in order to fairly reflect Taxpayer's Indiana income, under authority of IC § 6-3-2-2(l) and (m) disallowed these expense deductions. Thus, the issue is whether Taxpayer met its burden of demonstrating that these expenses were "ordinary and necessary" and that claiming the approximately $270 million in interest expense, $228 million in royalty expenses, and $490 million in "mark-up" expenses, did not distort, but accurately, correctly, and fairly represented "taxpayer's income derived from sources within the state of Indiana . . . ." IC § 6-3-2-2(l).

A. Interest Expenses.

At the outset of this relationship, Subsidiary Corporation was the beneficiary of assets previously held by Taxpayer but which were "invested" in Subsidiary Corporation. Included among those assets was a "note" valued at $575,000,000 compromising eighty-seven percent of the assets "invested." In effect, Taxpayer gave Subsidiary Corporation an IOU for $575,000,000 after which a loan was established in which Taxpayer borrowed the IOU back from Subsidiary Corporation. Taxpayer then used the IOU together with its $78,000,000 of other assets (net of liabilities) to purchase 100 percent of Subsidiary Corporation's stock upon the formation of Subsidiary Corporation. Taxpayer's "borrowing" this large part of the stock's purchase price from Subsidiary Corporation, obligated Taxpayer to pay 8.75 percent in interest each year for seven years. Taxpayer then claimed these interest payments, made from September 1999 to October of 2006, as "ordinary and necessary" business expenses and deducted them from its income for the respective tax years. The February 2006 to October 2006 payments fall in the first of the Tax Years in question here. In October of 2006, in the last few month of the $575,000,000 IOU payment schedule, Taxpayer paid off the remaining balance of the IOU and gave a second $575,000,000 IOU to Subsidiary Corporation with an interest rate of 8.25 percent to be paid each year for seven years. Taxpayer claimed these interest payments as "ordinary and necessary" business expenses and deducted them from its income for Tax Years.

The audit found that this intercompany transaction created a purported business expense deduction, which distorted Taxpayer's Indiana income. Thus, the Department determined that Taxpayer's Indiana income, as filed, did not fairly reflect income derived from sources within Indiana. Taxpayer objects stating that the $575,000,000 "loan was a business necessity in the formation of [Subsidiary Corporation], and the interest rate established at the time of the refinancing fell within the mid-term AFR."

During the audit and the hearing, Taxpayer was asked to provide documentation that substantiated the valuation of Subsidiary Corporation at the $652,000,000 purchase price. However, Taxpayer could not provide any documentation of the performance of a valuation of Subsidiary Corporation. Apparently, the purchase price of Subsidiary Corporation was based solely on the value of the assets Taxpayer transferred of which the $575,000,000 IOU that Taxpayer "borrowed" from Subsidiary Corporation that very same day constituted eighty-seven percent of the asset value. Moreover, the multiple transfers of the $575,000,000 between two closely related parties–from Subsidiary Corporation to Taxpayer and, then, from Taxpayer to the same Subsidiary Corporation on the same date which Subsidiary Corporation was formed–makes it difficult to discern which party is the "borrower" and which is the "lender." The multiple transfers of this $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. Additionally, Taxpayer's failure to provide any explanation or reasoning behind the refinancing of the "loan" for an additional $575,000,000 for seven more years also brings into question the financial realities necessary to justify claiming the 8.25 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 respective 8.75 and 8.25 percent interest payments of approximately $270,000,000 were "ordinary and necessary" business expenses. Since 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 disallowed Taxpayer's claimed deductions of interest payments for Tax Years.

B. Royalty Expenses.

Taxpayer, while keeping its foreign trademarks, transferred its domestic trademarks to Subsidiary Corporation, upon the formation of Subsidiary Corporation and, immediately, leased back those domestic trademarks to be used in Taxpayer's retail stores. In this instance, Taxpayer paid – and claimed as ordinary and necessary business expenses – approximately $41,000,000 in the fiscal year ending January 28, 2007, $90,000,000 in the fiscal year ending February 3, 2008, and $97,000,000 in the fiscal year ending February 1, 2009, to Subsidiary Corporation.

