DEPARTMENT OF STATE REVENUE

02-20100199.SLOF

Supplemental Letter of Findings: 02-20100199
Corporate Income Tax
For Tax Years 2005, 2006, and 2007

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ISSUES

I. Corporate Income Tax – Business/Nonbusiness Income.

Authority: IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-2; IC § 6-3-2-2.2; IC § 6-8.1-5-1; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; 45 IAC 3.1-1-41; 45 IAC 3.1-1-58; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); 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); Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983); F. W. Woolworth Co. v. Taxation and Revenue Dep't. of State of N. M., 458 U.S. 354 (1982); May Dep't Store v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct., 2001); Chief Industries, Inc. v. Indiana Dep't of State Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000); Black's Law Dictionary 1511 (8th ed. 2004); Letter of Findings 02-20100199 (September 28, 2011).

Taxpayer argues that the Indiana Department of Revenue erred in reclassifying some of its nonbusiness income on its Indiana income tax returns as business income.

II. Corporate Income Tax – Add-Back County Tax – Net Operating Losses.

Authority: IC § 6-3-1-3.5; Phoenix Coal Co. v. Comm'r, 231 F.2d 420 (2d Cir. 1956).

Taxpayer protests that the Department of Revenue failed to give Taxpayer credit for county tax which it paid but mistakenly added back to its returns, which in turn affected carryovers of its net operating losses ("NOLs").

III. Tax Administration – Interest.

Authority: IC § 6-8.1-10-1.

Taxpayer protests the imposition of interest.

STATEMENT OF FACTS

Taxpayer is an out-of-state company which owns and operates various facilities throughout the United States and internationally. Taxpayer conducted its business in Indiana through a limited liability company ("Indiana LLC") which initially was treated as a partnership, consisting of two partners. Taxpayer owned a majority of the shares in the Indiana LLC; the other partner, owning a small fraction of interest, was an unrelated third party. Taxpayer subsequently acquired the remaining interest from the other partner and wholly owned the Indiana LLC. As a single member LLC, the Indiana LLC became a disregarded entity for federal income tax purposes and was treated as a division of Taxpayer. Taxpayer does not file a consolidated return with any other entity. Taxpayer files its own Indiana corporate income tax returns; it has income both within and without Indiana.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of the tax years 2005, 2006, and 2007. Pursuant to the audit, the Department made several adjustments, which affected Taxpayer's carryover of its net operating losses ("NOLs"). The Department's audit noted that although some tax years "are out of statute and an assessment cannot be made, the net operating losses incurred in those years affect the audit years."

The Department's audit determined that Taxpayer had misclassified some of its income as nonbusiness income. The disputed income classification was attributed to the following transactions: (1) the sale of one of Taxpayer's facilities ("Facility at issue") in 1999 ("1999 asset sale"), (2) the sale of land adjacent to the Facility at issue in 2000 ("2000 asset sale"), (3) another sale of land adjacent to the Facility at issue in 2004 ("2004 asset sale") (collectively, "Asset Sales"), (4) the termination fee which resulted from an unsuccessful merger ("Termination Fee") in 2006. The Department considered the income attributed to the above-mentioned four transactions ("Income at issue") as business income. The Department's reclassification of the Income at issue reduced Taxpayer's NOLs and, as a result, the audit assessed Taxpayer additional income tax, penalty, and interest for the 2006 and 2007 tax years.

Taxpayer timely protested the assessments. In addition, Taxpayer discovered that it mistakenly added back the county tax it paid in calculating its Indiana corporate income tax; therefore, it requested that the Department allows Taxpayer the credits/refund concerning the overpayments for 2003-2007 tax years. A hearing was held. Letter of Findings 02-20100199 (September 28, 2011) ("LOF"), 20110928 Ind. Reg. 045110478NRA, denied Taxpayer's protest in part and sustained it in part. The LOF determined that Taxpayer's Income at issue was business income and, therefore, was apportionable for Indiana income tax purposes. The LOF also denied Taxpayer's protest on the issue of county taxes which Taxpayer paid but then mistakenly added back to its state

income tax calculations. The LOF sustained Taxpayer's protest of penalty. Subsequently, Taxpayer requested a rehearing and the rehearing was granted based on the additional information submitted. This Supplemental Letter of Findings ensues. Additional facts will be provided as necessary.

