

**Letter of Findings: 02-20190185  
Corporate Income Tax  
For the Years 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 Letter of Findings.

### HOLDING

Although the Department rejected Retail Subsidiary's reliance on transfer pricing studies because the studies did not reflect the true value of intercompany transactions entered into by Retail Subsidiary, the Department found that its reliance on the studies did not constitute "willful neglect" and that the ten-percent negligence penalty should be abated.

### ISSUE

#### **I. Corporate Income Tax - 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 on the ground Taxpayer exercised ordinary business care in determining its originally filed corporate income tax liability.

### STATEMENT OF FACTS

Taxpayer is a wholly owned subsidiary of a clothing retailer and distributor.

Taxpayer purchases clothing from parent company by means of "flash title" transactions. The flash title transactions consist of "controlled transactions" under I.R.C. § 482 which "allocate[] income and deductions among [affiliated] taxpayers."

Taxpayer is designated as the "non-exclusive" distributor of the parent organization's clothing.

The transactions' pricing were governed by a set of "transfer pricing studies" prepared by third-party financial consultants which determined the "arm's-length price range" for the intercompany transactions between parent and Taxpayer.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's 2014 and 2015 corporate income tax returns, business records, intercompany sales transactions, and transfer pricing studies. The Department determined that the transfer pricing studies did not correctly represent arm's-length transactions between disinterested parties. The Department's audit report disagreed with the "comparables" on which the pricing ranges were based because many of the studies' comparables "did not perform the same functions as distributors" and because one of the comparables was "a company that was under financial distress."

Having disagreed with the parties' existing pricing structure, the Department prepared its own set of "comparables," assessed additional corporate income tax, and imposed a "negligence" penalty. Taxpayer did not contest the audit assessment but did disagree with the penalty assessment and submitted a protest to that effect. Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

#### **I. Corporate Income Tax - Negligence Penalty.**

### DISCUSSION

For substantive reasons not necessarily relevant to the penalty issue raised here by Taxpayer, the Department

assessed Taxpayer additional corporate income tax along with a ten-percent negligence penalty. The Department's assessment was based on a determination that Taxpayer's intercompany pricing arrangements "were not in compliance with I.R.C. § 482 and its associated regulations." For purposes of this protest, Taxpayer does not disagree with that substantive decision.

However, Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty arguing that its original filing position "was determined upon I.R.C. § 482 regulations and [its] reliance on transfer pricing studies completed by third-party firms" and that, by doing so, it exercised the "reasonable care, caution and diligence . . . expected of any reasonable taxpayer with similar business activities."

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) requires 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) states that, "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.

The Department's audit found that Taxpayer erred in its reliance on the transfer pricing studies because the "comparables" on which its consultants calculated the intercompany pricing structure did not accurately reflect the economic realities of those sales. Nonetheless, the Department agrees that Taxpayer's reliance did not constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

## FINDING

Taxpayer's protest is sustained.

March 29, 2019

*Posted: 05/29/2019 by Legislative Services Agency*  
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