DEPARTMENT OF STATE REVENUE

02-20110556.LOF
03-20120568.LOF

Letters of Findings: 02-20110556; 03-20120568
Corporate Income and Withholding Tax
For the 2002 through 2007 Tax Years

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ISSUES

I. Corporate Income\Withholding Tax–Exclusion of Entities.

Authority: IC § 6-3-1-3.5; IC § 6-8.1-5-1; IC § 6-8.1-5-2; IC § 6-8.1-9-1; I.R.C. § 1361.

Taxpayer protests the Department's decision to exclude a subsidiary corporation and two limited liability companies from its corporate income tax returns.

II. Corporate Income\Withholding Tax–Apportionment: Payroll Factor Numerator.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; IC § 9-24-11-4; IC § 9-24-16-1; IC § 9-24-16-2; IC § 9-24-9-2; 45 IAC 3.1-1-49; 45 IAC 3.1-1-97; 45 IAC 3.1-1-102.

Taxpayer protests the Department's inclusion of a certain employee's salary in the payroll factor numerator of its corporate income tax returns.

III. Corporate Income\Withholding Tax–"Partnership Income."

Authority: IC § 6-3-1-19; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; IC § 6-3-4-10; IC § 6-3-4-11; IC § 23-16-1-7; IC § 23-16-1-8; IC § 23-16-1-9; IC § 23-16-4-3; IC § 23-18-1-10; IC § 23-18-4-1; Park 100 Dev. Co. v. Ind. Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Five Star Concrete, L.L.C. v. Klink, Inc. 693 N.E.2d 583 (Ind. Ct. App. 1998); Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); Chief Industries v. Indiana Dep't of Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000); May Dep't Stores Co. vs. Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); Riverboat Development, Inc. v. Indiana Dep't of State Revenue, 881 N.E.2d 107 (Ind. Tax Ct. 2008); 45 IAC 3.1-1-15; 45 IAC 3.1-1-106; 45 IAC 3.1-1-153; Letter of Findings 96-0632 ITC (Nov. 1, 1998); Letter of Findings 00-0379 (Feb. 1, 2004); Letter of Findings 02-0102 (July 1, 2004); Letter of Findings 02-0022 (July 1, 2004); Letter of Findings 04-0241 (April 1, 2006); and Letter of Findings 06-0310 (May 23, 2007).

Taxpayer protests the Department's inclusion of its share of a limited liability company's income in its corporate income tax returns.

IV. Tax Administration–Penalties.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the penalties for its failure to timely file corporate income tax returns and the imposition of negligence penalties on the withholding tax deficiencies.

STATEMENT OF FACTS

Taxpayer is an S corporation in a group of related entities involved in leasing, fractional ownership, and chartering of airplanes. The group consists of Taxpayer, two other corporations, and five limited liability companies ("LLCs"). One of the corporations is a subsidiary corporation that is wholly owned by Taxpayer. Taxpayer and this subsidiary corporation owned two of the LLCs (hereafter collectively "LLCs A & B"). Taxpayer and the other corporation own one LLC ("LLC C"). The remaining two LLCs are taxed as entities disregarded from Taxpayer. Taxpayer and the other two corporations in the group did not elect to file Indiana income tax returns on a consolidated basis, but instead elected to file Indiana income tax returns on a separate return basis.

During an investigation of Taxpayer's affiliate corporation, the Indiana Department of Revenue ("Department") discovered that Taxpayer was a non-filer for Indiana for the 2002 to 2007 tax years. Thus, Taxpayer was asked to file Indiana adjusted gross income tax returns for these tax years. Since Taxpayer's corporate income tax returns were not filed by their respective due dates, the Department issued failure to timely file return penalties for the 2002 through 2007 tax years. The Department also conducted a corporate income tax investigation of the Indiana adjusted gross income tax returns.

As a result of the investigation, the Department adjusted Taxpayer's adjusted gross income and apportionment factors increasing Taxpayer's Indiana apportioned taxable income for the 2002, 2006, and 2007 tax years. Since Taxpayer is an S corporation, the additional Indiana adjusted gross income resulted in Taxpayer owing additional nonresident shareholder withholding tax. Thus, the Department issued proposed assessments for the additional nonresident shareholder withholding tax, interest, and penalties due as a result of the adjustments to Taxpayer's Indiana adjusted gross income. Taxpayer protested the adjustments to its Indiana adjusted gross income, the resulting withholding tax and penalties due from the adjustments, and the assessment of the failure to timely file corporate income tax return penalties. An administrative hearing was conducted. These Letters of Findings result. Additional facts will be supplied as required.

