DEPARTMENT OF STATE REVENUE

02-20080545.LOF

Letter of Findings: 08-0545
Indiana Corporate Income Tax
For the Years 2003, 2004, and 2005

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ISSUES

I. Corporate Income Tax – Business Income.

Authority: IC § 6-3-2-2; IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-8.1-5-1; 45 IAC 3.1-1-29; 45 IAC 3.1-1-42; 45 IAC 3.1-1-153; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); Hunt Corp v. Indiana Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983).

Taxpayers challenge the Department's decision reclassifying Taxpayers' income, where the subsidiaries/affiliates were limited partners of partnerships or non-managing members of limited liability companies.

II. Corporate Income Tax – Capital Losses and Net Operating Losses (NOLs).

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

Taxpayers protest the disallowance of capital losses and NOLs.

III. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayers protest the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer, a multinational company, as well as its subsidiaries and affiliates (collectively "Taxpayers") engage in utility and related services in Indiana. Taxpayers ultimately share the same parent company (Parent), an out-of-state company, which wholly or partially owns, as well as directly or indirectly controls, Taxpayers through multi-tier subsidiaries.

On February 8, 1985, the Indiana Department of Revenue ("Department") granted Taxpayers, pursuant to Taxpayers' request, the permission to file a combined Indiana Corporation Income Tax return. From then on, Taxpayers have been filing combined returns as a group conducting a unitary business in Indiana.

The Department performed an audit of the tax years 2003, 2004, and 2005. Pursuant to the audit, the Department determined that Taxpayers failed to file their combined returns in a consistent manner as required according to 45 IAC 3.1-1-42. Specifically, the Department's audit found that Taxpayers misclassified certain income as nonbusiness income, which was considered business income. The audit also determined that Taxpayers reported certain income generated from its foreign operating company but failed to provide documentation to substantiate its reporting. Moreover, the audit found that, in addition to claiming certain capital losses, Taxpayers carried over net operating losses ("NOLs") from 1999 and 2003 to offset their income but could not substantiate the claimed capital losses and NOLs. The Department's audit thus (1) disallowed the reported nonbusiness income and reclassified the income as business income, (2) included the income of the foreign operating company into the audit adjustment, as well as (3) disallowed the claimed capital losses and the claimed NOLs. The audit's adjustment resulted in additional tax, penalty, and interest.

Taxpayers timely protest the assessments. A hearing was held. Prior to the administrative hearing, the Department agreed to remove the income of the foreign operating company from the adjustment based on documentation provided by Taxpayers. Taxpayers, however, continue to protest the remaining issues. This Letter of Findings ensues. Additional facts will be provided as necessary.

DISCUSSION

I. Corporate Income Tax – Business Income.

Pursuant to the audit, the Department found that Taxpayers, which filed the Indiana combined returns as a group conducting a unitary business for those years, failed to file the returns in a consistent manner. Specifically, the Department's audit determined that Taxpayers had misclassified certain income as nonbusiness income whereas the income was treated as business income in prior and subsequent filings at the time. Taxpayers, to the contrary, argued that the income Taxpayers received was either from limited partnerships ("LPs") (in which the subsidiaries/affiliates were limited partners) or from limited liability companies ("LLCs") (in which the subsidiaries/affiliates were non-managing members) and was nonbusiness income because they either did not have control over the LPs or did not actively manage the LLCs. Taxpayers further argue that since the subsidiaries/affiliates were either limited partners or non-managing LLC members, their activities were not unitary

and their income was nonbusiness income. Specifically, Taxpayers argue that the income from four of the entities–an Intangible Property LP (for Tax Year 2003), a Holdings LLC, which was treated as a partnership for federal income tax purposes (for Tax Year 2003 and 2004), a Joint Venture LLC, which was a joint venture of the Taxpayers with a third party in which Taxpayers owned sixty percent shares (for Tax Year 2003 and 2004), and a Partnership (for Tax Year 2003)–was nonbusiness income.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC § 6-3-2-1(b).] In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996).

IC § 6-3-1-20 provides:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

IC § 6-3-1-21 defines:

The term "nonbusiness income" means all income other than business income.

45 IAC 3.1-1-29 further explains:

"Business Income" is defined in the Act as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business. Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business.

45 IAC 3.1-1-153 provides:

(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.

