DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 05-0377
Adjusted Gross Income Tax
For the Tax Period 2000-2002

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ISSUES

I. Adjusted Gross Income Tax –Unitary Filing

Authority: IC § 6-8.1-5-1(b), IC § 6-3-2-2(l), IC § 6-3-2-2(m).

The taxpayer protests the imposition of combined unitary filing status.

II. Adjusted Gross Income Tax –Sales Factor

Authority: IC § 6-3-2-2(e), IC § 6-3-2-2(e)(1), IC § 2-5-3-1,45 IAC 3.1-1-53(7), *Miller Brewing Company v. Department of State Revenue,* 831 N.E.2d 859 (Ind.) Tax Ct. 2005), *Olympia Brewing Co. v. Comm'r of Revenue*, 326 N.W.2d 642, (Minn. 1982), *Dept. of Revenue v. Bulkmatic Transport*, 648 N.E. 2d 1156, 1159 (Ind. 1995), *General Motors Corp. v. Indiana Dep't of State Revenue*, 579 2d 399, 404 (Ind. Tax Ct. 1991).

The taxpayer protests the department's calculation of the sales factor.

III. Adjusted Gross Income Tax –Payroll Factor

Authority: IC § 6-3-2-2(d), *Wholesalers, Inc. v. Indiana Department of State Revenue,* 597 N.E.2d 1339 (Ind. Tax 1992).

The taxpayer protests the department's calculation of the payroll factor.

IV. Tax Administration- Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1, 45 IAC 15-11-2(b)(c).

The taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Corporation A is the parent corporation of the taxpayer and another subsidiary, Corporation B. Corporation A imports a product which is sold by the taxpayer to retail outlets for sale to the public. Corporation B sells the product to customers over the internet. During the tax period 2000-2002, the taxpayer filed Indiana corporate income tax returns and paid gross income taxes. In July 2004, the taxpayer filed amended income tax forms claiming exemption from the gross income tax and requesting a refund. Corporations A and B are non-filers for Indiana tax purposes. Pursuant to an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," confirmed that the taxpayer had properly calculated the gross income tax and denied the claim for refunds. The department also combined Corporations A, B, and the taxpayer for Indiana adjusted gross income tax purposes; and assessed additional adjusted gross income tax, interest, and penalty for the years 2001 and 2002. No additional adjusted gross income tax, interest, and penalty was assessed for the year 2000. The taxpayer protested and a hearing was held. This Letter of Findings results and addresses the adjusted gross income tax issues. A separate Notice of Decision addresses the gross income tax issues.

I. Adjusted Gross Income Tax-Unitary Filing

DISCUSSION

Indiana Department of Revenue assessments are prima facie evidence that the tax assessment is correct. IC § 6-8.1-5-1(b). The taxpayer bears the burden of proving that the assessment is incorrect. Id.

The department combined the taxpayer and its related corporations into a combined unitary return for adjusted gross income tax purposes under authority of IC § 6-3-2-2(l) as follows:

> 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 *or the department may require*, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting:
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> (2) the exclusion of any one (1) or more of the factors;
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> (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
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (emphasis added).

The department determined that the taxpayer's reporting method for adjusted gross income tax did not fairly reflect its Indiana sales. The distortion arose predominately from the assignment of cost of goods values. Prior to the division of one corporation into the taxpayer and the two related corporations that were the subject of this audit, the ratio of the cost of goods sold to total sales was 56.54 percent After the reorganization, the parent corporation sold the product to the taxpayer for a ratio of the cost of goods sole to total sales of 90.73 percent. The same product was sold to the related internet sales corporation for a ratio of the cost of goods to total sales of

54.39 percent. In more concrete terms, if one of the taxpayer's widgets was sold to the public for $100, the taxpayer paid $90.73 in costs and Corporation B (internet sales corporation) paid $54.39. There is no rationale for the widget sold in a store having a forty percent higher book value than the same widget sold over the internet. The effect of the higher cost of goods sold distorted the amount of the taxpayer's adjusted gross income by artificially lowering it to less than 10 percent of the retail sale price. This valuation did not fairly reflect the transaction. Although the taxpayer raises issues concerning royalty payments, the argument for distortion can be made solely on the variance in the cost of goods sold between the taxpayer and Corporation B.

In order to alleviate this distortion, the department mandated that the corporations file a combined unitary return for adjusted gross income tax purposes pursuant to the following provisions of IC § 6-3-2-2(m) as follows:

> 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 taxpayer's method of filing and paying Indiana adjusted gross income tax did not fairly reflect the income from Indiana sources. The department could not fairly reflect the taxpayer's net income through other means. Therefore, the department properly required the taxpayer and its related corporations to file Indiana adjusted gross income tax returns on a combined unitary basis.

FINDING

The taxpayer's protest is denied.

II. Adjusted Gross Income Tax–Sales Factor

DISCUSSION

The department determined the sales factor following the apportionment procedure set out at IC § 6-3-2-2(e) in relevant part as follows:

> The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year...

