

**Letter of Findings: 08-0726; 08-0727; 09-0165
Corporate and Individual Income Tax
For the Years 2003, 2004, 2005, and 2006**

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ISSUES

I. Corporate and Individual Income Tax – Disallowance of Deductions.

Authority: 26 U.S.C.S. § 385; 26 U.S.C.S. § 1368; IC § 6-3-1-3.5; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayers protest the Department's disallowance of Corporation's deductions.

II. Tax Administration – 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

Corporation, an Indiana S corporation, is in the business of selling cigarettes, cigars, pipes, and other related tobacco merchandise. Corporation has two shareholders, Shareholder A and Shareholder B. Shareholder A owns seventy (70) percent of the total shares and Shareholder B owns thirty (30) percent of the total shares.

Pursuant to an audit, the Indiana Department of Revenue ("Department") concluded that Corporation had improperly deducted certain business expenses which were shareholders' personal expenses. The Department's audit disallowed Corporation's deductions, which resulted in distributions to the shareholders, resulting in an increase of shareholders' income. Corporation and both shareholders (collectively "Taxpayers") protested the proposed assessment. Specifically, Corporation and Shareholder A protested the 2003, 2004, 2005, and 2006 tax liabilities, while Shareholder B protested the 2005 and 2006 tax liabilities. A hearing was held. This joint Letter of Findings ensues. Additional facts will be provided as necessary.

I. Corporate and Individual Income Tax – Disallowance of Deductions.

DISCUSSION

The Department's audit found that Corporation had deducted interest payments it had made concerning two loans, \$70,000 and \$100,000, which Shareholder A and her spouse borrowed from a bank. Additionally, the Department's audit discovered that Corporation improperly deducted the expenses, including interest, insurance premiums, property tax, maintenance, and utilities, associated with a Florida condominium owned by Corporation, because the shareholders often personally used the condominium. The Department's audit disallowed Corporation's deductions of the interest payments to the bank concerning the two loans as well as the expenses associated with the Florida condominium because those expenses were personal in nature.

Taxpayers first stated that Corporation needed money to fund a startup retail store, so Shareholder A and her spouse initially borrowed \$70,000 from the bank and then loaned the \$70,000 to Corporation. Shareholder A and her spouse then instructed Corporation to make direct payments to the lender bank because it was convenient. Taxpayers claimed that Corporation was entitled to the deductions as business expenses because this loan was between Corporation and Shareholder A. Next, Taxpayers claimed that Corporation mistakenly made interest payments to the lender bank concerning the \$100,000 loan. Taxpayers agreed that Shareholder A and her spouse were solely responsible for this \$100,000 loan. However, Taxpayers argued that this mistake should be treated as if Corporation repaid an older debt which Shareholder A previously advanced Corporation, a loan which is not disputed in this protest. Since Corporation was in debt to Shareholder A, Taxpayers argued these erroneous payments should be treated as repayments of the old loan to Shareholder A.

Lastly, Taxpayers argued that Corporation's purchase of the Florida condominium was an investment, and, therefore, Corporation was entitled to deduct the expenses associated with the condominium. Taxpayers claimed that the shareholders used the condominium "more than infrequently". Taxpayers also argued that the condominium was not habitable during 2005 due to mold damage. Thus, those expenses associated with the condominium were business expenses and Corporation was entitled to the deductions.

All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. 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).

The Indiana income tax rules piggyback on the federal income tax regulations. IC § 6-3-1-3.5. An S Corporation's income passes through to its shareholders. 26 U.S.C.S. § 1361 et seq.

A. Disallowance of Deductions Concerning Interest and Principal Payments

The Department's audit determined that Corporation had improperly deducted the interest payments on two loans, \$70,000 and \$100,000, because they were personal obligations of Shareholder A and her spouse. Thus, the audit disallowed Corporation's deductions of the payments, resulting in an increase of corporate income, which became taxable distributions to Shareholder A for tax years 2003, 2004, 2005, and 2006, because the distributions exceeded Shareholder A's basis.

Taxpayers first argued that a debtor-creditor relationship existed between Corporation and Shareholder A concerning the \$70,000 loan, and, therefore, Corporation was entitled to deduct the payments. Next, Taxpayers agreed that Corporation should not have made interest payments concerning the \$100,000 loan. Taxpayers nonetheless argued that since Shareholder A also had advanced Corporation a previous loan (not disputed in this protest), and since Corporation had to repay this undisputed loan to Shareholder A, then these erroneous payments should be treated as repayments towards this undisputed loan.

1. Disallowance of Deductions Concerning Payments towards the \$70,000 Loan

The Department's audit disallowed Corporation's deductions on the interest payments concerning the \$70,000 loan. Taxpayers argued that Shareholder A borrowed \$70,000 from the bank and then loaned the exact \$70,000 to Corporation to fund a startup retail store. Instead of having Corporation pay the interest to Shareholder A, and Shareholder A then pass the same interest to the bank, Shareholder A instructed Corporation to make payments directly to the lender bank because it was convenient. Taxpayers claimed that the payments were to repay the \$70,000 loan between Corporation and Shareholder A, but Corporation mistakenly recorded it as a loan which Shareholder A and her spouse owed to the bank. Therefore, Taxpayers argued that Corporation was entitled to deduct the payments.