I. Corporate Income Tax – Business/Nonbusiness Income.

DISCUSSION

The Department's audit determined, and the LOF subsequently concluded, that Taxpayer's income attributed to the Asset Sales and the Termination Fee was business income and, therefore, was apportionable under IC § 6-3-2-2(b). The Department's reclassification of the Income at issue reduced Taxpayer's carryover of its available NOLs for calculating its Indiana income tax, resulting in additional assessments for the 2006 and 2007 years.

Taxpayer, to the contrary, argued that its income from the Asset Sales and the Termination Fee was nonbusiness income and thus was not apportionable to Indiana. Stating that "the unitary business principle is the lynchpin of apportionability," Taxpayer claimed that the Indiana LLC's operations and Taxpayer's operations outside of Indiana were not unitary, and thus, "Indiana has no right to tax the gain" from the Asset Sales. Alternatively, Taxpayer asserted that its income from the Asset Sales was nonbusiness income; the 1999 asset sale was an installment sale contract, which dealt with real property outside Indiana and the sales of two parcels adjacent to the Facility at issue were sales of investment property. Taxpayer also maintained that the Termination Fee was nonbusiness income.

A. The Applicable Law.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." 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 Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

"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 § 6-3-2-2(b).

In Hunt Corp. v. Indiana Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999), the Indiana Tax Court addressed the issue of whether the out-of-state income of Hunt Corporation and its subsidiaries was subject to Indiana adjusted gross income tax. The Indiana Tax Court stated that:

> States do not have to evaluate each income generating activity of the corporate enterprise in order to determine whether the income gained from that activity is properly taxable by the state. Instead, the state may look at all of the income gained by the corporate enterprise's business activity and determine the state's fair share of that total. Id. at 769.

The Indiana Tax Court in Hunt further explained that:

> Indiana only levies adjusted gross income tax on corporate income attributable to Indiana. In order to determine what income is attributable to Indiana, it must be first determined whether the income sought to be attributed is business or non-business income. (Emphasis added).

Id. at 771.

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 "nonbusiness income" as follows:

> 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.
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> 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 3.1-1-30 also illustrates:

> For purposes of determining whether income is derived from an activity which is in the regular course of the

taxpayer's trade or business, the expression "trade or business" is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period.

(3) The frequency, number, or continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

The Indiana Tax Court, in May Dep't Store v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001), stated in relevant part that:

Pursuant to Ind. Code § 6-3-2-2, for the purpose of calculating a corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while nonbusiness income is allocated to Indiana or another state. A corporation's net income is its adjusted gross income, with certain adjustments.... [W]hether income is deemed business or nonbusiness income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states wherein the taxpayer is conducting its trade or business. Id. at 656.

The Indiana Tax Court concluded that the statutory definition of "business income" was ambiguous and, thus, established two tests–a transactional test and a functional test–to determine whether a taxpayer's income is considered "business income" pursuant to IC § 6-3-1-20. Id. at 661-63.

The court in May explained that:

Under the transactional test, the controlling factor by which business income is identified is the nature of the particular transaction giving rise to the income. In deciding whether a specific transaction generated business income, pertinent considerations include: (1) the frequency and regularity of similar transactions; (2) the former practices of the business; and (3) the taxpayer's subsequent use of the income.

...

Under the functional test, all gain from the disposition of a capital asset is considered business income if the asset disposed of was used by the taxpayer in its regular trade or business operations.... Under the functional test,... the extraordinary nature or infrequency of the sale is irrelevant. ("If the property had an integral function in the taxpayer's unitary business, its income properly can be apportioned and tax as business income, even though the transaction itself does not reflect the taxpayer's normal trade or business.") (Internal citations omitted.) Id. at 658-60.

The court in May further illustrated that:

The functional test focuses on the property being disposed of by the taxpayer. By the very terms of the statute, the "acquisition, management, and disposition" of the property generating income must constitute an "integral" part of the taxpayer's regular trade or business operations. Thus, the property at issue must have been acquired, managed and divested or disposed of by the taxpayer. More importantly, this process (i.e., acquisition, management and disposition) must be integral to the taxpayer's regular trade or business operations. It is not enough that the property was used to generate business income for the taxpayer prior to its disposition. The disposition too must be an integral part of the taxpayer's regular trade or business operations.

The term "integral" may be defined as "part or constituent component necessary or essential to complete the whole." (Internal citations omitted.) Id. at 664-65.

