DEPARTMENT OF STATE REVENUE

02-20130215.LOF

Letter of Findings: 02-20130215
Corporate Income Tax
For the Years 2008, 2009, and 2010

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ISSUES

I. Apportionment – Corporate Income Tax.

Authority: IC § 6-3-2-2(l); IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wabash v. Indiana Dept. of State Revenue, 729 N.E. 620 (Ind. Tax Ct. 2000); Sherwin-Williams Co. v. Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-38; 45 IAC 3.1-1-62.

Taxpayer argues that the Department of Revenue erred when it departed from the standard method of apportioning income and required Taxpayer and two associated entities to report their income using a "separate accounting" method.

II. Royalty Expenses – Corporate Income Tax.

Authority: IC § 6-3-2-2(m); IC § 6-8.1-5-1(c); Letter of Findings 02-20030423 (May 25, 2005); Letter of Findings 02-20060511 (November 15, 2007); Letter of Findings 02-20090945 (June 11, 2010); Letter of Findings 02-20100494 (January 4, 2011).

Taxpayer maintains that the Department of Revenue was not justified in disallowing (adding back) royalty expenses paid to a related, out-of-state entity.

STATEMENT OF FACTS

Taxpayer is a multi-state business which manufactures automobile parts. Taxpayer had been filing a separate Indiana income tax return until 2005 when it began filing a consolidated return with two entities here labeled as "Associated Company" and "Associated Company Two."

The Department of Revenue ("Department") conducted an audit of Taxpayer's income tax returns and its business records. The audit resulted in the assessment of additional corporate income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Apportionment – Corporate Income Tax.

DISCUSSION

Taxpayer, along with "Associated Company" and "Associated Company Two," filed consolidated Indiana income tax returns beginning in 2005.

"Associated Company" owned a warehouse in Indiana. The warehouse location was closed. The audit stated that "Taxpayer continued to include ["Associated Company"] in their consolidated filings . . . even though this company's presence in Indiana was removed."

The audit also found that "the [T]axpayer and ["Associated Company"] had such large disparities in both the amount of their Indiana activities and in their respective income and loss that the standard method of apportionment does not fairly represent the [T]axpayer's income derived from sources within the State of Indiana."

The audit found that "income/loss produced by the [T]axpayer is entirely attributable to activities taking place in Indiana while the income/loss of ["Associated Company"] is the result of activities taking place almost entirely outside of Indiana. In addition, the audit found that, "These disparities in Indiana activity were exacerbated when there were also large disparities in income/loss between the [T]axpayer and ["Associated Company"]. In the periods 2007 and 2008 ["Associated Company"] had losses that equaled or exceeded the income of [Taxpayer]."

The audit concluded that the standard method of apportioning income did not fairly reflect the parties' Indiana source income. "In this instance, losses that are produced almost entirely outside of Indiana by ["Associated Company"] eliminate income that is produced entirely in Indiana by [Taxpayer] under the standard method of apportionment." " This combination of dissimilar Indiana activity levels and income under the standard method of apportionment does not fairly represent the consolidated group's income derived from sources within the state of Indiana." (Emphasis added).

As authority for requiring "separate accounting," the audit report cited to IC § 6-3-2-2(l).

(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. (Emphasis added).

Taxpayer disagrees with the Department's analysis and interpretation of the facts. In support of its position Taxpayer cites to 45 IAC 3.1-1-62, which states:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

Taxpayer also cites to Wabash Inc. v. Indiana Dept. of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000) as authority for its position that the standard apportionment formula is the preferred method of reporting the income of multistate companies, that the Department has the burden of establishing that an alternative methodology is warranted, and that the Department bears the burden of establishing how the taxpayer's apportionment unfairly reflected Indiana-source income. Upon review, the audit issue that Wabash dealt with was the interpretation of IC § 6-3-2-2(b) which sets out the apportionment formula for calculating the Indiana source income of a multistate corporation, doing business inside and outside Indiana.

The issue in Wabash was whether a company that the petitioner wanted to include on its consolidated return had Indiana sourced income pursuant to P.L. 86-272 analysis therefore allowing it to enter its losses into the apportionment of Indiana income. The Department argued that the petitioner's Indiana contacts were minimal and therefore the petitioner's losses should not be included in calculating the consolidated group's apportioned Indiana income. That is, the argument was whether certain activities in Indiana were sufficient to establish Indiana nexus for purposes of including a particular company in a consolidated return. At trial, the Department raised the issue of whether the apportionment method fairly reflected the petitioner's business activities in Indiana and stated its preference for using the stacked method instead. The Tax Court stated that "having raised this issue, the Department bears the burden of proving that Wabash's Indiana income does not fairly reflect Indiana-sourced income." Id. at 624. This means that having raised this issue at trial, the Department, having not previously stated its rationale, had the burden to show how the petitioner's apportionment method did not fairly represent the petitioner's Indiana business activity.

