

LETTER OF FINDINGS: 10-0095
Individual Income Tax
For the Years 2006, 2007, and 2008

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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.

ISSUES

I. Individual Income Tax – Imposition.

Authority: I.R.C. § 1366; I.R.C. § 1367; IC § 6-8.1-5-1; IC § 6-3-1-3.5; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the imposition of additional income tax.

II. Tax Administration – Negligence Penalty.

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

Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer is the sole shareholder of an Indiana S corporation ("Corporation") which sells automobiles. Corporation's gain or loss passed through to Taxpayer and Taxpayer reported the income or deducted the loss on his federal and Indiana individual income tax returns according to I.R.C. § 1366 and IC § 6-3-1-3.5.

The Indiana Department of Revenue ("Department") conducted an audit of Corporation for tax years 2006, 2007, and 2008. The audit resulted in an investigation of Taxpayer, the sole shareholder. The Department determined that Taxpayer improperly deducted the passed through losses which Corporation incurred during 2006, 2007, and 2008 because Taxpayer did not have sufficient adjusted basis. The Department, thus, disallowed Taxpayer's alleged loss deductions. As a result, Taxpayer was assessed additional income tax, interest, and negligence penalty.

Taxpayer contended that he had sufficient basis to deduct losses for those years and, therefore, protested the proposed assessments. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Individual Income Tax – Imposition.

DISCUSSION

The Department disallowed Taxpayer's deductions of Corporation's 2006, 2007, and 2008 operating losses because Taxpayer did not have sufficient adjusted basis. Taxpayer, to the contrary, contended that he had sufficient adjusted basis and was entitled to deduct the losses on his 2006, 2007, and 2008 individual income tax returns.

As a threshold issue, 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).

Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine individual shareholder's tax liability.

I.R.C. § 1366 establishes that an S corporation's shareholders are entitled to deduct the S corporation's operating loss, passed through to them, up to the amount of their adjusted basis in corporate stock plus the adjusted basis of the corporation's debt. I.R.C. § 1366 (d) sets forth the limitations and, in relevant part, states:

(d) Special rules for losses and deductions.

- (1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of
- (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and
 - (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

I.R.C. § 1367 further provides:

(a) General rule.

- (1) Increases in basis. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
- (A) the items of income described in subparagraph (A) of section 1366(a)(1),
 - (B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and
 - (C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis. The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

- (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
- (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
- (C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),
- (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and
- (E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. The preceding sentence shall not apply to contributions made in taxable years beginning after December 31, 2009.

(b) Special rules.

(1) Income items. An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness.

(A) Reduction of basis. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d). This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock.

(A) In general. If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis. The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

In this instance, Taxpayer maintains that he made many loans to Corporation since 2003. Taxpayer further stated that while Corporation incurred losses in each of the years at issue, it was not able to repay Taxpayer. Taxpayer claimed that he had sufficient basis due to those loans.

To support his protest, in addition to copies of checks and several bank deposit receipts, Taxpayer also submitted copies of quotations or invoices with notation that payments were made regarding several contract projects. Taxpayer asserted that he paid those bills on behalf of Corporation which was responsible for paying the contractors for remodeling the office. Taxpayer also stated that he personally paid Corporation's operating cost. Thus, Taxpayer claimed that he had made loans to Corporation, and, as such, increased his basis.

Taxpayer's documentation showed, at best, that those transactions could have occurred in 2003 or 2004. A contractor's quote concerning cost of a remodel project is, at best, a bid or an offer to contract. Taxpayer did not provide documentation showing that Taxpayer did pay the contractors for the work done on behalf of Corporation. Additionally, neither Corporation nor Taxpayer maintained the records concerning any shareholder loans. Taxpayer's documentation failed to demonstrate the terms of any loans and Corporation made interest payments to Taxpayer on the alleged loans. Assuming that those transactions did occur in 2003 and 2004, and afforded Taxpayer some "basis," Taxpayer's documentation also failed to demonstrate that, after those years, any basis remained sufficient for Taxpayer and could be used in 2006, 2007, and 2008.

Given the totality of the circumstances, in the absence of other documentation, Taxpayer failed to demonstrate that he had sufficient basis. Since Taxpayer failed to meet his burden of proof demonstrating that the Department's assessment was not correct, Taxpayer's protest is respectfully denied.

FINDING

Taxpayer's protest on the imposition of additional income tax is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protested the imposition 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.

Taxpayer did not provide documentation to establish that his failure to pay tax timely was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest on the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest on the imposition of additional income tax is respectfully denied. Taxpayer's protest on the negligence penalty is also respectfully denied.

Posted: 12/22/2010 by Legislative Services Agency

An [html](#) version of this document.