I. Corporate Income\Withholding Tax–Exclusion of Entities.

DISCUSSION

The Indiana adjusted gross income tax returns that Taxpayer filed included the activities of Taxpayer's wholly-owned subsidiary corporation and the activities of "LLCs A & B" (hereafter collectively "Sub Corp"). During its investigation of the returns, the Department excluded "Sub Corp's" activities from Taxpayer's returns for the 2002 to 2005 tax years. The Department determined that "Sub Corp's" activities could not be included in the returns because "Sub Corp" had filed separate C corporation income tax returns and the three-year statute of limitations had expired for these returns. Taxpayer protests the Department's decision to exclude "Sub Corp's" activities from Taxpayer's corporate income tax returns.

Taxpayer maintains that the separate Indiana C corporation returns filed for "Sub Corp" do not trigger the running of the statute of limitations for Taxpayer. During the hearing, Taxpayer presented its timely filed qualified subchapter S subsidiary election ("QSub election"), Internal Revenue Service Form 8869, that it filed for "Sub Corp" in 2000. Taxpayer asserts that because of this "QSub election," "Sub Corp" is considered a disregarded entity. As an entity disregarded from Taxpayer, "Sub Corp" is required to report its activities with Taxpayer's activities on Taxpayer's return. Taxpayer and "Sub Corp" correctly filed "Sub Corp's" activities on Taxpayer's federal return. Thus, Taxpayer states that "Sub Corp's" filing of separate C corporation Indiana returns was incorrect. According to Taxpayer, the incorrectly filed Indiana returns are void returns that effectively make "Sub Corp" a non-filer for Indiana.

As a threshold issue, it is the Taxpayer's responsibility to establish the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Pursuant to I.R.C. § 1361(b)(1), a qualified subchapter S subsidiary ("QSub") is a wholly-owned subsidiary of a parent S corporation which the parent corporation elected to treat as an entity disregarded from the parent corporation. For federal and state purposes, a QSub is not treated as a separate entity, and all of its assets, liabilities, and tax items are treated as if they are the parent S corporation's. I.R.C. § 1361(b)(3)(A). Therefore, for federal and state tax purposes, the QSub is disregarded as an entity separate from the parent S corporation, and all of the QSub's tax information is reported on the parent S corporation's informational tax returns.

Taxpayer made a timely QSub election for "Sub Corp" for the tax years in question and correctly filed its federal income tax returns with "Sub Corp's" information reported on Taxpayer's return. Therefore, "Sub Corp" was an entity disregarded from Taxpayer that was required to report its tax information on Taxpayer's return, and "Sub Corp's" filing of the separate Indiana corporate income tax returns was incorrect. "Sub Corp's" income, activities, and tax items are considered Taxpayer's income, activities, and tax items. Taxpayer is required to report the income, activities, and tax items in the filing of its return.

While the statute of limitations has expired for "Sub Corp" to amend its incorrectly filed separate returns to zero, this fact does not affect Taxpayer's return. "Sub Corp" and Taxpayer are distinct taxpayers. Pursuant to I.R.C. § 1361, "Sub Corp's" income, activities, and tax items are part of Taxpayer's federal taxable income. Since the calculation to determine Taxpayer's Indiana adjusted gross income begins with Taxpayer's federal taxable income, these items that are part of Taxpayer's federal taxable income are also part of Taxpayer's Indiana adjusted gross income. See IC § 6-3-1-3.5(b) (defining adjusted gross income for corporations as a taxpayer's federal taxable income under I.R.C section 63 with a number of enumerated adjustments.) Therefore, "Sub Corp's" income, activities, and tax items should be included in Taxpayer's Indiana corporate income tax returns. Accordingly, Taxpayer's protest of the Department's decision to exclude "Sub Corp's" income, activities, and tax items from Taxpayer's corporate returns is sustained.

Taxpayer made an alternative argument in regards to the amount of "LLCs A & B's" activities that were wrongly excluded. It is unclear from the investigation report whether the Department excluded only "Sub Corp's" ownership portion of "LLCs A & B's" activities or whether it excluded all of "LLCs A & B's" activities. Nevertheless, since Taxpayer's protest was sustained on the issue of "Sub Corp" activities being included in the return, this issue becomes moot. However, the audit division is requested to review the documentation, and verify that both the "Sub Corp's" seventy-five percent ownership portion and Taxpayer's twenty-five percent ownership portion of "LLCs A & B" activities–i.e., one hundred percent of the activities–are included in the return.

FINDING

Taxpayer's protest of the Department's decision to exclude the activities of the wholly-owned subsidiary corporation and "LLCs A & B" from the corporate returns is sustained.

II. Corporate Income\Withholding Tax –Apportionment: Payroll Factor Numerator.

DISCUSSION

The Department made adjustments to Taxpayer's payroll factor numerator. The Department included additional wages in the Indiana numerator for the 2002 tax year. The Department also included the wages of an additional employee in the Indiana numerator for the 2006 and 2007 tax years. This decision, which increased Taxpayer's payroll factor, resulted in an increase in Taxpayer's Indiana apportionment. This increase in Taxpayer's Indiana apportionment leads to an increase in Taxpayer's apportioned taxable income. Based upon this increase in Taxpayer's apportioned taxable income, the Department issued Taxpayer assessments for the

additional nonresident withholding tax due. Taxpayer protests the adjustments and asserts that the adjustments were incorrect.

