

**Letter of Findings: 02-20140185
Corporate Income Tax
For the Years 2007, 2008, and 2009**

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 position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Medical Testing Company shared a unitary relationship with its Indiana business partner because the Medical Testing Company had authority to exercise effective and substantial control of the day-to-day operation of business partner and because the parties enjoyed the benefits of a unitary business relationship. The Department rejected Company's reliance on the Riverboat Development decision because Company's membership income should have been categorized as "operational" and not passive investment income. Under Indiana law, Company was required to add back royalty income paid to related parties.

ISSUES

I. Corporate Income Tax - Unitary Relationship.

Authority: IC § 6-3-2-1(b); IC § 6-8.1-5-1(c); *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.*, 458 U.S. 354 (1982); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Hunt Corp v. Indiana Dep't of State Revenue*, 709 N.E.2d 766 (Ind. Tax Ct. 1999); *Sherwin-Williams Co. v. Indiana Dep't. of State Revenue*, 673 N.E.2d 849 (Ind. Tax Ct. 1996); [45 IAC 3.1-1-153](#).

Taxpayer argues that it does not have a unitary relationship with its Indiana business partner.

II. Corporate Income Tax - Indiana Source Income.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1(c); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Vodafone Americas Inc. v. Indiana Dept. of State Revenue*, 991 N.E.2d 626 (Ind. Tax Ct. 2013); *Riverboat Development, Inc. v. Indiana Dep't of State Revenue*, 881 N.E.2d 107 (Ind. Tax Ct. 2008); *Commissioner's Directive 38* (October 2009); [45 IAC 3.1-1-42](#).

Taxpayer states that money earned from its membership interest in its Indiana partner is not subject to Indiana's corporate income tax because the income should be allocated to Taxpayer's out-of-state commercial domicile.

III. Corporate Income Tax - Addback of Intangible Royalty Expenses.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-3-2-20; IC § 6-3-2-20(b); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Comm'r v. Transp. Trading & Terminal Corp.*, 176 F.2d 570 (2d Cir. 1949); *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934); *Side v. Majors*, 341 N.E.2d 763, (Ind. 1976); *VanDam Estate v. Mid-America Sound*, 25 N.E.3d 165 (Ind. Ct. App. 2015); *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158 (Ind. Tax 1995).

Taxpayer maintains that the Department erred in requiring it to add back certain intangible royalty expenses paid to its business partners.

IV. Tax Administration - Underpayment Penalty.

Authority: IC § 6-3-4-4.1(b); IC § 6-3-4-4.1(c); IC § 6-3-4-4.1(d); IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); [45 IAC 15-11-2\(b\)](#); [45 IAC 15-11-2\(c\)](#).

Taxpayer states that the underpayment penalty imposed should be abated on the ground that the penalty is unlawful and was arbitrarily imposed.

STATEMENT OF FACTS

Taxpayer is an out-of-state C-corporation which provides clinical testing services. Taxpayer provides services in different states. In addition, Taxpayer has several joint ventures including a non-majority, 44 percent membership interest in a limited liability company. For purposes of this Letter of Findings, this company is designated as "Indiana Laboratory Partner" ("ILP"). ILP provides clinical testing services to customers in Indiana. Other than its relationship with ILP, Taxpayer has no other Indiana business activity.

For federal and Indiana income tax purposes, ILP is treated as a partnership under Treas. Reg. § 301.7701-3(2).

In May 2013, Taxpayer filed refund claims along with amended Indiana income tax returns for the tax years 2007, 2008, and 2009. The returns and refund claims raised several issues:

- Taxpayer claimed that it did not have a unitary relationship with ILP. Therefore its partnership income should first reflect apportionment at the partnership level;
- Taxpayer claimed that its ILP partnership income is not Indiana source income based on the Indiana Tax Court's Riverboat Development decision;
- Taxpayer stated that the substantive issues it raised in the refund claims and amended tax returns were issues previously resolved between itself and the Indiana Department of Revenue ("Department").

The Department's Audit Division reviewed the refund claims and amended returns. The Audit Division issued an "Audit Summary Report" dated October 2013 resulting in the denial of Taxpayer's refund request along with an assessment of additional tax. Taxpayer disagreed with that decision and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Unitary Relationship.

DISCUSSION

Taxpayer argued that it was entitled to the refund because it did not share a unitary relationship with ILP and that income it reports to Indiana reflects its 44 percent share of ILP's income already apportioned at the partnership level. The Department disagreed finding that Taxpayer did share a unitary relationship with ILP and that, as a result, the income Taxpayer reports to Indiana reflects its share of LLP's income without apportionment at the partnership level. In addition, in calculating Taxpayer's Indiana apportionment factors, ILP's Indiana and everywhere property, payroll, and receipts factors are added to Taxpayer's own property, payroll, and receipts factors.

