DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 02-20130300
Income Tax
For Tax Years 2009-2011

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

A holding company that had a partnership interest in a limited liability company (LLC) could have a non-unitary relationship with that LLC; holding company established that it was entitled to an abatement of the ten percent negligence penalty.

ISSUE

I. Income Tax–Unitary/Non-Unitary.

Authority: IC § 6-8.1-5-1; IC § 6-3-1-19; IC § 6-3-2-2; Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Hunt Corp. v. Department of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-153.

Taxpayer protests that it does not a have a unitary relationship with LLCs it has a partnership interest in.

II. Tax Administration–Penalty.

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

Taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

Taxpayer is a holding company. Taxpayer was audited by the Indiana Department of Revenue ("Department"). The audit found that Taxpayer held interests in multiple companies. As a result of the audit, the Department issued a proposed assessment for Indiana income tax, interest, and penalties for periods June 30, 2009 through June 30, 2011. Taxpayer filed a protest. An administrative hearing was held, this Letter of Findings results. More facts will be provided below as needed.

I. Income Tax–Unitary/Non-Unitary.

DISCUSSION

At the outset, the Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The audit report states that Taxpayer is "a holding company" and that "[i]ts business existence and economic substance is the receipt of income from the entities it owns." The audit report further states that for fiscal year ending June 30, 2009, Taxpayer "held a 37[percent] interest in [Company S] and a 50[percent] interest in [Company A]." In "FYE 6/3010 and FYE 6/30/11, [Taxpayer] held a 50[percent] interest in [Company A] and a 65[percent] interest in [Company L]."

Taxpayer, in a company overview, describes its LLC subsidiaries. Taxpayer states that Company A "is an independent seed company" and that Company A's "activities within Indiana include field and farming operations, as well as conducting data analysis and laboratory research." Company L is described by Taxpayer as "an independent cereal seed producer" that "maintains" a location at an Indiana school "and in various wheat-growing regions within Indiana and other states." Taxpayer further states:

> Although [Taxpayer] and [Company A] share a common address as their headquarters, no business activities of [Taxpayer] are performed at such address. [Taxpayer] is a holding company only. Since it is a holding company, [Taxpayer] performs no administrative or management functions for any of its subsidiaries.

Taxpayer states that the Department's audit of it "focused on the relationship between [Taxpayer] and its subsidiaries, [Company A] and [Company L] (the 'LLC subsidiaries')." Taxpayer states that the "Department did not agree with [Taxpayer's] treatment of its share of partnership income resulting from its ownership of [Company A] and [Company L]."

Taxpayer's argument is that "the activities of [Taxpayer] and the LLC subsidiaries are not unitary" and that Taxpayer's "share of partnership income attributable to Indiana should instead be determined by calculating apportionment at the partnership level." Taxpayer states that the "only tax attribute that should then flow up from the LLC subsidiaries to [Taxpayer] is the share of partnership income–as opposed to the share of partnership factors."

Turning to Taxpayer's specific arguments, Taxpayer states that the "LLC subsidiaries' filing status was erroneously mischaracterized and ignored . . . ." The audit report states that Taxpayer's "ownership in the LLC's is not that of a partner," and that:

> The income is reported as partnership income for federal income tax purposes only because the election has been made to do so. [Taxpayer] is a member in operating LLC's that conduct business in Indiana. It is not necessary to look further than that to establish whether [Taxpayer's] relationship to its LLC's is unitary or not.

Taxpayer states that the audit finding "is in direct contradiction to settled Indiana law."

The Department's audit report asserts that since Taxpayer is a "member in operating LLC's that conduct business in Indiana" that it is "not necessary to look further than that to establish whether [Taxpayer's] relationship to its LLC's is unitary or not." Taxpayer argues that the "Department's reliance on [Taxpayer's] status as a holding company does not satisfy the established standards for showing unity." Taxpayer states that the audit report "indicate[s] that, because [Taxpayer] is a holding company, its activities must be unitary with the entities it holds."

As preliminary matter, the Department notes the following relevant law. For example, the term "Partnership" is defined at IC § 6-3-1-19:

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

And 45 IAC 3.1-1-153 states:

> (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.

Turning to case law, the Indiana Tax Court in Hunt Corp. v. Department of State Revenue, 709 N.E.2d 766, 777 (Ind. Tax Ct. 1999) stated:

> Whether the issue is analyzed with reference to section 6-3-2-2 alone or section 6-3-2-2 in conjunction with the regulation (assuming arguendo that the regulation is applicable to the tax years at issue), the Court must determine whether the members of the affiliated group and the partnerships were engaged in a unitary business or not. Hunt fails to mention this issue in its brief, despite the fact that the regulation (which is quoted in full in Hunt's brief) clearly requires its resolution before determining how the income from the corporate partnerships is to be attributed. Hunt simply quotes subsection (c)(1) of the regulation and asks the Court to blindly follow it. However, subsection (c)(1) only would apply if the corporate partners and the partnership are not engaged in a unitary business.
> (Emphasis added).

And in Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 783 (1992), the United States Supreme Court discussed the unitary business principle of taxation:

> In the course of our decision in Container Corp., we reaffirmed that the constitutional test focuses on functional integration, centralization of management, and economies of scale. 463 U.S., at 179, 103 S.Ct., at 2947 (citing Woolworth, supra, 458 U.S., at 364, 102 S.Ct., at 3135; Mobil Oil, supra, 445 U.S., at 438, 100 S.Ct., at 1232). We also reiterated that a unitary business may exist without a flow of goods between the parent and subsidiary, if instead there is a flow of value between the entities. 463 U.S., at 178, 103 S.Ct., at 2947. The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for "the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise" than, for example, geographical or transactional accounting. Id., at 164-165, 103 S.Ct., at 2940 (citing Mobil Oil, 445 U.S., at 438-439, 100 S.Ct., at 1232-1233).

The audit report cites to the "fairly reflect" language found in IC § 6-3-2-2, treating "the pass through income as business income and include the LLC's factors in the apportionment computation." Taxpayer's argument is that for the audit report to get to that conclusion there must be a showing of a unitary relationship ("the Court must determine whether the members of the affiliated group and the partnerships were engaged in a unitary business or not," Hunt, 709 N.E.2d at 777). Thus Taxpayer's argument in the case at hand focuses on the issues of integration, centralization of management, and economies of scale (i.e., the test found in Allied-Signal). The latter argument is examined below.

A. Functional Integration

Taxpayer asserts that "no functional integration existed." Taxpayer states in its follow-up written protest that there are "a number of restrictions in the LLC Agreement" that "keep [Taxpayer] from functionally integrating with [Company A]." Taxpayer states that it "entered into a Non-Competition and Non-Solicitation of Employees agreement with regard to [Company A]." Taxpayer stated that as part of that agreement:

> [Taxpayer] is not permitted to enter into the restricted business of [Company A], and is not permitted to "solicit or seek to employ (including in any consulting company), in connection with any operations falling within the scope of the [Company A] Business, any employee, officer, director or person performing equivalent functions of [Company A]."

Taxpayer concludes:

> Without the ability to transfer employees between entities, nor the ability to freely transact with [Company A] in all regards, it cannot be said that [Taxpayer] enjoyed functional integration with [Company A].

The Department notes that Taxpayer's follow-up written protest does not develop this argument with regards to Company L.

B. Centralization of Management

Taxpayer owns 50 percent of Company A. Taxpayer states that the "LLC Agreement does not provide any member, acting individually, nor any member representative, acting individually, with the 'authority to act for or to undertake or assume, any obligations, debt, duty or responsibility on behalf of [Company A], except as specifically authorized' by the LLC Agreement."

Taxpayer further states that since it owns 50 percent in Company A that it "cannot maintain more than three positions on the membership committee" and that it "is never able to make key decisions without the consent of the other partner." Taxpayer then lists an array of decisions that require the other partner's consent, which include:

- "Any amendment of the [Company A] Certificate of Formation or the LLC Agreement;"
- "Issuance by [Company A] of any additional interests or other equity participations in [Company A] and [] admission of any new Member; provided that a person acquiring an interest in compliance with the LLC Agreement shall be deemed to have been admitted as a Member;"
- "Except as otherwise provided . . . the initiation or settlement by [Company A] of third-party litigation or arbitration or other third-party legal proceedings other than in the ordinary course of business . . . ;"
- "Any change in the scope of the [Company A] business;"
- Subject to provisions of the LLC Agreement, "the appointment or removal of the Chairman, the CEO, the CFO, or the Vice President-Marketing and Sales;"
- "Approval of, or any material amendment to or deviation from, any Business Plan
- "Any determination that additional capital contributions shall be made;"
- "Any change in the scope of the [Company A] business;" and the
- "adoption or modification of any employee compensation, incentive or other benefit plans (other than employee welfare plans)."

Taxpayer concludes that it "cannot centrally control the activities of [Company A], so no centralization of management can be said to exist."