Indiana imposes a tax on each corporation's adjusted gross income attributable to "sources within Indiana." IC § 6-3-2-1(b). Where a corporation receives income from both Indiana and out-of-state sources, the amount of tax is determined by a three-factor apportionment formula established by IC § 6-3-2-2(b) (as in effect for the tax years in question). That formula operates by multiplying a taxpayer's total business income by a fraction composed of a property factor, a payroll factor, and a sales factor.

The "payroll factor" consists of a fraction, "the numerator of which is the total amount paid in [Indiana] during the taxable year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year." IC § 6-3-2-2(d).

A. 2002 Adjustment.

The Department determined that, for purposes of calculating taxpayer's Indiana tax liability, the amount of Indiana wages reported in payroll numerator was incorrect. The Department's investigation report states, as follows (numbers rounded):

> [Taxpayer] reported [$75,000] in Indiana wages for its Indiana payroll factor. In that same year [Taxpayer] paid $18,000 in total withholding taxes... Dividing the Indiana withholding tax . . . by [the respective rate] yields taxable wages of $420,000. The taxpayer's reported wages for the audit period was $450,000. Based on the taxes withheld, $420,000 of that amount is treated as Indiana wages per the investigation.

An employer paying wages is required to withhold Indiana state and county withholding tax on the wages paid to an employee that are either earned by an employee working in Indiana or an employee that is an Indiana resident. 45 IAC 3.1-1-97. The employer withholds county taxes based upon the employee's county of residence and the employee's county of principal work activity that the employee declared to the employer on a Form WH-4. See 45 IAC 3.1-1-97 & 45 IAC 3.1-1-102. Accordingly, the Department determined that these wages–from which Taxpayer withheld amounts for the Indiana state and county taxes–were Indiana wages and adjusted the payroll numerator.

Again, it is a taxpayer's responsibility to establish that the existing withholding tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

During the protest, Taxpayer provided a schedule to detail its payment of wages for the 2002 tax year. The schedule reflected [$75,000] of Indiana wages and [$375,000] of Nevada wages. Taxpayer maintains that the [$350,000] adjusted by the Department is attributable to the wages Taxpayer paid to one of its employees, Taxpayer's President, who was based at the Taxpayer's corporate head quarters in Las Vegas, Nevada. Taxpayer contends these wages are allocable to Nevada and not to Indiana.

Other than its bear assertions, Taxpayer has not presented evidence to demonstrate that Taxpayer's corporate headquarters were in Nevada or that this employee was based in Las Vegas. Moreover, for the 2002 tax year this employee held a valid Indiana Identification Card listing a principal address in Indiana. IC §§ 9-24-16-1, -2 provide that to obtain an Indiana identification card you must be a resident of Indiana and you must provide your principal address on your application. IC § 9-24-11-4(b) also provides that "[a]n individual may not hold a driver's license and an identification card issued under IC 9-24-16 at the same time." Furthermore, there is nothing in the Department's records to indicate that Taxpayer or this employee claimed that the Indiana state and county withholding performed for this employee was improper. Since Taxpayer failed to provide documentation that supported its assertions, Taxpayer has failed to meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1(c). Based upon the information available, the Department finds no reason to disagree with the audit's conclusion that these wages are properly allocated to Indiana in the payroll numerator.

Accordingly, Taxpayer's protest of the adjustment to its payroll numerator in the 2002 tax year is respectfully denied.

B. 2006 and 2007 Employee Adjustment.

The Department determined that, for purposes of calculating taxpayer's Indiana tax liability, the wages of an additional employee should be included in payroll numerator. The Department found that this employee performed pilot services for two entities with Indiana domiciled flight operations, and that the employee reported an Indiana address on her FAA pilot's registration. Additionally, the audit found that "a sampling of the trip reports... shows that flights piloted by [this employee] usually originated or terminated... in Indiana.

The Department refers to 45 IAC 3.1-1-49(c), in relevant part, which states:

> If the employee's services are performed both within and without this state, the employee's compensation will be attributed to Indiana:
>
> (1) If the employee's base of operations is in Indiana, or
>
> (2) If there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in Indiana; or
>
> (3) If the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the employee's residence is in Indiana. The term "base

of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons, or to replenish stock or other materials, repair equipment, or perform any functions necessary to the exercise of his trade or profession at some other point or points. The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

Again, it is a taxpayer's responsibility to establish that the existing withholding tax assessment is wrong. IC § 6-8.1-5-1(c).

