DEPARTMENT OF STATE REVENUE

02-20140609.LOF

Letter of Findings Number: 02-20140609
Adjusted Gross Income Tax
For Tax Years 2011-12

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require 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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Restaurant did not provide enough documentation to affirmatively establish that its bank deposits were from anything other than sales. Restaurant did provide documentation establishing that certain deductions that the Department disallowed were properly deducted.

ISSUE

I. Adjusted Gross Income Tax–Additional Sales.

Authority: IC § 6-8.1-5-1; IC § 6-3-4-8; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Income Tax Information Bulletin 16 (January 2003).

Taxpayer protests proposed assessments for additional adjusted gross income tax.

II. Adjusted Gross Income Tax–Deductions

Authority: I.R.C. § 274(d); IC § 6-8.1-5-1; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); 26 C.F.R. § 1.274-5A; Treas. Reg. § 1.162-4; Treas. Reg. § 1.263(a)-3; Adler v. C.I.R., T.C. Memo. 2010-47 (U.S. Tax Ct. 2010); Streifel v. C.I.R., T.C. Memo. 2013-102 (U.S. Tax Ct. 2013); Deihl v. C.I.R., T.C. Memo. 2005-287 (U.S. Tax Ct. 2005); IRS Publication 535; IRS Publication 463.

Taxpayer protests the disallowance of certain deductions.

STATEMENT OF FACTS

Taxpayer is an Indiana restaurant organized as an S Corporation. The Indiana Department of Revenue ("Department") audited Taxpayer for sales and use tax, corporate income tax, and individual income tax. Taxpayer protested the results of all of these audits. This Letter of Findings addresses Taxpayer's protest of proposed corporate tax assessments. As the result of an audit, the Department determined that Taxpayer had under-reported its sales and deducted personal expenses as business expenses for tax years 2011 and 2012. The Department therefore issued proposed assessments for additional corporate taxes for years 2011 and 2012. Taxpayer protested the proposed assessments. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Additional Sales.

DISCUSSION

Taxpayer protests the Department's adjustments to its sales. The Department examined Taxpayer's federal and state income tax returns and bank statements, and determined that Taxpayer's cash and credit card deposits totaled more than the amount of gross sales reported on its returns. The Department also determined that Taxpayer's documentation showed credit card charges for personal items that were deducted as business expenses. The Department made adjustments to Taxpayer's claimed expenses which resulted in proposed

assessments for additional Indiana adjusted gross income tax for the tax years 2011 and 2012.

Taxpayer claims that it could not have had sales as high as the Department adjusted. Taxpayer calculated the average bill for tables and bar seats, and then multiplied that amount by the number of tables and bar seats in the restaurant and by the number of days the restaurant was open. Taxpayer explains that the result of this calculation is the restaurant's total possible sales. The Department notes that this calculation assumes that there is no turnover on any of the tables or bar seats on a regular business day. Taxpayer claims its total bank deposits were higher than its reported sales for two reasons. First, Taxpayer states that it paid more in tips than the employee W-2s denoted. Second, Taxpayer explains that it wrote checks for petty cash, and then later re-deposited the same cash.

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." Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . .[courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

The Department refers to IC § 6-3-4-8(a), which states:

> [E]very employer making payments of wages subject to tax under this article, regardless of the place where such payment is made, who is required under the provisions of the Internal Revenue Code to withhold, collect, and pay over income tax on wages paid by such employer to such employee, shall, at the time of payment of such wages, deduct and retain therefrom the amount prescribed in withholding instructions issued by the department.

Income Tax Information Bulletin 16 (January 2003), 26 Ind. Reg. 2146, further explains:

> Every employer, who has withheld tax from income paid or credited to any taxpayer, is required to provide the taxpayer with a statement of the amount of income paid or credited to him and the amount of tax withheld for him, during the calendar year. For both state and county tax purposes, Federal Form W-2, Wage and Tax Statement, should be used for Indiana withholding purposes.