The Department's audit report noted, as follows:

> The trademarks licensed by [Subsidiary Corporation] to [Taxpayer] have no intrinsic value on their own without the retail locations of [Taxpayer]. The value attaches to the trademarks solely upon use by [Taxpayer], at their retail sales locations . . .
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> . . .
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> These trademarks were developed by [Taxpayer]. [The trademarks'] value is heightened by the products and services provided in [Taxpayer's] retail locations. The administrative services [for the trademarks] were previously performed by the employees of [Taxpayer]. These same employees and their duties were merely moved [to Subsidiary Corporation]. 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 [Taxpayer] is making use of the marks. The services are still performed for the one customer, [Taxpayer]. The only thing that has changed in this move is the allocation of profits.

In disallowing the royalty expenses claimed by Taxpayer, the audit report also noted that "the licensed marks are valued somewhere below $1.6 million – yet when [Taxpayer] uses them – [it] pay[s] an annual fee in excess of $41 million per year to [Subsidiary Corporation]." The royalty payments claimed exceeded approximately four times the value of the licensed marks in the first Tax Year and then ten times the value of the licensed marks in the later two Tax Years.

The audit found that this intercompany transaction created a purported business expense deduction, which distorted Taxpayer's Indiana income. Thus, the Department determined that Taxpayer's Indiana income, as filed, did not fairly reflect income derived from sources within Indiana. Taxpayer objected stating that the royalty expenses were justified by a transfer pricing study obtained from a major accounting firm.

As discussed above, the issue is whether Taxpayer has met its burden of demonstrating that the royalty expenses were "ordinary and necessary" and that claiming – as an expense deduction – the approximately $228,000,000 in royalty expenses accurately, correctly, and fairly represented "taxpayer's income derived from sources within the state of Indiana . . . ." IC § 6-3-2-2(l).

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 Corporation, 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 $228,000,000 in royalties for the same 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 to Delaware where it would not be taxed at the state level, 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 economic reality dictated it's payment of approximately $228,000,000 to use its own trademarks, that the payment was "ordinary and necessary," and that its income, as filed, fairly represented the income derived from sources within Indiana. Taxpayer, however, failed to establish that the audit was unjustified in its finding that the royalty payments shifted money from one corporate pocket into another and that the effect of that shift was to distort Taxpayer's Indiana income. Accordingly, given the totality of the circumstances and in the absence of other documentation, the Department is not able to agree that Taxpayer has demonstrated that its returns, as filed, which deducted approximately $228,000,000 in royalty expenses accurately, correctly, and fairly represented Taxpayer's "income derived from sources within the state of Indiana."

C. "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 Subsidiary Corporation and, immediately entered into an agreement to subscribe to those services from Subsidiary Corporation. Subsidiary Corporation performed these "back office" functions and Taxpayer paid Subsidiary Corporation a fee based upon the reimbursement of expenses. Taxpayer also added to the reimbursement a "mark-up." Based on the service agreement, the amount of "mark-up" varies each month and is based on a percentage of Taxpayer's total sales revenue. For example, Taxpayer's documentation revealed that in fiscal year ending February 1, 2009, Taxpayer paid Subsidiary Corporation approximately $155 million as a reimbursement of costs incurred by Subsidiary Corporation and approximately $223 million as a service fee (i.e. approximately 4.6 percent of Taxpayer's sales revenues).

Taxpayer then filed its federal income tax returns reporting deductions for these "mark-up" payments and reimbursement of actual expenses as "ordinary and necessary" business expenses. The Department's audit, in order to fairly reflect Taxpayer's Indiana income, disallowed the "mark-up" expenses of approximately $490,000,000 for the Tax Years although it should be noted that the audit did not disallow the underlying expense reimbursements.

