DEPARTMENT OF STATE REVENUE

04-20170095.LOF

Letter of Findings Number: 04-20170095
Corporate Income Tax / Gross Retail Tax
For Tax Years 2013, 2014 and 2015

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Purchases of slot cars by Indiana Business were correctly classified as hobby activity and were therefore properly excluded from business expenses and assessed additional use tax. Indiana Business also failed to adequately document business-related fuel expenses and therefore did not show that a reduction in allowable deductions was incorrect.

ISSUES

I. Corporate Income Tax–Business expense deductions.

Authority: I.R.C. § 62; I.R.C. § 162; Treas. Reg. § 1.183-2; IC § 6-3-1-3.5; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Hopkins v. Comm'r*, T.C. Memo 2005-49 (2005); *Bower v. Comm'r*, T.C. Memo 1990-16 (1990); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); I.R.S. Pub. 463.

Taxpayer protests the exclusion of slot car and fuel purchases from deductible business expenses.

II. Use Tax–Retail sales exemption.

Authority: I.R.C. §183; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-1; IC § 6-2.5-5-8; *Rhoade v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044 (Ind. T.C. 2002); *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466 (Ind. Tax Ct. 1993); *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.,* 310 N.E.2d 96 (Ind. Ct. App. 1974); 45 IAC 2.2-3-4; 45 IAC 2.2-5-15.

Taxpayer protests the imposition of use tax on purchases of slot cars and accessories.

STATEMENT OF FACTS

Taxpayer is an Indiana subchapter S corporation in the business of selling lawn mowers and other outdoor power equipment. During the audit period, Taxpayer also purchased "slot cars" which are miniature, collectable cars that race on electric race tracks. The Indiana Department of Revenue ("Department") conducted a corporate income tax audit and sales/use tax audit of Taxpayer for the tax years 2013, 2014, and 2015. The Department's corporate income tax audit found that expenses resulting from the purchase of slot cars had been improperly deducted as business expenses, and that Taxpayer had overstated its deduction for fuel expenses. The Department's sales/use tax audit found that Taxpayer made several purchases of items subject to use tax, including slot cars and related supplies. As a result, the Department assessed additional corporate income tax, use tax and interest against Taxpayer. Because Taxpayer is an S corporation, the income tax liability flows through to Taxpayer's sole shareholder ("Shareholder"). Shareholder's protest is addressed in Letter of Finding 01-20170094 and issued in a separate decision.

Taxpayer protested the audit adjustments. A hearing was held during which Taxpayer and Taxpayer's representative explained the basis of its protest. This Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax–Business expense deductions.

DISCUSSION

Taxpayer protests the disallowance of certain business expense deductions originally reported on its corporate income tax returns for the tax years 2013, 2014, and 2015. The Department determined that the purchases of slot cars were not eligible as business deductions because the purchases were made as the individual shareholder's hobby. The Department also reduced the amount of fuel expense deductions allowed to fifty-percent of what Taxpayer originally reported because the amount reported was unreasonable and not supported by adequate documentation.

Taxpayer argues that the slot cars were properly deducted as business expenses because Taxpayer is an authorized dealer of the slot cars. During the 3-year audit period at issue, Taxpayer purchased $36,953 in slot cars and related equipment and made a total of $203.99 in sales during the same period. Taxpayer also argues that the Department improperly reduced its fuel expenses deduction and that the disallowed expenses were for use in Taxpayer's business.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing 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 Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. 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, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Indiana defines the term adjusted gross income "as [it is] defined in Section 62 of the Internal Revenue Code" with Indiana-specific modifications. IC § 6-3-1-3.5(a). Section 62 of the Internal Revenue Code defines adjusted gross income as "gross income minus [specific] deductions" which includes "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 62(a); I.R.C. § 162. Certain deductions are allowed for businesses for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162. "Ordinary" refers to expenses that "should have a reasonably proximate relation to the operation of [a taxpayer's] trade or business." *Bower v. Comm.*, T.C. Memo 1990-16 (1990). A general statement that "expenses were incurred in pursuit of a trade or business is not sufficient to establish that the expenses had a reasonably direct relationship to any such trade or business." *Hopkins v. Comm'r*, T.C. Memo 2005-49 (2005).

A. Slot Car Related Expenses

The audit report found that Shareholder had purchased slot cars and other related items and expensed them through Taxpayer's business under "cost of goods sold," "supplies expense" or "slot car expense." The audit report concluded that Taxpayer was not in the business of purchasing and reselling slot cars; rather, the audit found that the slot cars constituted Shareholder's hobby. The audit thus disallowed all of the expenses related to the slot cars over and above the amount of sales made during the audit period, finding that the activity was not operated in the manner of a business. Taxpayer argues that the purchases of slot cars and related accessories are part of its regular business activity.