26 U.S.C.S. § 385(b) sets forth five factors to determine whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists as follows:

- (1) Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
- (2) Whether there is subordination to or preference over any indebtedness of the corporation,
- (3) The ratio of debt to equity of the corporation,
- (4) Whether there is convertibility into the stock of the corporation, and
- (5) The relationship between holdings of stock in the corporation and holdings of the interest in question.

Here, Taxpayers claimed that Corporation borrowed the money from Shareholder A to fund Corporation's business, so a debtor-creditor relationship existed. However, Taxpayers' documentation showed that the promissory note was executed by Shareholder A and her spouse. Shareholder A and her spouse's names and signatures were the debtors on the promissory note. The lender bank issued the receipts to Shareholder A and her spouse after the bank received the payments from Corporation. Taxpayers did not provide any documentation concerning this \$70,000 loan between Corporation and Shareholder A, nor did Taxpayers provide any documentation showing that Shareholder A instructed Corporation to pay the lender bank. Furthermore, Corporation and Shareholder A did not have any agreement on the interest rate and the maturity date regarding this \$70,000 loan. Shareholder A, as the majority shareholder, controls and manages Corporation's day-to-day business, affecting Taxpayer's success and profitability. Taxpayers did not provide any documentation to substantiate the claim that Shareholder A intended to advance the \$70,000 to Corporation.

Given the facts mentioned above, the Department is not able to conclude that the debtor-creditor relationship existed between Corporation and Shareholder A concerning the \$70,000 loan. Since Shareholder A and her spouse were personally responsible for this loan, Corporation was not entitled to deduct the payments.

2. Disallowance of Deductions Concerning Payments towards the \$100,000 Loan

The Department's audit also disallowed the deductions of the interest payments which Corporation had made concerning a \$100,000 loan.

Taxpayers agreed that Corporation should not have made the interest payments on the \$100,000 loan because Shareholder A and her spouse were personally responsible for the loan, and Corporation mistakenly made payments to the lender bank. Taxpayers stated that Shareholder A had also previously advanced another older loan to Corporation. Taxpayer suggested to the Department, that since Corporation owed Shareholder A repayment of the older loan, the Department consider the interest payments Corporation erroneously made on the \$100,000 loan as "repayments" of Corporation's debt to Shareholder A for the older loan. This suggested approach would render the payments deductible *[sic]* business expenses. Taxpayers offered to "correct" its accounting to reflect this proposition.

The Department must decline Taxpayers' proposition. Here, Taxpayers admitted that Shareholder A and her spouse were personally responsible for the \$100,000 loan. Therefore, Corporation was not entitled to the deductions.

B. Disallowance of Expenses Associated with the Florida Condominium

The Department's audit also determined that Corporation was not entitled to deduct the expenses, including interest, insurance premiums, property tax, maintenance, and utilities, associated with the Florida condominium owned by Corporation, because shareholders had been personally using the condominium.

Taxpayers claimed that, prior to purchasing the current condominium in question, it had made some profits

from the Florida real estate market. In 2000, Corporation purchased the condominium in question with the same expectation. Taxpayers argued that the shareholders used the condominium "more than infrequently" by listing the following:

- [Shareholder A and her spouse] have taken 4 cruises in the last 10 years.
- [Shareholder A and her spouse] go to Las Vegas for 4 to 5 days almost every year for a reunion with friends.
- [Shareholder A and her spouse] went to Paris[,] France in 2002 for 2 weeks and to Scotland in 2007.
- [Shareholder A and her spouse] have close friends that live on the island that they sometimes stay with when they do go to Florida. Typically Shareholder A has a summer trip where she stays at her friend's home and both usually stay at a friend's home for an annual Halloween trip.

Taxpayers further claimed that the shareholders did not have any personal use of the condominium in question in 2005 because the condominium suffered mold damage rendering the condominium not habitable. Taxpayers thus argued that the expenses associated with the condominium were business expenses, and Corporation was entitled to the deductions. However, Taxpayers did not provide any documentation to support their arguments.

Taxpayers did not meet their burden of proof and, therefore, were not entitled to deduct the expenses associated with the condominium. The payments which Corporation had made concerning expenses associated with the condominium were distributions to the shareholders.

FINDING

Taxpayers' protest on the Department's disallowance of deductions is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayers also protest the assessment of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a tax return;
- (2) fails to pay the full amount of tax shown on the tax return;
- (3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
- (4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

[45 IAC 15-11-2](#)(b) further 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 a negligence penalty as provided in [45 IAC 15-11-2](#)(c), in part, 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 did not provide sufficient documentation establishing that their 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.

FINDING

Taxpayers' protest on the imposition of the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayers' protest on the disallowance of deductions is denied. Taxpayers' protest on negligence penalty is also respectfully denied.

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