

**Letter of Findings: 08-0286
Income Tax
For the Years 2004 and 2005**

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ISSUES

I. Adjusted Gross Income Tax – Underreported Income.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-5-4; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the assessment of additional income tax.

II. Adjusted Gross Income Tax – Disallowed Business Expense Deduction.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; 26 U.S.C.A. § 63; 26 U.S.C.A. § 119; 26 U.S.C.A. § 162.

Taxpayer protests the disallowance of claimed business expense deductions.

III. Tax Administration – Ten Percent Negligence Penalty.

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

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a C-Corporation that owns farmland which it rents to two related partnerships ("Partnership A" and "Partnership B"). While Taxpayer is primarily in the business of renting farmland, Taxpayer also does other business related to farming. Taxpayer has two officers who are also directors ("Officer 1" and "Officer 2").

The Indiana Department of Revenue ("Department") conducted an income tax audit of Taxpayer for the years 2004 and 2005. The Department reviewed Taxpayer's federal returns and supporting spreadsheets, bank statements, and daily transaction ledgers. Review of these documents showed some discrepancies which resulted in adjustments to Taxpayer's IT-20. Taxpayer protested some of the adjustments. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax – Underreported Income.

DISCUSSION

The Department's audit reviewed Taxpayer's corporate income tax returns for both years. The Department's audit also reviewed a spreadsheet provided by taxpayer showing where the accountant got the figures for the tax return, a daily transaction ledger, and bank statements. The Department concluded that Taxpayer had underreported income and assessed additional Indiana income tax on that basis.

Notices of proposed assessments are prima facie evidence that the Department's claim for unpaid taxes is valid. The Taxpayer has the burden of proving that the Department incorrectly imposed the assessment. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Taxpayers are required to keep adequate books and records so that the Department can determine the proper tax owed to the state. IC § 6-8.1-5-4. [IC 6-8.1-5-1](#)(b) states that "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."

The Department's audit found that Taxpayer had underreported the gross income for both years based on the documentation Taxpayer made available to the Department at the time of the audit.

Taxpayer protested that it did not underreport income in either 2004 or 2005. Taxpayer argued that the Department's numbers did not reflect the fact that some of the income to Taxpayer was actually in the form of loans by one of its officers, which taxpayer stated were mostly repaid. In support of its protest, after the hearing, Taxpayer presented additional documentation that consisted of its "officers loan account" and "check register."

Taxpayer, in a cover memo attached to the above submitted documentation dated October 10, 2008, explained that it identified on its "check register" deposits that represented loans from one of its officers. However these deposit entries are designated as "cash rents" which does not indicate that this income to Taxpayer is in the form of loans. Rather, these appear to be rent payments to Taxpayer who does, after all, lease farm land. In addition, the numbers on the on the "check register" and the "officers loan account" report do not always match.

Taxpayer also provided a document, print-dated February 7, 2008, signed by its two officers and directors, that stated the following:

Per previous oral agreement, and now a written agreement, [Taxpayer] shall now, as in the past, and continuing in the future be agreeable to loans to [Officer 1] and [Officer 2] as deemed necessary without applications, approval of outside interests or liens.

This after-the-fact document does not constitute an agreement that sets out clear terms relating to the loans it references. Even if it did, this agreement is about Taxpayer making loans to its two officers, not the reverse as

claimed by Taxpayer.

Taxpayer has not demonstrated that the Department's assessment of additional income tax is unwarranted.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Disallowed Business Expense Deduction.

DISCUSSION

The Department disallowed certain of Taxpayer's business expense deductions, thereby increasing Taxpayer's taxable Indiana income. The Department's audit found that Taxpayer had deducted expenses in excess of the actual employee benefit programs and non-deductible supplies which included grocery and food costs. Also, according to the audit, Taxpayer had taken an excess tax deduction and personal travel expenses.

Taxpayer protested that the deductions were properly taken.

Indiana imposes an adjusted gross income tax on the adjusted gross income of corporations. IC § 6-3-2-2. Indiana adjusted gross income is calculated by starting with the federal adjusted gross income and making certain modifications. IC § 6-3-1-3.5(b). The federal adjusted gross income calculation begins with the inclusion of all of the taxpayers' taxable income. 26 U.S.C.A. § 63.

A. Employee benefit program.

Taxpayer had taken a deduction for their medical expenses of its officers in 2004 and 2005. The audit disallowed almost 30 percent of Taxpayer's deduction in 2004. The audit did not disallow any employee benefit expense deductions for 2005.

Taxpayer provided a copy of its Schedule F which was attached to the 2004 Federal Form 1120 that states "employee benefit expenses" (line 17) that correspond with an income/expense report provided by Taxpayer that lists medical, intensive care, disability and health insurance expenses.

