DEPARTMENT OF STATE REVENUE

02-20160370R.LOF

Letter of Findings: 02-20160370R
Corporate Income Tax
For the Years 2010 and 2011

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Out-of-State Business was entitled to file amended, consolidated corporate tax returns in order to include a related entity which held intellectual property; related entity engaged in income producing activity within Indiana by licensing its intellectual property to Indiana affiliates.

ISSUE

I. Corporate Income Tax - Amended Consolidated Returns.

Authority: IC § 6-3-2-2(a); IC § 6-3-2-2(q); IC § 6-3-4-14; I.R.C. § 1501; I.R.C. § 1504; Treas. Reg. § 1.1502-75(b)(3); 45 IAC 3.1-1-38; 45 IAC 3.1-1-55; 45 IAC 3.1-1-110; Income Tax Information Bulletin 12 (October 2015); Audit Gram No. IR -014; Letter of Findings 02-20140072 (April 16, 2014); Letter of Findings 02-20040251 (February 3, 2005); Letter of Findings 02-20010171; 02-20010172 (September 19, 2002); Letter of Findings 02-20020026 (October 17, 2002).

Taxpayer argues that it is entitled to file amended consolidated corporate income tax returns in order to include in those returns a related company.

STATEMENT OF FACTS

Taxpayer is an out-of-state business which operates an Indiana manufacturing facility. Taxpayer filed 2010 and 2011 corporate income tax returns. On those returns, Taxpayer elected to file consolidated returns to include a related entity which held Taxpayer's "intellectual property" (IP Company). Taxpayer paid IP Company royalties in order to permit Taxpayer to make use of the intellectual property.

Subsequently, Taxpayer filed amended 2010 and 2011 consolidated tax returns in order to add a related company ("Related Company"). Taxpayer did so because it concluded that Related Company had been "incorrectly excluded" from the original consolidated returns. Taxpayer states that Related Company earned Indiana income by selling equipment to Indiana customers. Related Company's employees supervised the installation of the equipment Taxpayer sold to customers in Indiana.

The Indiana Department of Revenue ("Department") reviewed the amended returns concluding that Taxpayer and IP Company did not file consolidated returns but were - in reality - filing "combined returns" in order to correct what was a perceived distortion of the Taxpayer's and IP Company's Indiana source income attributable to the intercompany royalty payments.

Therefore, the Department's audit concluded that Related Company was required to file a separate Indiana income tax return and was not entitled to be included with Taxpayer and IP Company in the amended consolidated returns.

The Department's decision had the effect of denying Taxpayer a refund of approximately $270,000. Taxpayer disagreed with the audit results 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. Corporate Income Tax - Consolidated Return.

DISCUSSION

The issue is whether Taxpayer made a valid original decision to file consolidated 2010 and 2011 Indiana income tax returns, whether Related Company earned adjusted gross income from sources within Indiana, and whether Taxpayer was entitled to file amended consolidated income tax returns to include Related Company in those returns.

A. Audit Results.

The Department's audit reviewed evidence of Related Company's activities within Indiana. The audit concluded that Related Company satisfied the threshold requirements of "doing business" in Indiana pursuant to 45 IAC 3.1-1-38. The regulation provides in relevant part as follows:

> For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
> (4) Rendering services to customers in the state
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
> (6) Acceptance of orders in the state
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.

Based on its review of the facts and circumstances, the audit concluded that Related Company was "doing business" in Indiana and "as a result was subject to Indiana corporate income tax."

The audit then considered whether Taxpayer was correct when it originally filed consolidated returns to include both itself and IP Company in those returns. The audit cited to IC § 6-3-4-14 which provides:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.
>
> (b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.
>
> (c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.
>
> (d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group.

(Emphasis added).

The audit also cited to the "consolidated" provisions of the Internal Revenue Code which provides:

> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of

> separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

I.R.C. § 1501.