The audit found that this intercompany transaction created a purported business expense deduction, which distorted Taxpayer's Indiana income. Thus, the Department determined that Taxpayer's Indiana income, as filed, did not fairly reflect income derived from sources within Indiana. Taxpayer objected stating that the "mark-up" expenses were justified by a transfer pricing study.

As discussed above, the issue is whether Taxpayer met its burden of demonstrating that the "mark-up" expenses were "ordinary and necessary" and that claiming – as an expense deduction – the approximately $490,000,000 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 previously handled the "back office" functions before the "spinning off" and formation of Subsidiary Corporation. Upon formation of Subsidiary Corporation, Taxpayer paid Subsidiary Corporation a reimbursement of the actual expenses and a "mark-up" for these same "back office" services based upon a percentage of Taxpayer's sales. Since Taxpayer figured the "mark-up" based upon a percentage of its sales, the resulting "mark-up" represented an eighty-eight percent "mark-up" on the actual expense reimbursements for the Tax Years. Taxpayer's documentation for the Tax Years demonstrated that Taxpayer shares its headquarters with Subsidiary Corporation, that Taxpayer recorded 100 percent of the officer's compensation expenses on Taxpayer's books, and that the Subsidiary Corporation, which states that it is providing management services recorded no (zero) compensation paid to the corporate officers on the books of Subsidiary Corporation. Additionally, Taxpayer's documentation, after the "spinning off," 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 that Subsidiary Corporation only bears the risks related to the intangible assets.

Accordingly, given the totality of the circumstances and in the absence of other documentation, the Department is not able to agree that Taxpayer has demonstrated that its returns, as filed, which deducted approximately $490,000,000 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 interest, royalty, and "mark-up" payments to its wholly-owned subsidiary were "ordinary and necessary" business expenses, and that it was entitled to deductions which reduced its income for the Tax Years. Rather, Taxpayer's documentation demonstrated that Taxpayer, in a single day, created a Delaware Subsidiary Corporation, gave a $575,000,000 IOU to Subsidiary Corporation without receiving anything in return, transferred the $575,000,000 IOU and $77,000,000 of other assets to Subsidiary Corporation to purchase the stock of Subsidiary Corporation, agreed to millions of dollar of interest payments on the $575,000,000 IOU, entered into a licensing agreement to pay millions of dollars to use the trademarks that were immediately transferred to Subsidiary Corporation, and entered into service agreements to pay millions of dollars for services that Taxpayer previously performed. Thus, the effect of this single day's events with; (1) the creation of the Delaware subsidiary corporation; (2) the purported loans and payments of interest; (3) the purported transfer of its domestic trademarks and subsequent licenses in exchange for payments of royalty, as well as; (4) the transfer of "back office" functions and payments for those services, artificially created "expenses" for Taxpayer and, at the same time, shifted nearly $800,000,000 of Taxpayer's otherwise taxable net income to its wholly-owned Subsidiary Corporation which pays no state income tax under Delaware law. After which, as noted in the audit report, the Subsidiary Corporation returns the "shifted income" back to Taxpayer in the form of tax-free distributions. 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.

III. Tax Administration–Underpayment of Estimated Tax Penalty.

DISCUSSION

The Department found Taxpayer was subject to the underpayment penalty under IC § 6-3-4-4.1(e) for the Tax Years and issued assessments. Taxpayer protests the imposition of the underpayment penalty. IC § 6-3-4-4.1(d) provides:

(d) Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to twenty-five percent (25 [percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year. A taxpayer who uses a taxable year that ends on December 31 shall file the taxpayer's estimated adjusted gross income tax returns and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year. If a taxpayer uses a taxable year that does not end on December 31, the due dates for filing estimated adjusted gross income tax returns and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year. The department shall prescribe the manner and forms for such reporting and payment.

The Department believes that the additional tax liabilities upon which the penalty assessments are based are 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 . . . ." However, Taxpayer is advised that should these circumstances arise again in the future penalty waive likely will not be granted.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the imposition of underpayment of estimated tax penalty is sustained, as discussed in Issue III. However, the remainder of Taxpayer's protest is respectfully denied.

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