The Indiana Tax Court, in Hunt Corp v. Indiana Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999), has provided comprehensive guidance on computing a corporate taxpayer's tax liabilities when a taxpayer and its subsidiaries/affiliates file consolidated returns as a group where some income was from its subsidiaries/affiliates' distributive shares in partnerships. Even though the case dealt with a consolidated, not combined, filing, the court in Hunt provided instructive general rules on computing corporate taxpayer's tax liabilities. Nonetheless, the court in Hunt explained that IC § 6-3-2-2 "is a general provision that deals with how of all of a corporate taxpayer's adjusted gross income is attributed by way of allocation and apportionment rules.... [T]he fact that section 6-3-2-2 deals with the attribution of all of a corporate taxpayer's adjusted gross income means that income derived from a corporate partnership... is subject to section 6-3-2-2." Id. at 776. The court further illustrated that:

> Under section 6-3-2-2, in order to determine where the income from the corporate partnership is to be attributed, it must first be determined whether that income constitutes business or nonbusiness income for the affiliated group. That determination is made by ascertaining whether the affiliated group and the partnerships are engaged in a unitary business or not. If the income from the partnerships constitutes business income (i.e., if the affiliated group and the partnerships are engaged in a unitary business), under section 6-3-2-2, all of that income would be subject to apportionment based on an application of the affiliated group's property, payroll, and sales factors. If the income from the partnerships constitutes nonbusiness income for the affiliated group (i.e., if the affiliated group and the partnerships are not engaged in a unitary business), that income will be allocated to a particular jurisdiction. Section 6-3-2-2 does not specifically address the question of whether a partnership's property, payroll, and sales factors may be considered in apportioning a corporation's business income derived from a corporate partnership. The regulation [45 IAC 3.1-1-153] addresses this technical problem and provides a comprehensive description of the treatment of income derived from corporate partnerships. Mirroring the analysis required by section 6-3-2-2, the regulation makes the crucial distinction between the situation where the corporate partner's activities and the partnership's activities constitute a unitary business and when they do not. Id.

The United States Supreme Court's jurisprudence has established what is considered "unitary business" and allows a State to apply formula apportionment taxing some income (which a taxpayer's subsidiaries/affiliates received), which does not have its source in the taxing State. When in dispute, the Court examines whether "contributions to income of the subsidiaries resulted from functional integration, centralization of management, and economies of scale." Container Corp. v. Franchise Tax Board, 463 U.S. 159, 179 (1983).

In this instance, Taxpayers elected and were permitted to file combined returns as a group conducting a unitary business and, since 1985, Taxpayers have been filing the combined returns as conducting a unitary business in Indiana. Taxpayers, thus, were presumed to be in the unitary business for those years and they bear the burden to demonstrate otherwise.

To support their protest, Taxpayers submitted copies of the partnership agreements and operating agreements. Taxpayers, referring to those agreements, argued that, among those subsidiaries/affiliates, they were either the limited partners (which did not have control over the partnerships) or the non-managing LLC members (which did not have the power to manage the LLCs). Taxpayers maintained that while those subsidiaries/affiliates received the income from the LPs and the LLCs, their income was nonbusiness income because, as limited partners or non-managing members, they did not have control over the LPs or did not actively manage the LLCs.

Taxpayers' documentation, however, demonstrated otherwise. Notably, Taxpayers' documentation exhibited a common theme concerning the establishment of the corporate structure, both the LPs and the LLCs. Taxpayers' documentation demonstrated that the partners (both general and limited partners) or LLC members (both managing and non-managing members) were, wholly and/or partially, separately and/or jointly, as well as directly and/or indirectly, owned by Taxpayers and/or Parent. Among those LPs and LLCs, there was one general partner designated for each of the LPs and one managing member designated for each of the LLCs. The designated general partners or the designated managing members usually owned negligibly small percentage of ownership (usually one percent or less) of the LPs or the LLCs. Meanwhile, the designated limited partners and the designated non-managing members would, equally or proportionately, share the remaining ownership of the LPs and the LLCs.

Specifically, upon executing the agreements, most of the partnership agreements and operating agreements were signed and executed by the same group of individuals, who served as executives (Executives) for both the general partners and the limited partners of the partnerships at the same time or managing and non-managing LLC members simultaneously. Meanwhile, the same Executives also held major executive level positions (such

as, Chief Executive Officer, Chief Financial Officer, president, vice president, or director) in the management within and throughout Taxpayers and Parent. Moreover, some agreements further scrupulously stated that the LPs or the LLCs "shall not have any employees" since the date they were formed.

Taxpayers maintained that:

> As most of these corporations are holding companies without employees or operations apart from their ownership of the partnership interests, there generally are no employees or active officers. Thus, any officers appointed to these entities would primarily function solely in a ministerial capacity, i.e. signing contracts, etc. [Taxpayers] has conceded throughout the audit and hearing process that there is likely overlap between offices in the limited partners, general partners and the partnerships themselves.