Taxpayer maintains that this employee's wages are allocated to Nevada for apportionment purposes. Taxpayer states that, during the 2006 and 2007 tax years, this employee was a resident of Nevada and that her base of operations was in Las Vegas, Nevada. Taxpayer claims that this employee "was employed by [Taxpayer] as an analyst and asset manager" and "her duties for [Taxpayer] include[d] analyzing and managing investments and asset acquisition and sales. At times [she] also flew the corporate aircraft used by [Taxpayer] to transport its employees to meetings or other office locations." During the protest, Taxpayer presented a six month excerpt of this employee's flight log for 2007. Taxpayer asserts that this flight log demonstrates that "[this employee spent only 20.7[percent] of her total hours flying and most of those flights hours occurred outside of the State of Indiana."

However, a review of the flight log presented demonstrates that this employee piloted a flight nearly every week for trips that originated from Indiana and terminated in Indiana. For illustrative purposes, a summary of her trips for the first two months are detailed as follows:

Trip 1: 1/8 depart Indiana for destination and return from destination to Indiana on 1/8.

Trip 2: 1/13 depart Indiana for destination and return from destination to Indiana on 1/13.

Trip 3: 1/18 depart Indiana for destination 1, leave destination 1 on 1/18 for destination 2, and return from destination 2 to Indiana 1/22.

Trip 4: 2/7 depart Indiana for destination and return from destination to Indiana on 2/7.

Trip 5: 2/11 depart Indiana for destination 1, leave destination 1 on 2/11 for destination 2, and return from destination 2 to Indiana 2/11.

Trip 6: 2/15 depart Indiana for destination and return from destination to Indiana on 2/16.

Trip 7: 2/22 depart Indiana for destination 1, leave destination 1 on 2/22 for destination 2, and return from destination 2 to Indiana 2/24.

Moreover, other than its own assertions, Taxpayer has not presented evidence demonstrating that this employee was either a resident of Nevada or that this employee was based in Las Vegas. For example, Taxpayer has not provided travel documents demonstrating how this employee would get from Indiana to Las Vegas and then from Las Vegas back to Indiana to pilot these flights that each week originated out of Indiana. Furthermore, for the years in question, this employee had a valid Indiana driver's license listing a home address in Indiana. IC § 9-24-9-2 provides that to obtain a driver's license you must provide your residence address on your application. Since Taxpayer failed to provide documentation that supported its assertions, Taxpayer has failed to meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1(c). Based upon the information available, the Department finds no reason to disagree with the audit's conclusion that this employee's wages are properly allocated to Indiana in the payroll numerator.

Accordingly, Taxpayer's protest of the adjustment to its payroll numerator in the 2006 and 2007 tax years is respectfully denied.

FINDING

Taxpayer's protest to the adjustment to its payroll numerator in the 2002, 2006, and 2007 tax years is respectfully denied.

III. Corporate Income\Withholding Tax–"Partnership Income."

DISCUSSION

The Department made adjustments to Taxpayer's corporate income tax returns to include Taxpayer's share of "LLC C's" activities in Taxpayer's apportionment factors. The Department determined that while Taxpayer had included its share of "LLC C's" income in its adjusted gross income prior to apportionment as a Taxpayer reporting income for a unitary partnership under 45 IAC 3.1-1-153(b), Taxpayer had failed to include any of "LLC C's" activities in its apportionment factors as also provided in 45 IAC 3.1-1-153(b). Therefore, the Department made adjustments to Taxpayer's apportionment factors to include Taxpayer's partner share of "LLC C's" activities. These adjustments to Taxpayer's apportionment factors lead to an increase in Taxpayer's taxable income apportioned to Indiana that resulted in the assessment of additional nonresident withholding tax. Taxpayer protests these adjustments to its apportionment factors and asserts that the adjustments were incorrect.

Again, it is the Taxpayer's responsibility to establish the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

IC § 6-3-1-19 provides:

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

The term "partner" means a member of a partnership.

(**Emphasis added**).

45 IAC 3.1-1-106 states:

(a) A partnership is not subject to the adjusted gross income tax. The partners will include their share of partnership income whether distributed or undistributed on their separate or individual returns.

(b) An individual will report as follows:

(1) The distributive share of a resident partner will be reported in total no matter where the partnership's business is located or in which states it does business.

(2) The distributive share of a nonresident partner will be reported after apportionment to determine the partnership income derived from sources within Indiana. This determination will be accomplished by use of the apportionment formula described in IC 6-3-2-2(b).

(3) A resident 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 62 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.

(4) A nonresident 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 62 of the Internal Revenue Code for taxes based on or measured by income 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 determined by use of the apportionment formula described in IC 6-3-2-2(b).

(c) **A corporate partner will report its share in accordance with section 153 of this rule**.

(**Emphasis added**).

45 IAC 3.1-1-153 further illustrates:

(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.

(**Emphasis added**).