This documentation is sufficient to meet the burden of IC § 6-8.1-5-1(c).

Taxpayer's protest of the disallowance of employee benefit expenses for 2004 is sustained.

B. Supplies purchased – food.

The audit disallowed a deduction Taxpayer took in 2004 and 2005 for certain supply expenses. For 2005, Taxpayer conceded the audit's determination.

Taxpayer argued that for 2004 the supplies deduction related to food expenses. Taxpayer argues that these food expenses are deductible because the food was purchased for the officers who were required to live on the homestead during the taxable year. In support of its contention, Taxpayer provided photocopied text from a treatise on farm corporations which supports this deduction. The treatise states:

Section 119 allows an employee to exclude the value of meals and lodging supplied to the employee and his family. These items must be provided on the employer's business premises and supplied for the convenience of the employer. Acceptance of lodging must also be a condition of employment – presumably that means that the employee would not be allowed to hold the job if he did not accept the lodging.

This is an exclusion that is available to the employee – as Taxpayer's treatise reference clearly states – not a business expense deduction available to the employer. 26 U.S.C.A. § 119(a).

Therefore, Taxpayer's protest of the disallowance of expenses relating to supplies in 2004 is denied.

C. Excess taxes and licenses.

The audit disallowed certain expenses relating to excess taxes and licenses in 2004. Taxpayer provided documentation explaining what taxes and licenses were paid and why, thereby, meeting the burden imposed by IC § 6-8.1-5-1(c).

Taxpayer is sustained on this issue for 2004.

D. Travel.

The audit denied all of the deductions Taxpayer had taken for travel expenses in 2004 and 2005. Taxpayer had taken a portion of its officers' travel expenses as business expense deductions.

26 U.S.C.A. § 162(2) allows for a deduction of "ordinary and necessary expenses" relating to travel, if the travel away from home is "in pursuit of a trade or business."

Taxpayer provided credit card statements showing cost of travel expenses in both 2004 and 2005. Taxpayer further explained the rationale for claiming travel expense deductions in an email dated September 30, 2008. Taxpayer explained that in 2004 its officers traveled to Florida where a parent, who is also in partnership with one of its officers, lives in the winter. Other family members were present. Taxpayer's officers are in several partnerships with other family members. Taxpayer explains that its officers had several business issues to resolve relating to "near and far future planning," improvements on the farm, markets and more. The officers also traveled to another relative in Florida who had helped design some of the improvements to Taxpayer's ship and grain bin area on the farm. They took part of the expenses of the trip as business expenses.

In 2005, Taxpayer explained that its officers travelled to Colorado to attend the wedding of one of its officers' sister's wedding. The officer's sister is in partnership with one of its officers. Other relatives who are in other partnerships with whom Taxpayer does business were also present. Taxpayer stated that it is usual to discuss the family farming business with the family at this time. They also drove by farming operations in the area, and stopped to examine one that raised alpacas as this was an interest of one of the officers. Again Taxpayer took

part of the expenses of the trip as business expenses.

The travel deduction allowance cannot be taken for travel that is primarily for personal reasons. Given the close family ties of all the participants in this instance, Taxpayer needed to do more than provide credit card statements of its travel, lodging and meal expenses to substantiate the business purpose of its travel. Furthermore, when a trip is primarily for personal reasons only expenses that relate directly to the business can be claimed as deductions.

Taxpayer's protest of the disallowance of the travel expenses it deducted is respectfully denied.

FINDINGS

Taxpayer's protest of the disallowance of employee benefit expenses for 2004 is sustained (subpart A).

Taxpayer's protest of the disallowance of expenses relating to supplies in 2004 is denied (subpart B).

Taxpayer is sustained on this issue for 2004 (subpart C).

Taxpayer's protest of the disallowance of the travel expenses it deducted in 2004 and 2005 is respectfully denied (subpart D).

III. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation [45 IAC 15-11-2](#)(b) clarifies the standard for the imposition of the negligence penalty as follows:

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 standard for waiving the negligence penalty is given at [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.

Taxpayer has not shown reasonable cause for its underpayment of income tax to overcome the assessment of the negligence penalty.

FINDING

Taxpayer's protest of the assessment of the negligence penalty is respectfully denied.

CONCLUSION

Issue I – Taxpayer's protest of the underreporting of its income is denied.

Issue II – Taxpayer's protest of the disallowance of business expense deductions relating to employee expenses and excess tax and licenses is sustained (subpart A and C, respectively). Taxpayer's protest of the disallowance of expenses relating to food and travel are respectfully denied.

Issue III – Taxpayer's protest of the penalty is respectfully denied.

Posted: 06/24/2009 by Legislative Services Agency

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