Ruling in favor of the petitioner, the court in May determined that the gains from the sale of the petitioner's subsidiary's assets did not qualify as business income under the transactional test. Id. at 664. The court further opined that the sale of the subsidiary's assets also did not qualify as business income under the functional test because the divestiture of the assets was neither a necessary nor an essential part of the petitioner's business operation–the planned transaction was ordered by a court and was for the benefit of a competitor. Id. at 665.

B. Taxpayer's Arguments.

The LOF concluded that Taxpayer has business income within and without Indiana, and that Taxpayer's Income at issue was business income; therefore, Taxpayer's Income at issue was apportionable to Indiana pursuant to the above mentioned Indiana statutes, regulations, and case law.

At rehearing, Taxpayer reiterated that there is no unitary relationship between its operations outside of Indiana and its Indiana LLC's operations. Taxpayer argued that the income attributed to the Asset Sales was nonbusiness income and was not apportionable to Indiana although the Indiana LLC is wholly-owned by Taxpayer and has been treated as a disregarded entity. Alternatively, Taxpayer argued that its income from its sale of the Facility at issue qualified as receipts from an installment sale and was not attributed to Indiana under IC § 6-3-2-2.2(a). Taxpayer also claimed that the income attributed to the sales of two parcels of land adjacent to the Facility at issue was nonbusiness income pursuant to 45 IAC 3.1-1-41, example 4, and 45 IAC 3.1-1-58. Taxpayer further asserted that its income from the Termination Fee was nonbusiness income under May. This Supplemental Letter of Findings addresses each of Taxpayer's arguments separately as follows:

1. Unitary Business.

Taxpayer asserted that "the unitary business principle is the lynchpin of apportionability." Taxpayer further argued that the Indiana LLC's operations and Taxpayer's operations outside of Indiana were not unitary, so "Indiana has no right to tax the gain" from Taxpayer's Asset Sales.

Under the United States Constitution, a State may tax a nondomiciliary corporation's multi-state income when there is a "minimal connection" between the interstate activities and the taxing State and there is "a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business." Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 772 (1992). The United States Supreme Court's jurisprudence further illustrates that "a State need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary." Id. The Indiana Tax Court acknowledged, in Hunt, that the "constitutional limitations" restrict a state from looking "beyond its borders in order to determine the value of things within its borders." Hunt Corp., 709 N.E.2d at 770. The Hunt court stated that:

> These limitations arise from the unitary business principle.... The unitary business principle allows a state to consider all of a corporate enterprise's income arising from the enterprise's unitary business in calculating that state's apportioned share of that income. However, where a corporate enterprise receives income from unrelated business activity which constitutes a discrete business enterprise, a state may not include that income in the apportionable base. (Internal quotation marks and citations omitted.) Id.

Thus, "unitary business principle" allows a state to apply formula apportionment when taxing income which does not have its source in the taxing state. When in dispute, courts examine 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).

At rehearing, Taxpayer contended that its operations outside of Indiana and its Indiana LLC's operations were "fundamentally different" and, thus, they were not a unitary business. Specifically, Taxpayer argued that Indiana LLC's operations and its operations outside of Indiana are different because they provide different forms of entertainment and they earn income in different ways. Referring to F. W. Woolworth Co. v. Taxation and Revenue Dep't. of State of N. M., 458 U.S. 354 (1982), Taxpayer suggested that "functional integration involve[s] manufacturing businesses which are vertically integrated, i.e., businesses which own or control multiple states of a process." Taxpayer thus maintained that its operations outside of Indiana and its Indiana LLC's operations were not functionally integrated because they were "not subject to the same vertical integration possibilities as a manufacturing business." Taxpayer also referred to Woolworth, arguing that each of its facilities, including the Facility at issue, was operated independently and that they "did not benefit from an umbrella of centralized management and controlled interaction." Taxpayer further asserted that the facilities "did not benefit from economies of scale because they did not engage in the same business." Thus, Taxpayer asserted that there was no unitary relationship between its operations outside of Indiana and its Indiana LLC's operations because they "were not functionally integrated;" they "did not have centralized management;" and they "did not benefit from economies of scale."