C. Economies of Scale

Taxpayer states that the "LLC Agreement restricts [Company A] from enjoying any benefits simply because of [Taxpayer's] ownership." Taxpayer, citing to the LLC Agreement, states that:

> [t]he debts, obligations and other liabilities of [Company A], whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of [Company A], and none of the Members or officers of [Company A] shall have any obligation or liability in respect therof [sic] by reason of being a Member or otherwise holding any interest or acting as an officer of [Company A].

Taxpayer also cites to the LLC Agreement to state that the "Members intend that [Company A] shall, at its own cost and expense, at all times take out an [sic] maintain full and adequate insurance in respect of all risks which are customarily insured against by an entity engaged in a business similar to the [Company A] Business." Taxpayer concludes that "[Company A] could not benefit from [Taxpayer's] ownership interest for the purposes of taking on debt or even purchasing insurance. No economies of scale existed in this holding company relationship, and a unitary relationship, therefore, cannot be found." Taxpayer states that the "Limited Liability Company Agreement between [Taxpayer] and [Company G] demonstrates that [Taxpayer] did not maintain 'functional integration, centralization of management, or economies of scale' with regard to [Company A] . . . ."

The audit report does not contain an analysis of the unitary relationship (i.e., integration, centralization of management, and economies of scale) and the audit report does not address whether or not Taxpayer is in compliance with its LLC Agreement with Company A. The audit report does contain background information on the company history of Taxpayer (i.e., the various acquisitions and formations), noting that "[a]fter the formations of these LLC's [Taxpayer's] business operations were that of a holding company. Its only activity is the receipt of income from the entities it owns and based on the membership agreement it directs operations and financial decisions of these LLC's." And as previously noted, the audit report stated that since Taxpayer is a member in operating LLCs that it was "not necessary to look further than that to establish whether [Taxpayer's] relationship to its LLC's is unitary or not."

Under IC § 6-8.1-5-1(c) the Department's proposed assessment is "prima facie evidence that the department's claim for the unpaid tax is valid," thus that is the starting point and it is then a taxpayer's burden to show why a proposed assessment is wrong. The audit report did not develop the unitary/non-unitary partnership analysis, whereas Taxpayer did develop that argument as it relates to Company A. In the present case, given the minimal analysis in the audit report, Taxpayer has met its burden of proof–for the specific audit years at issue–and shown that it is not unitary with Company A. Taxpayer's agreement regarding Company A is with an unrelated third party (i.e., Company G). The Department notes that if an ownership or operational relationship between Taxpayer and Company G existed, this would be a relevant fact that could lead to a different finding for the protest. Regarding the other LLCs, Taxpayer did not sufficiently develop its argument and is thus denied regarding all other LLCs.

It should be noted that Taxpayer argues, in the alternative, that if the Department were to find a unitary relationship between Taxpayer and the LLC subsidiaries, then according to Taxpayer two additional companies would need to be included as part of the unitary group (Company H and Company V, at least one of which is a corporation and not an LLC). As noted above, Taxpayer's argument was sustained regarding Company A, but denied with regards to Company S and Company L since Taxpayer did not sufficiently develop the latter arguments. Taxpayer states that "although a unitary relationship cannot be found based on ownership alone, the Department must include all [Taxpayer's] subsidiaries, if it expects to include any." These other companies (Company H and Company V) are not addressed in the audit report and are given less than two pages of discussion by Taxpayer in its follow-up material. That argument is not sufficiently developed, and is also beyond the scope of this Letter of Finding since the audit report does not address it.

FINDING

Taxpayer's protest that it is not unitary with Company A is sustained. Taxpayer's argument that it is not unitary with the other LLC is denied. Taxpayer's alternative argument is also denied.

II. Tax Administration–Penalty.

DISCUSSION

Taxpayer "requests that the Department exercise its discretion to abate the ten-percent penalty . . . ." Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including an assessment of a penalty - is presumptively valid.

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 . . . ."

Taxpayer states that, "there is a substantial amount of federal and Indiana-specific support" for its position that it was unitary with the LLCs. Taxpayer was, in fact, sustained regarding its argument as it relates to Company A. The Department finds that Taxpayer has met its burden of proof for its request for penalty waiver.

FINDING

Taxpayer's protest of the penalty is sustained.

SUMMARY

Taxpayer's protest that it is not unitary with Company A is sustained. Taxpayer's argument that it is not unitary with the other LLC is denied. Taxpayer's alternative argument is also denied. Taxpayer's protest of the penalty is sustained.

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