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| CINTAS SALES CORPORATION<br>CINTAS CORPORATION NO. 2<br>CINTAS CORPORATION NO. 1<br>P.O. Box 625737<br>Cincinnati, OH 45262-5737, | § | STATE OF ALABAMA<br>DEPARTMENT OF REVENUE<br>ADMINISTRATIVE LAW DIVISION |
| Taxpayers, | § | DOCKET NOS. CORP. 03-332<br>CORP. 04-125<br>CORP. 04-163 |
| v. | § | |
| STATE OF ALABAMA<br>DEPARTMENT OF REVENUE. | § | |

**OPINION AND PRELIMINARY ORDER**

The Department assessed Cintas Sales Corporation ("Cintas Sales") for corporate income tax for the fiscal years ending May 31, 1999 and May 31, 2000; Cintas Corporation No. 1 ("Cintas No. 1") for the fiscal year ending May 31, 2000; and Cintas Corporation No. 2 ("Cintas No. 2") for the fiscal year ending May 31, 2001. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. The appeals were consolidated, and a hearing was conducted on May 13, 2004.[1] Bruce Ely and Russell Cunningham represented the Taxpayers. Assistant Counsel Jeff Patterson and Wade Hope represented the Department. Assistant Counsel J.R. Gaines subsequently filed the Department's brief.

The Taxpayers were wholly-owned subsidiaries of Cintas Corporation ("Cintas") during the years in issue. The Cintas family of companies, i.e., the Cintas Group, manufactures, sells, rents, and launders identity uniforms for businesses, among other

[1] The Administrative Law Division held the case in abeyance by agreement of the parties after the May 2004 hearing to allow the parties time to settle the case. The parties notified the Administrative Law Division in August 2006 that they were unable to settle the case. The parties thereafter filed briefs, with the Taxpayers' reply brief being filed in January 2007.

activities. Cintas Sales and Cintas No. 1 were independent operating subsidiaries before June 1, 2000. The Cintas Group restructured effective that date, with Cintas Sales and Cintas No. 1 becoming operating divisions of the newly-created Cintas No. 2.

The Department audited the Taxpayers and entered the final assessments in issue. As explained below, the final assessment against Cintas No. 1 is no longer disputed.

**ISSUES**

The issues involving Cintas Sales and Cintas No. 2 are as follows:

(1) Did Cintas Sales and Cintas No. 2 correctly compute their federal taxable income reported on line 1 of their Alabama returns in the subject years. Specifically, in computing the line 1 amounts, did Cintas Sales and Cintas No. 2 correctly subtract their non-taxable intra-company sales from the federal taxable income amounts reported on line 28 of the pro forma federal returns submitted with their Alabama returns.[2] If so, did Cintas Sales and Cintas No. 2 provide the Department with records and other evidence identifying the intra-company sales and proving that the Alabama line 1 amounts as reported were the federal line 28 amounts less the intra-company sales?

(2) Did Cintas Sales and Cintas No. 2 correctly exclude their non-taxable intra-company sales from their respective apportionment sales factors?

(3) Should the Alabama deduction for federal tax paid be computed consistently, i.e., pursuant to 26 U.S.C. §1552(a)(1), for all three Taxpayers in the years in issue?

[2] As discussed below, intra-company sales are non-taxable transfers between divisions within each Cintas Group subsidiary, as recorded on Cintas' computerized general ledger system.

## FACTS

Cintas and its subsidiary corporations filed consolidated federal income tax returns during the years in issue. The Taxpayers in this case filed separate Alabama returns in those years. They also prepared and submitted pro forma separate federal returns with their Alabama returns, as directed by the instructions on the Alabama return. Federal taxable income is reported on line 28 of the federal return.

Alabama's corporation income tax return begins with federal taxable income on line 1. In computing the federal taxable income amounts reported on Alabama line 1 in the subject years, the Taxpayers deducted or excluded their intra-company sales and profits from the federal taxable income amounts reported on line 28 of their pro forma federal returns. The Taxpayers also did not include the intra-company sales in either the numerator or the denominator of their apportionment sales factors.

On audit, the Department increased the Alabama line 1 amounts as reported by the Taxpayers up to the line 28 amounts as shown on their respective pro forma federal returns. In substance, the Department added-back the intra-company sales and profits to the Alabama line 1 amounts. The Department also included the intra-company sales in both the numerator and denominator of the Taxpayers' sales factors.

Department Reg. 810-3-35-.01(1)(b)3 requires members of a consolidated federal group that file separate Alabama returns to compute their respective Alabama deductions for federal income tax paid in accordance with the method initially elected by the group for federal purposes, i.e., either 26 U.S.C. §1552(a)(1), (a)(2), or (a)(3). If no method is elected, the default (a)(1) method is applied, see Reg. 810-3-35-.01(b)3(iv)(1).

Cintas No. 1 elected the §1552(a)(2) method in the year in issue, the fiscal year ending May 31, 2000. It failed, however, to make any election on another year's return reviewed by the Department during the audit. The Department examiners asked Cintas No. 1 to produce the Cintas Group's initial federal election concerning §1552. Cintas No. 1 was unable to produce the federal return on which that election was made. The examiners accordingly computed Cintas No. 1's federal tax paid deduction using the default §1552(a)(1) method.