The Department is not able to agree. Upon reviewing Taxpayer's documentation, its documentation demonstrates that Taxpayer has been in the entertainment business, offering its customers various forms of entertainment. Taxpayer publicly holds itself out as a "diversified... entertainment company engaged in the ownership and operation of [various facilities] and the development of other [entertainment] related opportunities." Thus, the Indiana LLC's business operations and Taxpayer's operations outside of Indiana essentially align with each other. Taxpayer's documentation also states that the facility owned by the Indiana LLC is Taxpayer's "first company-designed and developed" facility. Thus, the Department concludes that Taxpayer and the Indiana LLC are functionally integrated. Additionally, Taxpayer's documentation shows that the Indiana LLC was formed in the State of Indiana in 1995 and was initially treated as a partnership (consisting of two partners), in which Taxpayer owned the majority interest and, which subsequently was treated as a disregarded entity and became a division of Taxpayer after Taxpayer acquired the remaining interest from the other partner. Taxpayer may assert that there is no centralized management with respect to each of facilities, but Taxpayer's documentation shows that Taxpayer has designed, developed, controlled and was involved in the Indiana LLC's business operations. Moreover, Taxpayer's annual report to the U.S. Securities and Exchange Commission, in relevant part, states:

> [Taxpayer's] strategic plan is to continue to grow its [] business by (i) expanding and increasing the utilization of its existing properties, (ii) developing real estate at its existing properties and developing projects at new sites, and (iii) making selected acquisitions, principally in [its] industry, to diversify its operations and to achieve economies of scale.

Specifically, Taxpayer planned and constructed another facility adjacent to the Facility at issue. Similar to the Indiana LLC, that facility adjacent to the Facility at issue also offers its customers the same form of entertainment. Taxpayer may claim that it could not operate that facility. However, Taxpayer was the owner of that facility and that facility offers essentially the same entertainment as Taxpayer initially planned. Thus, Taxpayer maintains its control over the use of that facility. The shared use of the property at the same location further maximizes the value of Taxpayer's entertainment business operations, including the Facility at issue. It also makes Taxpayer's

entertainment business more attractive and more competitive than its competitors in the similar entertainment business, which was part of Taxpayer's business strategy. Thus, Taxpayer may assert that it is not involved in the day-to-day operations of each of the facilities, but it plans, develops, controls, and manages every aspect of its entertainment business operations to achieve economies of scale as evidenced by its documentation.

Accordingly, Taxpayer's documentation demonstrates that there is functional integration, centralization of management, and economies of scale within its business enterprise. Taxpayer and the Indiana LLC thus are in a unitary business.

2. Sale of the Facility at Issue ("1999 Asset Sale").

At rehearing, Taxpayer asserted that "[t]o be subject to Indiana's adjusted gross income tax, a taxpayer's income must be classified as income derived from sources within the state and this classification must have been made prior to deciding whether the income was business" pursuant to Chief Industries, Inc. v. Indiana Dep't of State Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000). Taxpayer argued that the income attributed to its 1999 asset sale was an installment sale contract, which dealt with real property outside of Indiana, and that its income from the 1999 asset sale was not attributable to Indiana and should be allocated to the state outside of Indiana under IC § 6-3-2-2.2(a) according to Chief Industries.

Taxpayer's reliance on Chief Industries and IC § 6-3-2-2.2(a), however, is misplaced. In Hunt, the Indiana Tax Court stated that "in order to determine what income is attributable to Indiana, it must first be determined whether the income sought to be attributed is business or nonbusiness income." Hunt Corp., 709 N.E.2d at 771. In May, the Indiana Tax Court stated that, "[p]ursuant to [IC] § 6-3-2-2, for the purpose of calculating a corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while nonbusiness income is allocated to Indiana or another state." May Dep't Store, 749 N.E.2d 651 at 656.

In Chief Industries, the Indiana Tax Court interpreted statutory language – "having a situs in this state" – under IC § 6-3-2-2(a)(5); IC § 6-3-2-2.2 did not exist at that time. The statutory language – "having a situs in this state" – was removed from IC § 6-3-2-2(a)(5) by the Indiana General Assembly (the "General Assembly") in 1989 and was replaced with a conditional phrase – "if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter."

The General Assembly added IC § 6-3-2-2.2 as a new provision to complement IC § 6-3-2-2 in determining whether income is "attributable to the state of Indiana." IC § 6-3-2-2.2 cannot be applied in isolation but rather must be applied in the context of IC § 6-3-2-2 (1989) which, in relevant part, states:

> (a) With regard to corporations and nonresident persons, " adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
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> (1) income from real or tangible personal property located in this state;
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> (2) income from doing business in this state;
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> (3) income from a trade or profession conducted in this state;
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> (4) compensation for labor or services rendered within this state; and
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> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property, **if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter**.
>
> In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provision of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. (**Emphasis in original 1989 amendment**) (Emphasis added).

