DEPARTMENT OF STATE REVENUE

01-20070474.LOF

Letter of Findings: 07-0474
Individual Income Tax
For the Years 2004, 2005, 2006

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ISSUES

I. Income Tax – Imposition.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-5-4; IC § 6-3-2-1; IC § 6-3-1-3.5; I.R.C. § 1366.

Taxpayers protest 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.

Taxpayers protest 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"). S-Corp is a tavern located in Indiana. The Indiana Department of Revenue ("Department") performed sales and income tax audits of the S-Corp for the years 2004, 2005, and 2006. Those assessments flowed through to Taxpayers. S-Corp's records were reviewed for tax years 2004, 2005, and 2006. The sales records presented for review were not verifiable. In the absence of reliable records substantiating sales, the auditor utilized an alternative method of estimating sales based on the S-Corp's reported cost of goods sold to arrive at a reasonable sales amount. Pursuant to IC § 6-8.1-5-1 and 45 IAC 2.2-6-8, sales tax was assessed on additional taxable sales. Also, the S-Corp made some purchases exempt from the sales tax for which the Department determined there was no exemption allowed. Pursuant to 45 IAC 2.2-3-4, use tax was assessed on certain items. S-Corp protested the sales and use tax assessment. Please refer to Letter of Findings 07-0467 for further information relating to the sales and use tax assessment where taxpayer was sustained on its protest of use tax but denied on its protest of sales tax assessed through the audit.

Also S-Corp income records were reviewed for the same tax years. Additional income was imputed to S-Corp from certain gaming machines and illegal Cherry Masters for 2004, 2005, and 2006. 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 07-0467). 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(c).

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.

If the Department reasonably believes that a person has not reported the proper amount of tax due, the Department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the Department. IC § 6-8.1-5-1(a). Every person subject to a listed tax must keep books and records so that the Department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. IC § 6-8.1-5-4 (a). A person must allow inspection of the books and records and returns by the Department or its authorized agents at all reasonable times. IC § 6-8.1-5-4 (c). 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(c).

A. Additional Income From Sales

(see Letter of Findings 7-0467)

B. Income From Gaming Machines

The records the Department reviewed consisted of state and federal income tax returns, bank statements and some records maintained by the S-Corp relating to income generated from a jukebox, an electronic dart machine, an electronic bowling machine, and countertop and touch screen games. Because the records

presented for income from the above listed gaming machines were incomplete, the missing information was calculated based on the percentage of week's income that was reported. The Department determined that in 2004, S-Corp reported 51 of 52 weeks or 98%; in 2005, S-Corp reported only 22 weeks or 42%; in 2006, S-Corp reported only 27 weeks or 52%. The reported sales were divided by the reported percentage to arrive at attributed sales. The reported sales were then deducted from the attributed sales. This resulted in additional income to S-Corp.

As a starting point Taxpayers argued at hearing that in 2004 S-Corp only had Cherry Master machines on the premises, so there could not have been income from other gaming machines. Taxpayers further explain that S Corp purchased the gaming machines in 2005 after the Cherry Master machines were removed from its premises (see below). At hearing, Taxpayers agreed to provide documentation that supported this contention, however Taxpayers did not do so. Therefore, while the facts may be exactly as Taxpayers describe, the Department requires some substantiation of Taxpayers' claim in order to find that Taxpayers have met their burden of proof.

As to the Department's calculations based on percentage of weeks income from the gaming machines was reported, Taxpayers state that in 2005 and 2006 income was reported when the Taxpayers came in to the tavern to collect the money from the gaming machines, typically once every 2 weeks. Taxpayers present documentation for 2005 that shows that income from gaming machines, beginning in June, were picked up every 2 weeks. This documentation suggests that the Department's calculations based on the number of weeks it presumed reporting is likely incorrect. Since S Corp's numbers for 2005 and 2006 income from the gaming machines are reasonably comparable, Taxpayers are deemed to have met their burden of proof to show that S Corp's reported income from the gaming machines is correct for 2005 and 2006. For 2004, Taxpayers have not met their burden to show that S Corp did not have gaming machines on the premises; therefore the Department's assessment for that year remains.

C. Income from Cherry Master Machines

The Department assessed tax on additional income it imputed to Taxpayers from the Cherry Master machines for 2004 and 2005.

The Department found that the S-Corp had four illegal "Cherry Master" machines until mid-2005. The gaming income records presented to the Department did not include income from these machines. Since there are generally no records made available pertaining to Cherry Master machines, the Department has taken the position that each Cherry Master machine generates annual gross income of $55,000. For computational purposes the machines were deemed to have been in the tavern throughout June 2005. It was the auditor's belief that the machines were then removed from the premises in mid-2005 due to stringent enforcement of gaming laws by the local excise officers. This resulted in additional income to the S-Corp in 2004 and 2005.

As to 2005 Cherry Master income imputed to Taxpayers, Taxpayers argue that the Cherry Master machines were rendered unusable in December 2004 after an inspection by Excise officers. The Excise inspection resulted in a fine to S-Corp that was paid on March 5, 2005. Taxpayers therefore argue that the Cherry Master machines were not usable in 2005 and that indeed the machines were finally removed from the premises that year, therefore, the income the Department imputed from the Cherry Master machines for 2005 should be removed. Taxpayers have presented documentation to show that the Cherry Master machines were not used in 2005 and were removed from the premises during that year. Therefore, income imputed to S Corp from Cherry Master machines for 2005 should be removed from the Department's assessment.

Taxpayers also argue that the income the Department imputed for 2004 is overstated. The Taxpayers had an obligation, as the sole shareholders and operators of S Corp to keep books and records so that the Department can determine the amount, if any, of the S Corp's liability. IC § 6-8.1-5-4. 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). In the absence of these records, the Department was authorized to make BIA assessments. IC § 6-8.1-5-1(a). Therefore, the Department's assessment of tax on income imputed to S Corp for 2004 stands.

FINDING

Taxpayers' protest is sustained in part and denied in part.

S Corp's reported income from the gaming machines is correct for 2005 and 2006. The Department's assessment of income stands for 2004.

Income imputed to S Corp from Cherry Master machines for 2005 should be removed from the Department's assessment. However, the Department's assessment for 2004 stands.

II. Tax Administration – Imposition of 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 imposition of 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, Taxpayers 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 are under a legal obligation to maintain its books and records in such a manner that the Department can determine the amount, if any, of Taxpayers' tax liabilities by reviewing those books and records. IC § 6-8.1-5-4(a). Taxpayers have not affirmatively established that its failure to maintain its books and records or pay the deficiencies was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayers' protest is respectfully denied.

CONCLUSION

Taxpayers are assessed additional income tax based on the following:

Income from S Corp's additional sales per Letter of Findings 7-0467.

As to income from the gaming machines: (1) the Department's numbers for 2004 stand, and, (2) for 2005 and 2006 Taxpayer's reported numbers are sustained.

As to income from the Cherry Master machines: (1) for 2004, the Department's number stands, and (2) for 2005, the Department's imputation of income is removed.

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