As a threshold issue, it is the Taxpayer's responsibility to establish that the 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." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, reasonable interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

A. Audit Summary Report.

The Audit Summary Report pointed to six factors leading to its conclusion that Taxpayer and ILP shared a unitary

relationship:

- Taxpayer appointed three members to ILP's Board of Managers;
- Taxpayer appointed ILP's general manager, the general manager was required to be a Taxpayer employee, and the general manager oversaw the day-to-day operations of ILP;
- Taxpayer was the "tax matters partner for the partnership;"
- Taxpayer was the largest (44 percent) owner of ILP;
- Taxpayer provides ILP with marketing, billing, legal, and compliance services and is provided a fee for doing so;
- Taxpayer and ILP enjoy economies of scale "by being in the same line of which is [medical services]."

In addition, the Department's Audit Summary Report cited to Taxpayer and ILP's Operating Agreement as a further basis for its decision. In doing so, the Department's audit responded to the Taxpayer's concern that Taxpayer and ILP served different markets and that, as a result, Taxpayer and ILP did not share a unitary relationship.

The business purpose of [ILP] is to establish and operate one or more economically viable licensed **clinical laboratories** and to engage in any and all business activities permitted under the laws of the State of Indiana.

[ILP's] initial business shall be the provision of **clinical laboratory** services . . . and hospital laboratory management services. (**Emphasis in original**).

The audit found that:

This is precisely the business of [ILP] and the other affiliates of [Parent] which are . . . providers of diagnostic testing information and services. Through its operating affiliates [Taxpayer] also provides a broad range of clinical testing services used by physicians in the detection, diagnosis, evaluation, monitoring and treatment of diseases and other medical conditions. [ILP] is just an extension of [Taxpayer's] normal business in a different form.

The Audit Summary Report also cited to the parties' service agreements and Operating Agreement that, according to the Report, established that there was "a significant flow of value between [ILP] and [Taxpayer]."

[ILP] and Taxpayer have executed service agreements for selected services including Billing, Marketing, Legal and Compliance." In addition, the Operating Agreement Section 3.4 Appointment Tax Matters Member states "[Taxpayer] is hereby designated as the Tax Matters Member. The Tax Matters Member shall be responsible for all matters involving Federal, state, local or other taxes of any type."

The Department concluded that Taxpayer shared a unitary relationship with ILP for the following three reasons:

- "Centralized Management": Taxpayer provided three members to the ILP's managing board and a general manager to oversee ILP's day-to-day operations;
- "Functional Integration": The parties' membership agreement required that ILP's general manager be Taxpayer's employee;
- "Economies of Scale": Taxpayer was in a similar business with ILP, that they were able to "provide items at a lower cost because the already functioning personnel and institutional knowledge of the business." In addition, Taxpayer provided ILP with billing, marketing, legal, and compliance services.

Whether ILP and Taxpayer are or are not unitary, Taxpayer will earn taxable Indiana income and will be required to file Indiana income tax returns. If Taxpayer and ILP are not unitary, ILP will first apply its own apportionment factors at ILP's level; thereafter, only the Indiana portion of ILP's income will "flow through" to Taxpayer's Indiana taxable income.

If Taxpayer and ILP are unitary as the Department concluded, ILP does not first apply its own apportionment factors at its own Indiana level. Instead, 100 percent of Taxpayer's pro-rated membership share of ILP's income and its share of ILP's apportionment factors will "flow through" to Taxpayer.

B. Taxpayer's Response.

Taxpayer disagreed with the audit's conclusion maintaining its position that Taxpayer and ILP did not share a

unitary relationship and that the Indiana partnership income should be apportioned first at the partnership level.

During the Years in Issue and at all other times, [ILP] operated independently of all of the investors, including [Taxpayer]. Among other things, [ILP] was managed independently by its own Board of Managers. The General Manager of [ILP] reported to the Board of Managers and was subject to the direction and control of the Board of Managers, and no one else, and owed a duty of loyalty under Indiana law solely to [ILP].

Taxpayer explained that ILP was a limited liability company governed by the parties' operating agreement. ILP's investors provided for ILP's management by means of that operating agreement. Under that agreement, no single investor was entitled to select a majority of the managers. According to Taxpayer, although it owned 44 percent of ILP, it was only authorized to appoint 33 percent of ILP's managers.

In terms of actual operation, [ILP] operated its own field operation department, clinical labs, quality and regulatory affairs department, hospital services department, sales and marketing department, accounting department, human resources department, and information technology/technical support department. [ILP] maintained its own employee handbook, its own telephone system, its own accounting system, its own insurance, and it devised and administered its own company policies. [ILP] also purchased its own supplies and equipment. Finally, [ILP] also maintained its own pension plans and other employee benefit plans.

