DEPARTMENT OF STATE REVENUE

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Letter of Findings: 06-0524
Gross Income Tax and Adjusted Gross Income Tax
For the Years 2000, 2001, 2002, 2003

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ISSUES

I. Gross and Adjusted Gross Income Tax – Disallowance of Special Allocation Deductions.

Authority: I. R. C. § 704; IC § 6-8.1-5-1; 45 IAC 1.1-2-13; 45 IAC 3.1-1-105; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the disallowance of certain special allocation deductions.

II. Gross Income Tax – Business Situs.

Authority: IC § 6-8.1-5-1; IC § 6-2.1-2-2; 45 IAC 1.1-1-3; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the inclusion of a partnership in calculating its GIT.

III. Adjusted Gross Income Tax – Non-Unitary Treatment of Partnership.

Authority: The Department's audit treatment of the partnership's distributions to Taxpayer for AGIT.

Taxpayer originally protested this issue, but at hearing stated that it is in agreement with the Department's position.

IV. Adjusted Gross Income Tax – Bonus Depreciation - **Calculation.**

Authority: IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests that the Department's bonus depreciation calculations contain mathematical errors.

V. Gross and Adjusted Gross Income Tax – Net Partnership Distributions -**Calculation.**

Authority: IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests that the Department's net partnership distribution calculations contain mathematical errors.

STATEMENT OF FACTS

For the years at issue, Taxpayer was an out-of-state wholly-owned subsidiary of a Fortune 500 company ("Parent"). Taxpayer provided wireless communications services and directory advertising.

In late 2000, Taxpayer contributed its domestic wireless and data operation to a joint venture with an unrelated company ("Company A") forming a third entity ("Wireless LLC"). Wireless LLC is a limited liability company treated as a partnership for federal and state tax purposes.

For the years at issue, Taxpayer's group and Company A respectively had forty-percent and sixty-percent interests in Wireless LLC. Wireless LLC was governed by a partnership agreement that set out the rights and obligations of the partners including contributions, distributions, liquidation, determination of capital accounts, etc. Wireless LLC was managed independently by both companies with a four-seat board of directors comprised of two individuals appointed by each partner.

The Indiana Department of Revenue ("Department") conducted an income tax audit of Taxpayer for the years 2000, 2001, 2002, and 2003. Taxpayer and several affiliates (collectively referred to as "Taxpayer") were on the IT-20s for the audit years.

The Department assessed additional Gross Income Tax ("GIT") for 2000, 2001, and 2002, and additional Adjusted Gross Income Tax ("AGIT") for 2000, 2001, 2002, and 2003. Taxpayer protested the issues delineated below. A hearing was held and this Letter of Findings results. Additional facts will be provided as necessary.

I. Gross and Adjusted Gross Income Tax – Disallowance of Special Allocation Deductions.

DISCUSSION

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

The Department's audit found that Taxpayer incorrectly claimed specially allocated deductions for assets Taxpayer contributed to Wireless LLC and deductions for charitable contributions in computing its distributive share of partnership income when reporting its Indiana GIT. The Department's audit referred to 45 IAC 1.1-2-13(d) which states that the amount credited to a corporate partner as its distributive share of partnership income derived from sources within Indiana is taxable at the high rate and presumptively does not include these (or any) deductions. The Department made adjustments for 2000, 2001, and 2002 that disallowed the special allocations.

Taxpayer has not challenged the disallowance of the charitable contribution deductions, but cited to 45 IAC 1.1-2-13(a) to show that the partner's distributive share is calculated according to the requirements of section 704 and its prescribed regulations before any Indiana modifications. Taxpayer argues that the specially allocated deductions it reflected in reporting its distributive share of income result from I.R.C. § 704(c) required tax depreciation adjustments for basis, and as referenced in Article 9(d)(i) of Wireless LLC's partnership agreement.

45 IAC 1.1-2-13, which defines and describes the Gross Income Tax treatment of a corporate partner's distributive share of partnership income, states:

(a) 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.

(b) An amount credited to a corporate partner as its distributive share of partnership income, which is derived from sources within Indiana is subject to the gross income tax. An amount previously subjected to the gross income tax because it was included in the partner's distributive share but not actually distributed is not subject to the gross income tax again when it is actually distributed.

(c) For purposes of this subsection, all income of the partnership shall be considered business income. If a partnership does business in a state besides Indiana, a partner's distributive share of partnership income which is derived from sources within Indiana, for gross income tax purposes, shall be determined by multiplying the partner's distributive share by a fraction. The numerator of the fraction shall be the sum of:

(1) the property factor;

(2) the payroll factor; and

(3) the sales factor;

of the partnership. The denominator of the fraction shall be determined by the number of factors used. The property factor shall be determined under IC 6-3-2-2(c). The payroll factor shall be determined under IC 6-3-2-2(d). The sales factor shall be determined under IC 6-3-2-2(e) and IC 6-3-2-2(f).