Accordingly, for Indiana income tax purposes, "LLC C"–by electing to be taxed as a partnership at the federal level–is a partnership by definition and Taxpayer is a corporate partner in that partnership. "LLC C," a partnership under Indiana tax law, as required by IC § 6-3-4-10, filed an Indiana partnership return, Form IT-65, reporting all of its activities as "business income" attributable to Indiana under apportionment and requiring it to issue Form IT-65 IN K-1s ("Indiana K-1s") to its corporate partners.

Pursuant to IC § 6-3-4-11(a), Taxpayer, the corporate partner, is liable for "LLC C's" adjusted gross income tax in its separate or individual capacity and is required to report its portion of the partnership's Indiana business activity, as represented on the Indiana K-1, on Taxpayer's Indiana adjusted gross income tax return. Since Taxpayer owns ninety-nine percent of "LLC C," Taxpayer reports its ninety-nine percent partner share of "LLC C's" income and activities on its Indiana corporate income tax return. Taxpayer's affiliated C corporation–owning the other one percent–will report its one percent partner share of "LLC C's" income and activities on its Indiana corporate income tax return.

Taxpayer claims that the Department's adjustments to its apportionment factors are incorrect. Taxpayer first argues that "LLC C's" income should be included in the Indiana corporate returns on what Taxpayer refers to as a "post-apportionment basis." Alternatively, Taxpayer argues that "LLC C's" income should not be included in the Indiana returns based upon Riverboat Development, Inc. v. Indiana Dep't of State Revenue, 881 N.E.2d 107 (Ind. Tax Ct. 2008).

A. "Post-Apportionment Basis."

Taxpayer argues that when it reported its ninety-nine percent share of "LLC C's" income in its adjusted gross income prior to apportionment, as a taxpayer reporting income for a unitary partnership under 45 IAC 3.1-1-153(b), it did so wrongfully. Taxpayer asserts that if it is to report "LLC C's" income in its adjusted gross income that it should have reported it on a "post-apportionment basis" as a taxpayer reporting income for a non-unitary partnership as provided in 45 IAC 3.1-1-153(c)(1). Taxpayer maintains that, contrary to its initial reporting of the income and the Department's determination, its relationship with "LLC C" is not unitary and is similar to that of the limited partners referred to in Letter of Findings 96-0632 ITC, 22 Ind. Reg. 595 (Nov. 1, 1998); Letter of Findings 00-0379, 27 Ind. Reg. 1677 (Feb. 1, 2004); Letter of Findings 02-0102, 27 Ind. Reg. 3412 (July 1, 2004); Letter of Findings 02-0022, 27 Ind. Reg. 3410 (July 1, 2004); Letter of Findings 04-0241, 29 Ind. Reg. 2414 (April 1, 2006); and Letter of Findings 06-0310, 20070523 Ind. Reg. 045070261NRA (May 23, 2007).

A "limited partnership" is a partnership formed by two or more persons under the laws of Indiana (domestic limited partnership) or another state (foreign limited partnership) where at least one partner is a "general partner" and at least one partner is a "limited partner." IC § 23-16-1-9. IC § 23-16-1-7 provides "'General partner' means a person who has been admitted to a limited partnership or a foreign limited partnership as a general partner in accordance with the partnership agreement and is named in the certificate of limited partnership or similar instrument under which the limited partnership is organized, if so required." IC § 23-16-1-8 provides that "'limited partner' means a person who has been admitted to a limited partnership as a limited partner in accordance with the laws of Indiana or, in the case of a foreign limited partnership, in accordance with the laws of the state, foreign country, or other foreign jurisdiction under which the foreign limited partnership is organized." Limited partners will lose their status and become general partners as soon as they have any amount of control of the business of the limited partnership. See IC § 23-16-4-3.

Notwithstanding whether the general treatment for a limited partner would apply to Taxpayer's specific factual situation, Taxpayer has not shown that it was a "limited partner." Based upon a review of the documentation presented, "LLC C" was neither formed as a "limited partnership" nor was it set up or operated structurally similar to a "limited partnership." First, "LLC C" was formed as a limited liability company which vests all management rights with the members equally unless the articles of organization state otherwise. IC § 23-18-4-1. Taxpayer did not provide its "Articles of Organization," but instead presented its "Operating Agreement." As provided in the Operating Agreement, Taxpayer when first formed was one-hundred percent owned by Taxpayer, and after one year Taxpayer gave a one percent interest to its affiliated C corporation. Taxpayer's affiliated C corporation is owned eighty-three percent by Taxpayer and seventeen percent by either affiliated entities of Taxpayer or the officers and directors of Taxpayer and/or Taxpayer's affiliated entities. However, the "Operating Agreement" did not provide for or refer to a "general partner" member or a "limited partner" member. In fact, the "Operating Agreement" makes no distinction between the two members.