The audit pointed out that "Associated Company's" Indiana warehouse was closed in 2006 and that "Associated Company's" presence in Indiana was removed." Taxpayer disputes the audit's characterization pointing out that "Associated Company" has a significant number of clients and product sales in Indiana, that it maintains a full time resident employee in Indiana who serves as an "after market territory manager," that it employs technical service representatives who regularly visit Indiana customers, that its service representatives train its customers' mechanics and technicians, and oversee customer repair issues, perform "Product Installation Audits."

Taxpayer provided documentation establishing that "Associated Company" maintained resident and non-resident employees whose responsibility was to "support customers on all quality related issues," "[m]ake regular customer visits on a proactive & reactive basis," "[m]itigate and/or negotiate customer issues," "[w]rite and implement internal corrective actions," along with other duties and responsibilities such as testing, developing, and training. Taxpayer provided documentation establishing that "Associated Company's" employees regularly conduct activities that "Associated Company's" Indiana activities exceed the protections set out under Public Law 86-272. See 45 IAC 3.1-1-38 (stating that, for apportionment purposes, a taxpayer is "doing business" in this state if it conducts "[A]ny other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 . . . .").

Taxpayer points out that, as a consolidated group, "Associated Company" and Taxpayer had positive Indiana taxable income during 2008 and 2010, that Taxpayer – the purported profitable entity – experienced losses in its 2009 returns, while "Associated Company – the purported "loss" entity – had Indiana taxable income in its 2005 and 2006 returns. In addition, Taxpayer argues that the Department's audit placed too much weight on the disparities between "Associated Company" and Taxpayer's property and payroll factors. Taxpayer points out that Indiana law places increased "weight" on the amount of sales in the apportionment factor (70, 80, and 90 percent) and that "in determining where a company's income is earned is in great part based on where your customers are located and services, and where your product is delivered." Taxpayer states that if the Department has "focused on where ["Associated Company's"] and [Taxpayer's] customers were located and their products were sold, [the Department] would have concluded that the income/loss of [Taxpayer] is the result of activity taking place almost entirely outside Indiana, while the income/loss of ["Associated Company"] is the result of activity taking place almost entirely inside Indiana" a conclusion which is in direct contrast to the audit's finding.

The issue is whether the Department was sufficiently justified in exercising its authority under IC § 6-3-2-2(l) requiring a "separate accounting" of Taxpayer and "Associated Company" to determine to what audit stated was the "correct income derived from sources within Indiana." As a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

As Taxpayer correctly points out, it is well established law that the standard apportionment formula "is the most accepted and recognized method of computing a company's taxes." Wabash, 729 N.E.2d at 625, and that the Department "has consistently required that a consolidated return use a combined three-factor apportionment as the fairest method of reflecting the income derived from Indiana sources." (See also Sherwin-Williams Co. v. Dept. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996)). While the Tax Court noted in Wabash that "[s]ufficient differences in the method of doing business may be justification for separate classification and differential tax treatment," the Department has the responsibility of establishing that the preferred apportionment method does not fairly reflect the Taxpayer's Indiana source income. Wabash, 729 N.E.2d at 624.

Taxpayer has established that "Associated Company" had more significant contacts with Indiana than first understood. In these particular circumstances and for these particular years, the Department has failed to demonstrate that it was necessary to depart from the standard apportionment formula under the standard set out in Wabash.

FINDING

Taxpayer's protest is sustained.

II. Royalty Expenses – Corporate Income Tax.

DISCUSSION

The audit found that both Taxpayer and "Associated Company" paid multi-million dollar royalties each year to a related entity here designated as "Corporation." The royalties were paid in order to permit Taxpayer and "Associated Company" to use Corporation's intellectual property. The audit noted that the royalty payments "had no effect on the consolidated federal income" of the parent company because the payments were simply eliminated as intercompany expenses on the parent company's consolidated federal return. The audit also noted that the parent company's "economic position was not changed in a meaningful way as [a] result of these intercompany transactions."

However, the audit found that the royalty payments had the effect of distorting Taxpayer and "Associated Company's" Indiana source income. "[T]he royalty payments did have the effect of distorting Indiana income by transferring income from the two corporations subject to Indiana taxation to an entity that was not included on the Indiana consolidated income tax return."

As explained in the audit report:

> An adjustment to these royalty expenses for the periods 2005 and 2006 has been made to correct this distortion and fairly reflect Indiana source income to determine the proper net operating loss carry forward from these periods.

As authority for eliminating the royalty expenses, the audit cited to IC § 6-3-2-2(m) as follows:

> (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.

Taxpayer disagrees stating that "Corporation" was established and acquired the intellectual property from Parent Company in order to "maintain and enhance the value of [Parent Company's] intangible assets which were being utilized both domestically and internationally." Those intangible assets consist of "technology, patents, trademarks, trade names, copyrights and service marks."

Taxpayer points out that it arranged for a Transfer Pricing Study in order to evaluate the worth of the intellectual property and to determine an "arms length range of royalty rates." After the Transfer Pricing Study was complete, "Associated Company" and Taxpayer entered into signed licensing agreements with "Corporation" which granted a non-exclusive right to use the intellectual property on a domestic and world-wide basis "in connection with the production, marketing, distribution and sale of a wide range of products." In exchange, Taxpayer and "Associated Company" made annual cash payments to "Corporation" in accordance with the licensing agreements.

Taxpayer maintains that the independently authored Transfer Pricing Study supports the amounts of royalties paid, and that "there is nothing inherently distortive about various business functions being located within different controlled legal entities."

The issue is whether the Department was sufficiently justified in exercising its authority under IC § 6-3-2-2(m) to disallow (add back) royalty expenses claimed during 2008, 2009, and 2010 in order to correct "distortion" and fairly reflect Indiana source income to determine the proper net operating loss carry forward . . . ."

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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 Department has routinely found that there are circumstances justifying the disallowance or add back of claimed royalty expenses when the taxpayer was unable to explain the "nature and substance of the underlying [royalty] agreement," Letter of Findings 02-20030423 (May 25, 2005), 28 Ind. Reg. 3379, when the deduction of the royalty expenses and interest expenses resulted in an "unfair reflection of the income earned from Indiana sources," Letter of Findings 02-20090945 (June 11, 2010), 20110323 Ind. Reg. 045110114NRA, when the royalty expenses constituted an "abusive tax scheme," Letter of Findings 02-20060511 (November 15, 2007), 20080130 Ind. Reg. 045080019NRA, when the payment of royalties represented an intercompany circular flow of money which had no "commercial business purpose." Letter of Findings 02-20100494 (January 4, 2011), 20110323 Ind. Reg. 045110119NRA.

Taxpayer presented documentation establishing that "Corporation" acquired the intangible property pursuant agreements with Parent Company under which "Corporation" made payments totaling $10,460,000 to acquire certain rights to that intellectual property, that an independent assessment was made to arrive at that purchase price, and that the price paid for the property was commensurate with the income produced by the property. Taxpayer admits that while "Associated Company" and Taxpayer experienced federal and Indiana losses during the audited years and that the royalty fees increased the amount of losses, the royalty fees – standing alone – were insufficient to change either company from a profitability or a loss position (or vice versa) in any year. As explained by Taxpayer, "Each company was consistently profitable or unprofitable for both federal and Indiana tax reporting purposes in every year both before and after taking into account license fees paid to ["Corporation"]."

Under IC § 6-8.1-5-1(c), Taxpayer has met its burden of proof of establishing that – for the audit years 2008, 2009, 2010 – these specific royalty payments did not significantly change either company's financial results, that the royalty payments were commensurate with the value of the intellectual property, that the particular payments to and from "Corporation" did not constitute an abusive "intercompany circular flow of money which had no 'commercial business purpose,'" and that the money earned from licensing the intellectual property was legitimately administered pursuant to the parent company's "centralized cash [management] process." As explained and demonstrated by Taxpayer, "Throughout tax years at issue, cash was moved among various businesses throughout the world as needed most notably to assist in debt service incurred due to acquisitions, intercompany loans, working capital needs, and funding of business[] units throughout the world."

In these particular circumstances and for these particular years, the Department has failed to sufficiently establish that the royalty payments paid Corporation distorted Taxpayer and "Associated Company's" Indiana source income.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest is sustained in all respects.

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