Thus, the same Executives, who made any business decisions regarding the LPs, represented the general partners and, at the same time, also represented the limited partners. Similarly, the same Executives, who engaged in the LLCs' day-to-day operations, represented the managing members and, at the same time, also represented the non-managing members.

In this instance, among Taxpayers' four entities, the Intangible Property LP focused on protecting, managing, and enhancing certain Taxpayers' intangible property. The Holdings LLC primarily involved in "sale [and] leaseback transactions of utility assets for certain related affiliates." The Joint Venture LLC and the Partnership provided utility services. Those LPs and LLCs' business activities were essentially and relatively aligned with Taxpayers' business trade or activities–providing utility services. Thus, those LPs and LLCs offered critical support to Taxpayers and ultimately to Parent to achieve "economies of scale."

Taxpayers claimed that the designated limited partners of the LPs did not have control over the LPs and the non-managing members of the LLCs did not actively manage the LLCs day-to-day operations. But, Taxpayers' documentation demonstrated that the general partner and the limited partners of the partnerships or managing and non-managing members of the LLCs were controlled and managed by the same Executives, who also participated in vital business decision-making and were responsible for executing the business plans throughout Taxpayers' utility enterprise. The substance of their arrangements belies the formal designations. Thus, given the totality of the circumstances, in the absence of other documentation, Taxpayers have not met their burden of showing they were non-unitary, and, therefore, the income was correctly treated as business income.

In short, Taxpayers' documentation demonstrated that Taxpayer and subsidiaries/affiliates are unitary and that the income which Taxpayers received for those years was correctly treated as business income because the "contributions to income of the subsidiaries resulted from functional integration, centralization of management, and economies of scale."

FINDING

Taxpayers' protest is respectfully denied.

II. Corporate Income Tax – Capital Losses and Net Operating Losses (NOLs).

The Department's audit disallowed Taxpayers' claimed capital losses, resulting in additional tax for tax years 2003 and 2004. The Department's audit also disallowed Taxpayers' 2003 and 1999 NOLs carried over to reduce Taxpayers' 2004 tax liability. Taxpayers, to the contrary, claimed that the capital losses and the NOLs were available to be utilized for those years.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(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, in pertinent part, noted that:

> [Taxpayers] understated the amounts subject to Federal Income Taxes. Further investigation revealed that the discrepancy was largely due to differences in the treatment between federal and state capital losses. [Taxpayers] did not secure needed detailed state information by entity about past years activities to determine whether for state purposes capital loss carry forwards exist. For federal purposes, the capital losses would have largely been exhausted through carry backs.
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> ...
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> [Taxpayers] had deducted a 2003 NOL losses and a [Subsidiary S] Loss from 1999, on which [Taxpayers] did not provide sufficient backup that it should have been utilized in an earlier period of time. The 2003 loss does not exist after audit adjustments have been made.

To support their protest, Taxpayers provided copies of summary schedules they have created, a copy of the federal adjustment (Form 4549) concerning the Subsidiary S's income for 1997, 1998, and 1999, as well as the Subsidiary S's amended 1999 Indiana return to demonstrate that there were capital losses or NOLs available. However, Taxpayers did not offer other documentation to establish that those losses have not been utilized by Taxpayers in the past and still available to be used for 2003 and 2004.

Given the totality of the circumstances, in the absence of other documentation to substantiate that those losses were still available, the Department is not able to agree with Taxpayers that they have met the burden of demonstrating that the Department's assessment is incorrect.

FINDING

Taxpayers' protest is respectfully denied.

III. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a tax return;
(2) fails to pay the full amount of tax shown on the tax return;
(3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
(4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayers did not provide sufficient documentation to demonstrate that their failure to pay tax was not due to negligence.

FINDING

Taxpayers' protest of the negligence penalty is denied.

SUMMARY

For the reasons discussed above, Taxpayers' protest of the Department's decision reclassifying Taxpayers' income is denied. Taxpayers' protest of the Department's disallowance of the capital losses as well as the NOLs is also denied. Additionally, Taxpayers' protest of the negligence penalty is respectfully denied. However, prior to the hearing, the Department agreed that Taxpayers have provided sufficient documentation demonstrating that certain income which they received was from the foreign operating company. Thus, the Department will remove that portion of income and recalculate Taxpayers' tax liabilities in a supplemental audit.

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