DEPARTMENT OF STATE REVENUE

02-20080449.LOF

Letter of Findings Number: 08-0449
Adjusted Gross Income Tax
For Tax Years 2003-04

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ISSUES

I. Adjusted Gross Income Tax–Cost of Goods Sold.

Authority: IC § 6-3-2-2; IC § 6-8.1-3-12; IC § 6-8.1-5-1; 45 IAC 3.1-1-62; I.R.C. § 482.

Taxpayer protests the assessment of adjusted gross income tax based on the Department's adjustment to Taxpayer's cost of goods sold.

II. 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.

III. Tax Administration–Underpayment Penalty.

Authority: IC § 6-3-4-4.1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is a corporation doing business in Indiana and throughout the United States and the world. Taxpayer markets goods produced by a related corporation. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had overstated the cost of goods sold in its calculation of Indiana adjusted gross income tax for the tax years 2003 and 2004. The Department therefore issued proposed assessments for adjusted gross income tax, negligence penalty underpayment of estimated taxes penalty, and interest for those years. Taxpayer protests that the cost of goods sold was accurate for those years and protests the imposition of adjusted gross income tax and both penalties. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Cost of Goods Sold.

DISCUSSION

Taxpayer protests the imposition of adjusted gross income tax for the tax years 2003 and 2004. The Department determined that Taxpayer's reported cost of goods sold ("COGS") were overstated and therefore reduced Taxpayer's income as reported on its federal returns, thereby reducing the amount of income apportioned to Indiana. The Department determined that the overstatement of COGS distorted Taxpayer's Indiana income and adjusted the COGS to a level supported by the best information available as provided by IC 6-8.1-5-1(b). Taxpayer protests that the income reported on its federal returns is accurate and therefore no adjustment to its Indiana income is required. 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).

In its audit report, the Department referred to IC § 6-3-2-2, which states in relevant parts:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation for labor or services rendered within this state; and
(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter) only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

...

(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 part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(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.

....

(Emphasis added).

The Department also referred to 45 IAC 3.1-1-62, which states:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [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.

Also of relevance is IC § 6-8.1-3-12(a), which states:

The department may audit any returns filed in respect to the listed taxes, may appraise property if the property's value relates to the administration or enforcement of the listed taxes, may audit gasoline distributors for financial responsibility, and may investigate any matters relating to the listed taxes.

(Emphasis added).

The Department determined that the standard apportionment formula did not fairly reflect Taxpayer's Indiana income and would produce incongruous results, as explained by IC § 6-3-2-2(l) and 45 IAC 3.1-1-62. The Department therefore investigated Taxpayer's federal returns since those relate to the Indiana adjusted gross income tax, as provided by IC § 6-8.1-3-12(a). Upon review, the Department determined that the COGS Taxpayer claimed on its federal returns were higher than the available documentation could support. The Department therefore reduced the amount of COGS available to Taxpayer, which resulted in additional taxable income for the years at issue. The Department then applied the Indiana apportionment percentage to the additional income and arrived at the amounts of proposed assessments of adjusted gross income.

Taxpayer protests that the Department did not rely on proper authority when disallowing a portion of its COGS. Taxpayer believes that IC § 6-3-2-2(m) and 45 IAC 3.1-1-62, which were cited in the audit report, only allow the Department to review and adjust apportionment and allocation methods. While Taxpayer is correct that the overall substance of IC § 6-3-2-2(m) and 45 IAC 3.1-1-62 do concern apportionment and allocation, both also contain provisions explaining that if the standard formulas do not fairly reflect a taxpayer's Indiana income then the Department may use other methods to fairly reflect a taxpayer's Indiana income. In addition, IC § 6-3-2-2(l) explains that the Department may employ any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. Also, IC § 6-8.1-5-1(b) explains that if the Department reasonably believes that a person has not reported the proper amount of tax due, the Department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. Finally, IC § 6-8.1-3-12 explains that the Department may investigate any matters relating to a listed tax. Read together, these statutes and this regulation allow the Department to review a taxpayer's reporting methods and to make adjustments to reflect that taxpayer's Indiana income as fairly and accurately as possible.

Next, Taxpayer protests that the Department did not understand how it arrived at COGS and that the income added by the Department is not accurate. Taxpayer states that it based its COGS on pricing studies prepared by independent third parties and that the COGS reported on the federal returns fell within the range of acceptable prices listed in those studies. Taxpayer states that the pricing studies comply with Internal Revenue Code ("I.R.C.") section 482 requirements. Therefore, Taxpayer believes that the COGS are valid as reported and the Department's adjustments are unnecessary and incorrect.

In its audit report, the Department explained that the second largest COGS expense category, representing forty-four percent of overall COGS, was "other costs" and that for both 2003 and 2004 over ninety percent of

"other costs" were attributable to a single transaction referred to as "standard cost of sales intercompany." The Department explained that its own research revealed that "other cost" deductions are typically incurred by manufacturers, not by marketing companies such as Taxpayer. The Department requested business records supporting the "other cost" deductions. The records provided by Taxpayer to the auditor explained how Taxpayer allocated COGS among its divisions, but did not explain how the expenses were incurred. The Department did not consider this sufficient to support the "other costs" in particular and the amount of COGS overall. This resulted in the Department's adjustments.

At hearing, Taxpayer again explained that it had pricing studies prepared by independent third parties and that the amount of COGS listed on its federal returns fell within the range listed in the pricing studies. As explained in the audit report, the Department did not directly dispute the pricing studies, but rather determined that the pricing studies and the accompanying I.R.C. § 482 analysis were not relevant to determining Indiana adjusted gross income tax. Instead, the Department explained that the "fairly reflect" standard discussed above was the relevant factor. That was the reason for the Department's request for documentation explaining how the COGS were incurred. Without adequate documentation, the Department was compelled to conclude that the COGS were not accurate and to remove them from the calculations of Taxpayer's income.

Taxpayer still has not provided documentation which explains how the COGS were incurred. As explained above, the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made. While the amount of COGS claimed do fall within the range recommended by the pricing studies, the Department's concerns regarding the lack of explanation and substantiation on how the COGS were incurred remain. Since Taxpayer has not explained how the "other costs" in particular and COGS in general were incurred, Taxpayer has not met the burden imposed by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Tax Administration–Negligence Penalty.

DISCUSSION

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

> If a person:
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> . . .
>
> (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). Taxpayer has affirmatively established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

III. Tax Administration–Underpayment Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent underpayment penalty for the tax years in question. Taxpayer protests the imposition of penalty. IC § 6-3-4-4.1(c) and (d) provide:

> (c) Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:
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> (1) twenty-five percent (25%) of such corporation's estimated adjusted gross income tax liability for the taxable year; or

(2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax.

A taxpayer who uses a taxable year that ends on December 31 shall file the taxpayer's estimated adjusted gross income tax returns and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year. If a taxpayer uses a taxable year that does not end on December 31, the due dates for filing estimated adjusted gross income tax returns and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year. The department shall prescribe the manner and forms for such reporting and payment.

(d) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

(1) the annualized income installment calculated under subsection (c); or

(2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25%) of the corporation's final adjusted gross income tax liability for such taxable year.

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). Taxpayer has affirmatively established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer is denied on Issue I regarding the Department's disallowance of COGS claimed. Taxpayer is sustained on Issue II and Issue III regarding negligence penalty and underpayment penalty.

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