There were no loans by [ILP] to [Taxpayer], nor loans by [Taxpayer] to [ILP]. [ILP's] funds were not "commingled with [Taxpayer's] funds. Rather, [ILP] maintained its own bank accounts. All funds needed by [ILP] for capital improvements or equipment was acquired independently and not acquired from [Taxpayer]. There were no uniform credit card systems between [Taxpayer] and [ILP], no uniform packaging, no common use of brand names, nor common promotional packages run from [Taxpayer], [Taxpayer's] "national headquarters" or otherwise.

Taxpayer states that the facts and issues currently under consideration were addressed, conceded, and resolved in Taxpayer's favor following a previous 2004, 2005, and 2006 audit. Taxpayer criticizes the Department for raising issues which the Department had full and fair opportunity to resolve years earlier.

The Department had the opportunity to investigate the facts thoroughly through the audit, then again during the appeal, and then again in Tax Court. In fact, the Attorney General's Office conducted extensive discovery, which included not only extensive written discovery requests, but also an Indiana Trial Rule 30(b)(6) deposition. Following that exhaustive investigation, both the Attorney General's Office and the Department determined that the Department should drop its assessments in their entirety.

In effect, Taxpayer concludes that the Department is now attempting to resurrect issues which - after extensive administrative review and legal analysis - the Department found deficient in 2012.

C. Hearing Analysis.

The issue is whether Taxpayer has provided sufficient evidence to establish that it and ILP do not have a unitary relationship.

At the outset, the Department rejects Taxpayer's argument that the Department settled the prior year income tax assessments because the Department found that its position was untenable. Admittedly Taxpayer and the Department executed a settlement agreement January 2013. However, even conceding that the substantive issues resolved by that agreement were identical to those here under dispute, the resolution was not nearly as one-sided as Taxpayer represents. While the Department agreed to abate the then-pending assessment in excess of \$500,000, Taxpayer simultaneously conceded that it was not entitled to a refund in excess of \$1,000,000. As the Agreement expressly provided, "[T]he Department shall have no liability with respect to the Taxpayer's [refund] claims" Whether the Department had properly marshaled facts and arguments to make its case for the assessment or whether Taxpayer had made its case for a refund as thoroughly as possible are questions not addressed here. However, there is nothing in the Agreement which can be read as a concession or acquiescence to the arguments which Taxpayer now offers. To the contrary, the 2013 agreement specifically provides:

Neither party to this Agreement, by the execution of this Agreement or the performance of its terms, shall be deemed to have made any admission or concession of fact or law whatsoever other than as expressly set forth therein.

"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).

[45 IAC 3.1-1-153](#) provides:

- (a) A corporate partner's share of profit or loss from a partnership will be included in its federal taxable income and therefore generally subject to the same rules as any other adjusted gross income.
- (b) If the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors for any partnership year ending within or with the corporate partner's income year, with the following modifications:
 - (1) The value of property which is rented or leased by the corporate partner to the partnership or vice versa shall, with respect to the corporate partner, be excluded from the property factor of the partnership or eliminated to the extent of the corporate partner's interest in the partnership, whichever the case may be, in order to avoid duplication.
 - (2) Intercompany sales between the corporate partner and the partnership shall be eliminated from the corporate partner's sales factor as follows:
 - (A) Sales by the corporate partner to the partnership to the extent of the corporate partner's interest in the partnership.
 - (B) Sales by the partnership to the corporate partner not to exceed the corporate partner's interest in all partnership sales.
- (c) If the corporate partner's activities and the partnership's activities do not constitute a unitary business under established standards, disregarding ownership requirements, the corporate partner's share of the partnership income attributable to Indiana shall be determined as follows:
 - (1) If the partnership derives business income from sources within and without Indiana, the business income derived from sources within Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the partnership.
 - (2) If the partnership derives business income from sources entirely within Indiana, or entirely without Indiana, such income shall not be subject to formula apportionment.
- (d) A partner's distributive share of income will be adjusted by the partner's proportionate share of the partnership's income that is exempt from taxation under the Constitution and statutes of the United States and by the partner's proportionate share of the partnership's deductions allowed or allowable under Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States.
- (e) After determining the amount of business income attributable to Indiana under subsection (c), the corporate partner's distributive share of such income shall be added to the corporate partner's other business income apportioned to Indiana and its nonbusiness income, if any, allocable to Indiana, in determining the corporate partner's total taxable income. (Emphasis added).

