

Letter of Findings: 10-0225
Individual Income Tax
For the years 2004, 2005, and 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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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. S-Corporation Expenses – Adjusted Gross Income.

Authority: IC § 6-8.1-5-1(c); [45 IAC 3.1-1-66](#); Jondahl v. Comm'r., T.C. Memo. 2005-55, 2005 WL 675444 (2005); I.R.S.Gov., Small Business Paying Yourself, <http://www.irs.gov/businesses/small/article/0,,id=101038,00.html>.

Taxpayer argues that the Department incorrectly imputed income from its S-corporations.

STATEMENT OF FACTS

Taxpayers are husband and wife joint owners of two S-corporations. For convenience and simplicity sake, this Letter of Findings will simply use "Taxpayer" to designate the two interested parties. Taxpayer's first S-corporation – an oil company – ended operations in 2005. Taxpayer also owns a second, ongoing car wash business.

The Department of Revenue (Department) conducted an audit review of the Taxpayer's business records and tax returns.

The Department's audit found that "several expenses of the corporation were found to not be ordinary and necessary expenses of the corporation." As a result, the audit found that Taxpayer had received unreported income subject to individual Indiana income tax.

Taxpayer disagreed with three adjustments and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer explained the basis for the protest. This Letter of Finding results.

I. S-Corporation Expenses – Adjusted Gross Income.

DISCUSSION

The Department's audit found that Taxpayer had received imputed income from the S-corporations. According to the audit report, Taxpayer received "Shareholder loans from [oil company S-corporation] during 2005 and 2006." Taxpayer did not have "any loan agreements and no repayment agreement." The audit report found that "[t]his arrangement does not qualify as a bona fide loan" and should be "reclassified as a taxable dividend to the shareholder as per IRS Regulation 7872."

Oil company S-corporation also made a loan to car wash S-corporation. However, the audit found that the loan "was zeroed out during the period September 30, 2005 to December 31 as per the tax return balance sheet reflecting the loan having been repaid." Again, there was "[n]o loan agreement or repayment schedule...." and "[n]o interest appears to have been received or paid for this loan and repayments to [oil company S-corporation]...." The Department's audit found that the "transaction[] amounts to a taxable dividend to the shareholder."

A garage and storage facility was constructed at Taxpayer's home. The audit report describes the facility as follows:

The exterior décor of the structure and the landscaping are consistent with that of the taxpayer's home. The paved driveway and utilities of the taxpayer's residence are interconnected with those of this structure. A low wall enclosed patio area with a canopy, tables and chairs is on one end of the structure toward the taxpayer's house. The interior is finished with cabinets, a heated half bath, storage closet, overhead recessed lighting and overhead fans.... The property tax card for real property of the [Taxpayer's county] property tax officials reflects this structure being owned by the taxpayer and having the living quarters. This structure does not appear on any fixed asset listing or depreciation scheduled of [oil company S-corporation] but does appear on the depreciation schedule of [car wash S-corporation]. The expenses and disbursements for this appear to be a distribution to the taxpayer and not ordinary and necessary expense of either [S-corporation].

Taxpayer objects to the three adjustments stating that the issue is simply related to a "timing issue" and that Taxpayer plans to now repay the loans over a period of ten years.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(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."

An S corporation normally does not pay income tax. [45 IAC 3.1-1-66](#), states that, "Corporations electing Subchapter S status under Internal Revenue Code § 1372... are exempt from adjusted gross and supplemental net income tax on all income except capital gains...." Rather than taxing the income at the business level, the S

corporation's income is passed through to the shareholders. The shareholders then must report the income on their own income tax return. [45 IAC 3.1-1-66](#) states that, "Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate." This is the dilemma in which Taxpayer finds himself; because certain of the S-Corporation's deductions were disallowed, additional taxable income flowed through to the taxpayer as the S-Corporation's shareholder. It was this additional "flow through" income which led to the imposition of additional, individual income taxes.

Guidance on this issue is found at the United States Tax Court decision in *Jondahl v. Comm'r.*, T.C. Memo. 2005-55, 2005 WL 675444 (2005).

Whether a withdrawal of funds from a corporation creates a true debtor-creditor relationship is a factual question to be decided on the basis of all of the relevant facts and circumstances. For disbursements to constitute true loans, there must have been an unconditional obligation on the part of the transferee to repay the money and an unconditional intention on the part of the transferor to secure repayment at the time that the funds were transferred. Courts have focused on certain objective factors to distinguish bona fide loans from disguised dividends, compensation, and contributions to capital. The factors considered relevant for purposes of identifying bona fide loans include (1) the existence or nonexistence of a debt instrument; (2) provisions for security, interest payments, and a fixed payment date; (3) treatment of the funds on the corporation's books; (4) whether repayments were made; (5) the extent of the shareholder's participation in management; and (6) the effect of the "loan" on the transferee's salary. When the individual is in substantial control of the corporation... special scrutiny of the situation is necessary. *Id.* at *16 (Internal citations omitted).

Additional guidance is provided by the Internal Revenue Service which explains as follows:

A loan by a corporation to a corporate officer should include the characteristics of a loan made at arm's length. That is, there should be a contract with a stated interest rate, a specified length of time for repayment, and a consequence for failure to repay the loan. Collateral would also be an indication of a loan. A below-market loan is a loan which provides for no interest or interest at a rate below the federal rate that applies. If a corporation issues you, as a shareholder or an employee, a below-market loan, the lender's payment to the borrower is treated as a gift, dividend, contribution to capital, payment of wages, or other payment, depending on the substance of the transaction. I.R.S. Gov., Small Business Paying Yourself, <http://www.irs.gov/businesses/small/article/0,,id=101038,00.html>.

Taxpayer explains that it has begun to repay the loans to the S-corporations and that the construction of the garage at Taxpayer's home "should not be income as it was a distribution from [car wash S-corporation] to me, the owner." However, the issue is not how Taxpayer intends to treat these disbursement/expenses in the future, but whether the Department properly imputed additional income at the time of the original transactions and at the time of the audit.

At the time the original loans were made and at the time the garage was constructed at Taxpayer's home, there was no "unconditional obligation on the part of the [Taxpayer] to repay the money and an unconditional intention on the part of the [S-corporation] to secure repayment at the time that the funds were transferred." *Jondahl v. C.I.R.*, T.C. Memo. 2005-55, 2005 WL 675444 at *17 (2005). In addition, there is no evidence of a "debt instrument... provisions for security, interest payments, and a fixed payment date." *Id.* In cases, such as this, where Taxpayer is in "substantial control of the corporation," the Tax Court has cautioned that "special scrutiny of the situation is necessary." *Id.*

The Department does not question Taxpayer's good faith intentions; however, Taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) of establishing that the audit's original decision was incorrect. The audit correctly concluded that Taxpayer received taxable income attributable to the two S-corporations.

FINDING

Taxpayer's protest is respectfully denied.

Posted: 09/01/2010 by Legislative Services Agency
An [html](#) version of this document.