

**Letter of Findings: 09-0655
Corporate Income Tax
For the Years 2005 and 2006**

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ISSUES

I. Adjusted Gross Income Tax – "Other Costs" of Goods Sold Deduction.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-2.

Taxpayer protests the imposition of additional corporate income tax.

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.

STATEMENT OF FACTS

Taxpayer, a Delaware corporation domiciled in Michigan, is the worldwide sales and distribution arm of its parent company, a leading producer of food products. Taxpayer provides sales, distribution, logistical and promotional services for its affiliate food producers. Taxpayer's Indiana business locations consist of cold storage and distribution centers.

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 2005 and 2006. The Department therefore issued proposed assessments for adjusted gross income tax, negligence 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 the penalties. An administrative hearing was held and this Letter of Findings results. Further facts will be provided as necessary.

I. Adjusted Gross Income Tax – "Other Costs" of Goods Sold Deduction.

DISCUSSION

According to the Department's audit, Taxpayer markets products produced by several affiliated companies. Taxpayer acquires these goods through inter-company purchases at rates specified in various transfer pricing and service agreements. Taxpayer warehouses, distributes, promotes and sells these products to a broad range of customers through a system of distribution centers and sales personnel. Taxpayer does not operate any production facilities nor does it employ any production workers.

The Department's audit revealed that Taxpayer reflected its product purchases on the "Purchases" line of the Cost of Goods Sold ("COGS") Schedule of its federal returns. The Schedule also reflected small credit amounts for labor and other 263A costs, and a sizeable amount each year for "Other Costs." The audit determined that since Taxpayer had no capacity to incur other costs of production, these amounts likely resulted from an additional transfer pricing mechanism. The audit sought to clarify the sources of these reported "purchases" and "Other Costs" numbers over a period of 16 months. Taxpayer provided transfer pricing studies and agreements, but was not responsive to the auditor's request for materials supporting the studies' calculations and the underlying terms of the agreements. In the end, the audit concluded that the Taxpayer's COGS were overstated at least to the extent of "Other Costs" of goods sold since Taxpayer did not have production capability or responsibilities which is where "other costs" typically arise.

Therefore, the Department found that Taxpayer's "Other Costs" of goods sold deduction distorted Taxpayer's apportioned Indiana income and resulted in a significant underpayment of Taxpayer's Indiana adjusted gross income tax. The Department consequently disallowed Taxpayer's deduction for "Other Costs" of goods sold and recalculated Taxpayer's apportioned Indiana income. IC § 6-3-2-2.

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).

Taxpayer makes several arguments in support of its protest including an argument that the Department did not have authority to disallow "Other Costs" of goods sold. However, since Taxpayer's alternative argument that its "Other Costs" of goods sold were bona fide and therefore legitimately deductible is dispositive in this case, this Letter of Findings will only address this alternative argument.

Taxpayer stated that for the years at issue the "Other Costs" of goods sold it deducted in calculating its federal taxable income were mostly transportation expenses with third parties. At hearing Taxpayer demonstrated that the bulk of the "Other Costs" related to transportation expenses which were all to related third party transportation companies. Taxpayer provided account documentation of these "other costs." This documentation was not provided to the Department's auditor despite the fact that the auditor, on more than one occasion, requested substantiation of the "Other Costs" of the goods sold deduction. Nonetheless, Taxpayer's

documentation at hearing substantiated it's protest that these were bone fide expenses properly included in "Other Costs" of the goods sold deduction.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued 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)(3), which provides "if a person... 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.

The Department may waive a negligence penalty as provided in [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.

Since the underlying assessment is removed, Taxpayer is not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest of the assessment of additional income tax is sustained, as is its protest of the negligence penalty.

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