IC § 6-3-2-2.2(a) (1989) states:

> Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property are attributable to this state if the security or sale property is located in Indiana. (Emphasis added).

Since 1989, the General Assembly only made one correction with respect to the above statutory language–changing the phrase "the provision of subsections (h) through (k)" to "the provisions of subsections (h) through (k)" in 1993. The above mentioned pertinent statutory language remained unchanged in 1999 and thus is applicable in this instance.

Applying the 1989 statute, the Tax Court in Sherwin-Williams stated that:

> 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. Indiana has adopted a standard form apportionment method that multiplies the business income derived from sources both within and without Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. Sherwin-Williams, 673 N.E.2d at 851.

Based on all of the above, if the corporation's income is "nonbusiness income," it is allocated pursuant to IC §

6-3-2-2(h) through(k); if the corporation's income is "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 pursuant to IC § 6-3-2-2(b).

In this instance, Taxpayer stated that, before 1990, its sole business was operating the Facility at issue. Thus, prior to the 1999 sale of the Facility at issue, Taxpayer used this Facility for its business to generate its business income, and thus proceeds of the sale was Taxpayer's business income pursuant to Indiana statute, regulations, and May. Taxpayer derived its business income from sources both within and without Indiana since this Facility was located outside of Indiana. Therefore, its "adjusted gross income derived from sources within the state of Indiana is determined by an apportionment formula." The income from Taxpayer's 1999 asset sale should have been apportioned under IC § 6-3-2-2(b).

IC § 6-3-2-2(b) (1999) states, in relevant part:

> Except as provided in subsection (l), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3).... (Emphasis added).

IC § 6-3-2-2(e), in relevant part, states:

> (e) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. **Sales include receipts from intangible property and receipts from the sale or exchange of intangible property**. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. **Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personable property are attributable to Indiana under section 2.2 of this chapter**. (**Emphasis in the 1989 amendment and remains unchanged in 1999**).

IC § 6-3-2-2.2(a) further states:

> Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property are attributable to this state if the security or sale property is located in Indiana.

In this instance, the Department's audit noted that Taxpayer's 1999 "sale was treated as an installment sale for federal purposes and recognized a gain [] in year 2000." Upon reviewing Taxpayer's documentation, its documentation demonstrates that the 1999 sale dealt with real property outside of Indiana. While the receipt from the 1999 sale is business income and is apportionable under IC § 6-3-2-2(b), the receipt, for apportionment purposes, is not attributable to Indiana. Pursuant to IC § 6-3-2-2(e) and IC § 6-3-2-2.2(a), the asset in question of the 1999 Asset Sale dealt with real property outside of Indiana. Thus, for apportionment purpose, Taxpayer's receipts from the 1999 sale, rather than being included in the numerator (which is the total sales of Taxpayer in this state during the taxable year), should only have been included in the denominator (which is the total sales of Taxpayer everywhere during the taxable year).

The Department's audit correctly reclassifies income from Taxpayer's 1999 sale as business income. However, upon further reviewing the Department's audit report, the report did not reflect the reclassification in computing the apportionment factors–specifically the sales factor–to properly attribute the receipts from the 1999 sale. Accordingly, the Department will recalculate the apportionment factors for the years affected in a supplemental audit.

3. Sales of Two Parcels adjacent to the Facility At Issue.

Taxpayer claimed that the income attributed to the sales of two parcels of land adjacent to the Facility at issue was non-business income pursuant to 45 IAC 3.1-1-41, example 4, and 45 IAC 3.1-1-58. Taxpayer stated:

> The vacant land adjacent to [the Facility at issue] was used in [Taxpayer's] business when it operated [its entertainment] business. After [Taxpayer] sold [the Facility at issue] in 1999, it did not use the adjacent vacant parcels in the regular course of business for its remaining business divisions. [Taxpayer] held onto the parcels solely for investment purposes: in the event that [the state where the real property is located changed its state law], [Taxpayer] would have developed the properties for [another entertainment] purpose.

Taxpayer asserted that "at the time that the parcels were converted into investment property, they were removed from the property factor, and any income from the property, including income from the sale of the property, was nonbusiness income.... Thus, the income from the sale of the [two] parcels is nonbusiness income and cannot be apportioned to Indiana."

