LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

200 W. Washington, Suite 301
Indianapolis, IN 46204
(317) 233-0696
http://www.in.gov/legislative

FISCAL IMPACT STATEMENT

LS 7001 | **NOTE PREPARED:** Jan 17, 2005
BILL NUMBER: SB 608 | **BILL AMENDED:**

SUBJECT: Expense disallowance.

FIRST AUTHOR: Sen. Weatherwax | **BILL STATUS:** As Introduced
FIRST SPONSOR:

FUNDS AFFECTED: X **GENERAL** | **IMPACT:** State & Local
X **DEDICATED**
FEDERAL

Summary of Legislation: This bill requires a corporation, for purposes of computing state Adjusted Gross Income Tax, to add back deductions taken on the corporation's federal income tax return for certain interest and intangible expenses incurred in a transaction with a related business.
Effective Date: January 1, 2005 (retroactive).

Explanation of State Expenditures: This bill provides that the Department of State Revenue (DOR) has the burden of proof in disputes of a taxpayer's liability under the bill's add back provisions if:

(1) the taxpayer has produced evidence that establishes that there is a reasonable dispute with respect to the issue; and,
(2) the taxpayer has adequate records of its transactions and provides the DOR reasonable access to the records.

This provision is a change from current law where, in most cases, the taxpayer has the burden of proof in disputes over tax liability. The administrative cost impact to the DOR of having to carry the burden of proof is indeterminable, and will depend upon the number of disputes that arise.

Explanation of State Revenues: This bill's overall impact on state Corporate Adjusted Gross Income (AGI) Tax revenue is indeterminable. The requirement to add back deductions taken on the corporation's federal income tax return for certain interest and intangible expenses incurred in a transaction with a related business applies to tax years beginning January 1, 2005 and will impact revenue collections beginning in FY 2006.

Related Member Transactions: This provision requires that interest and expenses incurred in certain related member transactions, and taken as a federal income tax deduction, are to be added back to Indiana AGI. The bill could increase Corporate AGI Tax liability for the firms involved. The amount of revenue that could be captured by this provision is indeterminable. It will depend upon the number of companies conducting these types of transactions.

Primary Purpose of Avoiding Tax: The bill also gives a list of conditions that a company may show to establish a conclusive presumption that the related member transaction did not have as its primary purpose the avoidance of tax. This provision narrows the DOR's interpretation of the allocation and apportionment provisions under IC 6-3-2-2(l). By narrowing the DOR's interpretation the bill could restrict the DOR's ability to establish taxpayer liability in some cases. Therefore, the overall impact of this provision could result in a decrease in Corporate AGI Tax revenues. By narrowing DOR's interpretation this bill could be allowing more related member transactions to be found as having a valid business purpose, and not found to be transactions conducted for tax avoidance.

Related Member Transactions (Background): A common example of a related member transaction involves the use of a passive investment company (PIC) to transfer income to a tax haven state that is actually income earned and taxable in Indiana. An Indiana operating company can establish a PIC in a state that does not have a corporate income tax (like Nevada) or that has a special income tax exemption for intangibles (like Delaware). Once the company establishes a PIC in another state, the company can then transfer income ("profits) to the PIC by having the PIC charge a royalty fee to the Indiana company for the use of a trademark, patent, or other type of intangible asset. This reduces the Indiana AGI tax liability of the operating company.

These transactions are further complicated when a PIC loans "profits back to the operating company, and the operating company can then deduct the loan interest from Indiana AGI, thereby reducing their tax liability. Typically, large multi-state retailers engage in these sorts of transactions. Companies are not required to include payments for intangibles in Indiana Adjusted Gross Income if the company has a location in another country with a comprehensive income tax treaty with the United States.

The bill requires these intangible expenses to be added back to Indiana AGI. The bill could increase Corporate AGI Tax liability for the firms involved. The amount of revenue that could be captured by this provision is indeterminable. It will depend upon the number of companies conducting these types of transactions.

Background: In 1991, the state of Ohio passed legislation to capture income transferred through PICs for state tax purposes. The Ohio Department of Taxation's analysis of the tax returns of the 1500 largest corporations in the state estimates that including PIC income has generated \$55 M to \$60 M per year in tax revenues for the past two years. Of the 1500 corporations, 100 to 200 have PIC income. The 1500 taxpayers included in the Ohio database account for about 2/3 of the revenue from general corporations (not financial institutions).

Corporate Adjusted Gross Income Tax is deposited in the General Fund and the Property Tax Replacement Fund.

Explanation of Local Expenditures:

Explanation of Local Revenues:

State Agencies Affected: Department of State Revenue.

Local Agencies Affected:

Information Sources:

Fiscal Analyst: Adam Brown, 317-232-9854