Activities conducted as hobbies are not deductible as ordinary and necessary expenses under I.R.C. § 162. In order to determine whether a taxpayer's activity constitutes a business or a hobby, the IRS employs a nine-factor test set forth in Treas. Reg. § 1.183-2(b). The nine factors are as follows:

> **Relevant factors**. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) Manner in which the taxpayer carries on the activity. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) The expertise of the taxpayer or his advisors. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) The time and effort expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) Expectation that assets used in activity may appreciate in value. The term profit encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) The taxpayer's history of income or losses with respect to the activity. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. *However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.* If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) The amount of occasional profits, if any, which are earned. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. *An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit.* However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. *Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.*

> **(9) Elements of personal pleasure or recreation.** The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.
> (*Emphasis added*).

The Department does not agree that the slot car purchases are part of Taxpayer's business because the activity only fulfills one factor of the nine-factor test. The slot car activity fulfills factor four, the expectation that assets used in the activity may appreciate in value. Taxpayer stated that the slot cars are collectable items available on a limited basis that tend to increase in value over time. For this reason, Shareholder stated that he holds onto the slot cars so that their value may increase. However, Shareholder also stated during both the audit investigation and the protest hearing that he regards the purchase of slot cars as an "investment" for his retirement, and did not indicate that there was a set period of time for a retailer to retain its inventory in order for the slot cars to increase in value prior to sale. Nevertheless, the slot cars do appreciate in value, so this factor is satisfied.

Taxpayer's slot car activity does not satisfy the remaining eight factors considered in order to distinguish business from hobby activities. The manner in which Taxpayer carries on the activity is not consistent with a business; Taxpayer does not advertise the slot cars and accessories for sale, with the exception of a decal on Taxpayer's door; Taxpayer does not display the slot cars in its main showroom, but rather keeps them in an upstairs storage area not readily accessible to the public; and Taxpayer has not undertaken any efforts to increase its slot car sales over the audit period. Taxpayer has not demonstrated his or his advisors' expertise in the sale of slot cars, and the demonstrated expertise is primarily in the collection and racing of the slot cars. Taxpayer expends disproportionately less time and effort in selling slot cars as compared to the sales of its other products, and had only $203.99 in sales of slot cars and accessories for the 3-year audit period as compared to purchasing approximately $37,000 worth of slot car inventory during the same time period. Finally, Taxpayer's advertising with respect to the slot car activity is primarily focused on racing events, and Shareholder expressed that he is acquiring the slot cars as an investment for his personal retirement. There is a strong recreational and personal purpose in engaging in the slot car activity, and Taxpayer derives substantially all of its income from other products sold by the business.

These facts and the associated factors do not demonstrate that Taxpayer is engaged in the slot car activity for profit. The Department concludes that the slot car purchases constitute a hobby, and Taxpayer has not shown that the disallowance of these expenses, over and above the amount of sales, to be incorrect. Taxpayer is free to sell whatever type of merchandise it deems appropriate for its business; however the activity must be operated in the manner of a business in order to be considered a business expense. Taxpayer has not met its burden of proving the proposed assessment wrong with regard to the slot car activity, as required by IC § 6-8.1-5-1(c). For that reason, the deductions associated with slot car and accessory purchases were properly disallowed because they were not ordinary and necessary business expenses of Taxpayer's business.

B. Fuel Expenses

The corporate income tax audit report concluded that Taxpayer's deduction of the cost of fuel purchases under fuel/oil expense was excessive, and reduced the amount claimed by fifty percent. The audit report found that Taxpayer did not maintain mileage logs to account for the fuel usage, but concluded that Taxpayer was entitled to deduct some fuel expenses for use in the regular course of its business. Taxpayer argues that a greater amount of fuel expenses should have been allowed as business deductions.

If an individual uses a vehicle for business purposes, the taxpayer may deduct vehicle expenses using one of two methods to calculate the deductible expenses: (1) standard mileage rate, or (2) actual vehicle expenses. I.R.S. Pub. 463: TRAVEL, ENTERTAINMENT, GIFT, AND CAR EXPENSES, 2015 WL 10322924, at *32. Actual vehicle expenses include depreciation, licenses, fuel, oil, tolls, lease payments, insurance, garage rent, parking fees, registration fees, repairs, and tires. *Id.* at *34. Taxpayer utilized the second option and reported the deductions as actual vehicle expenses. Taxpayer provided copies of receipts and spreadsheets, prepared for the protest,

separating out the fuel purchases based upon its best estimation of the purpose of each transaction. Taxpayer did not keep contemporaneous records to designate whether each purchase was made for business or personal use.