45 IAC 3.1-1-41 provides:

> The property factor includes all property owned or rented by the taxpayer which is actually used or is available for or capable of being used to produce business income. Property held as reserves or stand-by facilities, or for a reserve source of materials, is included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are included in the factor. Property under construction

during the tax period (except inventoriable goods in process) are includable only if and only to the extent it is actually used to produce business income.

Property used or held for the production of business income must remain in the property factor until its permanent withdrawal is established by an identifiable event such as its sale or conversion to the production of nonbusiness income, such as a lease for an extended period of time.

Examples:

(1) The taxpayer closed one of its plants and held the property idle until it was sold five months later. The value of the property is included in the property factor until the date of sale.

(2) Same as in (1) [subsection (1) of this section], except the property is leased until sale. The rental income is business income and the property remains in the property factor until sale.

(3) Same as in (1) [subsection (1) of this section], except the property remains idle for more than 5 years pending sale. At the end of the first 5 years, it is removed from the property factor.

(4) The taxpayer ceases to operate one of the divisions of its business, but holds part of the property of such division solely for investment purposes. It does not thereafter use the property in the regular course of business. At the time the property is converted to investment property, it is removed from the property factor. Any income from the use of the property as an investment is nonbusiness income. (Emphasis added).

45 IAC 3.1-1-58 states:

Capital gains and losses from the sale of real property formerly used to produce nonbusiness income are allocated to the state where the property is located. Capital gains and losses from the sale of nonbusiness tangible personal property are allocated to Indiana if the property had a situs in the state when sold, or if the taxpayer's commercial domicile is in Indiana and it is not taxable in the state in which the property had a situs. Capital gains and losses from sales of nonbusiness intangible property are allocated to Indiana if the taxpayer's commercial domicile is in this state.

Taxpayer's reliance on 45 IAC 3.1-1-41, example 4, and 45 IAC 3.1-1-58 is misplaced. The second paragraph to 45 IAC 3.1-1-41 states that "[p]roperty used or held for the production of business income must remain in the property factor until its permanent withdrawal is established by an identifiable event such as its sale or conversion to the production of nonbusiness income, such as a lease for an extended period of time." In this instance, Taxpayer stated that, before these two parcels were sold to unrelated third parties, it used these two parcels in the regular course of its entertainment business. Taxpayer further stated that it continued to hold onto the land and that it "would have developed the properties for [another entertainment] purpose" pending the change of the state law. Holding onto the land – pending the state law change – was not "an identifiable event" which established "its permanent withdrawal," and converted its use of these two parcels to the production of nonbusiness income.

In short, Taxpayer's income attributed to the 2000 and 2004 sales of the parcels adjacent to the Facility at issue was business income and should be apportioned pursuant to Indiana law.

4. Termination Fee.

The Department's audit determined, and the LOF concluded, that Taxpayer's income attributed to the Termination Fee was business income. Specifically, the LOF concluded that the Termination Fee was business income under the functional test of May.

Taxpayer, to the contrary, maintained that it properly classified the income attributed to the Termination Fee as nonbusiness income. Specifically, Taxpayer asserted that the Termination Fee was nonbusiness income under both the transactional test and the functional test. Taxpayer further asserted that since both parties to the merger agreement were not domiciled in Indiana, the Termination Fee was not subject to Indiana income tax because it qualified as "nonbusiness income" and, therefore, should have been allocated to the state of Taxpayer's domicile.

Both Taxpayer and the Department agreed that the Termination Fee was not business income under the transactional test. Therefore, this Supplemental Letter of Findings focuses on the issue in dispute: whether the Termination Fee was business income under the functional test pursuant to Indiana statute, regulations, and the May decision.

According to IC § 6-3-1-20, "'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." "[N]onbusiness income means all income other than business income." IC § 6-3-1-21.

"Termination fee" is defined, as follows:

A fee paid if a party voluntarily backs out of a deal to sell or purchase a business or a business's assets. • Termination fees are [usually] negotiated and agreed on as part of corporate merger or acquisition negotiations. The fee is designed to protect the prospective buyer and to deter the target corporation from entertaining bids from other parties. – Also termed break-up fee.

Black's Law Dictionary 1511 (8th ed. 2004).

In this instance, Taxpayer claimed that the income attributed to the Termination Fee was nonbusiness income because the Termination Fee did not meet the requirements of the functional test pursuant to May.