Second, even if "LLC C" had been formed with Taxpayer as a passive "limited partner," based upon the facts presented, Taxpayer's interest in "LLC C" is far more than a mere passive, investment only, "limited" interest. The Operating Agreement states that "the business of ["LLC C"] shall be conducted by the Mangers and all management of ["LLC C"] shall be vested in the managers.... The Managers shall be [President of Taxpayer–who

owns ninety-one percent of Taxpayer] and [President of Taxpayer's son–who also has ownership interests in Taxpayer and its affiliates]." Thus, "LLC C," in its Operating Agreement, designated the same individual that is also the President of Taxpayer as one of its mangers. This fact in and of itself defeats Taxpayer's argument that its interest in "LLC C" is to act as a passive limited partner. Accordingly, in this instance, the management activities of "LLC C's" and Taxpayer, its corporate partner, are essentially one and the same because they were managed by the same person. Additionally, all of the operational activities of "LLC C" were conducted on the premises of Taxpayer and its affiliates. The Department's audit investigation states:

> [Taxpayer and "LLC C"] had a unitary relationship. They had unity of ownership–ultimately ["LLC C"] was owned [nearly] 100 [percent] by [Taxpayer]. Unity of operation and use where present. ["LLC C"] was so tightly intertwined and identified with Taxpayer that it had no physical location outside the locations of [Taxpayer] and its affiliates. ["LLC C"] had no public identity apart of its owners and no operations outside the rental and investment interest of [Taxpayer]. Ultimately both entities were subject to the control of [President of Taxpayer/Manager of "LLC C" of 2001-2007], his family, and entities that he and his family directly or indirectly owned.

Accordingly, based upon the information provided, Taxpayer has much more than a mere investor, "limited partner" type relationship with "LLC C," and appears to have the majority and arguably controlling interest in "LLC C." Taxpayer has not presented any evidence that would rebut the auditor's determination of a unitary relationship. Since Taxpayer failed to provide any evidence that supported its assertions in rebuttal of the auditor's determination of a unitary relationship, Taxpayer has not meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1(c). Based upon the information available, the Department finds no reason to disagree with the audit's conclusion that Taxpayer, the corporate partner, was unitary with its partnership, "LLC C."

Accordingly, Taxpayer's protest of the Department's adjustments to its apportionment factor to include the activities of "LLC C," based upon "LLC C's" income being included on a "post-apportionment basis," is denied.

B. Exclusion of "LLC C's" Income.

Alternatively, Taxpayer asserts that it wrongfully included any part of its share of the income of "LLC C" in the Indiana adjusted gross income. Taxpayer maintains that not only should "LLC C's" activities be excluded from its apportionment factors, but "LLC C's" income should be excluded entirely from its Indiana adjusted gross income as well. Taxpayer claims that its partner share of "LLC C's" income is not Indiana source income for Taxpayer, but is Nevada source income based upon Riverboat Development, Inc. v. Indiana Dep't of State Revenue, 881 N.E.2d 107 (Ind. Tax Ct. 2008) and Chief Industries v. Indiana Dep't of Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000). Taxpayer contends that Riverboat Development, Inc. and Chief Industries stand for the general proposition that a taxpayer with income to report from an LLC or any other pass-through entity is deemed to have received income from intangible property that is always allocated or sourced to the state of the taxpayer's commercial domicile.

Taxpayer cites to the Tax Court's decision in Riverboat Development, Inc. In that case, the court held that a nonresident S corporation that owned a minority interest in a limited liability company doing business in Indiana did not have a withholding tax responsibility because the S corporation's interest was an intangible interest with the income deemed a "dividend." As such, the court found that the "dividends" should be sourced to the petitioner's domiciliary state and not to Indiana pursuant to IC § 6-3-2-2.

According to Taxpayer, the court in Riverboat Development, Inc. found that the membership interest in an Indiana LLC was intangible personal property under Indiana law. As Taxpayer explains, Riverboat Development, Inc. derived the income in question from intangible personal property which, under Indiana law, was only attributable to Indiana if Riverboat Development, Inc. had its commercial domicile in Indiana. Consequently, Taxpayer claims that the income was not Indiana-source income and was, therefore, not subject to [a] withholding requirement.

However, even if the Department were to accept Taxpayer's interpretation of Riverboat Development, Inc., the Department must point out that the facts of Riverboat Development, Inc. are distinguishable from the facts presented by Taxpayer in this administrative protest. For example, in Riverboat Development, Inc. the court found that the LLC's members were unrelated, that Riverboat Development, Inc. was a minority interest holder, and a presumed limited-partner (given that the LLC in Riverboat Development, Inc. elected partnership treatment) as it was deemed to merely have an investment interest in the Indiana riverboat that the court found transformed the riverboat's ordinary income into "dividends." Unlike the unrelated owners in Riverboat Development, Inc., Taxpayer and the other owner of "LLC C" were related entities. In fact, in this instance the "LLC C's" corporate partners are essentially one and the same, as mentioned previously. Unlike the "minority interest holder" in Riverboat Development, Inc. that was deemed to have mere investment interest, Taxpayer has much more than a mere investment interest in the operations of "LLC C."