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

Under section 6-3-2-2, in order to determine where the income from the corporate partnership is to be attributed, it must first be determined whether that income constitutes business or nonbusiness income for the affiliated group. That determination is made by ascertaining whether the affiliated group and the partnerships are engaged in a unitary business or not. If the income from the partnerships constitutes business income (i.e., if the affiliated group and the partnerships are engaged in a unitary business), under section 6-3-2-2, all of that income would be subject to apportionment based on an application of the affiliated group's property, payroll, and sales factors. If the income from the partnerships constitutes nonbusiness

income for the affiliated group (i.e., if the affiliated group and the partnerships are not engaged in a unitary business), that income will be allocated to a particular jurisdiction. Section 6-3-2-2 does not specifically address the question of whether a partnership's property, payroll, and sales factors may be considered in apportioning a corporation's business income derived from a corporate partnership. The regulation [\[45 IAC 3.1-1-153\]](#) addresses this technical problem and provides a comprehensive description of the treatment of income derived from corporate partnerships. Mirroring the analysis required by section 6-3-2-2, the regulation makes the crucial distinction between the situation where the corporate partner's activities and the partnership's activities constitute a unitary business and when they do not. *Id.*

The United States Supreme Court's jurisprudence has defined the unitary business principle which allows a State to apply formula apportionment to all unitary business income which a taxpayer's affiliates or subsidiaries received. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 179 (1983). See *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *F.W. Woolworth Co. v. Taxation and Revenue Dep't.*, 458 U.S. 354 (1982); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *Exxon Corp. v. Department of Revenue*, 447 U.S. 207 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980). The three unities are: "functional integration;" "centralization of management;" and "economies of scale." *Id.* However, the Court has held that the showing of day-to-day operational control in the partnership indicates the existence of a unitary business relationship. See *Allied-Signal, Inc.*, 504 U.S. at 788; *Container Corp. of America*, 463 U.S. at 166.

On balance, the totality of the facts establish that Taxpayer and ILP share a unitary relationship based on the integration of the parties' business operations, the benefits which the parties enjoyed as a result of that integrated relationship and especially the degree to which Taxpayer exercised - or had the potential and authority to exercise - control over the ILP's "day-to-day" management and operational functions.

Specifically, Taxpayer holds the dominant ownership interest in ILP and has the authority to designate one of its own employees as ILP's general manager thereby guaranteeing it the right to make - or participate in making - essential business decisions reflecting directly on Taxpayer's potential profits or losses in ILP.

Taxpayer is entitled to appoint three of the nine members of the ILP's governing "Board of Managers." Under the terms of the Operating Agreement, the Board of Managers has:

[F]ull and complete authority, power, and discretion to manage and control the business, affairs, and properties of [ILP], to make all decisions regarding those matters and to perform any and all other acts or activities customary or incident to the management of [ILP's] business.

The Operating Agreement requires unanimous consent of the managers in making certain, critical business and day-to-day operational decisions. Without the consent of Taxpayer's three plurality members, ILP's Board of Managers has no independent authority to: (1) borrow money or obtain financing; (2) enter into a "contract, agreement, license or other instrument" obligating ILP for unbudgeted expenses in excess of certain dollar limits; (3) assign ILP's rights or property; (4) accept certain capital contributions; (5) make a loan of more than \$50,000; (6) terminate or settle legal proceedings in excess of \$50,000; and (7) "adopt[] or amend[] the annual Operating and Capital budgets and [ILP's] strategic plan." Under the terms of the Operating Agreement, Taxpayer's three appointed managers effectively exercised veto power over critical decisions involving the operation, control, obligations, and expenditures of ILP.

The Operating Agreement also requires that certain other business decisions require the approval of six of the nine Managers. Although Taxpayer's three plurality members do not exercise effective veto power over these "super-majority" decisions, Taxpayer's three members necessarily play a significant if not outsized role in those decisions.

In addition to the right to choose a plurality of the Board of Managers, the Operating Agreement designates Taxpayer as the "Tax Matters Member" who is "responsible for all matters involving Federal, state, local or other taxes of any type." In addition to routine tax matters, the Tax Matters Manager is entitled to "represent [ILP] in connection with all administrative and judicial proceedings with respect to [ILP's] affairs involving or resulting from examinations by any and all Federal, state or other tax authorities"

As noted previously, Taxpayer has authority to designate one of its own employees as ILP's General Manager. Under the terms of the parties' service agreement, ILP's General Manager is responsible for supervising "the day to day operating of [ILP] and to perform such other duties for the proper management of [ILP]" Among other responsibilities, the General Manager has authority to: (1) manage ILP's personnel and staff; (2) "manage the clinical pathology services provided by [ILP]" (3) oversee [medical] tests conducted by ILP; (4) "obtain and

maintain" ILP's licenses; (4) "take acts necessary so that [ILP] remains eligible for accreditation by the College of American Pathologists' Commission on Laboratory Inspection . . . ;"(5) implement and maintain ILP's quality control and assurance programs; and (6) oversee the maintenance and repair of ILP's equipment and facilities.

There is substantial evidence that Taxpayer has authority to materially participate in and exercise substantial control over many of both the major and routine aspects of ILP's day-to-day business by virtue of its right to designate the plurality of ILP's Board of Managers. In addition, Taxpayer exercises authority and control over ILP to the extent that that Taxpayer provides marketing, billing, legal, and collection services on behalf of ILP.

Based on Taxpayer's plurality control of ILP's Board of Managers, its authority to designate one of its own employees as ILP's General Manager, the degree of authority exercised by that General Manager, Taxpayer's provision of marketing, billing and legal services to ILP, and the practical and financial benefits which the parties enjoy as a result of their integrated relationship, and the significant flow of value between the parties, there is sufficient evidence to establish that ILP and Taxpayer share a unitary relationship.

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax - Indiana Source Income.

DISCUSSION

Taxpayer maintains it is entitled to a refund of income tax because "[t]he only income derived by [Taxpayer] was through its membership interest in [ILP]. According to Taxpayer, the money earned from that membership interest in ILP is "income from intangible personal property allocable to the members' state of commercial domicile" Taxpayer concludes that because Taxpayer was commercially domiciled in New Jersey during the years at issue, the membership money was not income "derived from sources within Indiana" and Taxpayer was not subject to Indiana's adjusted gross income tax.

A. Audit Summary Report.

The Department's Audit Summary Report provides:

The [T]axpayer's position [is] that instead of apportioning the income received from [ILP] to Indiana, this income should properly be allocated to its state of commercial domicile which is New Jersey. This presupposes that the [T]axpayer, in fact, allocated this income to New Jersey on the tax returns filed with New Jersey. Specifically, Commissioner's Directive 38 - Refunds to Pass-through Entities and Taxation of Shareholder/Partners/Members - [provides]:

A person applying for a credit or refund because of an overpayment of taxes is required to file a GA-110L Claim for Refund with the following information:

1. In the explanation section of the GA-110L, reference "Riverboat Development, Inc. v. Ind. Dep't of Revenue";
2. a list of tax years for which the overpayment applies;
3. the amount of the overpayment;
4. the date of the original payment;
5. the Indiana amended return(s) for the tax years to which the claim for refund applies;
6. copies of the Indiana K-1s and/or WH-18 verifying the amount of the distributive share of income for each year; and
7. copies of filed returns in the home state or jurisdiction of the person proving that the income subject to the credit or refund was reported as income attributable to that state or jurisdiction. (Subject to verification by the home state or jurisdiction). Commissioner's Directive 38 (October 2009), 20091028 Ind. Reg. 045090849NRA (Emphasis in original).

The Audit Summary Report indicates that the Department reviewed Taxpayer's New Jersey income tax returns. After reviewing those returns, the Department found that the ILP membership income "was included in the net income which was apportioned and was not reported as Nonoperational Income . . . which would have been allocated." The Audit Summary Report references Taxpayer's filing position that ILP "has no New Jersey Nexus," that the "partnership property, payroll and sales were included in [Taxpayer's] total property, total payroll and total sales for apportionment purposes," and that Taxpayer's position was "not supported by its actual tax reporting

where it apportioned this income to New Jersey and other states."

In addition, the Department challenged Taxpayer's reliance on the Tax Court's decision in *Riverboat Development, Inc. v. Indiana Dep't of State Revenue*, 881 N.E.2d 107 (Ind. Tax Ct. 2008) because "the structure and operation of [Taxpayer] differs significantly from *Riverboat Development, Inc.*" The Department's Audit Summary Report stated that, "[T]he mere fact that a taxpayer was a partner in a general partnership gives its income from that partnership the character of operational income. As such the [T]axpayer's income is not income in the form of 'dividends from investments' under Indiana Code 6-3-2-2.2(g)." (Emphasis added). The Report concludes:

[Taxpayer's] involvement in the management of [ILP] . . . is operational income not investment income. [Taxpayer's] direct involvement in Billing, Marketing, Legal, Compliance and Tax also supports the conclusion that it is directly and extensively involved in the management of [ILP] and that the income it receives from [ILP] is operational income which is apportionable to Indiana.

B. Taxpayer's Response.

Taxpayer disagreed with the Department arguing that "[t]he only income [Taxpayer] reported on its Indiana AGIT returns for the Years in Issue were a result of the membership interest in [ILP]. As such, under [Riverboat Development], [Taxpayer] had no Indiana AGIT for the Years in Issue, and is entitled to a full refund of the income tax reported and paid on its AGIT returns."

Taxpayer explains:

The law was simple and straightforward during 2007 and 2008. A membership interest in a limited liability company is an intangible. Income from an intangible was sourced to the recipient's state of commercial domicile. [Taxpayer] held a membership interest in a limited liability company, received income with respect to that membership interest, and [Taxpayer's] commercial domicile was outside Indiana.

Taxpayer discounts the Department's reliance on Commissioner's Directive 38 (October 2009) because the Directive "does not carry the force of law, and [that] portions of the directive are contrary to and not in accordance with Indiana law, and therefore have not force and effect." Taxpayer contends that the Directive is an "administrative fiat" and that the "Department may not impose conditions not contained in the statutes." According to Taxpayer, the Department's "fiat" promulgates a requirement that "would violate the Due Process Clause and Commerce Clause of the United States Constitution by basing Indiana's tax on the tax policies selected by the legislature of another state, which has no rational basis to the Taxpayer's tax obligations in Indiana."

C. Hearing Analysis.

As noted in Part I, under IC § 6-8.1-5-1(c) imposes on Taxpayer the burden of establishing that the assessment of tax was wrong. In addition, the Indiana Supreme Court in *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014) reiterated its position that the Department's reasonable interpretation of Indiana tax law is "entitled to deference."

Taxpayer is a corporate entity with a 44 percent membership interest in "ILP" which is a limited liability company. Taxpayer maintains that "[a] membership interest in a limited liability company is an intangible" and that "[i]ncome from an intangible [is] sourced to the recipient's state of commercial domicile." In arriving at the decision, Taxpayer relies on the Tax Court's *Riverboat Development* opinion.

In the *Riverboat Development* 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." The court concluded that the "dividends" should be sourced to the petitioner's domiciliary state and not to Indiana pursuant to IC § 6-3-2-2.2.

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. The petitioner in, *Riverboat Development, Inc.* argued that 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 from ILP was not Indiana-source income and that it is now

entitled to a refund of the tax mistakenly paid on that membership income.

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 was a minority interest holder, and a presumed limited-partner (given that the LLC in Riverboat Development 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." However, unlike the unrelated owners in Riverboat Development, Inc., Taxpayer and the other member-owners of "ILP" are related entities. Unlike the "minority interest holder" in Riverboat Development, Inc. that was deemed to earn investment interest, Taxpayer has much more than a simple passive investment interest in the operations of "ILP." As pointed out in Part I, Taxpayer exercises or has authority to exercise substantial operational control over ILP's day-to-day and strategic business affairs. Taxpayer has authority to designate a plurality of ILP's nine-member Board of Managers. Taxpayer's three managers exercise effective veto power over ILP's major business decisions. In addition, Taxpayer designates one of its own employees as ILP's general manager, and this employee/manager controls many of ILP's day-to-day business operations. Accordingly, the relationship between the parties in Riverboat Development, Inc. is substantively different from the relationship between Taxpayer and "ILP," and, that, the Riverboat Development, Inc. case is not determinative of Taxpayer's protest.

The Department finds Taxpayer's relationship with ILP more closely analogous to the parties in *Vodafone Americas Inc. v. Indiana Dept. of State Revenue*, 991 N.E.2d 626 (Ind. Tax Ct. 2013). In *Vodafone* the petitioner argued that it was not subject to Indiana's adjusted gross income tax on income earned in the form of distributive shares from sources in Indiana. *Id.* at 627. The petitioner argued that the distributive shares constituted intangible income in the form of investment dividends not taxable in Indiana. *Id.* at 627-28. The court rejected the petitioner's argument that petitioner was a "passive investor" because petitioner - even though a minority partner - participated in the management of the Indiana partnership. *Id.* at 629. The court pointed out that the petitioner appointed members of the Indiana partner's "Board of Representatives," appointed the Indiana partner's chief financial officer, and held "certain veto rights by which [petitioner could] block [Indiana partner] from taking specifically identified and extraordinary actions" *Id.* at 630. The court concluded that the petitioner's income "had the character of operational income and was therefore not income in the form of 'dividends from investments'" *Id.*

As in the case of *Vodafone*, the Department concludes that Taxpayer's ILP income constitutes operational income and not passive, dividend income.

In addition, the Department rejects Taxpayer's argument that the Commissioner's Directive 38 constitutes overreaching by the Department implicating Taxpayer's constitutional Due Process rights and violates constitutional principles under the Commerce Clause. The Department is not interpreting and applying Indiana tax law based on Taxpayer's obligations under New Jersey law. Instead, the Directive applies the basic principle that taxpayers report their income consistently from state to state to state. See [45 IAC 3.1-1-42](#). If Taxpayer believes that the membership income should be allocated to its New Jersey commercial domicile, then it is neither unreasonable nor untenable that Indiana should expect that this same income be reported to New Jersey in a manner consistent with that position.

FINDING

Taxpayer's protest is respectfully denied.

III. Corporate Income Tax - Addback of Intangible Royalty Expenses.

DISCUSSION

The issue is whether the Department was justified in or even acting within its authority in requiring Taxpayer to add back 2008 and 2009 royalty payments Taxpayer paid to a related company.

A. Audit Summary Report.

The Department found that on its 2007 Indiana income tax return, Taxpayer had added back intangible royalty expenses paid to a related company here designated as "Investments." Taxpayer stopped adding back the royalty income in 2008 and 2009. Taxpayer continued to pay approximately \$338 million dollars in royalties to

Investments but ceased adding back any of these expenses on its returns.

Investments used the royalty money to purchase additional shares of another related company here designated as "Finance" even though Investments already owned a 100 percent ownership interest in Finance.

Subsequently, Finance made loans to Taxpayer, ILP, Investments, and Finance's common parent company ("Parent").