Specifically, Taxpayer asserted that, under May, "when applying the functional test, the initial question is whether there was a disposition of an asset." Taxpayer further claimed that it "is in the business of operating [entertainment facilities] not collecting termination fees." Taxpayer maintained that:

> When it negotiated its merger agreement with [Seller], it negotiated for a Termination Fee to be paid if the merger was not consummated. By including this fee in the agreement, [Taxpayer] clearly considered the possibility that [Seller] would terminate the merger agreement, and planned for that possibility.

Taxpayer further asserted that "planning for the collection of a fee is insufficient to show that the transaction occurred in the regular course of the taxpayer's business" because "[t]he benefit to [Taxpayer laid] in the consummation of the merger, not in its termination."

The Department, however, is not able to agree. Taxpayer stated that it entered into the merger agreement to "gain access" to "new market[s]" in its industry. Taxpayer's documentation, in relevant part, states that its "strategic plan is to continue to grow its... business by... making selected acquisitions, principally in [its] industry, to diversify its operations and to achieve economies of scale." Thus, whether Taxpayer can successfully complete its merger determines whether its business can prosper. Before Taxpayer can manage its merged business and gain access to properties in new markets, it would have incurred expenses. Those expenses also include expenses incurred in the process of acquiring Taxpayer's business assets, which would have generated business income for Taxpayer if the deal went through. Thus, Taxpayer's entertainment business includes selectively targeted mergers to increase its market share.

Unlike the taxpayer in May who received income from an involuntary sale of its asset, Taxpayer, in this instance, contemplated and initiated the merger to increase the market share of its business. In a friendly merger negotiation, both seller and purchaser usually consider a merger to be beneficial to both parties' business; two companies (the seller and the buyer) would have combined and grown as a result. Taxpayer's above statements demonstrated a common business practice to ensure a satisfactory result to both the seller and the purchaser, so neither one of them will walk away empty-handed. In this instance, Taxpayer stated that, during the merger negotiation, Taxpayer was asked to increase its offer several times when Seller received higher bids from other bidders. However, Taxpayer eventually declined. Taxpayer received a large sum of payment under the merger agreement as a result; the money was to compensate Taxpayer and also was used for Taxpayer's business operations. Taxpayer negotiated and Seller agreed to the Termination Fee to ensure the desired result–completion of the acquisition. Thus, the Termination Fee was intended to prevent Seller from entertaining higher bidders and breaching the merger agreement. It also serves as a remedy to compensate Taxpayer for its effort and costs incurred during the acquisition. Thus, the Termination Fee was essential and integral part of Taxpayer's business operations.

Accordingly, under the functional test, the income attributed to the Termination Fee is business income; Taxpayer's income attributed to the Termination Fee should have been apportioned pursuant to IC § 6-3-2-2(b).

In conclusion, the income attributed to the above mentioned Asset Sales and Termination Fee was Taxpayer's business income and was apportionable to Indiana. However, the Department's audit did not reflect the reclassification of the receipt of the 1999 Asset Sale in computing the apportionment factors. Thus, the Department will recalculate the apportionment factors in a supplemental audit.

FINDING

Taxpayer's protest of the Department's reclassification of its income attributed to the Asset Sales and the Termination Fee is respectfully denied. However, upon further reviewing the audit report, the Department did not properly compute the apportionment factors. Thus, the Department will recalculate the apportionment factors in a supplemental audit.

II. Corporate Income Tax – Add-Back County Tax – Net Operating Losses.

DISCUSSION

The LOF concluded that Taxpayer was not entitled to a refund of the claimed credits (overpayments) regarding the county tax it mistakenly added back to the returns at issue. Taxpayer subsequently submitted its amended returns for the years at issue and requested a rehearing.

At rehearing, referring to IC § 6-3-1-3.5(b)(3), Taxpayer maintained that it is entitled to a credit or refund for county taxes that it paid but mistakenly added back in calculating Indiana income taxes. Taxpayer explained that, for the years at issue, it had net operating losses and the amount of the county taxes it mistakenly added back would have changed its carryovers of the net operating losses, which could reduce its potential tax liabilities for the tax years at issue. This Supplemental Letter of Findings focuses on whether Taxpayer was entitled to a reduction (in the amount equal to the county taxes paid but mistakenly added back to its federal taxable income in calculating its state income taxes) to properly calculate the carryovers of its net operating losses and to determine "the correct amount of tax owed." Please refer to LOF 02-20100199 for discussion of Taxpayer's argument concerning its claim for refund.