As mentioned previously, Taxpayer has a majority and arguably controlling interest in "LLC C" with the operational activities of "LLC C" being conducted on the premises of Taxpayer and its affiliates. In its Operating Agreement, "LLC C" designated the same individual that is also the President of Taxpayer as one of its mangers. The Operating Agreement states that "the business of ["LLC C"] shall be conducted by the Mangers and all management of ["LLC C"] shall be vested in the managers.... The Managers shall be [President of Taxpayer–who

owns ninety-one percent of Taxpayer] and [President of Taxpayer's son–who also has ownership interests in Taxpayer and its affiliates]." This fact in and of itself defeats Taxpayer's argument that its interest in the LLC is that of a passive limited partner and therefore "intangible." Accordingly, the relationship between the parties in Riverboat Development, Inc. is substantively different from the relationship between Taxpayer and "LLC C," and, therefore, the Riverboat Development, Inc. case is not determinative for Taxpayer.

Additionally, Taxpayer's reliance on Chief Industries is mistaken because, as a preliminary matter, it should be noted that Chief Industries deals with a prior 1986 version of IC § 6-3-2-2.

Chief Industries held that the sale of an out-of-state corporation's stock in a related corporation lacked an Indiana tax situs, and thus could not be subjected to Indiana's adjusted gross income tax even though the corporation has a business situs in Indiana. The Tax Court concluded that the corporation's activities at its Indiana situs during the tax year were unrelated to the sales of the stock. The court concluded:

> As a matter of law, the Court finds that the capital gains earned by Chief from its sales of automotive common stock during the tax year had no tax situs in Indiana. Therefore, income from the sales is not "derived from sources within the state of Indiana" per section 6-3-2-2(a)(5). Lacking an Indiana source, the capital gains in question cannot be subjected to Indiana's adjusted gross income tax, as imposed by section 6-3-2-1(b). Chief Industries, 792 N.E.2d at 978-79.

The Tax Court's analysis in Chief Industries is classic gross income tax "situs" analysis and addresses the central question of whether the income at issue in that case had anything to do with Indiana. As the court's analysis above demonstrates, the sale of stock in Chief Industries was not related to the taxpayer's business activities in Indiana. Under gross income tax analysis, as an out-of-state company, the taxpayer's sale of stock could have been deemed to be business income and still not be subject to tax in Indiana if the critical transactions relating to the income were not situsted in Indiana.

The same cannot be said about the current adjusted gross income regime under which this protest falls. In this case, "LLC C's" income derives from activities directly related to its Indiana business activities. The income derived from these activities is business income, and therefore it is subject to formulary apportionment among all the states in which Taxpayer does business, including Indiana. Furthermore, even under Chief Industries' gross income tax analysis, the activities described in this current protest would have been situsted to Indiana and subject to adjusted gross income tax in Indiana.

A case more directly on point because it involves a non-resident corporate partner is Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766, 771 (Ind. Tax Ct. 1999). In Hunt the Tax Court found 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 non-business income." (**Emphasis added**). In fact, contrary to Taxpayer's suggestion, the 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. Additionally, in May Dep't Stores Co. vs. Dep't of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001), the court further explained "[p]ursuant 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." "**[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. (**Emphasis added**).

Lastly, Taxpayer argues that the Department is ignoring the form of its entities and that the established form must be respected. As such, Taxpayer is seeking a result based on its structure–an S corporation owning a partner's share of another pass-through entity–that is not otherwise directly permitted under Indiana law. In other words, Taxpayer, an S corporation owing an interest in a limited liability company, seeks to avoid its tax liability because the S corporation is to report the income of the pass-through entity. The Indiana Supreme Court discussed such a situation in Park 100 Dev. Co. v. Ind. Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981).

In Park 100, the Indiana Supreme Court was faced with a situation in which a partnership was itself a partner in a partnership and, on that ground sought to avoid Indiana taxes. Id. at 223. In other words, one pass-through entity was owned by another pass-through entity. The Supreme Court held that a partnership could not avoid its Indiana tax obligations by becoming a partner in a different partnership and funneling the business receipts through these pass-through entities. Id. at 223. Thus, using tiered pass-through entities to funnel income to another partner did not obviate the taxpayer's tax obligation. Id. The court reasoned that passing income through multiple layers of partnerships does not cancel out the tax liability associated with the original partnership's income. Id. As the court explained, "[T]he legislature did not intend for a corporation to escape the corporate tax liability indirectly by forming a two-tiered partnership when it did not allow a corporation to escape that liability as a direct or first-tier partner." Id.