The taxpayer argues that there were no sales in Indiana to include in the numerator. The taxpayer bases this argument on the Indiana Tax Court decision in *Miller Brewing Company v. Department of State Revenue,* 831 N.E.2d 859 (Ind. Tax Ct. 2005) (*Miller 1).* In that case, Miller Brewing Company sold beer to Indiana purchasers. Those purchasers arranged for the transportation by commercial carrier of the beer to Indiana. The Tax Court determined that in Miller's case, the receipts from the customer-arranged-sales were not to be included in the numerator of the Indiana sales factor because the customers picked up the product in another state. The Tax Court based this decision on its interpretation of 45 IAC 3.1-1-53(7) which states that sales where purchasers pick up their purchases in another state actually take place in the other state. The department appealed the ruling on procedural grounds. The Tax Court declined to address the issue. The taxpayer argues that its customers also arrange transportation by commercial carrier of the product they buy from the taxpayer in the same manner as the customers of Miller Brewing Company. Therefore, the taxpayer's income from customer-arranged-sales should not be included in the numerator of the sales factor. Since they have no other sales, that would effectively exempt all of their income from Indiana adjusted gross income tax.

The department disagrees with this position. In its discussion of the sales to be included in the numerator of the sales factor, the statute mandates the inclusion of the following types of sales at IC § 6-3-2-2(e)(1) in relevant part as follows:

> Sales of tangible personal property are in this state if:
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> > (1) the property is delivered or shipped to a purchaser, other than the United States government, within this state, regardless of the f.o.b. point or other conditions of the sale;...

With this language, Indiana has adopted a "destination rule." ("[I]f the shipment terminates in this state there is a delivery or shipment within this state and the sale is deemed [within the state]. *Olympia Brewing Co. v. Comm'r of Revenue*, 326 N.W.2d 642, 861 (Minn. 1982)). The department asserts that Indiana should source out-of-state "customer –arranged-transportation" sales to the Indiana sales factor as long as the product comes directly to Indiana. The Uniform Division of Income for Tax Purposes Act ("UDITPA"), which Indiana follows, interprets the statutory language as a mandatory destination rule and prescribes the inclusion of the customer-arranged-transportation sales in the numerator of the Indiana sales factor.

In addition, the department does not agree that the taxpayer has met its burden of demonstrating that it is entitled to exclude the "customer-arranged-transportation" Indiana sales from the formulary apportionment. The taxpayer's position flies in the face of the well established principle that "ambiguous exemption statutes are to be strictly construed against the taxpayer." *Dept. of Revenue v. Bulkmatic Transport*, 648 N.E.2d 1156, 1159 (Ind. 1995), *General Motors Corp. v. Indiana Dep't of State Revenue*, 579N.E.2d 399, 404 (Ind. Tax Ct. 1991). Although the department does not agree that the statutory exemption is ambiguous, and, if it were, the taxpayer's eligibility to utilize the exemption would be denied.

The *Miller I* decision entirely removes the taxpayer's "customer-arranged-transportation" sales from Indiana taxation. The taxpayer's own home-state uses the majority "destination rule" and sources the taxpayer's

"customer-arranged-transportation" sales to Indiana for adjusted gross income taxation purposes. As a result, the taxpayer's home state does not impose its own adjusted gross income tax on these sales thereby making the "customer-arranged-transportation sales "nowhere sales." These sales are sourced to no state and are free from taxation. The result is that in-state taxpayers, who make "customer-arranged-transportation" sales to non-Indiana customers will be required to source these sales to Indiana while out-of-state taxpayers, engaging in the same type of transaction, will be insulated from paying tax to any state. The taxpayer's position conflicts with Indiana's revenue policy found at IC § 2-5-3-1 which mandates a "revenue raising structure in Indiana that will provide adequate revenues to carry on the efficient operation of the state, county, and city governments and at the same time will assure that *its burdens will be shared equitably by all taxpayers*." (emphasis added). The result taxpayer seeks is an anomalous tax-free zone which plainly contradicts the Indiana General Assembly's intent and raises issues of a practical, equitable, and constitutional dimension.

Notwithstanding the decision set out in *Miller I,* IC § 6-3-2-2(e)(1) establishes a destination rule. The customer-arranged-transportation sales were properly included in the formulary apportionment for Indiana Adjusted Gross Income Tax purposes.

FINDING

The taxpayer's protest is denied.

III. Adjusted Gross Income Tax –Payroll Factor

DISCUSSION

The department determined the payroll factor following the apportionment procedure set out at IC § 6-3-2-2(d) in relevant part as follows:

> The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the taxable year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year....

The taxpayer argues that it had no employees in Indiana during the tax period. Therefore, it did not have any Indiana payroll to include in the numerator of the payroll factor.

In support of its contention that it had no Indiana employees, the taxpayer cites contracts between itself and two persons. The contracts referred to the persons in Indiana as independent contractors. However, a memo from taxpayer's Senior Vice President dated February 10, 1997, stated that the memo is concerning a "New Hire." The memo went on to state that the memo recipients are to, "Please make sure [representative] receives the necessary documents for new employees from our personnel department ASAP." The taxpayer withheld Indiana adjusted gross income taxes on these persons. These factors indicate that the representatives were in actuality considered employees of the taxpayer. The department determines tax consequences by construing the substance of the agreement over the form. *Wholesalers, Inc. v. Indiana Department of State Revenue,* 597 N.E.2d 1339 (Ind. Tax Ct. 1992). Although the contract labeled the Indiana persons independent contractors, they were employees.

The payroll for the employees was properly included in the numerator of the payroll factor.

FINDING

The taxpayer's protest is denied.

IV. Tax Administration- Ten Percent Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> 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.
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> The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:
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> 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:
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> (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.

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

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