DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 06-0442
Gross Income Tax
For Tax Year 2002

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ISSUE

I. Gross Income Tax–Partnership Exemption.

Authority: Treasury Reg. § 301.7701-2 (as amended in 2006); IC § 6-2.1-1-16; IC § 6-2.1-2-1; IC § 6-2.1-3-25; IC § 6-3-1-10; IC § 6-3-1-19; IC § 6-8.1-5-1; 45 IAC 1.1-5-4

Taxpayer protests the assessment of individual income tax.

STATEMENT OF FACTS

Taxpayer is a parent company for a consolidated group consisting of Taxpayer and three other companies involved in various aspects of the recreational vehicle, manufactured housing, and marine industries. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for gross income tax for the tax year 2002. The gross income tax was repealed in 2003. All Indiana code and Indiana administrative code citations referred to are as they were in effect prior to the repeal of the gross income tax. Taxpayer protests the imposition of gross income tax and negligence penalty.

In its audit report, the Department described the situation, and Taxpayer stipulates to that description, as follows: On December 31, 2001, two of the corporations in the consolidated group (hereinafter referred to as "Related One Corp." and "Related Two Corp.") created new related entities. Related One Corp. contributed ninety-nine percent undivided interest in the net book value of its balance sheet to the capital of a partnership which will be referred to as "Related One LP", in exchange for the issuance of a ninety-nine percent membership interest in Related One LP. In addition, Related One Corp. contributed one percent undivided interest in the net book value of its balance sheet to a related LLC, which will be referred to as "Related One LLC", in exchange for a one hundred percent interest in the capital of Related One LLC. Related One LLC then became a one percent partner in Related One LP, by contributing its net book value to the capital of Related One LP. As a result, the ownership of the new entities is as follows: Related One LLC is owned one hundred percent by Related One Corp. Related One LP is one percent owned by Related One LLC and ninety-nine percent by Related One Corp. Since Related One LLC is a single member LLC, it is considered a disregarded entity separate from its owner Treasury Reg. § 301.7701-2. As a result of Related One LLC being a disregarded entity, Related One LP essentially has one sole partner, Related One Corp. and therefore this entity is also treated as a disregarded entity under Treasury Reg. § 301.7701-2.

Related Two Corp. undertook the same transactions, with the resulting ownership as follows: Related Two LLC is owned one hundred percent by Related Two Corp. Related Two LP is one percent owned by Related Two LLC and ninety-nine percent by Related Two Corp. Since Related Two LLC is a single member LLC, it is considered a disregarded entity separate from its owner under Treasury Reg. § 301.7701-2. As a result of Related Two LLC being a disregarded entity, Related Two LP essentially has one sole partner, Related One Corp. and therefore this entity is also treated as a disregarded entity under Treasury Reg. § 301.7701-2. For federal income tax purposes, the disregarded entities are considered divisions of Related One Corp. and Related Two Corp., and these two entities are considered subsidiaries of Taxpayer and file a consolidated return with the parent, Taxpayer. Further facts will be supplied as required.

I. Gross Income Tax–Partnership Exemption.

DISCUSSION

Taxpayer protests the imposition of gross income tax for 2002. The Department issued the proposed assessment to Taxpayer after determining that the receipts in question were actually received by taxable corporations, not exempt partnerships. Taxpayer states that the income in question was received by partnerships which were exempt from Indiana gross income tax. The Department notes that the burden of proving a proposed assessment wrong rests with the Taxpayer, as provided by IC § 6-8.1-5-1(c).

Taxpayer states that the two entities which received the income are partnerships under Indiana law, and are the proper entities to consider as receiving the income in question. Taxpayer refers to IC § 6-2.1-3-25, which stated:

> (a) As used in this section, "partnership" and "partner" have the same meanings as those terms are defined in IC 6-3-1-19.
>
> (b) Gross income received by a partnership is exempt from gross income tax. However, gross income is not exempt from the gross income tax if it is received by a publicly traded partnership that is treated as a corporation for federal income tax purposes under Section 7704 of the Internal Revenue Code.

IC § 6-3-1-19, which defines partnerships for adjusted gross income tax purposes, and was referred to by IC § 6-2.1-3-25, states:

(a) The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this chapter, a corporation or a trust or an estate. The term also includes a limited liability company that is treated as a partnership for federal income tax purposes.

