DEPARTMENT OF STATE REVENUE

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Letter of Findings: 08-0382
Individual Income Tax
For the Years 2004, 2005, 2006

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ISSUES

I. Individual Income Tax – Imposition.

Authority: IC § 6-8.1-5-1; IC § 23-1-46-1; IC § 23-1-46-2; IC § 23-4-1-6; 45 IAC 3.1-1-2; 45 IAC 3.1-1-105; 45 IAC 3.1-1-106; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayers protest the imposition of additional income tax based on the claim that they are not involved with the partnership through which the income was generated.

II. Tax Administration – Imposition of 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, a husband and wife filing their income tax return jointly, were, for the years in question, partners in a partnership ("Partnership") with two other relations. Partnership was a registered retail merchant operating a gift shop in Indiana since September 1994. The other two partners actively operated the business. The Indiana Department of Revenue ("Department") conducted sales and income tax audits of the retail merchant who had never filed a partnership (or other) tax return with the Department until December 31, 2007. Because of the lack of records, the Department's income tax audit of Partnership used gross sales from the sales tax audit (derived from the business' bank deposits) and using "best information available" estimates of expenses arrived at net income for the unreported years thus creating additional partnership income reportable by and assessed against each of the four partners in conformity with their respective distributive shares (see Letters of Findings 07-0516 and 07-0517 for reference to the protests on the audits themselves).

Taxpayers were therefore assessed additional income tax for 2004, 2005, and 2006. Taxpayers protested the proposed assessment of additional income tax arguing that they were not affiliated with the business for the years in question.

I. Individual Income Tax – Imposition.

DISCUSSION

The Department notes that all tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

In a letter dated July 22, 2008, Taxpayers state that they were originally each twenty-five (25) percent shareholders in the retail business. The business was then organized as a subchapter S corporation. Taxpayers state that they received Schedule K-1s from the corporation for several years and reported this income on their tax returns from 1998 through 2005. However, Taxpayers did not receive Schedule K-1s after 2005. Taxpayers further explain that in January of 2008, Schedule K-1s were issued to Taxpayers for the years 2002, 2003, 2004, and 2005 for the business as a partnership. Taxpayers state that the limited information relayed to them is that the corporation was administratively dissolved at some time and partnership returns were prepared from 2003 through 2005. Taxpayers state that they were never notified or informed of any of these matters nor did they have any knowledge of the circumstances concerning Partnership as pertains to the non-filing of tax returns, dissolution of the corporation and subsequent classification as a partnership. In addition, Taxpayers state they never received any distribution or remuneration of any kind from Partnership. Taxpayers had previously stated at the hearing that they had wanted to get out of the business and assumed that to be the case when they no longer received 1120S K-1s after 2005.

In a letter dated February 11, 200[9], Taxpayers again state that they did not actively participate in the operation of Partnership. Taxpayers further argue that they did not receive notification of audit review or non-filing of the entity's returns.

Before and during the hearing process Taxpayers were asked to present any documentation available to them that would describe the nature of their interest in the business and the termination of any such interest. Taxpayers did not present any documentation that described the nature of their interest in the subchapter S corporation or any partnership agreement. Taxpayers did present a notarized handwritten document dated April 2nd, 2007, signed by the four partners that states that Taxpayers:

> [Taxpayers] agreed to terminate their activities and involvement with [Partnership]. Terms shall be a 10 year issuant [sic] of appropriate consideration via K1 distribution as shareholders and then all stock share[s]

valued at $0.2 per share or $1 per individual. This agreement will be effective following the calendar year ending 1996 carrying through the year 2006.

Under the authority granted under IC § 23-1-46-1, the secretary of state administratively dissolved the subchapter S corporation (of which Taxpayers were each twenty-five (25) percent shareholders) when the corporation failed to make reports to the secretary of state for more than three years in succession.

Under IC § 23-1-46-2(c), an administratively dissolved corporation "continues its corporate existence," but "it may not carry on any business except that necessary to wind up and liquidate its business and affairs...." However, in this instance, the retail merchant continued to operate, thus by default creating a partnership. IC § 23-4-1-6. IC § 23-4-1-6 defines a partnership, in relevant part, as "an association of two (2) or more persons to carry on as co-owners a business for profit...."

The document Taxpayers presented in order to absolve them of participation in Partnership is not valid since it was dated after the years at issue. Even if, as Taxpayers claim, Taxpayers wished to be out of the business, nonetheless, Taxpayers failed to act in business-like fashion to properly terminate their participation in the business – be it a subchapter S corporation or a partnership. Therefore in the absence of any relevant documentation that describes more limited participation by Taxpayers in the business, Taxpayers are deemed to be equal partners in Partnership.

45 IAC 3.1-1-2 defines gross income for individuals, and states that "Indiana resident must report all income as defined by § 61 of the Internal Revenue Code." The regulations goes on to list some sources of income which include "(13) [d]istributive share of partnership income."

45 IAC 3.1-1-105 states in part:

(a) A partnership must file an annual return, IT-65, with the department, disclosing each partner's distributive share of partnership income, on or before the fifteenth day of the fourth month following the close of the partnership's accounting year. Any partnership doing business in Indiana or deriving gross income from sources within Indiana is required to file the return.

(b) As used in this section, "partner's distributive share" means the amount determined under Section 704 of the Internal Revenue Code and its prescribed regulations before any modifications required by Indiana tax statutes.

45 IAC 3.1-1-106 describes, in relevant part, a partner's distributive share:

(a) A partnership is not subject to the adjusted gross income tax. The partners will include their share of partnership income whether distributed or undistributed on their separate or individual returns.

(b) An individual will report as follows:

(1) The distributive share of a resident partner will be reported in total no matter where the partnership's business is located or in which states it does business.

(2) The distributive share of a nonresident partner will be reported after apportionment to determine the partnership income derived from sources within Indiana. This determination will be accomplished by use of the apportionment formula described in IC 6-3-2-2(b).

(3) A resident partner's distributive share of income will be adjusted by the partner's proportionate share of the partnership's income that is exempt from taxation under the Constitution and statutes of the United States and by the partner's proportionate share of the partnership's deductions allowed or allowable under Section 62 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States.

(4) A nonresident partner's distributive share of income will be adjusted by the partner's proportionate share of the partnership's income that is exempt from taxation under the Constitution and statutes of the United States and by the partner's proportionate share of the partnership's deductions allowed or allowable under Section 62 of the Internal Revenue Code for taxes based on or measured by income levied at the state level by any state of the United States or for taxes on property levied by any subdivision of any state of the United States determined by use of the apportionment formula described in IC 6-3-2-2(b).

(c) A corporate partner will report its share in accordance with section 153 of this rule.

(Emphasis added).

In the absence of any documentation to the contrary, Taxpayers are partners of Partnership and therefore must comply with their obligation as partners to remit all the tax obligations that flow through their distributive shares of the partnership.

FINDING

Taxpayers' protest is respectfully denied.

II. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

Taxpayers 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.

Taxpayers have not affirmatively established that their failure to pay tax on the income resulting from Partnership 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' protest of the assessment of additional income tax and the imposition of negligence penalty are both denied.

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