The audit recognized that Taxpayer filed what Taxpayer categorized as consolidated returns by the due date for filing those returns. "[Taxpayer] did file a return including two companies and they did check the box stating it was a consolidated return." For the tax years 2010 and 2011 Taxpayer included an affiliated member, IP Company, which is an affiliated member of the group's parent company.

The audit described the activities of IP Company:

- IP Company owns the rights to "employ in the manufacture, assembly, and sale of products certain technical knowledge, proprietary rights, trade secrets and special techniques concerning the manufacture of [Taxpayer's manufactured goods];

- IP Company acts as an agent for "monitoring, and servicing all licenses or sublicenses of the technology to non-affiliates. Products must be marked, registered, and sold under such names and marks;"

- For the right to use the licensed rights and technologies, IP Company pays a royalty to Parent Company totaling 5 percent of total net revenues;

- The IP assets owned by IP Company were contributed to IP Company by Taxpayer;

- IP Company had no payroll or physical assets. It was only a pass through entity with no economic substance;

- IP Company's sole source of revenue was the royalty payments received from Taxpayer;

However, the audit concluded that because Taxpayer was paying for technology it originally owned and then transferred to IP Company, Taxpayer was in effect paying a duplicate expense. Taxpayer deducted research and development expenses to develop this IP technology. By also paying a royalty fee for the use the IP product Taxpayer developed, Taxpayer was - in essence - paying a second time.

The audit concluded that because of the perceived distortion caused by the intercompany royalty payments, Taxpayer included IP Company in the original Indiana returns. However, these returns "represents a combined filing between two corporations to fairly reflect income and alleviate a distortion. If they did not file a combined return, the royalty payment would have been subject to the addback of intangibles statute enacted in 2006."

The audit pointed out that a combined return is filed by two corporations to fairly reflect income in order to correct distortive transfers of income. "In a combined return, a corporation [such as IP Company] does not have to have nexus in the state to be included."

The audit explained that a consolidated return is made between two or more corporations that have adjusted gross income from Indiana sources. Taxpayer had nexus with Indiana; IP Company did not have nexus and their 2010 and 2011 returns should not be classified as a consolidated return because IP Company did not have employees or physical assets in Indiana and therefore "did not have any activity in the state which gave it nexus."

Since IP Company did not have income from Indiana sources, the returns it filed with Taxpayer "could not be considered a consolidated return. **It was in fact a combined return.**" (**Emphasis in original**).

The audit concluded that Taxpayer never filed original consolidated returns and now "could not amend their returns to file consolidated." The election to file consolidated had to be made by the due date of the return per I.R.C. § 1501.

Instead, the audit held that Related Company was now required to file separate 2010 and 2011 returns. Any net losses sustained by Related Company would have to be carried forward to 2012 and thereafter.

B. Taxpayer's Response.

Taxpayer disagrees with the audit results on the following grounds:

• Taxpayer made a valid Indiana consolidated return election on the original returns to include IP Company. Related Company should now be included in the amended "consolidated" returns because all of the affiliates consented to the consolidated election on the original returns;

• Related Company received adjusted gross income from sources within the State of Indiana and should be included in the amended 2010 and 2011 consolidated returns.

• Indiana guidance expressly provides that if a proper consolidated return election was made on the originally filed return and if an Indiana affiliated member failed to file a return in Indiana or filed a separate return, then the member "will be included in an amended return."

• The audit was wrong when it concluded that Taxpayer and IP Company filed "combined returns." An Indiana combined return can only be filed when a petition to do so is granted by the Department and Taxpayer never petitioned to file combined returns.

1. Taxpayer's Election to File Consolidated Returns.

Taxpayer cites to IC § 6-3-4-14 as the basis for its premise that it made a valid choice to originally file consolidated returns. The statute provides:

(a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.

(c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.

(d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group.

(Emphasis added).

Taxpayer also cited to 45 IAC 3.1-1-110 as supporting its premise that it was entitled to originally file consolidated returns including itself and IP Company.

An affiliated group as defined in IC 6-3-4-14(b) may file consolidated returns for Adjusted Gross Income Tax and Supplemental Net Income Tax purposes if the members of the affiliated group consent to follow the provision of IC 6-3-4-14 and the regulations established thereunder, including Federal regulations promulgated pursuant to Internal Revenue Code section 1502 which are incorporated by reference in IC § 6-3-4-14. The inclusion of a member of an affiliated group in the consolidated return is deemed to be its consent to the consolidated filing. Once an election is made to file consolidated, a taxpayer must obtain written permission from the Department to change from this method of reporting.

> Taxpayers filing consolidated returns should notify the Department of their election to so file by attaching to their first consolidated return a statement indicating which corporations are joining in the return. In addition, a worksheet must accompany all consolidated returns showing the consolidated income of the affiliates.

Taxpayer points out that Indiana law provides that a group of affiliated companies have the option of deciding to file consolidated returns. IC § 6-3-4-14 references "affiliated group," as defined in I.R.C § 1504 with one exception; an "affiliated group" may not include any corporation which does not have adjusted gross income derived from sources within Indiana.

Taxpayer states that it took all the necessary steps to file consolidated returns.

> The Taxpayer filed the original returns on or before the last date prescribed by law for the filing of the Indiana return. On each original return, the election was made on Line S to indicate that the return represented a consolidated filing. It was the intent of the Taxpayer to file an Indiana consolidated return with the consent of all their affiliates.

2. IP Company's Indiana Source Income.

Taxpayer argues that the audit erred when it concluded that IP Company should not have been included in the original "consolidated" return on the ground that IP Company did not receive Indiana source income during the years at issue. Taxpayer states that IP Company was entitled to be included in the original "consolidated return" because it received adjusted gross income from sources within Indiana during those years. As authority for that decision, Taxpayer cites to IC § 6-3-2-2(a) and 45 IAC 3.1-1-55.

IC § 6-3-2-2(a) provides in part as follows:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) income from doing business in this state;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section.

45 IAC 3.1-1-55 defines "business situs" in part as follows:

> "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property. Example: Taxpayer, a corporation whose principal business activity is the manufacture and sale of hot water heaters, obtains notes for the sale of such water heaters in connection with its Indiana business activity. The property has a business situs in this state, therefore, interest income derived from such notes is attributable to this state.

(Emphasis added).

Taxpayer argues that IP Company established a business situs in this state despite the fact that it did not have employees or physical assets located in Indiana. "Substantial value" was attached to the intellectual property because the value of the intellectual property was exploited in this state. Taxpayer explains that IP Company derived Indiana value from the property because Taxpayer licensed the intellectual property for use in this state.

> The Taxpayer manufactures and sells goods which incorporated Taxpayer's trademarks and other intellectual property and which are licensed for use in Indiana. The Taxpayer has a manufacturing plant in Indiana and makes sales to third parties within Indiana. A portion of the royalty income generated by [IP Company] is sourced to Indiana in correlation with the sales generated in the state by Indiana.

Taxpayer states that its position - that intellectual property exploited in Indiana - creates Indiana source income - is consistent with the Department's previously stated positions. Taxpayer explains:

> [N]umerous LOFs concluded that royalty payments from intellectual property is an "income producing activity" performed in Indiana because "the acts or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit" occur in Indiana.

Therefore, IP Company "has nexus and is doing business in Indiana because it develops intellectual property, licenses that intellectual property to Indiana affiliates, and obtains money from activity which occurs within Indiana."

As a result, Taxpayer concludes that IP Company derives Indiana source income and qualified to be included in the Taxpayer's consolidated return.

3. Adding an Affiliated Company to a Consolidated Return.

Taxpayer concludes that because it properly filed original "consolidated" returns and not - as stated in the audit report "combined returns" - it is now entitled to amend those returns in order to include Related Company.