(d) The amount credited to a corporate partner as its distributive share of partnership income which is derived from sources within Indiana is taxable at the high rate.

(Emphasis added).

45 IAC 3.1-1-105(b) states a similar qualification for Adjusted Gross Income Tax purposes:

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.

(Emphasis added).

I.R.C. § 704 states in part:

(a) Effect of partnership agreement.--A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of distributive share.--A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if--

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

(c) Contributed property.--

(1) In general.--Under regulations prescribed by the Secretary--

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution,

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed--

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph, and

(C) if any property so contributed has a built-in loss--

(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C), the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution.

(2) Special rule for distributions where gain or loss would not be recognized outside partnerships.--Under regulations prescribed by the Secretary, if--

(A) property contributed by a partner (hereinafter referred to as the "contributing partner") is distributed by the partnership to another partner, and

(B) other property of a like kind (within the meaning of section 1031) is distributed by the partnership to the contributing partner not later than the earlier of--

(i) the 180th day after the date of the distribution described in subparagraph (A), or

(ii) the due date (determined with regard to extensions) for the contributing partner's return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs,

then to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).

(3) Other rules.--Under regulations prescribed by the Secretary, rules similar to the rules of paragraph (1) shall apply to contributions by a partner (using the cash receipts and disbursements method of accounting) of accounts payable and other accrued but unpaid items. Any reference in paragraph (1) or (2) to the contributing partner shall be treated as including a reference to any successor of such partner.

(d) Limitation on allowance of losses.--A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership. (Emphasis added).

I.R.C. § 704(c)'s purpose is to apparently prevent shifting of tax consequences among partners that can occur when property is contributed to a partnership with a fair market value ("FMV") that differs from its tax basis. The property's FMV at the time of contribution is what is called the "book value." Where the "book value" and the "tax basis" (basis carried over from the contributing partner) differ, the property is referred to as "section 704(c) property." The goal of IRC section 704(c) is to prevent the shifting of tax consequences with respect to appreciated or depreciated property contributed by a partner to a partnership. It upholds the "assignment of income" principle by requiring the contributing partner to be taxed on the portion of the gain or loss that arose prior to the property's contribution to the partnership. It prevents partners from shifting pre-contribution gain or loss among themselves. As a result, gain or loss inherent in contributed property must be allocated back to the contributing partner. In the case of depreciable property, gain or loss inherent in the property will be recognized over time as depreciation deductions are allocated to other partners and away from the contributing partner, thereby increasing the contributing partner's share of partnership income.

Taxpayer is correct. Short of an argument that Taxpayer incorrectly applied I.R.C. § 704(c) when it depreciated the assets it contributed to Wireless LLC, the Indiana statutes that define a partner's distributive share, 45 IAC 1.1-2-13 (GIT) and 45 IAC 3.1-1-105 (AGIT), allow for 704(c) property depreciation deductions to be reflected in reporting its partnership distributive share for Indiana GIT and AGIT purposes.

FINDING

Taxpayer's protest of this issue is sustained.

II. Gross Income Tax – Business Situs.

DISCUSSION

The Department notes again that all tax assessments are presumed accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer contends that Wireless LLC's income should not be included in the calculation of GIT. Taxpayer argues that according to IC § 6-2.1-2-2 (repealed January 1, 2003) only corporations with business activity within Indiana are subject to GIT, and Indiana determined business activity in the context of whether or not a taxpayer had "business situs" in Indiana as defined in 45 IAC 1.1-1-3. Taxpayer argues that according to 45 IAC 1.1-1-3(7), the group's Wireless LLC income, as the income of a "limited partner," does not have situs in Indiana and therefore should not be included for GIT purposes (Taxpayer's group will be referred to as "Taxpayer").

In the alternative, Taxpayer argues that if it is determined that Taxpayer's Wireless LLC income is to be included in the calculation of GIT, then the income should be included net of special allocations (see "Issue I" above).

45 IAC 1.1-1-3 defines "business situs" for GIT purposes:

(a) A "business situs" arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile.

(b) A taxpayer may establish a business situs in ways, including, but not limited to, the following:

(1) Use, occupancy, or operation of an office, shop, construction site, store, warehouse, factory, agency route, or other place where the taxpayer's affairs are conducted.

(2) Performance of services.

(3) Maintenance of an inventory or stocks of goods for sale, distribution, or manufacture.

(4) Sale or distribution of merchandise from company-owned vehicles where title to the goods passes at the time of sale or distribution.

(5) Acceptance of orders without the right of approval or rejection in another state.

(6) Ownership, leasing, rental, or other business activities connected with income-producing property (real or personal).

(7) Ownership (in whole or part) of a partnership doing business in Indiana **unless the ownership is that of a limited partner who does not participate in the control of the business**.

