

Letter of Findings Number: 07-0207
Income Tax
For Tax Years 2003-05

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ISSUES

I. Income Tax—Individual.

Authority: IC § 6-3-2-1; IC § 6-8.1-5-1; [45 IAC 3.1-1-66](#).

Taxpayer protests the assessment of individual 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 is an individual. During the tax years 2003, 2004, and 2005, Taxpayer was the sole proprietor of an Indiana business in the fur industry which was incorporated in August, 2003 with Taxpayer as the sole shareholder. As the result of an investigation adjusting the income of both businesses, and since both a sole proprietorship's and an S Corporation's income flows through to the proprietor and shareholder respectively, the Indiana Department of Revenue ("Department") issued proposed assessments for individual income tax, negligence penalty and interest for 2003, 2004, and 2005. As the result of further communications between Taxpayer and the auditor who conducted the investigation, the Department agreed to remove the assessments for 2004 and 2005. Taxpayer protests three of the remaining adjustments which resulted in proposed assessment of income tax and negligence penalty for 2003. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Income Tax—Individual.

DISCUSSION

Taxpayer protests the imposition of individual income tax for the year 2003. Taxpayer states that the Department incorrectly adjusted several items which resulted in additional income being attributed to Taxpayer. 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).

Adjusted gross income tax is imposed on individuals by IC § 6-3-2-1. Adjusted gross income tax is imposed on shareholders of S corporations as provided by [45 IAC 3.1-1-66](#) which states:

Corporations electing Subchapter S status under Internal Revenue Code §1372 and which comply with the withholding requirements of [IC 6-3-4-13](#) are exempt from adjusted gross and supplemental net income tax on all income except capital gains subject to tax under Internal Revenue Code §1378. This exemption is effective until the corporation's shareholders terminate the election with the Internal Revenue Service or until the corporation engages in transactions which disqualify it from Subchapter S status. A complete or partial corporate liquidation or the intent to dissolve will not in itself terminate the election.

Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate. The character of the income (as capital gains or ordinary income) also passes through to the shareholders.

Although Subchapter S corporations are generally not subject to adjusted gross income tax, they are subject to use tax and intangibles tax, and must report and pay such tax at the time the annual return is filed.

Subchapter S corporations must also withhold adjusted gross income tax on any nonresident shareholder's share of corporate income.

(Emphasis added.)

Since Taxpayer was at all times either a sole proprietor or the sole shareholder of the S corporation, income for either business transfers to Taxpayer.

The first adjustment which Taxpayer protests is the inclusion of what the investigation report describes as "Monies for use of vehicles to Corporation." The Department included such funds as income for all three years of the investigation period. As previously explained, in the course of subsequent correspondence including additional explanation and documentation by Taxpayer, the Department agreed to remove the assessments for 2004 and 2005. The "Monies for use of vehicles to Corporation" were removed for 2004 and 2005. Since this is the identical category in 2003, it stands to reason that Taxpayer's explanation for 2004 and 2005 is similarly adequate for 2003. Therefore, the \$18,000 listed as "Monies for use of vehicles to Corporation" will be removed from the adjustments for 2003.

The second adjustment which Taxpayer protests is the inclusion of \$90,000 in advances from one of the fur

industry's higher-placed entities. Taxpayer protests that this represents a loan from the higher entity, rather than income to Taxpayer. In support of this position, Taxpayer submitted a printout of a page from its account on the higher entity's website. The printout does not go into detail of what the amounts listed are. As explained by Taxpayer during the administrative hearing, the nature of the fur business did not call for written contracts in this type of circumstance. While this may be standard operating procedure for the fur business, the burden of proving a proposed assessment still rests with Taxpayer. Since there is no documentation directly explaining what the \$90,000 in question actually was, Taxpayer does not meet the burden imposed by IC § 6-8.1-5-1(c).

The third adjustment which Taxpayer protests is the inclusion of \$126,000 for fur which the Department characterized as "Fur sold belonging to [Taxpayer]." Taxpayer protests that these furs were actually transferred to the S corporation when the incorporation occurred, and that there was no money transferred from the corporation to Taxpayer. The documentation provided by Taxpayer in support of this position is insufficient to confirm what the \$126,000 in question was for. Again, this is insufficient for Taxpayer to meet the burden imposed by IC § 6-8.1-5-1(c).

In conclusion, the Department conducted further investigation subsequent to the issuance of the investigation report. The Department concluded that Taxpayer provided sufficient explanation and documentation to remove the proposed assessments for 2004 and 2005. Also, the explanation and documentation deemed sufficient for the Department to remove amounts related to "Monies for use of vehicles to Corporation" is sufficient to remove the identical item from the calculations for 2003. Taxpayer has not met the burden of proving the proposed assessments wrong regarding either the \$90,000 in advances from another entity in the fur business or the \$126,000.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) 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.

[45 IAC 15-11-2\(c\)](#) provides in pertinent part:

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.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under [45 IAC 15-11-2\(b\)](#), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer was partially sustained in Issue I, Taxpayer has not affirmatively established that his failure to pay the remaining deficiency was due to reasonable cause and not due to negligence, as required by [45 IAC 15-11-2\(c\)](#). The penalty will be recalculated to reflect the lower amount of base tax.

FINDING

Taxpayer's protest is denied.

CONCLUSION

Taxpayer is sustained on the total assessments for 2004 and 2005. The Department will remove the amount related to "Monies for use of vehicles to Corporation" from the calculations for 2003. The two protested amounts of \$90,000 and \$126,000 will remain in the calculations for 2003. The Department will recalculate the ten percent penalty to reflect the reductions discussed in Issue I.

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