Taxpayer cites to Audit Gram No. IR-014 which provides that an initial consolidated return must include all Indiana affiliates members including:

> • If an Indiana affiliated member failed to file a return in Indiana, the member will be included in an amended Indiana consolidated return.
> • If an Indiana affiliated member filed a separate return in Indiana, the member will be included in an amended Indiana consolidated return.

Taxpayer also points to Treas. Reg. § 1.1502-75(b)(3) which provides:

> If any member has failed to join in the making of a consolidated return . . . then the tax liability of each member of the group shall be determined on the basis of separate returns unless the common parent corporation establishes to the satisfaction of the Commissioner that the failure of such member to join in the making of the consolidated return was due to a mistake of law or fact, or to inadvertence. In such case, such member shall be treated as if it had filed a Form 1122 for such year for purposes of paragraph (h)2) of this section, and thus joined in the making of the consolidated return for such year.

4. Prerequisite to Filing Combined Returns.

Finally, Taxpayer states that its original returns - including Taxpayer and IP Company - were not "combined returns" because it never received permission from the Department to do so, and the Department's permission is a pre-requisite to filing any combined return.

As authority for this position, Taxpayer cites to IC § 6-3-2-2(q) which provides:

> Notwithstanding subsections (o) and (p), one (1) or more taxpayers may petition the department under subsection (l) for permission to file a combined income tax return for a taxable year. The petition to file a combined income tax return must be completed and filed with the department not more than thirty (30) days after the end of the taxpayer's taxable year. A taxpayer filing a combined income tax return must petition the department within thirty (30) days after the end of the taxpayer's taxable year to discontinue filing a combined income tax return.

(Emphasis added)

Taxpayer also cites to Income Tax Information Bulletin 12 (October 2015);

> A taxpayer may petition the department for permission to file a combined income tax return for a tax year. However, the petition must be filed with the department on or before 30 days after the end of the tax year for which permission is sought. The petition should be sent to the Tax Policy Division, 100 North Senate Ave., Room N248, MS[] 102, Indianapolis, IN 46204. A timely filed petition will be granted if combined reporting will more fairly reflect the unitary group's Indiana source income. However, combined reporting is limited to the "water's-edge" of the United States.
>
> A unitary group that has petitioned and received permission from the department to file a combined return in

> Indiana may file one return for the unitary group, providing a schedule is attached showing the adjusted gross income tax due by member. In the alternative, the unitary group should file an Indiana return for each member doing business in Indiana. The taxpayer filing the combined return must petition the department within 30 days after the end of the tax year for permission to discontinue the filing of a combined return.

Taxpayer concludes that it legitimately elected to file consolidated returns including both itself and IP Company correctly identifying tax information for both entities and that it is now entitled - and required - to file amended returns to include Related Company.

C. Hearing Analysis.

As explained at the outset, the issue is whether "Taxpayer made a valid original decision to file consolidated 2010 and 2011 Indiana income tax returns . . . ." That question depends on whether IP Company had "adjusted gross income derived from sources within the state of Indiana" during those years such that it could have been included in those consolidated returns. IC § 6-3-2-2(a).

If Taxpayer made a valid original decision to file consolidated returns including both itself and IP Company, then Taxpayer is entitled to amend the 2010 and 2011 returns to include Related Company because the Department readily admits that Related Company was "doing business" in Indiana, earned income from sources within that state, and was "subject to Indiana corporate income tax."

IP Company earns money from royalties charged Taxpayer for the right to employ rights, technologies, trade secrets, and "special techniques" including techniques used in the manufacture of Taxpayer's goods. The only question is whether those royalties constitute Indiana source income as defied in IC § 6-3-2-2(a).

The Department has previously addressed questions concerning the situs of income producing activities attributable to the exploitation of intellectual property rights in this state. In Letter of Findings 02-20140072 (April 16, 2014), 20140625 Ind. Reg. 045140212NRA, the Department held that the exploitation of intellectual property rights within this state by a company commercially domiciled in Delaware gave that company an Indiana situs and that money received from the intellectual property constituted Indiana source income.

> Taxpayer's commercial domicile is in Delaware. However, by virtue of the royalty agreements between itself and its affiliates, the intellectual property - consisting of its trade names and trademarks - has acquired a "business situs" within Indiana. Taxpayer licensed its intellectual property to its Indiana affiliates and earned money from those licensing agreements.

. . . .

> The "substantial use or value" which attaches to this intellectual property derives from the Taxpayer's right to exploit that intellectual property within this state. Taxpayer is the entity which exploits the intellectual property because it is the licensee in the royalty agreement. As the licensee, Taxpayer exploits its intellectual property within Indiana each time a manufactured good is produced and sold within this state. The royalties are simply the economic benefits which derive from the ability of Taxpayer to exploit the intellectual property within this state; those economic benefits (the royalties) flow from Taxpayer's affiliates to Taxpayer. Under 45 IAC 3.1-1-55, the trademarks have acquired an Indiana business situs; under IC § 6-3-2-2(a), the royalty payments are subject to Indiana's adjusted gross income tax.

The Department addressed a similar question in Letter of Findings 02-20040251 (February 3, 2005), 28 Ind. Reg. 2576. In that case, the Department held that a retail chain entering into a licensing agreement to monetize the value of intellectual property within this state, created a "business situs" within this state.

> The Department concludes that taxpayer's intellectual property has acquired a "business situs" within Indiana. Taxpayer licenses the intellectual property for the exclusive use by the retail chain store which sells goods bearing taxpayer's trade and service marks. Based upon the parties' agreement and the independent valuation of the value of these marks, it is evident that the parties attach significant value to the trade and service marks.

. . . .

> The value taxpayer derives from the exploitation of the intellectual property is attributable entirely to activities occurring within the state of Indiana. The value of the intellectual property to the taxpayer consists of the ability to "place" that intellectual property within the state and to derive the consequent benefits attributable entirely to the intellectual property's Indiana business situs. As the regulation itself states, "'Business situs' is the place at which [the] intangible personal property is employed as capital . . . ." 45 IAC 3.1-1-55. The place at which "value attaches to the [intellectual] property" is within the state of Indiana. Id. The significant value

attached to these properties derives entirely from the ability to assign the properties for use within the state. Taxpayer reaps benefits in the form of royalties directly attributable to retail sales made to Indiana customers.

The Department has long and consistently held that the exploitation and monetization of intellectual property within this state constitutes activities within Indiana giving rise to Indiana source income. See Letter of Findings 02-20020026 (October 17, 2002), 26 Ind. Reg. 1400. ("The Delaware holding company licensed the taxpayer to use and exploit the intellectual property; the taxpayer obtained Indiana source income by providing its services within the state; the value obtained from possessing and exploiting the intellectual property was inextricably linked with the provision of taxpayer's services within the state."); Letter of Findings 02-20010171; 02-20010172 (September 19, 2002), 26 Ind. Reg. 955. ("[I[t is . . . apparent that the holding company's intellectual property has acquired a 'business situs' within Indiana. The Delaware holding company has licensed taxpayer to employ the intellectual property within Indiana in conjunction with taxpayer's Indiana manufacturing activities. The substantial value attached to the intellectual property exists solely in the ability to 'place' that intellectual property within this state and to derive the economic benefits attributable entirely to the intellectual property's Indiana business situs.")

Consistent with the Department's past decisions on this issue, IP Company engaged in "income producing activity" within this state, derived Indiana source income from that activity, and was subject to this state's adjusted gross income tax. Therefore, Taxpayer made a legitimate decision to originally file consolidated income taxes reporting the income for both itself and IP Company. That said, Taxpayer was within its right to file amended consolidated returns to include Related Company in those returns as an entity which was inadvertently omitted in the original filings.

FINDING

Taxpayer's protest is sustained.

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