STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition of **MCDONNELL DOUGLAS CORPORATION** for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1984.	DECISION

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on June 23, 1988 with respect to the petition of McDonnell Douglas Corporation, P.O. Box 516, Airport Road and McDonnell Boulevard, St. Louis, Missouri 63166 for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the year 1984 (File No. 804921). Petitioner appeared by Janette M. Lohman, Esq. The Division appeared by William F. Collins, Esq. (Herbert Kamrass, Esq., of counsel).

The Division filed a brief and petitioner filed a letter brief with its petition. Oral argument, at the request of the Division, was heard on November 9, 1988.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether petitioner, pursuant to 20 NYCRR 9-1.5, established that its failure to timely file its 1984 corporation franchise tax report with payment of tax was due to reasonable cause, and that such failure to timely file clearly indicated an absence of gross negligence or willful intent to disobey the taxing statutes.

FINDINGS OF FACT

We find the facts as stated in the Administrative Law Judge's determination and such facts are incorporated herein by this reference, except that we modify finding of fact "7" as stated below.

On or before March 15, 1985, petitioner, McDonnell Douglas Corporation (MDC), timely filed an application for a three-month extension of time for filing its 1984 corporation franchise tax report.

On its application, MDC reported that it had paid tax of $251,704.00 in the preceding year and estimated that its tax liability for 1984 would be $110,000.00. In conjunction with the application, MDC paid a total estimated tax of $137,750.00 ($47,306.00 of this total was prepaid in March 1984). Subsequently, petitioner requested an additional three-month extension to September 15, 1985.

On or before September 15, 1985, MDC filed its 1984 corporation franchise tax report, reporting a total tax liability of $203,923.00, with a balance due of $66,173.00, plus a license fee of $443.00 for a total balance due of $66,616.00. Payment of the balance accompanied the return.

On December 9, 1985, the Division of Taxation ("Division") issued to MDC a Statement of Corporation Tax Adjustment, asserting an underpayment of $14,315.56. The underpayment reflected the imposition of a penalty of $15,904.99 for late filing of a report and payment of tax. The basis for the penalty was the Division's determination that MDC's application for an extension was invalid because the tax estimated was less than 90 percent of the tax finally determined to be due.

On or about December 19, 1985, MDC paid the asserted liability plus interest.

In January 1986, MDC applied for a refund of penalties plus interest. The refund was denied by the Division on or about June 30, 1986.

We modify finding of fact "7" to read as follows:

> The underpayment of estimated tax arose from the error of an MDC employee.
>
> (a) MDC is a defense contractor whose business consists of assembling or manufacturing airplanes, helicopters, missiles and similar military hardware. Its sales consist primarily of a small number of very expensive items. Many of its contracts take years

to complete, so that in any given year some contracts are begun, others are continued in process and other contracts completed.

(b) MDC employs two different accounting methods to report its income, the book sales method, also called the percentage of completion method, and the completed contract method. In 1984 MDC filed income tax returns in 40 states. It used the book sales method to compute its receipts allocation factor in all states except New York and Wisconsin. Under the book sales method, sales were assigned to a taxing jurisdiction either as the contract was completed or as the items were delivered.

(c) Following an earlier audit of taxable years ending in 1977 and 1979, New York instructed MDC to assign sales to New York in the year in which the contract was completed, regardless of whether deliveries of goods were made in the same year. In practice, a contract may be completed years after the goods are delivered. This accounting method was referred to by MDC as the completed contract method.

(d) In estimating MDC's tax liability for 1984, an employee inadvertently used the book sales rather than the completed contract method to determine the New York receipts factor of the business allocation percentage. This resulted in an understated percentage and an overall underestimate of tax due.

Because of the nature of its business, MDC's sales in any given state can fluctuate widely on a year-by-year basis. Because of this it chose to pay an estimated tax based on its own projections, rather than exercising the option of paying 100 percent of the preceding year's tax, when filing its extension of time.

