DEPARTMENT OF STATE REVENUE

01-20070474.SLOF

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

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Adjusted Gross Income Tax – Imputed Income from Illegal Cherry Masters.

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 amount of income imputed to Taxpayers from their S-Corp's illegal Cherry Master machines.

STATEMENT OF FACTS

Taxpayers are a married couple who are the individual shareholders of an Indiana 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. S-Corp was assessed additional sales and use tax as a result of the sales tax audit. Please refer to Letter of Findings 07-0467 for further information relating to the sales and use tax assessment where S-Corp was sustained on its protest of use tax but denied on its protest of sales tax assessed through the audit.

As stated above, 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 S-Corp income, as well as penalty and interest. Taxpayers protested the income tax assessment and related penalty. The Department issued Letter of Findings 07-0474 sustaining Taxpayer in part and denying Taxpayer in part. Taxpayer requested rehearing on several issues, and was granted rehearing to clarify one issue: the annual gross income the Department imputes to illegal Cherry Master machines in the absence of taxpayer records.

I. Adjusted Gross Income Tax – Imputed Income from Illegal Cherry Masters.

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(b). 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).

In its request for rehearing Taxpayers argued that based on the Letter of Findings 07-0474, income imputed to Taxpayers for 2004 (the only year remaining at issue) by the Department from S-Corp's Cherry Master machines should be adjusted downward from $110,000 per machine to $55,000 per machine.

The Department's S-Corp audit summary stated that "the Department has taken the position that each Cherry Master machine generates annual gross income of $110,000." On page 5 of Taxpayers' audit summary, the Department calculated the income from the Cherry Master machines imputed to Taxpayers. In its calculations, the Department again stated the average annual gross receipts per Cherry Master machine at $110,000. Further along in its calculations on page 5 of the Taxpayers' audit summary, the Department then presumed a fifty (50) percent split to the vendor, resulting in $55,000 of income imputed to Taxpayers for each Cherry Master machine; i.e., fifty percent of the $110,000 receipts per machine.

In addressing the assessment of tax on the additional income that the Department imputed to Taxpayers from the Cherry Master machines, Letter of Findings 07-0474 stated that "[s]ince 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." While the context is clear, the Letter did not again state that the dollar amount it referenced was what was imputed to Taxpayer from each Cherry Master machine and not each machine's receipts prior to the split with the vendor.

Taxpayers' reading of the Letter may be arguably understandable, but is incorrect. In the absence of taxpayer records, the Department correctly imputed $110,000 average annual gross receipts to each Cherry Master machine. After the split to the vendor, the Department correctly imputed $55,000 in receipts per machine to Taxpayer for 2004.

FINDING

Taxpayers' protest is respectfully denied.

Posted: 12/17/2008 by Legislative Services Agency
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