DEPARTMENT OF STATE REVENUE

02-20130676.SLOF

Supplemental Letter of Findings: 02-20130676
Corporate Income Tax
For the Years 2009, 2010, 2011, and 2012

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Supplemental Letter of Findings.

HOLDING

Food product developer and manufacturer's research activities, related to the development of new food products and improvement of existing food products, was not entitled to additional credits following the results of a supplemental audit.

ISSUES

I. Corporate Income Tax - Research and Development Credits.

Authority: IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Letter of Findings 02-20130676 (January 16, 2015).

Taxpayer argues that the Department again erred when it denied research expense credits claimed on Taxpayer's original corporate income tax returns.

II. Tax Administration - Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer asks that the Department exercise its discretion to abate a ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company which develops and manufactures flavors, fragrances, and colors used in foods, pharmaceuticals, cosmetics, personal care products, and in the printing and imaging business. Taxpayer has an Indiana business location.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in an assessment of additional corporate income tax for the years 2009, 2010, and 2011. Subsequently, the Department adjusted Taxpayer's 2012 income tax return in accordance with the audit. That adjustment also resulted in an assessment of additional tax.

Taxpayer disagreed with both the audit's conclusions, the original assessments, and the subsequent 2012 assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. A Letter of Findings was issued January 2015 sustaining certain of Taxpayer's objections. A supplemental audit was conducted and a second audit report issued.

Taxpayer disagreed with the results of the second audit and requested a rehearing. Another administrative hearing was conducted during which Taxpayer's representatives explained the basis for its repeated objections. This Supplemental Letter of Findings results.

I. Corporate Income Tax - Research and Development Credits.

DISCUSSION

This Supplemental Letter of Findings incorporates by reference the statement of facts and statement of law set out in Letter of Findings 02-20130676 (January 16, 2015) (20150325 Ind. Reg. 045750065NRA).

The supplemental audit reviewed Taxpayer's research and expense credits in light of the January decision. As stated in that decision:

> To the extent that the audit concluded that research activities related to food taste, texture, smells or flavor are precluded by correct application of federal and Indiana law, Taxpayer's protest is sustained.

During the course of the supplemental audit, the Department reviewed a sample of research projects conducted during 2001 through 2011. Taxpayer had provided the list of thirty-three projects during the original audit.

The audit concluded that eight of the projects did not qualify for the credit because the projects "were for activities whose purpose was the adaption of existing business components to a particular customer's requirement or need."

Based on the sample provided by Taxpayer, the supplemental audit disallowed twenty-four percent of the credits. The audit report indicated that although the sample of projects was relatively small "the methodology replicated that used by the IRS in the last audit" in which the IRS sampled four local projects.

Taxpayer objects on the ground that the supplemental audit report issued only short descriptions of the projects sampled, "and ignored the detailed explanations of each project provided by [Taxpayer]." According to Taxpayer, the report's "brief conclusory 'descriptions' are not accurate descriptions of the projects."

In addition, Taxpayer challenges the report's reference to a prior IRS audit on the ground that "there is no logical correlation between the IRS's review of 4 projects in the 1990's, and the auditor's review of 33 different projects in the 2000's."

Taxpayer further argues that the audit is effectively "double counting" the results of the IRS audit by making additional adjustments to the claimed credits. According to Taxpayer:

> That inconsistency and misrepresentation of the impact of [the auditor's] actions is further illustrated by the auditor's failure to make corresponding adjustments to the base period amount. It is also shown by the amount of the proposed assessments before and after the supplemental audit (only a 50[percent] change in the assessments). That error is on top of the audit's mischaracterization of these projects after [the auditor] had been given accurate descriptions which [the auditor] ignored.

Elsewhere, Taxpayer objected stating the supplemental audit "was not conducted on the basis of an agreed upon sampling approach. Rather during the audit [Taxpayer] explained to the auditor that there were approximately 45,000 projects descriptions at [Taxpayer's] Indianapolis facility and because of the highly confidential nature of the information contained in them, [Taxpayer's] management and legal department did not want to turn over copies which left the facility. [Taxpayer] asked that they be reviewed at the [Indianapolis] facility."

Taxpayer provided a three-page list of eight different projects which Taxpayer asserts qualify for the credit. Taxpayer believes the projects involve development of new flavors or formula distinctly different from flavors and formula previously developed.

Tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Briefly stated, Indiana provides certain credits whereby a taxpayer may reduce its Indiana taxable income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year."

Taxpayer levies serious challenges to the findings contained in the supplemental audit including that the report mischaracterized the nature and substance of the Taxpayer's research, that the audit's descriptions were abrupt and conclusory, that the audit made certain computational issues, and that the results of the audit are at odds with the findings of IRS review of the identical issues.

Taxpayer asks the Department to overturn the results of the supplemental audit and conclude that the eight projects specifically rejected by the supplemental audit do in fact qualify for the sought-after exemption. Effectively, the Taxpayer asks that it be granted a credit for all of the thirty-three projects considered by the supplemental audit and that this result be projected across the entirety of its claimed credits.

Taxpayer claims credits attributable to a complex and technologically sophisticated process and disputes the audit's specific decisions allowing a portion of these claimed credits and disallowing other claimed credits. As in all such cases, the auditor was in a better position to communicate directly and immediately with the Taxpayer and review the source records available at the time of that audit. In the absence of project files, contracts, direct communication with Taxpayer's clients, or objective evidence necessary and sufficient to meet its burden of proof, Taxpayer asks the Department to entirely overturn the results of this second audit review; Taxpayer asks too much. Although Taxpayer feels strongly about this issue, there is insufficient justification to now second-guess the audit's determinations on these issues in an administrative process once-removed from both the original and supplemental audit review, and Taxpayer's protest must be denied.

FINDING

Taxpayer's protest is denied.

II. Tax Administration - Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer asks that the Department revisit the issue of the ten-percent negligence penalty.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) imposes a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) provides as follows:

> If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty.

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the negligence penalty - is presumptively valid.

As explained in the January 2015 Letter of Findings, "[T]he audit imposed the penalty in apparent response to either the perceived or actual difficulty in obtaining the records sought." However, in recognition of the complexity of the issues at issue and Taxpayer's sensitivity in sharing materials which it consider proprietary and confidential, the Department is prepared to agree that the penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the supplemental audit's denial of certain research expenses credits is denied. Taxpayer's protest of the penalty is sustained.

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