OPINION

In the decision below, the Administrative Law Judge found that petitioner's failure to timely file its 1984 corporation franchise tax report was the result of an understatement of estimated tax, due to "the understandable calculation error of an employee." The Administrative Law Judge also concluded that the failure to timely file the 1984 report was not the result of gross negligence or a willful intent to disobey the taxing statutes. Accordingly, it was determined that the Division improperly imposed a penalty for petitioner's failure to timely file its report, and as a result, such penalties were cancelled.

On exception, the Division argues that the employee acted negligently in applying the wrong accounting method to estimate its tax liability, and that the record did not indicate an absence of gross negligence or willful intent to disobey the taxing statutes.

We reverse the determination of the Administrative Law Judge.

In order for petitioner to have properly applied for an automatic extension of time to file its annual corporation franchise tax report, the properly estimated tax must have been paid on or before the date the report was required to be filed, without any regard to the extension of time (Tax Law § 213.1; 20 NYCRR 7-1.3[a]).

A tax is deemed to be properly estimated if the amount paid is equal to (1) not less than 90 percent of the tax finally determined or (2) not less than the tax shown on the taxpayer's report for the preceding year (Tax Law § 213.1[b][a]; 20 NYCRR 7-1.3[a]). Petitioner in the present case used the percentage of completion method to calculate its receipts allocation factor instead of the completed contract method, and thus arrived at an inaccurate number against which it estimated its tax liability.

To compound the problem, rather than paying 100 percent of the tax shown on the petitioner's report for the preceding year, it attempted to pay not less than 90 percent of the tax finally determined; however, the payment was inaccurate due to the fact that petitioner implemented the improper method for determining the estimated tax due. Because petitioner paid less than 90 percent of the tax finally determined to be due, the Division properly deemed its application for extension invalid, therefore its 1984 tax report was filed late.

Tax Law section 1085(a)(1) authorizes the imposition of a penalty for failure to file a return required under Article 9-A on or before the prescribed date "unless it is shown such failure is due to reasonable cause and not due to willful neglect."

20 NYCRR 9-1.5 (as applicable to the tax year 1984) provides that grounds for reasonable cause must be clearly established and may include:

> "(a) death or serious illness of the responsible officer or employee of the taxpayer, or his unavoidable absence from his usual place of business;
>
> (b) destruction of the taxpayer's place of business or business records by fire or other casualty;
>
> (c) timely prepared reports misplaced by a responsible employee and discovered after the due date;
>
> (d) inability to obtain and assemble essential information required for the preparation of a complete return despite reasonable efforts;
>
> (e) pending petition to Tax Commission or formal hearing proceeding involving a question or issue affecting the computation of tax for the year of delinquency;
>
> (f) any other cause for delinquency which appears to a person of ordinary prudence and intelligence as a reasonable cause for delay in filing a return and which clearly indicates an absence of gross negligence or willful intent to disobey the taxing statutes. Past performance should be taken into account."

The Administrative Law Judge, relying on subsection (f) determined that the understatement of estimated tax was due to an understandable calculation error of the employee, and that regardless of such error, petitioner proved that it made a prudent and reasonable attempt to ascertain its tax liability. We do not agree.

The record indicates that petitioner's taxable activity in New York fluctuates from year to year, in that its tax liability can be substantial or non-existent depending upon its schedule for manufacture and delivery of aircraft. Petitioner argued that this factor, when combined with the nature of the completed contract method which assigns sales to New York only in the year in which the contract is completed, results in a complicated structure of bookkeeping.

We agree that the process of estimating and reporting corporate franchise tax liability is a complicated procedure. However, contrary to the Administrative Law Judge's finding, the underestimation of tax was not due to a calculation error. The crux of the matter here is that the employee used the percentage of completion method in estimating its tax liability, and we must

therefore determine whether or not pursuant to 20 NYCRR 9-1.5, petitioner clearly established that such an error was grounded in reasonable cause.

As discussed above, the Division of Taxation required petitioner to use the completed contract method in calculating its receipts factor pursuant to an audit adjustment for its taxable years ended 1977 and 1979. Therefore, petitioner had been using this method of calculation for at least five years prior to 1984, the year at issue.

In addition, petitioner was required to use the completed contract method in two states, Wisconsin and New York. These are the only two states which require petitioner to adhere to an alternative format for calculating its receipts factor. In that the remaining 38 states collectively use the percentage of completion method, such a requirement represents only a minor deviation from the established norm. We cannot, therefore, accept petitioner's contention that the employee error was understandable considering the complexity of the procedure.