Taxpayer paid the royalties to Investments in order to license the use of trade names, trademarks, service marks, patents, and "other intangible assets." Investments acquired this intellectual property from the group's former parent company in 1989. Investments acquired the intellectual property in exchange for all of its own shares. The intellectual property was created within the group and was not acquired from third parties.

According to the Audit Summary Report:

The following facts were considered when evaluating the royalty expenses of [Taxpayer]:

- The royalty payments are for the use of intellectual property held within a controlled group.
- The [T]axpayer had control of the intellectual property both before and after the transfer of the intellectual property to [Investments].
- The licensing agreement with [Investments] resulted in royalty expenses which substantially reduced the [T]axpayer's income without any clear economic benefit.
- Expenses to maintain the intellectual property are incurred by the [T]axpayer while [Investments] does little to maintain the value of the intellectual property.
- The [T]axpayer shares common officers with [Investments] demonstrating common control.
- Funds flow though the controlled affiliated corporate back to [Parent] and affiliates including [Taxpayer]. Through this arrangement, most of the [T]axpayer's profits flow to [Finance] which loans it to [Parent] and affiliates creating interest expenses on their returns in addition to the royalty expenses on the [T]axpayer's returns.
- Funds from the royalty payments flow in a circular manner within the controlled group from [Taxpayer] as royalties to [Investments] then as purchases of shares to [Finance] and then as loans to [Parent] and other affiliates including [Taxpayer]. This is evidence of a lack of economic substance. The [T]axpayer could achieve the same economic results (other than the tax effect) by not paying royalties and just making the loans directly to its [Parent] and affiliates.

As authority for its decision requiring the addback of the royalty expenses, the Audit Summary Report cited to IC § 6-3-2-20(b) which provides:

Except as provided in subsection (c), in determining its adjusted gross income under [IC 6-3-1-3.5\(b\)](#), a corporation subject to the tax imposed by [IC 6-3-2-1](#) shall add to its taxable income under Section 63 of the Internal Revenue Code:

- (1) intangible expenses; and
 - (2) any directly related intangible interest expenses;
- paid, accrued, or incurred with one (1) or more members of the same affiliated group or with one (1) or more foreign corporations.

The Department therefore added back the royalty expenses pursuant to IC § 6-3-2-20(b). In addition to the IC § 6-3-2-20(b) addback provision, the Department also cited to authority found at IC § 6-3-2-2(l) and (m). IC § 6-3-2-2(l) states:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
- (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis added).

IC § 6-3-2-2(m) authorizes the Department to resort to alternative methods of reporting income:

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The Audit Summary Report also concluded that "the [T]axpayer's reporting does not reflect the economic realities of its Indiana operations" and proceeded to add back \$338 million dollars in royalty expenses.

B. Taxpayer's Response.

Taxpayer maintains that the Department acted outside its authority in requiring Taxpayer to add back the interest expenses because Taxpayer "had no property, payroll, or sales in Indiana during the Years in Issue . . . and no apportionable income in Indiana in any event. Consequently, there is no adjusted gross income in Indiana to adjust."

In addition, Taxpayer states that the royalty transactions "were entirely extraterritorial to the State of Indiana." Taxpayer explains:

- Investments was a foreign corporation;
- Investments managed and controlled its intellectual property outside Indiana;
- Investment is managed by two directors unaffiliated with Taxpayer or any of the Parent or other affiliates;
- Investment's directors reside outside Indiana;
- Investment's directors' meetings take place outside Indiana;
- Investment's office is outside Indiana;
- The royalty licensing agreements were entered into outside Indiana;
- The licensing agreements are not governed by Indiana state law;
- All of licenses used the intellectual property outside Indiana;

Taxpayer points out that Finance conducted all of its business outside Indiana:

- Finance was a foreign corporation;
- Finance managed and controlled all of its assets outside Indiana;
- Finance is managed by directors who live outside Indiana;
- Finance's directors' meetings take place outside Indiana;
- Finance's office is outside Indiana;
- Finance's royalty agreements were entered into outside Indiana;
- Finance's licensing agreements are not governed by Indiana state law.

In addition, Taxpayer challenges the "addback" rules set out in IC § 6-3-1-3.5 and IC § 6-3-2-20 on the ground that these provisions tax "extraterritorial values" by "inextricably linking the ability to deduct expenses with the amount of tax a related company may have paid in another state." In effect, Taxpayer maintains that the addback provisions violate the Commerce Clause when the "practical effect is to control [conduct] beyond the boundaries of the state."

