

Letter of Findings Number: 02-20120189
Adjusted Gross Income Tax
For Fiscal Year End March 30 2006, 2007, and 2008 Tax Years

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ISSUES

I. Adjusted Gross Income Tax–Business/Non-Business Income.

Authority: IC § 6-3-1-20; IC § 6-8.1-5-1; [45 IAC 3.1-1-29](#); [45 IAC 3.1-1-30](#); May Dep't Store Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001).

Taxpayer protests the reclassification of income from non-business income to business income.

II. Adjusted Gross Income Tax–"RAR Adjustments."

Authority: IC § 6-8.1-5-1.

Taxpayer protests that certain federal revenue agent report ("RAR") adjustments need to be made to arrive at the proper assessment amounts.

III. Adjusted Gross Income Tax–Mathematical Error.

Authority: IC § 6-8.1-5-1.

Taxpayer protests the calculation of its Indiana apportioned income for the fiscal year end March 30, 2007.

IV. Tax Administration–Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is engaged in the information technology and professional services industries serving government and non-government entities and files Indiana adjusted gross income tax returns reporting its Indiana activity. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had adjusted gross income tax liabilities for 2006, 2007, and 2008 and issued proposed assessments for the additional adjusted gross income tax, interest, and penalties for the 2006, 2007, and 2008 fiscal year end March 30 tax years. Taxpayer protested. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Business/Non-Business Income.

DISCUSSION

Taxpayer protests the reclassification of income from the sales of two of its subsidiaries. Taxpayer states that its main line of business is providing information technology services and that it acquired these two subsidiaries in a merger which occurred prior to the audit years. At hearing, Taxpayer stated that this merger was undertaken to allow Taxpayer to acquire the merged company's information technology service subsidiaries and that it never intended to operate these two subsidiaries as part of its core business. After the merger, Taxpayer continued to operate these two subsidiaries. Taxpayer also asserts that the sale of the two subsidiaries in question represent non-business income because the sales were not conducted as part of Taxpayer's normal business operations. 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 Department relied upon [45 IAC 3.1-1-29](#) in determining that the income in question was business income. [45 IAC 3.1-1-29](#) states:

"Business Income" is defined as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business.

Also, the Department referred to [45 IAC 3.1-1-30](#), which states:

For purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression "trade or business" is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business and

derive business therefrom depending upon but not limited to some or all of the following:

- (1) The nature of the taxpayer's trade or business.
- (2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period.
- (3) The frequency, number, or continuity of the activities and transactions involved.
- (4) The length of time the property producing income was owned by the taxpayer.
- (5) The taxpayer's purpose in acquiring and holding the property producing income.

Also of relevance is IC § 6-3-1-20, which provides:

The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

Further guidance in determining business income under Indiana law is found in *May Dep't Store Co. v. Indiana Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax Ct. 2001), in which the Indiana Tax Court determined that IC § 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. *Id.* at 662-3. Taxpayer states that the sale of its subsidiary does not meet either the transactional test or functional test and that the income from the sale is therefore non-business income.

In *May*, the court looked to [45 IAC 3.1-1-29](#) and 30 for guidance in determining whether income is business or non-business income under the transactional test. These regulations state, "[T]he critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." *May*, 749 N.E.2d at 664. [45 IAC 3.1-1-30](#) lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In *May*, the court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. *May*, 749 N.E.2d at 664.

The functional test focuses on the property being disposed of by the taxpayer. *Id.* Specifically the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. *Id.* In order to satisfy the functional test the property generating income must have been acquired, managed, and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. *Id.* The court in *May* defined "integral" as "necessary or essential to complete the whole." *Id.* at 664-5. The court held that *May's* sale of one of its retailing divisions was not "necessary or essential" to *May's* regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not *May*. In essence, the court determined that because *May* was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to *May's* business operations. Therefore, the proceeds from the sale were not business income under the functional test.