It must be pointed out that, "Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for tax by reviewing those books and records." IC § 6-8.1-5-4(a). The very basis for that requirement is that Taxpayer maintain demonstrably *accurate* reports. Taxpayer has failed to do so, and now is in a position that makes it difficult for Taxpayer to overcome its statutory threshold to prove that any portion of the assessment was wrong. IC § 6-8.1-5-1(c). Taxpayer's alternative estimations do not rise to the level of record-keeping and do not satisfy the statutory requirements placed on it as a taxpayer. Without the contemporaneous records regarding the nature of the fuel usage as business or personal, Taxpayer's alternative estimations are not sufficient to prove the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest with respect to disallowed business expenses deductions is respectfully denied.

II. Use Tax–Retail sales exemption.

DISCUSSION

The sales and use tax audit report assessed Taxpayer additional use tax on the purchase of slot cars and accessories. The audit found that the purchases made above and beyond the inventory sold during the audit period did not qualify for an exemption from gross retail tax. *See* I.R.C. §183(b) (allowable deductions for activities not engaged in for profit). Because sales tax was not paid at the time of purchase, the audit assessed use tax on the slot cars and accessories that were not subsequently sold during the audit period. Taxpayer asserts that the slot car purchases are exempt under the retail resale exemption found in IC § 6-2.5-5-8(b).

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). Use means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a).

The use tax is functionally equivalent to the sales tax. *See Rhoade v. Ind. Dep't of State Revenue*, 774 N.E.2d 1044, 1047 (Ind. T.C. 2002). By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. *Id*. at 1048; *USAir, Inc. v. Indiana Dep't of State Revenue*, 623 N.E.2d 466, 469 (Ind. Tax Ct. 1993). An exemption from the use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4 and 45 IAC 2.2-3-4. There are various tax exemptions available under IC 6-2.5-5; these enumerated exemptions also apply to transactions which are subject to Indiana use tax. 45 IAC 2.2-3-14.

Taxpayer has the burden of establishing that it is entitled to the sought after exemption. In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dept. of State Rev. v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988). A statute which provides a tax exemption, however is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.,* 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101 (citing *Conklin v. Town of Cambridge City,* 58 Ind. 130, 133 (1877)).

Indiana provides an exemption from gross retail tax for purchases made by retailers for resale under IC § 6-2.5-5-8(b), which states:

> Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

Also of relevance is 45 IAC § 2.2-5-15, which states:

(b) General rule. Sales of tangible personal property for resale, rental or leasing are exempt from tax if all of the following are satisfied:

(1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;

(2) **The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business**; and

(3) The property is resold, rented or leased in the same form in which it was purchased.

(c) Application of general rule.

(1) **The tangible personal property must be sold to a purchaser who makes the purchase with the intention of reselling, renting or leasing the property**. This exemption does not apply to purchasers who intend to consume or use the property or add value to the property through the rendition of services or performance of work with respect to such property.

(2) **The purchaser must be occupationally engaged in reselling, renting or leasing such property in the regular course of his business. Occasional sales and sales by servicemen in the course of rendering services shall be conclusive evidence that the purchaser is not occupationally engaged in reselling the purchased property in the regular course of his business.**
(**Emphasis added**).

As discussed in Issue I, the purchases of the slot cars and accessories were not for a business purpose, but rather for Shareholder's personal hobby. Taxpayer did not demonstrate an intention to resell the property in the regular course of its business during the audit period; rather, Shareholder expressed that he intends to hold onto the property for his personal retirement. Taxpayer's sales records indicate that it was only engaged in occasional sales of slot cars and accessories, which is "conclusive evidence" that Taxpayer is not occupationally engaged in reselling the property in the regular course of its business. 45 IAC § 2.2-5-15(c)(2).

The Department concludes that Taxpayer does not meet the requirements for the resale exemption to apply to the slot car purchases, and therefore has not met its burden under IC § 6-8.1-5-1(c) of showing that the proposed assessment of additional use tax was incorrect.

FINDING

Taxpayer's protest of use tax assessed on slot car and accessory purchases is respectfully denied.

SUMMARY

Taxpayer's protest with respect to both Issue I and Issue II is respectfully denied.

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