

**Letter of Findings: 07-0154
Income Tax
For the Years 2004 and 2005**

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ISSUES

I. Income Tax – Imposition.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-1; IC § 6-3-1-3.5; I.R.C. 1366.

Taxpayer protests the assessment of additional income tax.

II. Tax Administration – Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayers are a married couple who are the sole individual shareholders of an Indiana Subchapter S corporation (S-Corp). The Indiana Department of Revenue (Department), performed sales and income tax audits of the S-Corp for the years 2004 and 2005. Taxpayers also own and operate another Subchapter S corporation. The sales of the two companies were co-mingled. Due to discrepancies in the companies' records and missing sales invoices, the Department based its sales tax audit on the best information available (BIA) and all sales were allocated to S-Corp. The Department used the S-Corp's bank deposits to arrive at its BIA assessment. Please refer to Letter of Findings 07-0155 for further information relating to the sales tax assessment methodology. S-Corp protested that the BIA assessment deemed all the bank deposits gross income to S-Corp when some of those deposits, according to S-Corp, were cash advances from Taxpayers' personal credit cards that were transferred to S-Corp.

The Department assessed Taxpayers additional adjusted gross income tax on their share of the S-Corp income, as well as penalty and interest. Taxpayers protested the income tax assessment and penalty pending resolution of the related sales tax investigation (see Letter of Findings 07-0155). This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Income Tax – Imposition.

DISCUSSION

The notice of proposed assessment is prima facie evidence that the Department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made. IC § 6-8.1-5-1(b).

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with the federal income and making certain adjustments. IC § 6-3-1-3.5. Income from a Subchapter S corporation flows through to the individual shareholder's personal income for federal tax purposes. I.R.C. 1366. Therefore, it also flows through to the individual shareholder's personal income for Indiana tax purposes.

In this instance, the protest concerns what was income to the S-Corp. In the related sales tax protest, some of the monies that Taxpayers transferred to S-Corp were deemed not to be taxable sales. However, the character of these transfers from Taxpayers to the S-Corp is unclear. Taxpayers did not present any information that would characterize these transfers, for example, as loans or other contributions to the S-Corp. If these monies were loans to the S-Corp, the Taxpayers did not present any information to the Department that describes the terms of these loans or to otherwise establish that the transfers did not qualify as adjusted gross income.

Under IC § 6-8.1-5-1(b), "the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Taxpayer has not met its burden of proof in substantiating its protest. Since Taxpayers failed to report and pay the taxes owing on their share of the income from the S-Corp, the Department properly assessed additional adjusted gross income tax on Taxpayers' income which flowed through from the S-Corp.

FINDING

Taxpayers' protest is respectfully denied.

II. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years in question. Taxpayer protests the penalty. 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 the 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. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

In this case, Taxpayer incurred a deficiency which the Department determined was due to negligence under [45 IAC 15-11-2\(b\)](#), and was subject to a penalty under IC § 6-8.1-10-2.1(a).

Under IC § 6-8.1-5-1(b), "the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Taxpayers have not affirmatively established that their failure to report and pay the taxes owing on their share of the income from the S-Corp was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#).

FINDING

Taxpayer's protest to the imposition of the penalty is respectfully denied.

CONCLUSION

I. Income Tax – Imposition.

The income tax assessment stands.

II. Tax Administration – Ten Percent Negligence Penalty.

The negligence penalty is not waived.

Posted: 04/30/2008 by Legislative Services Agency

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