
Indiana – General partner’s distributive income is operational income

July 11, 2013

UPDATE: Pursuant to a July 21, 2014, court order, the parties entered into a joint stipulation of dismissal. Accordingly, there will be no subsequent appeal to the Tax Court ruling.

In brief

An out-of-state corporation’s only connection with Indiana was its general partnership interest in a partnership doing business in Indiana. The corporation argued that, although a general partner, its absence of management control over the partnership causes income from the partnership to be treated as investment income, which is sourced to the corporation’s domicile outside of Indiana. The tax court disagreed, finding that the mere fact that the corporation was a general partner gives its income from the partnership the character of operational income. [[*Vodafone Americas Inc. v. Indiana Department of State Revenue*](#), Indiana Tax Court, No. 49T10-1002-TA-7 (6/18/13)]

In detail

During the fiscal years 2005 through 2008 at issue, Vodafone Americas Inc. was a 45% general partner in a partnership, Cellco, that was doing business in Indiana. Vodafone initially included a portion of its distributive share of Cellco’s income in its Indiana adjusted gross income tax returns for the years at issue. Vodafone subsequently filed refund claims for those years, asserting that its income from the Cellco partnership was not derived from sources within Indiana.

Income derived from sources within Indiana

Indiana’s adjusted gross income tax is measured by income ‘derived from sources within Indiana,’ which includes income from intangible property if such income is attributable to the state under Indiana’s sourcing rules.

Vodafone argued that its partnership interest was intangible property and, therefore, any income derived from that partnership interest was properly attributed based on Indiana’s intangible sourcing rules. Vodafone asserted that the applicable sourcing rule provides that receipts ‘in the

form of dividends’ from investments are attributable to Indiana if the taxpayer’s commercial domicile is in Indiana. Since Vodafone was not domiciled in Indiana, it asserted that none of its partnership income was attributed to Indiana.

Dividends from investments

The Tax Court recognized that the term ‘dividends from investments’ reflects a distinction between operational income and investment income (rather than a ‘dividend’ as commonly defined). Accordingly, the court examined whether income received from the partnership was in the

character of operational income or investment income

Vodafone argued that the substance of its participation in Cellco's business should control how its income is characterized. Despite the fact that it was a general partner, its lack of control over the partnership placed it essentially in the same position as being a limited partner, or passive investor, in Cellco. As an example of the absence of control, Vodafone could appoint only four of nine board members and corporate actions required a majority vote.

The court disagreed, observing that a limited partner is considered to be a passive investor because the quid pro quo for its limited liability is the sacrifice of its right to participate in the management of the enterprise. On the other hand, a general partner has a right to participate in management. The court found that the absence of 'control' is not determinative regarding whether one is a 'passive investor.' Examples of Vodafone participating in management include: appointing members to the board, appointing Cellco's chief financial officer, and holding certain veto rights. The court concluded that there mere fact that Vodafone was a general partner "gives its income from that partnership the character of operational income." As a result, Vodafone's income from Cellco could not be characterized as a dividend

from 'investments' and should be sourced based on Indiana's general sourcing rules.

The takeaway

Vodafone also argued that, as a passive investor, it did not exploit the Indiana marketplace so as to create a substantial nexus necessary to permit taxation under the Commerce Clause. Because the tax court rejected Vodafone's assertion that it was a passive investor, the court did not reach the nexus issue (which was premised on Vodafone's contention that it was passive investor).

Vodafone argued that its position was consistent with the tax court's opinion in [*Riverboat Development, Inc. v. Indiana Department of State Revenue*](#), 881 N.E.2d 107 (Ind. Tax Ct. 2008) (*RDI*), which held that income received by an out-of-state S corporation from its LLC doing business in Indiana was not 'derived from sources' within Indiana. The *RDI* court reached its conclusion by recognizing that the interest in an LLC is intangible property, and that income from intangible property is attributable to a taxpayer's corporate domicile.

The *Vodafone* court ruled against the taxpayer yet viewed its ruling as consistent with *RDI*. Similar to *RDI*'s treatment of the LLC interest, the *Vodafone* court recognized that the

partnership interest at issue was intangible property and that any income from the partnership would be sourced to the taxpayer's domicile. However, *Vodafone* introduced an additional consideration, not addressed in *RDI*, by measuring the partner's level of management control over the partnership. Finding that Vodafone did exercise control, the *Vodafone* court ruled that the partnership income could not be passive income and therefore should be attributed to Indiana. While the *Vodafone* court viewed its ruling as consistent with *RDI*, the *Vodafone* decision raises a concern that *RDI*'s precedential impact is minimized due to the introduction of a passive investor litmus test.

Note also that effective January 1, 2009, Indiana provides that income from an ownership interest in a pass-through entity doing business in Indiana is considered to be adjusted gross income from Indiana sources as if the owner had engaged directly in the pass-through's income producing activity. The passive v. operational test in the *Vodafone* decision could give rise to an argument that income from a limited partnership or LLC can qualify as passive investment income even after the law change.

This decision was based on a motion for summary judgement. Proceedings remain at the trial court to address other issues.

Let's talk

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