The evidence does not show the method or methods used by Cintas Sales and Cintas No. 2 to compute their federal tax paid deductions in the subject years. It is also not in evidence whether the Department computed those Taxpayers' federal tax paid deductions pursuant to the default (a)(1) method, and if not, why not.

Additional facts are stated as necessary in the following analysis of the issues.

## ANALYSIS

**Issue (1). Did the Taxpayers Correctly Report Federal Taxable Income on Alabama Line 1?**

During the years in issue, Alabama's corporate income tax return required a corporation to report its federal taxable income on line 1 of the return.[3] The Taxpayers

[3] Federal taxable income was statutorily adopted as taxable income for Alabama purposes pursuant to Act 99-664, effective for tax years beginning on or after January 1, 2000. See, Code of Ala. 1975, §40-18-33. Before that statute, and during the years in issue, there was no Alabama statute or Department regulation that defined or tied a corporation's Alabama taxable income to its federal taxable income. Rather, the Alabama return form simply required a corporation to report its federal taxable income on line 1 of the return as a convenient starting point. Various reconciliation adjustments were then required to arrive at Alabama taxable income.

contend that the Alabama line 1 amounts they reported in the subject years were less than the line 28 amounts on their pro forma federal returns because the line 28 amounts were pre-elimination totals taken from schedules attached to the Cintas Group's consolidated federal returns. That is, the line 28 amounts included non-taxable intra-company sales that had to be eliminated or subtracted in arriving at the correct federal taxable income amounts to be reported on Alabama line 1.

The Department examiners adjusted the Taxpayers' Alabama line 1 amounts as reported up to the federal line 28 amounts because, according to the examiners, the Taxpayers had not proved that the line 28 amounts included intra-company sales. "The taxpayer has not provided the auditors with enough documentation concerning the intra-company transactions in order to support deviating from the line 28 as reported" on the federal pro forma returns. The examiners further claimed that "the taxpayer has not explained why intra-company transactions would be included in (line 28 of) the federal return. . . ." See, Department's revised assessment workpapers attached to the Department's response to the Seventh Preliminary Order, at 5. In substance, the Department contends that the Taxpayers failed to provide adequate records identifying the intra-company sales and profits or establishing that the Alabama line 1 amounts as reported were the federal line 28 amounts less the intra-company sales and profits. I disagree.

The Taxpayers presented extensive testimony and numerous exhibits at the May 2004 hearing explaining the intra-company sales and profits and how and why they are recorded on Cintas' general ledger system. That evidence, which is accurately summarized in the Taxpayers' Post-Hearing Brief at 6 – 14, established that every

operating division within each corporation in the Cintas Group has a separately prepared internal financial statement on which its intra-company sales and profits are recorded. The intra-company sales and profits are recorded and tracked for a legitimate non-tax related business purpose, i.e., as a method of grading and compensating the general managers of the various divisions.

The evidence further established that the federal taxable income amounts reported by the Taxpayers on line 28 of their pro forma federal returns were pre-elimination; that is, they included intra-company sales and related profits. Scott Clark, the manager of corporate taxation for the Cintas Group, testified in part as follows:

> Q. I want to show you Taxpayer's Exhibit #6. If you would walk us through that what you would call a rollup schedule.
>
> A. Yeah. Exhibit #6 is very similar to the – the Department's exhibits that they've included in with the two returns. This is basically pages out of our consolidated federal tax return that is filed. And, again, what this is, is the reporting by separate legal entity their pro formas for that year, pre-elimination that roll up into the subtotal before eliminations. We then apply all eliminating entries which will include any transactions between divisions to come up to a consolidated federal taxable income number. That's the amount that is carried over to page 1 of our 1120 consolidated. This is merely a detailed rollup of the separate legal entities plus the eliminations.
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> * * *
>
> Q. Okay. So when you're preparing a federal pro forma, not an actual federal 1120, but just a federal pro forma 1120, how do these consolidating adjustments tie into the number on their pro forma?
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> A. In our separate pro formas, these (eliminations of the inter-company and intra-company transfers) are not reflected at this point in time. We only reflect these when we do a consolidated federal. So all of our pro formas are basically pre-elimination financial data.

Laura Byerly, the controller for the Cintas manufacturing and distributions divisions, testified that Cintas maintains a number-coded financial accounting system in which the

separate operating divisions and the various types of transactions are identified by number. When an intra-company transfer occurs between divisions within a Cintas subsidiary, the appropriate entries are made in the divisions' accounts. Equal and opposite entries are then made to a fictitious "elimination" company account (Company 998), which in substance nets out or eliminates the previously recorded intra-company sale. Ms. Byerly further explained that the system is programmed to recognize intra-company transfers between divisions in the same subsidiary, and that intra-company sales and profits can be identified and removed from the pre-elimination federal taxable income amount shown on line 28 of the pro forma federal return.

