**DEPARTMENT OF STATE REVENUE**

02-20070255.LOF

**Letter of Findings Number: 07-0255**
**Adjusted Gross Income Tax**
**For the Tax Period 2003 - 2005**

**NOTICE:** Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Adjusted Gross Income Tax – Forced Combination.**
**Authority:** IC § 6-8.1-5-1(c); IC § 6-3-2-2; 45 IAC 3.1-1-62.

The Taxpayer protests the forced combination of related companies for adjusted gross income tax purposes.

**II. 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**

The Taxpayer is a distribution company for the sale of medical products. In an audit for the years 2003-2005, the Indiana Department of Revenue (Department) combined the Taxpayer with several related companies that produce the medical products distributed by the Taxpayer. This forced combination of the related corporations resulted in an assessment of additional adjusted gross income tax, interest, and penalty. The Taxpayer protested the assessments of adjusted gross income tax and penalty. A hearing was held and this Letter of Findings results.

**I. Adjusted Gross Income Tax – Forced Combination.**

**DISCUSSION**

Tax assessments are presumed to be accurate. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id*.

The Department combined the Taxpayer and its related corporations into combined Indiana returns for the tax period 2001 - 2003 pursuant to the provisions of IC § 6-3-2-2 as follows:

> ...
> (l) 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 of the taxpayer's business activity, if reasonable:
> (1) separate accounting:
> (2) the exclusion of any one (1) or more of the factors:
> (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.
> (m) 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 Department's requirements for forcing a combination of related corporations is also described at 45 IAC 3.1-1-62 as follows:

> All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2(l)(4) [45 IAC 3.1-1-37 – 45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

When a taxpayer's method of filing individual Indiana adjusted gross income tax returns for related corporations distorts the Taxpayer's income from Indiana sources, the Department may require that the related taxpayers file a combined return. The purpose of the forced combined return would be to fairly reflect the taxpayer and related corporations' actual Indiana income and expenses.

The first step the Department must follow in forcing a combination of corporations for adjusted gross income

tax purposes is a finding that the corporations form a unitary group. In this situation, the Taxpayer agrees with the Department that it and the related corporations form a unitary group.

Secondly, the Department must make a finding that the Taxpayer's method of filing the adjusted gross income tax distorts the Taxpayer's Indiana income and/or expenses. The Department's audit explanation of adjustments contains the following language:

> It is the opinion of the auditor that separate filing does not reflect the income attributable to the State of Indiana for the years under audit... On audit it was determined that if a unitary return was not filed, the amount of income reported to Indiana would not fairly reflect the income originating from operations within Indiana... In order to more properly determine the income generated by Indiana activities, the taxpayer and all related companies have been combined. This combination gives a better view of the entire business enterprise....

Each of these statements is a conclusion by the auditor that the Taxpayer's method of filing distorts the Taxpayer's Indiana income and/or expenses and requires a forced combination to remedy the distortion. The audit report does not provide an explanation of how the Taxpayer's reporting procedures were inadequate. The audit report gives no indication of any particular circumstance such as the manufacturing facilities charging the Taxpayer unusually high prices for the medical equipment that the Taxpayer distributes causing the distortion. Neither does the audit report explain why a combined filing was necessary in this case.

Without a finding supported by some specific facts that the Taxpayer's method of filing distorted the Taxpayer's Indiana income, the Department cannot at this time force a combination of the Taxpayer and its related corporations for adjusted gross income tax purposes.

During the audit process, the Taxpayer discovered that the related manufacturers purchased stock options from the Taxpayer. The income from these purchases should be added to the Taxpayer's income prior to apportionment.

**FINDING**

The Taxpayer's protest to the forced combination is sustained. The income from the stock options will be added to the Taxpayer's pre-apportionment income.

**II. 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.

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

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer provided substantial documentation to indicate that its failure to pay the correct amount of adjusted gross income tax was due to reasonable cause rather than negligence.

**FINDING**

The Taxpayer's protest to the imposition of the penalty is sustained.

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