(b) The term "partner" means a member of a partnership.

Taxpayer also refers to IC § 6-3-1-10, which defines corporations for adjusted gross income tax purposes, which stated during the relevant years:

As used in this article, "corporation" includes all corporations, associations, real estate investment trusts (as defined in the Internal Revenue Code), joint stock companies, whether organized for profit or not-for-profit, any receiver, trustee or conservator thereof, business trusts, Massachusetts trusts, any proprietorship or partnership taxable under Section 1361 of the Internal Revenue Code, and any publicly traded partnership that is treated as a corporation for federal income tax purposes under Section 7704 of the Internal Revenue Code.

Taxpayer states that the two entities are partnerships as defined by IC § 6-3-1-19 and do not qualify as a corporation as defined by IC § 6-3-1-10. Taxpayer protests that the income in question was received by exempt partnerships, as provided by IC § 6-2.1-3-25(b).

In reaching its determination that the income in question was received by taxable corporations rather than exempt partnerships, the Department referred to 45 IAC 1.1-5-4, which stated:

(a) A partnership must file an annual return, Form IT-65, disclosing each partner's distributive share of distributed and undistributed income.

(b) As used in this section, "partner's distributive share" means the amount determined under Section 704 of the Internal Revenue Code and its prescribed regulations before any modifications required by Indiana tax statutes.

The Department also referred to Treasury Reg. § 301.7701-2 (as amended in 2006), which states:

Business entities. For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. *A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.* But see paragraphs (c)(2)(iv) and (v) of this section for special employment and excise tax rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

(*Emphasis added.*)

The Department determined that, since neither Related One LP nor Related Two LP filed partnership returns in Indiana as required by 45 IAC 1.1-5-4, neither Related One LP nor Related Two LP were partnerships for Indiana gross income tax purposes. Also, the Department's audit report explained that Taxpayer considered Related One LLC and Related Two LLC as not subject to Indiana gross income tax, since they are single member LLCs pursuant to IC § 6-2.1-1-16 and are disregarded for federal income tax purposes.

Also, since the two LLCs were disregarded for federal income tax purposes, each LP had only one member. The Department considered that, because the LPs had only one member, and because the LPs were also not true partnerships, the sole members were deemed to have received the income. Since the sole members were Related One Corp. and Related Two Corp., and both were regular corporation subject to gross income tax as provided by IC § 6-2.1-2-1, the income in question was taxable as gross income.

Taxpayer protests that both LPs were properly registered as partnerships, and has provided documentation supporting this position. As previously mentioned, Taxpayer states that the two LPs qualified as partnerships under all relevant Indiana law, particularly the Indiana gross income tax at IC § 6-2.1-3-25, which adopted the language of IC § 6-3-1-19 for purposes of defining partnerships. Taxpayer argues that neither of these Indiana Code sections refers to the federal income tax code for gross income tax definitional purposes regarding partnerships.

A review of IC § 6-2.1-3-25 and IC § 6-3-1-19 shows that Taxpayer is correct. The Department correctly noted that Treasury Reg. § 301.7701-2 states that a business entity with only one owner is classified as a corporation or is disregarded, and if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. However, the Department did not reference any reason why that definition for federal purposes was to be adopted for Indiana gross income tax purposes. IC § 6-2.1-3-25 plainly stated that gross income received by a partnership was exempt from gross income tax. The Department's reference to the failure of the partnerships to file partnership returns required by 45 IAC 1.1-5-4, means that the partnerships are non-filers under 45 IAC 1.1-5-4. Non-filing carries its own tax consequences, but that issue was not addressed in this audit. Non-filing may be a factor in determining that a partnership is not valid, but there is no

other explanation in the protest file to establish that the partnerships are not valid.

In conclusion, Taxpayer is correct that there was no Indiana provision which referred to federal definitions for the purpose of determining if a partnership is valid for Indiana gross income tax. The income in question was received by partnerships, and IC § 6-2.1-3-25 exempted gross income received by a partnership. There was no reference in the Department's reasoning to explain why that exemption was negated by the partnership's federal status. Taxpayer has met its burden under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is sustained.

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