During the hearing, Taxpayer was asked to provide documentation—i.e., board minutes, merger agreements, press releases, etc.—that would support its assertions that Taxpayer never intended to operate these subsidiaries as part of its business strategy and that these subsidiaries were only operated until a buyer could be found. Taxpayer was also asked to provide documentation and analysis that would establish that the sale was not necessary or essential to its regular trade or business—i.e., the subsidiaries in question were not acquired, managed, and disposed of by Taxpayer in a process integral to Taxpayer's regular trade or business. However, Taxpayer did not provide any documentation to support its assertions. Therefore, Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) to establish that the sales of the two subsidiaries in question did not meet either the transactional test or the functional test as provided in *May*. In fact, the Department, in researching publicly available information that Taxpayer had included with its reports to the U.S. Securities and Exchange Commission, found that Taxpayer's merger agreement did not mention these operations being discontinued but discussed other areas where operations were to be discontinued. In these reports, Taxpayer also stated that its decision to sell the two subsidiaries was part of its business strategy because it would raise capital, allow it to pay debts, and allow it to refocus its operations on what it considered its core operations.

Alternatively, Taxpayer asserts if the income is properly classified as business income, these items of business income should be included in the apportionment factor as well. It appears that these income amounts may not have been taken into account in Taxpayer's apportionment factor. While under IC § 6-8.1-5-1(c) Taxpayer has not proven that the assessment is wrong, Taxpayer has raised an issue which should be considered during a supplemental audit. The audit division is requested to review the audit report, to review the accompanying documentation, and to make whatever adjustments it deems warranted.

FINDING

While Taxpayer's protest is respectfully denied as to the substantive issue of the classification of this income as business, Taxpayer's protest as to the apportionment calculation is sustained subject to the results of a supplemental audit.

II. Adjusted Gross Income Tax—"RAR Adjustments."

DISCUSSION

Taxpayer claims that the audit failed to take into account certain "RAR adjustments" in the calculation of its Indiana adjusted gross income.

It appears that Taxpayer may be correct. While under IC § 6-8.1-5-1(c), Taxpayer has not proven that the assessment is wrong, Taxpayer has raised an issue which should be considered during a supplemental audit. The audit division is requested to review the audit report, to review the accompanying documentation, to review the amended returns Taxpayer filed reporting the RAR adjustments, and to make whatever adjustments it deems warranted.

FINDING

Taxpayer's protest is sustained subject to the result of a supplemental audit.

III. Adjusted Gross Income Tax—Mathematical Error.

DISCUSSION

Taxpayer claims that the audit made a "mathematical error" in the calculation of its Indiana apportioned income for fiscal year end March 20, 2007, as noted on page 19 of the audit report.

It appears that a multiplication error occurred. While under IC § 6-8.1-5-1(c), Taxpayer has not proven that the assessment is wrong, Taxpayer has raised an issue which should be considered during a supplemental audit. The audit division is requested to review the audit report, to review the accompanying documentation, and to make whatever adjustments it deems warranted.

FINDING

Taxpayer's protest is sustained subject to the result of a supplemental audit.

IV. Tax Administration—Negligence Penalties.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to [45 IAC 15-11-2\(b\)](#), which states:

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.

[45 IAC 15-11-2\(c\)](#) provides in pertinent part:

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.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under [45 IAC 15-11-2\(b\)](#), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer was denied on certain of its protest issues, it has affirmatively established that the deficiency was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#). The negligence penalty will be waived.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest to the imposition of adjusted gross income tax from the reclassification of non-business income to business income is respectfully denied, but Taxpayer's protest as to the apportionment calculation is sustained subject to the results of a supplemental audit, as discussed in Issue I. Taxpayer's protest to imposition of tax resulting from not incorporating its RAR adjustments for the years in question is sustained subject to the result of a supplemental audit, as discussed in Issue II. Taxpayer's protest regarding the calculation of its Indiana apportioned income for the fiscal year end March 30, 2007, is sustained subject to the result of a supplemental audit, as discussed in Issue III. The audit division is requested to review the calculation and to assure that the calculation comports with the findings of the corresponding audit report. Taxpayer's protest to the imposition of negligence penalties is sustained, as discussed in Issue IV.

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