What must be more fully explored, however, is petitioner's contention that a responsible employee made an inadvertent error, and that its reliance upon such an employee was therefore reasonable. Thus, ultimately petitioner claims that under these particular circumstances, reliance on a responsible employee established the reasonable cause necessary to avoid payment of the penalty involved.

The Appellate Division addressed the issue of reliance in LT & B Realty, when it held that in regard to the filing of returns, reliance on counsel is only reasonable depending upon the circumstances (LT & B Realty v. State Tax Commn., 141 AD2d 185). What the record before us lacks is evidence establishing the circumstances surrounding petitioner's employee. There exists neither testimony nor documentation concerning the employee's qualifications, his training and experience or his employment history prior to the year at issue.

Supervision is also a key element in determining whether the circumstances involved warrant a finding of reasonable cause (see, Turnpike Tobacco, Tax Appeals Tribunal, August 4, 1988). Yet, again, there is nothing in the record to indicate that the employee was supervised or

not, and if so, whether the type of supervision implemented at the time was that upon which petitioner could reasonably rely.

Petitioner has established a sound record with the Division in regard to prompt and accurate filing of corporate franchise tax. Petitioner's reputation for timeliness in the past must be commended, however, petitioner in turn has failed to outline the procedure used in the past and whether the same procedure was utilized for the return at issue so that we might find reliance upon said procedure to be reasonable under the circumstances (see, Levine v. Commr., Tax Court Memo 1963-230). Without such documentation it is impossible to determine that the "inadvertent" employee error occurred notwithstanding reasonable precautions taken to avoid miscalculations or misestimations.

The Administrative Law Judge uses Matter of Studebaker-Worthington, Inc. (State Tax Commn., June 25, 1987) and Matter of Benderson Development Co. and 1979 Seneca, Inc. (State Tax Commn., March 16, 1984) to support the finding that petitioner has conformed with the mandate of the taxing statute, by noting that these cases which sustained issuance of penalty were factually inapposite to the present case. We, however, do not find such disparity alone to provide persuasive authority for cancellation of the penalty involved here. While we do find Studebaker-Worthington, Inc. and Benderson Development Co. to be factually inapposite to the present case, the disparity in fact works against petitioner's position. Both of these cases involved circumstances much more complicated than those found in the case before us. In Studebaker-Worthington, the State Tax Commission determined that confusion resulting from corporate mergers and acquisitions did not constitute reasonable cause pursuant to 20 NYCRR 9-1.5, and in Benderson, the confusion caused by an ongoing federal audit and the training of new personnel did not constitute a reasonable cause for the oversight to file additional extensions of time.

It must also be noted that petitioner, pursuant to Tax Law section 213.1, failed to avail itself of the option of paying 100 percent of the preceding year's tax, which is an option designed to prevent assignment of penalty in cases such as these. Petitioner's representative asserted at

hearing that to do so would have caused petitioner to pay approximately $75,000.00 in additional tax over and above what it owed in 1984. However, once it is determined that in paying 100 percent of the tax paid in the previous year, a taxpayer has paid more than what was actually owed, said taxpayer will naturally be afforded a refund.

In the present case, the right to a hearing was waived by petitioner. Thus, the Administrative Law Judge was limited in terms of the scope of review to the documents found within the record. In the determination below, the Administrative Law Judge's determination found reasonable cause for abatement of penalty pursuant to 20 NYCRR 9-1.5. Due deference is ordinarily exercised with regard to an Administrative Law Judge's determination of the credibility of witnesses. However, in the present case, credibility of witnesses is not at issue in that it was submitted for decision without benefit of a hearing. Subsequent to a review of the entire record before us, we cannot sustain the finding of reasonable cause (see, Turnpike Tobacco, supra).

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is in all respects granted;

2. The determination of the Administrative Law Judge is reversed; and

3. The petition of McDonnell Douglas Corporation is in all respects denied and the Division of Taxation's denial of the refund claim is sustained.

Dated: Troy, New York
May 4, 1989

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner