

**Letter of Findings Number: 09-0909
Individual Income Tax
For the Year 2006**

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ISSUE

I. Individual Income Tax – Imposition.

Authority: I.R.C. § 1377.

Taxpayers protest the assessment of individual income tax.

STATEMENT OF FACTS

Taxpayers are a married couple. Husband owned an interest in an S corporation. During the year, Husband acquired the shares of the S Corporation owned by an unrelated shareholder. Taxpayers filed an individual income tax return reporting income from the S corporation.

The Indiana Department of Revenue ("Department") determined that Husband underreported his income from the S corporation and assessed tax, interest, and penalty. Taxpayers protested the assessment, the Department conducted an administrative hearing, and this Letter of Findings results.

I. Individual Income Tax – Imposition.

DISCUSSION

Taxpayers protest the Department's redetermination of their 2006 income from the S corporation. In particular, Taxpayers protest the method used by the Department to attribute income from the S corporation to Husband.

Under I.R.C. § 1377(a)(1), the default rule is to treat all tax attributes (income, deductions, and credits) as occurring pro rata each day, then divide the respective attributes among the shareholders based on their ownership each day of the year. The S corporation listed Husband's percentage ownership on his federal form K-1 as if the S corporation and its shareholders had used the default method.

However, under I.R.C. § 1377(a)(2), if a shareholder's interest in an S corporation is terminated, that shareholder and all other shareholders to whom that shareholder has transferred shares during the taxable year can elect to treat the S corporation's taxable year as two taxable years. The first "taxable year" starts on the first day of the S corporation's taxable year and ends on the day the shareholder's ownership in the S corporation terminates. The second "taxable year" begins the next day and continues for the rest of the S corporation's regular taxable year.

Taxpayers assert that Husband used the method elected and otherwise permitted under the I.R.C. § 1377(a)(2) election, and the federal form K-1 listed the respective income items apparently as if the election had been properly made. The Department, based on Husband's federal form K-1, treated Husband as if it had in effect not made the I.R.C. § 1377(a)(2) election.

Taxpayers have provided sufficient information to conclude that the S corporation's affected shareholders made an election under I.R.C. § 1377(a)(2). Taxpayers have shown that Husband's income from the S corporation was calculated properly using the I.R.C. § 1377(a)(2) election, along with the S corporation's income as reported and as allocated between the S corporation's two short "taxable years." Thus, Taxpayers' protest is sustained. However, in the event the federal election is disallowed, the S corporation's income is otherwise redetermined or reallocated between the two tax periods, or any other federal audit adjustments related to Taxpayers' 2006 income, the Department reserves the right to redetermine Taxpayers' income as otherwise permitted by statute.

FINDING

Taxpayers' protest is sustained.

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