C. Analysis.

The Department disagrees with Taxpayer's interpretation of the relevant legal authorities and, in particular, Taxpayer's assertion that "there is no gross income to adjust." In unique circumstances such as here described, Taxpayer's interpretation would effectively render IC § 6-3-2-2(l), (m) a nullity. As the Indiana Tax Court explained in *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158, 1164 (Ind. Tax 1995), "The Court cannot presume the legislature intended to enact a nullity." Instead, the Department concludes that IC § 6-3-2-2(m) plainly provides the authority for the decision to disallow the royalty expenses at issue. The statute is clear: "[T]he department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers." *Id.* As set out in Part I and II above, Taxpayer clearly earned income from its membership in ILP. To allow Taxpayer to avoid tax by continuing to claim royalty expenses for the right to use intellectual property which it once owned - the nature and substance of which the Department raises legitimate questions - on the ground that it has no income to apportion, would render the IC § 6-3-2-2(l), (m) "fairly reflect" principle meaningless. Taxpayer's interpretation of Indiana law would create

a tax planning strategy not contemplated under either law or common sense; any taxpayer would be entitled to - as the audit report sets out - manage and transfer its intellectual property in such a way as to create a royalty obligations which are inherently distortive of the actual income earned within this state.

Taxpayer is, of course, entitled to transfer and structure ownership interest in its intellectual property in any way it deems appropriate. The Department recognizes that Taxpayer is under no obligation to manage its own property in such a way as to maximize its tax liability. As noted in *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." However, it should also be noted that in the Supreme Court decision *Gregory v. Helvering*, 293 U.S. 465 (1935), challenging the previously cited decision, the Court stated that in order to qualify for favorable tax treatment, a business reorganization must be motivated by the furtherance of a legitimate corporate business purpose. *Id.* at 469. A business activity undertaken merely for the purpose of avoiding taxes was without substance and "to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id.* at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial or industrial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." *Comm'r v. Transp. Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950).

The audit chose an alternative legitimately available under IC § 6-3-2-2(l), (m) which the audit regarded as an appropriate way to address what it regarded as the distortive effect of paying Investments \$338 million in royalties. Especially given the substantial amount of expenses claimed, the manner in which the parties structured the transfer of the intellectual property, the subsequent control and management of the intellectual property, and the ultimate disposition of the royalties to Taxpayer's parent, the audit's decision was not an unreasonable or untenable attempt to "effectuate an equitable allocation and apportionment of the taxpayer's income" which is supported by both the facts and law.

The Department does not agree that the specific addback provisions contained in IC § 6-3-1-3.5 and IC § 6-3-2-20 are constitutionally deficient on the ground that the provisions have an extraterritorial effect. Even given that both Finance and Investments structured and managed their business affairs outside Indiana, the Department's decision requiring the addback of the royalties was intended to address real and immediate effects within this state and to address Taxpayer's reporting obligations within this state. Whether or not - as Taxpayer contends - the addback has the effect of controlling Taxpayer and its related parties' conduct outside this state in such a way as to violate the Commerce Clause is not fully developed. As noted in *Sidle v. Majors*, 341 N.E.2d 763, 766 (Ind. 1976), "[E]very statute stands before us clothed with the presumption of constitutionality, and such presumption continues until clearly overcome by a showing to the contrary." See also *VanDam Estate v. Mid-America Sound*, 25 N.E.3d 165, 168-69 (Ind. Ct. App. 2015) (The court "will not presume the General Assembly violated the constitution unless the unambiguous language of the state so mandates.") Whether or not the statutory provisions on their face violate the Constitution's Commerce Clause is a matter not properly addressed within this administrative proceeding.

FINDING

Taxpayer's protest is respectfully denied.

IV. Administration - Underpayment Penalty.

DISCUSSION

The assessment of additional income tax triggered imposition of an underpayment penalty. Taxpayer maintains that the penalty is unlawful, because the Department has failed to meet its burden of substantiating the penalty, and that the penalty is "inherently arbitrary and capricious"

IC § 6-3-4-4.1(b) imposes on each taxpayer the responsibility to make and pay a "declaration of estimated tax for the taxable years" if the amount of that estimated is more than \$1,000. *Id.*

Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:

(1) twenty-five percent (25[percent]) of such corporation's estimated adjusted gross income tax liability for

the taxable year; or

(2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax. IC § 6-3-4-4.1(c).

IC § 6-3-4-4.1(d) imposes a penalty if a taxpayer fails to pay the correct amount of estimated tax.

The penalty prescribed by [IC 6-8.1-10-2.1](#)(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

(1) the annualized income installment calculated under subsection (c); or

(2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year. Id.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty."

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.

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"

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 the underpayment penalty - is presumptively valid.

As discussed in Parts I, II, and III above, the Department disagrees with Taxpayer's substantive arguments. The Department specifically refutes Taxpayer's argument that the penalty was "unlawful," that the Department is required to "prove" the penalty, or that imposition was either arbitrary or capricious. The routine imposition of the penalty is anything but "arbitrary" but is simply driven by straightforward application of IC § 6-3-4-4.1(d).

However, there is sufficient information to conclude that Taxpayer "exercised ordinary business care and prudence" and that the penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The Department agrees that the underpayment penalty should be abated but does not agree with Taxpayer's arguments as set out in Part I, II, and III.

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