The data in Cintas' computerized financial accounting system is maintained in the regular course of business, and as such constitutes business records admissible as evidence in Alabama's courts. See, Rule 803(6), Alabama Rules of Evidence, which is modeled after Federal Rule 803. Courts have recognized that computer data compilations constitute admissible business records. *Electric Supply co. v. Kitchens Construction*, 750 P.2d 114 (New Mexico 1988), citing *Rosenberg v. Collins*, 624 F.2d 659 (5th Cir. 1980). Computer data compilations and other business records are allowed "to dispense with the necessity of proving each and every book entry by the person actually making it. The theory underlying (the admissibility of business records) is that business records in the form regularly kept by the company and relied on by that company in the ordinary course of its business have a certain probability of trustworthiness." *Louisville & Nashville Railroad Co. v. Knox Homes Corp.*, 343 F.2d 887, 896 (5th Cir. 1965).

The fact that the data contained in Cintas' computerized financial accounting system is admissible as evidence does not automatically establish that the information is correct.

However, those computerized records clearly constitute "records, books, and other information" that the Taxpayers maintained in the ordinary course of business. Those records, together with testimony explaining what the data represents, how the system works, etc., "have a certain probability of trustworthiness," *Louisville & Nashville Railroad*, 343 F.3d at 896, and were sufficient to carry the Taxpayers' burden of providing adequate records, as required by Code of Ala. 1975, §40-2A-7(a)(1).

The Department cannot and should not be required to rely on partial or incomplete records or unsubstantiated verbal assertions. See generally, *State v. Mack*, 411 So.2d 799 (Ala. Civ. App. 1982). As discussed, however, the Taxpayers provided the Department with access to its computerized accounting system from which the intra-company transactions could be identified. If the Department examiners doubted the accuracy of the system or the information in the system, they could have reviewed all or a sampling of the intra-company transactions to determine if the transactions had been properly recorded in the system. They elected not to.

The Taxpayers provided the examiners with access to all of their records during the audit. It is unclear, however, what the examiners actually reviewed during the audit. Consequently, the examiners may not have seen sufficient evidence that proved to them that the federal line 28 amounts included non-taxable intra-company sales. But the uncontraverted evidence submitted at the May 2004 hearing established that the intra-company sales were included in the line 28 amounts. The Taxpayers thus correctly reported federal taxable income on line 1 of their Alabama returns by first subtracting the non-taxable intra-company sales and profits from the line 28 amounts.

**Issue (2). Should the Intra-Company Sales be Included in the Taxpayers' Sales Factors?**

The Department does not dispute that intra-company sales or transfers are not true sales, and should not be included in the apportionment sales factor. But as in Issue (1), the Department again argues that because the Taxpayers failed to keep records identifying the intra-company transfers, all sales, including intra-company sales, must be included in the Taxpayers' apportionment sales factors. I again disagree for the reasons explained in the above analysis of Issue (1). The Taxpayers' intra-company sales, as identified in Cintas' financial accounting system, should not be included in the Taxpayers' sales factors.

**Issue (3). The Federal Tax Paid Deduction Issue.**

Alabama allows a corporation a deduction for federal income tax paid or accrued during the corporation's taxable year. Code of Ala. 1975, §40-18-35(a)(2). As discussed, Reg. 810-3-35-.01(1)(b)(3) requires members of a consolidated federal group that file separate Alabama returns to compute their respective Alabama federal tax paid deductions in accordance with the method initially elected by the group for federal purposes pursuant to §1552. Reg. 810-3-35-.01(b)(3)(iv)1 specifies that if no method is elected, the default §1552(a)(1) method shall be used.

Cintas No. 1 elected different methods of computing its federal tax paid deduction on the returns reviewed by the Department's examiners. The examiners requested that Cintas No. 1 provide a copy of the Cintas Group's consolidated federal return on which the §1552 election was first made. That return could not be located. Consequently, the examiners computed Cintas No. 1's deduction pursuant to §1552(a)(1). The final assessment against Cintas No. 1 is based on that adjustment, and, as stated, is not disputed.

Cintas Sales and Cintas No. 2 argue that the method used to compute the federal tax paid deduction should be consistent for all three Taxpayers. The record does not show the method or methods elected by Cintas Sales or Cintas No. 2 during the years in issue, or whether the Department contested or changed the method or methods selected by those entities. I agree, however, that if Cintas No. 1 must use the default (a)(1) method because the Cintas Groups' initial federal consolidated return cannot be located, then the same method should also be used by Cintas Sales and Cintas No. 2.

The final assessment against Cintas No. 1 is due to be affirmed. The Department is directed to recompute the final assessments against Cintas Sales and Cintas No. 2 in accordance with the above findings. The parties indicated at the May 2004 hearing that they were in the process of settling a throwback sales issue. The Taxpayers also stated in their post-hearing brief that they had filed amended Alabama returns after the May 2004 hearing based on IRS adjustments. The Department should also consider the throwback sales and the reported IRS adjustments in recomputing the final assessments. A Final Order will then be entered for the adjusted amounts due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 23, 2007.

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BILL THOMPSON
Chief Administrative Law Judge

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