(8) Other business or investment activities, other than de minimis, performed on behalf of the taxpayer by an employee of the taxpayer. These activities shall be considered together, not in isolation, in deciding if they are de minimis.

(Emphasis added).

Taxpayer argues that during 2001 and 2002 its Wireless LLC's net distributive share of income (or loss) is not subject to Indiana GIT because Taxpayer is not a controlling partner in the partnership. Taxpayer argues that it has a minority interest - forty-percent - in Wireless LLC. Taxpayer argues that it did not control Wireless LLC or participate in its day-to-day operations. Therefore, according to Taxpayer, the income (or loss) received by these entities from Wireless LLC did not arise from transactions or activity in the regular course of the partnerships' trade or business and therefore should not be included in the GIT calculation.

As stated earlier, Wireless LLC, treated as a partnership for federal and state tax purposes, was co-owned by Taxpayer and Company A. At hearing, Taxpayer stated that Wireless LLC was managed in a 50-50 negative control structure; i.e., as Taxpayer explained, it was managed by a board comprised of two members from each of the partners where each of the partners had veto power. Quite apart from whether or not Taxpayer's minority ownership resulted in sufficient control to ascribe business situs to its distributive share of Wireless LLC income, according to Taxpayer's own description of the management structure of Wireless LLC, Taxpayer had negative control through equal veto rights. This removes Taxpayer from the ambit of 45 IAC 1.1-1-3(7)'s exclusion because Taxpayer is not a "limited partner who does not participate in the control of the business." At the very least this creates a presumption in favor of the Department's treatment of Wireless LLC's income in calculating Taxpayer's Indiana GIT.

Taxpayer, therefore, has not sustained its burden to show that its distributive share of Wireless LLC's income should not be included in calculating its GIT.

Taxpayer's alternative argument that Wireless LLC's income should be included net of special allocations is addressed under Issue I above where the finding supports Taxpayer's contention.

FINDING

Taxpayer's protest that its distributive share of Wireless LLC's income should not be included in calculating its 2001 and 2002 GIT is respectfully denied.

However, Taxpayer is sustained, as explained in Issue I, in its alternative protest that Wireless LLC's income should be included net of special allocations.

III. Adjusted Gross Income Tax – Non-Unitary Treatment of Partnership.

DISCUSSION

Originally Taxpayer had protested the Department's AGIT treatment of Taxpayer's Wireless LLC's distributive share as non-unitary and therefore allocable directly based on apportionment percentages. At hearing Taxpayer stated it was no longer contesting this issue.

FINDING

This issue is no longer protested. The Department's audit treatment of the LLC's distributions to Taxpayer for AGIT stands.

IV. Adjusted Gross Income Tax – Bonus Depreciation – Calculation.

DISCUSSION

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer protests that the Department's Bonus Depreciation calculations are incorrect. Taxpayer believes that for 2001, 2002 and 2003, the Department mistakenly double counted bonus depreciation amounts already reported in RAR adjustments, although Taxpayer was not as clear about the source of discrepancy for the 2003 year. After the hearing Taxpayer submitted additional detailed documentation that purports to illustrate the double-counting in each of the years – for 2003, Taxpayer provided a reconciliation of the bottom-tier K-1 numbers. Taxpayer's post-hearing documentation includes a "Summary Restatement of the Issues" which points specifically to the numbers it contends were double-counted. After the audit and prior to hearing the auditor agreed that there may be double-counting issues.

FINDING

Taxpayer is sustained on the protest of this issue subject to verification in a supplemental audit.

V. Gross and Adjusted Gross Income Tax – Net Partnership Distributions-Calculation.

DISCUSSION

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer protests the Department's audit calculation of net partnership distributions, again arguing that the Department's audit double-counted some distributions working up through the tiered partnerships. After the hearing Taxpayer submitted additional detailed documentation that purports to illustrate the double-counting in each of the years. Taxpayer's post-hearing documentation includes a "Summary Restatement of the Issues" which points specifically to the numbers it contends were double-counted.

FINDING

Taxpayer is sustained on the protest of this issue subject to verification in a supplemental audit.

CONCLUSION

Issue I – Taxpayer properly deducted "704(c) property" depreciation in reporting its distributive share of partnership income for GIT and AGIT purposes.

Issue II – The Department properly included in the partnership in its calculation of Taxpayer's GIT, subject to allowing the special allocation deduction per Issue I.

Issue III – Taxpayer agrees to the non-unitary treatment of the partnership for AGIT purposes.

Issue IV – Taxpayer's protest that the Department's audit contained mathematical errors in calculating bonus depreciation is sustained subject to verification in a supplemental audit.

Issue V – Taxpayer's protest that the Department's audit contained mathematical errors in calculating net partnership distributions is sustained subject to verification in the supplemental audit.

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