

**Letter of Findings: 01-20140583
Individual Income Tax
For the Years 2010 through 2012**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

President of S-Corporation and owner of an Indiana restaurant had additional individual income tax because the mandatory gratuities not paid to employees became part of the S-Corporation's overhead and flowed through to the President as income.

ISSUE

I. Individual Income Tax - Subchapter S Corporation Receipts.

Authority: IC § 6-3-1-3.5; IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Black's Law Dictionary (9th ed. 2009); Letter of Findings 04-20100498 (January 12, 2011).

Taxpayer argues that the Department erroneously assessed additional income tax.

STATEMENT OF FACTS

Taxpayer, an Indiana resident, is the only shareholder of an S Corporation ("S-Corp"). The S-Corp is a restaurant operating in the State of Indiana. For tax purposes, Taxpayer elected to treat the S-Corp as a disregarded entity.

The Indiana Department of Revenue ("Department") conducted an investigation of S-Corp's business records and tax returns for the 2010, 2011, and 2012 tax years. The Department's investigation began in December 2013. Taxpayer was informed on December 5, 2013, that the investigation would require an opportunity to review Taxpayer's books and records. The investigation resulted in the assessment of additional individual income tax.

During the investigation the auditor discovered that the tips reported on the employees' form W-2s were less than the tips reported on the S-Corp's point-of-sale ("POS"). In addition, the S-Corp's annual total tips reported on its form W-3 for each year also showed the total tips reported were considerably less than those reported in the POS. Furthermore, there were no additional tips reported on either the W-2s or W-3s to reconcile the difference between the total tips on each tax form and at the POS. Thus, the Department determined that the S-Corp made more sales than originally reported; these sales flowed through the S-Corp to Taxpayer as additional income.

Taxpayer disagreed with the assessments and submitted a protest to that effect. An administrative hearing was conducted by telephone during which Taxpayer explained the basis for the protest, this Letter of Findings results.

I. Individual Income Tax - Subchapter S Corporation Receipts.

DISCUSSION

Taxpayer stated that she does not owe additional income tax because the investigation contributed the "automatic/mandatory gratuities" to the S-Corp as additional sales. Taxpayer maintains that these gratuities were distributed to employees.

As a threshold issue, it is the Taxpayers' 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." Indiana Dep't of State Revenue v. Rent-A-Center East,

Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with the federal income and making certain adjustments. IC § 6-3-1-3.5. Income from an S corporation flows through to the individual shareholder's personal income and is reported by the shareholders on their personal income tax returns. See I.R.C. § 1366. See also [45 IAC 3.1-1-66](#); [45 IAC 3.1-1-2\(14\)](#); [45 IAC 3.1-1-7\(6\)](#).

Simply stated, an S Corporation - such as Taxpayer's restaurant - is "[a] corporation whose income is taxed through its shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009). 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 an individual shareholder's tax liability. Furthermore, any additional income received by the S-Corp as a profit passes through to the individual shareholders as income.

If the Department reasonably believes that a person has not reported the proper amount of tax due, the Department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the Department. IC § 6-8.1-5-1(a). Every person subject to a listed tax must keep books and records so that the Department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. IC § 6-8.1-5-4 (a). A person must allow inspection of the books and records and returns by the Department or its authorized agents at all reasonable times. IC § 6-8.1-5-4 (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 incorrect rests with the person against whom the proposed assessment is made. IC § 6-8.1-5-1(c).

According to the investigation report, automatic gratuities are amounts that are mandatory "tips" imposed by Taxpayer if a party has five guests or more. The automatic tip imposed was listed separately on the bottom of the check when given to the customer. Furthermore, the automatic gratuities were listed under the gratuity column on the POS reports and voluntary tips were listed under the tips column on the POS system. The auditor reviewed the employees' W-2s and the S-Corp's annual W-3 for each year of the audit period. This review showed that the total reported tips on the employees' W-2s and the S-Corp's W-3 were considerably less than the voluntary tips reported on the POS reports. These "mandatory tips" not reported on W-2s and W-3, were included as additional sales for the S-Corp. Taxpayer was assessed additional income tax based upon the adjustments made to the S-Corp's adjusted gross income from the "additional taxable sales."

Taxpayer must be able to show that the automatic/mandatory tips were paid and therefore deducted such costs under IRC § 165; if Taxpayer cannot demonstrate such an expense the "tips" are then deemed income to the S-Corp under IRC § 61 and pass through to Taxpayer under IRC § 1366.

During the hearing, Taxpayer presented no additional documentation showing that the mandatory gratuities were paid to employees. Given the information provided by the investigation and Taxpayer's assertions during the hearing demonstrate that Taxpayer did not meet their burden of showing the mandatory gratuities were paid. The Department is unable to agree that, under IC § 6-8.1-5-1(c), Taxpayer has met its burden of demonstrating that the amount at issue represents an exempt gratuity. There is little to indicate that the amount represents anything more than additional sales to the S-Corp and thus individual income to the Taxpayer.

Taxpayer failed to meet their burden of establishing that the assessment of additional income tax was "wrong" as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayers' protest is denied

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