DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0279
Corporate Income Tax
For the Years 1999, 2001-2003

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ISSUE

I. Corporate Income Tax—Unitary Partnership.

Authority: *Allied-Signal Corp. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *Woolworth Co. v. Taxation and Revenue Dep't. of New Mexico*, 458 U.S. 354 (1982); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980); 45 IAC 3.1-1-153.

Taxpayer protests the assessment of adjusted gross income tax based on the denial of unitary status between it and a partnership.

STATEMENT OF FACTS

Taxpayer is a corporation that produces precision metal components. In 1999, Taxpayer formed a Mexican partnership to produce components for Mexican manufacturers. Because Mexican law required two partners to own a business entity, Taxpayer owned ninety-five percent of the partnership while a sister corporation owned five percent of the partnership.

Taxpayer included the Mexican partnership as a unitary business on Taxpayer's income tax returns. The Indiana Department of Revenue ("Department") determined that Taxpayer and the Mexican partnership did not conduct a unitary business and thus the Department assessed additional tax, penalty, and interest. Taxpayer protested the assessment, the Department conducted a hearing, and this Letter of Findings results. Any other issues not discussed in this Letter of Findings are deemed to be determined in accordance with the results of the Department's audit.

I. Corporate Income Tax—Unitary Partnership.

DISCUSSION

Taxpayer argues that it and the Mexican Partnership conducted a unitary business. In particular, Taxpayer argues that the entities conducted one integrated business, with functional integration, centralized management, and economies of scale in the companies' operations.

While Indiana statutes do not specify the allocation or apportionment of income and apportionment factors from unitary and non-unitary partnerships, 45 IAC 3.1-1-153 provides the treatment of income from such partnerships. The regulation states:

> (a) A corporate partner's share of profit or loss from a partnership will be included in its federal taxable income and therefore generally subject to the same rules as any other adjusted gross income.
> (b) If the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors for any partnership year ending within or with the corporate partner's income year, with the following modifications:
>> (1) The value of property which is rented or leased by the corporate partner to the partnership or vice versa shall, with respect to the corporate partner, be excluded from the property factor of the partnership or eliminated to the extent of the corporate partner's interest in the partnership, whichever the case may be, in order to avoid duplication.
>> (2) Intercompany sales between the corporate partner and the partnership shall be eliminated from the corporate partner's sales factor as follows:
>>> (A) Sales by the corporate partner to the partnership to the extent of the corporate partner's interest in the partnership.
>>> (B) Sales by the partnership to the corporate partner not to exceed the corporate partner's interest in all partnership sales.
> (c) If the corporate partner's activities and the partnership's activities do not constitute a unitary business under established standards, disregarding ownership requirements, the corporate partner's share of the partnership income attributable to Indiana shall be determined as follows:
>> (1) If the partnership derives business income from sources within and without Indiana, the business income derived from sources within Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the partnership.
>> (2) If the partnership derives business income from sources entirely within Indiana, or entirely without Indiana, such income shall not be subject to formula apportionment.
> (d) A partner's distributive share of income will be adjusted by the partner's proportionate share of the partnership's income that is exempt from taxation under the Constitution and statutes of the United States and by the partner's proportionate share of the partnership's deductions allowed or allowable under Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States.
> (e) After determining the amount of business income attributable to Indiana under subsection (c), the corporate partner's distributive share of such income shall be added to the corporate partner's other business income apportioned to Indiana and its nonbusiness income, if any, allocable to Indiana, in determining the corporate partner's total taxable income.

Under 45 IAC 3.1-1-153, a partnership and a corporate partner that conduct a unitary business includes the corporation's share of the partnership's income in the corporation's business income, and includes its *pro rata* share of the partnership's property, payroll, and receipts in the corporation's totals for the respective categories. The income from a nonunitary partnership is subject to allocation based on the partnership's activities.

To determine whether a taxpayer and a partnership comprise a unitary business, one must analyze the (1) functional integration; (2) centralization of management; and (3) economies of scale. *Allied-Signal Corp. v. Director, Division of Taxation*, 504 U.S. 768, 781 (1992) *(citing F.W. Woolworth Co. v. Taxation and Revenue Dep't. of New Mexico*, 458 U.S. 354, 364 (1982)). In order to exclude certain income from the apportionment formula, the company must prove that "the income was earned in the course of activities unrelated to the sale of [property] in that State." *Exxon Corp. v. Dept. of Revenue of Wisconsin*, 447 U.S. 207, 223-224 (1980) *(citing Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980)). To avoid taxation on given income, one "looks to the 'underlying economic realities of a unitary business,' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise,'" *Exxon*, 447 U.S. at 223-224 (*citing Mobil*, 445 U.S. at 439, 441-442).

With respect to functional integration, in *F.W. Woolworth*, the court noted that the operation of taxpayer and four foreign subsidiaries who maintained separate operations with no managerial integration or cross-employment failed to constitute functional integration necessary to permit unitary taxation. 458 U.S. at 364-369.

However, in *Exxon*, the taxpayer was a large oil company, which engaged in marketing activities in Wisconsin. Its other subsidiaries, engaged in oil exploration and refining, were located entirely outside the state. The court noted that its marketing operations and various other necessary components of the oil business, including exploration and refining, constituted a unitary enterprise. *Exxon* at 224-225. As a result, the company was overall a functionally integrated enterprise, and thus the apportioned share of the income of its overall enterprises was subject to state income tax, rather than just the share from its marketing operations. *Id.* at 229-230.

In this protest, Taxpayer and the Mexican partnership shared technological expertise, troubleshooting, purchasing power and financing arrangements with third parties.

With respect to centralization of management, Taxpayer and the Mexican partnership had the same central management personnel. Most management decisions for both entities were made by the same personnel at Taxpayer's parent level. In addition, many of the company policies set for both companies were established at the parent or Taxpayer level. Based on the common management personnel, decision making, and policies at the parent-company level, Taxpayer and the Mexican partnership met the common management prong of the test.

With respect to economies of scale, Taxpayer and the Mexican partnership shared many functions. For instance, the entities shared the same personnel who performed tasks on behalf of

both companies. In addition, Taxpayer and the Mexican partnership shared common purchasing power with respect to the items that they purchased, allowing the companies to use their combined purchasing power to purchase items at a lower cost per item than the companies could have purchased the items individually. Thus, based on the cost-sharing and lowering of overall costs, Taxpayer met the economies of scale element for a unitary business.

Taxpayer and the Mexican partnership have demonstrated functional integration, centralization of management, and economies of scale between the entities—a "unitary relationship under established standards" as required by regulations. Thus, Taxpayer's treatment of the income and factors from the Mexican partnership was proper and Taxpayer's protest is sustained.

FINDING

Taxpayer's protest is sustained.

JR/BK/DK April 9, 2007