Like the taxpayer in Riverboat Development, Inc., the taxpayers in Park 100 owned a minority ownership interest in the pass-through entity generating the taxable income. Nevertheless, the tax liability still passed through to the owners. Moreover, the court was not swayed by the fact that the tax liability stemmed from the

taxpayer's intangible interest in a partnership. The court's ultimate concern was avoiding the creation of law that would lead to untenable results, such as avoiding tax liabilities by funneling income through a partnership. At no point in the Park 100 decision did the court suggest that the character of the income, and resulting tax liability, was dependent upon whether the taxpayer's ownership interest in the partnership was tangible or intangible in nature. Nor was there any reason for the court to consider the nature of the ownership, because the focus was the character of the business income earned by the pass-through entity.

Furthermore, in Five Star Concrete, L.L.C. v. Klink, Inc. 693 N.E.2d 583 (Ind. Ct. App. 1998), the Indiana Court of Appeals explained that LLCs are like partnerships, and like partnerships the "income 'passes through' the entity and is taxed to the member, an owner of an interest in the company." Id. at 586. The court was very specific–LLCs pass-through income to their members to be taxed in the same manner as partnerships do. The court also noted that there was no dispute that the company properly passed its income and tax liability to its owners. Id. Therefore, like the Park 100 decision, the end result is that income and the related tax liability flow through entities taxed as partnerships, and the manner in which the taxpayer chooses to define its ownership interest in the company is not relevant.

Finally, Indiana law defines a member's ownership "interest" in an LLC as " economic rights in the limited liability company, including the member's share of the profits and losses of the limited liability company and the right to receive distributions from the limited liability company." IC § 23-18-1-10 (Emphasis added). Thus, a member's ownership "interest" in an LLC is a right of action–i.e., the right to receive distributions from the business. In other words, a member's "interest" in a LLC defines the owner's right to receive the profits and losses generated by the LLC. However, it does not describe how those profits or losses were earned or how they are to be taxed. Whereas the character of a LLC's income to be reported by the member for tax purposes is dictated by the manner in which the LLC had earned the income. See IC § 6-3-4-10; IC § 6-3-4-11(a); 45 IAC 3.1-1-106; 45 IAC 3.1-1-153(a).

Accordingly, Taxpayer's protest of the Department's adjustments to its apportionment factor to include the activities of "LLC C," based upon the "LLC C's" income being excluded from the return, is also denied.

FINDING

Taxpayer's protest of the adjustments the Department made to its apportionment factors to include the activities of "LLC C" is denied.

IV. Tax Administration–Penalties.

DISCUSSION

The Department issued proposed assessments for withholding tax, interest, and penalties for the tax years in question. Taxpayer was assessed failure to timely file return penalties under IC § 6-8.1-10-2.1(g) for tax years 2002 through 2007. The Department refers to IC § 6-8.1-10-2.1(g), which provides:

> A person who fails to file a return for a listed tax that shows no tax liability for a taxable year, other than an information return (as defined in section 6 of this chapter), on or before the due date of the return shall pay a penalty of ten dollars ($10) for each day that the return is past due, up to a maximum of two hundred fifty dollars ($250).

Taxpayer was also assessed negligence penalties under IC § 6-8.1-10-2.1(a) for the 2002, 2006, and 2007 tax years. The Department refers to IC § 6-8.1-10-2.1(a), which provides "If a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

Taxpayer protests the imposition of the failure to timely file return penalties and the negligence penalties. Taxpayer maintains that the penalties should be waived. For both of these penalties, penalty waiver is permitted if the taxpayer shows that its failure to act–i.e., its failure to timely file the return and its failure to pay the tax due–was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1(d). The Indiana Administrative Code, 45 IAC 15-11-2 further provides in relevant part:

> (b) "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.
>
> (c) 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.

Again, under IC § 6-8.1-5-1(c) the Department's proposed assessments (in this instance, the penalties), are presumed to be correct.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer was denied on certain of its protest issues, it has affirmatively established that the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c). The negligence penalties and failure to timely file return penalties will be waived.

FINDING

Taxpayer's protest to the imposition of the failure to timely file return penalties and negligence penalties is sustained.

SUMMARY

Taxpayer's protest of the Department's decision to exclude the activities of the wholly owned subsidiary corporation and "LLCs A & B" from the corporate returns is sustained, as discussed in Issue I. Additionally, the audit division is requested to review the documentation, and verify that both the subsidiary corporation's seventy-five percent ownership portion and Taxpayer's twenty-five percent ownership portion of "LLCs A & B's" activities are included in the return. Taxpayer's protest of the adjustment to its payroll numerator in the 2002, 2006, and 2007 tax years is respectfully denied, as discussed in Issue II. Taxpayer's protest of the adjustments the Department made to its apportionment factors to include the activities of "LLC C" is denied, as discussed in Issue III. Taxpayer's protest to the imposition of the failure to timely file return penalties and negligence penalties is sustained, as discussed is Issue IV.

Posted: 06/26/2013 by Legislative Services Agency
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