The Internal Revenue Code requires taxpayers to report and pay their federal income tax when their gross income exceeds a certain amount. For state income tax purposes, the presumption is that the taxpayers properly and correctly file their federal income tax returns and, thus, to efficiently and effectively compute what is considered the taxpayers' Indiana income tax, the Indiana statute refers to the Internal Revenue Code. Thus, IC §

6-3-1-3.5(b) simply provides the starting point for determining Taxpayer's taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows...."

Additionally, Indiana follows the federal rules concerning the application of NOLs. In Phoenix Coal Co. v. Comm'r, 231 F.2d 420 (2d Cir. 1956), the taxpayer reported income and paid a tax thereon in 1945 and 1946, but, in 1947 and 1948, the taxpayer reported a net operating loss. Id. at 421. The taxpayer in Phoenix Coal "carried back to 1945 a portion of the 1947 net loss sufficient to wipe out net income in 1945, and then carried back the remainder of the 1947 loss to 1946." Id. The taxpayer's "1948 net loss was then carried back in toto to reduce further the 1946 net income." Id. The taxpayer, in Phoenix Coal, then "filed an application for a tentative carry-back adjustment based upon net operating loss carry-backs from 1947 to 1945 and 1946." Id. The Commissioner of Internal Revenue ("Commissioner") made a refund of the entire income tax paid for 1945 and additional refund for 1946. However, the Commissioner later recomputed 1945 income and disallowed certain deductions, resulting in less NOLs available to be carried back and applied in 1946. As a result, the taxpayer was assessed a deficiency for 1946. The court found that the Commissioner, in making adjustments of 1946 income tax and in determining a deficiency for 1946, properly considered items on 1945 return, though adjustment of the 1945 return was barred by the three-year limitation period. Id. The court concluded that "[t]his assessment of deficiency came less than three years after the filing of the 1946 return, but more than three years after the filing of the 1945 return." Id.

In this instance, Taxpayer maintained that it mistakenly added back the county taxes it paid to its federal taxable income in calculating its state income taxes, which reduced its net operating losses available to be carried over. Thus, Taxpayer provided the amended income tax returns for those years, stating that it was "entitled to a credit or refund in the amount of county [] tax that should not have been added back when it determined its Indiana adjusted gross income." Taxpayer believed that this erroneous calculation affected its NOLs which could be carried over to different tax years to calculate the correct amount of tax owed.

Upon reviewing Taxpayer's documentation, its documentation showed that the county tax it mistakenly added back to the Indiana returns did affect its NOL calculation. Pursuant to Phoenix Coal, the Department will adjust Taxpayer's NOLs for those years at issue based on the information submitted. Thus, Taxpayer's protest is sustained to the extent that Taxpayer's NOLs will be recalculated to correct where Taxpayer had mistakenly added back the amount of county taxes it paid to its federal taxable income. The Department will make the appropriate adjustments in a supplemental audit. Nonetheless, the statute of limitations and requirements in claiming any tax refund remains unchanged and applicable regarding Taxpayer's refund claim, if any.

FINDING

Taxpayer's protest is sustained to the extent that Taxpayer's NOLs will be recalculated to correct where Taxpayer had mistakenly added back the amount of county taxes it paid to its federal taxable income. The Department will make the appropriate adjustments in a supplemental audit.

III. Tax Administration – Interest.

DISCUSSION

The Department assessed interest on the tax liabilities. Taxpayer protested the imposition of interest.

IC § 6-8.1-10-1(a) provides, as follows:

If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on the person's return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

Pursuant to IC § 6-8.1-10-1(e), the Department does not have the authority to waive the interest.

FINDING

Taxpayer's protest regarding the imposition of interest is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest of Issue I, reclassification of the income attributed to the Asset Sales and the Termination Fee, is respectfully denied. However, the Department's audit did not properly compute the apportionment factors, and thus the Department will recalculate the apportionment factors and make the adjustments accordingly in a supplemental audit, as provided in Issue I.

Taxpayer's protest of Issue II is sustained to the extent that Taxpayer's NOLs will be recalculated to correct where Taxpayer had mistakenly added back the amount of county taxes it paid to its federal taxable income. The Department will make the appropriate adjustments in a supplemental audit.

Taxpayer's protest of Issue III, imposition of interest, is respectfully denied.

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