Therefore, Taxpayer was required to state the amount of tip income that it remitted to its employees on their W-2s. The Department used the Taxpayer's W-2s to determine how much tip income to subtract from the total sales. Taxpayer claims its total sales were less than the amount adjusted by the Department because it had remitted more tip income to its employees than what was denoted on the employees' W-2s. To substantiate its claim, Taxpayer provided monthly financial statements, which included the amount it had received in tips. However, even if the financial statements are accurate, they do not establish how much Taxpayer actually remitted to its employees. Taxpayer did not provide any documentation to show that its employees' W-2s were inaccurate. Therefore, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

Taxpayer also claims that the Department's adjustments are overstated because Taxpayer regularly withdrew petty cash from its account and then later re-deposited the cash. Taxpayer provided documentation in the form of photocopies of the checks for petty cash to confirm its claim. However, Taxpayer did not provide receipts of deposits or any other documentation to verify that it ever re-deposited any of the cash that it withdrew. Since Taxpayer did not provide any documentation to affirmatively establish that its bank deposits were from anything other than sales, Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax–Deductions

Taxpayer protests the Department's disallowance of certain deductions. Taxpayer had deducted expenses on its income tax returns for the years 2011 and 2012 under the headings of: Auto, Maintenance, Travel, Uniforms, and Research. The Department examined Taxpayer's credit card bills and determined that these were personal expenses which were improperly deducted. Taxpayer claims that it is not an ordinary restaurant with the typical business expenses. Instead, Taxpayer asserts that it is a unique, high-end restaurant, which requires additional expenses to operate properly.

As stated in Issue I above, 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." Indiana Dept. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . .[courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Taxpayer refers to IRS Publication 535, which states in part:

> To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your industry. A necessary expense is one that is helpful and appropriate for your trade or business.

The Department refers to Adler v. C.I.R., where the Tax Court said, "[S]ection 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, but section 6001 requires the taxpayer to maintain records sufficient to substantiate his claimed deductions." Adler v. C.I.R., T.C. Memo. 2010-47, at 7 (U.S. Tax Ct. 2010). The Tax Court further explains that, "Deductions are a matter of legislative grace, and a taxpayer must prove his or her entitlement to a deduction." Streifel v. C.I.R., T.C. Memo. 2013-102, at 3 (U.S. Tax Ct. 2013) (Citing INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992)). "To that end, taxpayers are required to substantiate each claimed deduction by maintaining records sufficient to establish the amount of the deduction and to enable the Commissioner to determine the correct tax liability." Id. at 3. Therefore, Taxpayer must provide adequate documentation to affirmatively establish that the purchases it deducted were for business purposes.

A. Auto, Travel, and Research Deductions

Taxpayer protests the Department's disallowance of deductions for some of its auto, travel, and research expenses. The Department disallowed these deductions because Taxpayer's credit card bills showed that these purchases resulted from traveling to bars and restaurants, which were determined to be non-deductable, personal expenses. Taxpayer claims that it is important for its employees to travel to high-end restaurants in other cities to examine their price points, observe new trends, and learn professional techniques. Taxpayer believes that this constitutes market research, which furthers its employees' understanding of the industry and enables them to provide an enhanced level of service. Taxpayer therefore claims that these expenses are necessary to its business and should be deductable.

Taxpayer relies on IRS Publication 463, which states in part:

> For tax purposes, travel expenses are the ordinary and necessary expenses of traveling away from home for your business, profession, or job.

The Department refers to I.R.C. § 274, which provides in part that:

> (d) No deduction or credit shall be allowed
> . . .
> (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,

26 C.F.R. § 1.274-5A(b)(1) further explains:

> Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:
> (i) Amount;
> (ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;
> (iii) Business purpose; and
> (iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

Therefore, expenses related to entertainment, amusement, or recreation are not deductable unless Taxpayer can produce records substantiating that the expenses were for business purposes. In this instance, Taxpayer provided credit card statements, which showed many travel and restaurant expenses. Taxpayer labeled the purchases with "T"s to denote travel and "R"s to denote research. Taxpayer also provided receipts from high-end restaurants. However, Taxpayer did not provide documentation that ties any of these purchases to a specific business purpose. In the instant case, the Department is unable to verify that any of these purchases were for ordinary and necessary business expenses and not personal expenses. Taxpayer's expenses for traveling to bars and restaurants are generally considered to constitute entertainment, amusement, and recreation. Therefore, absent any documentation establishing a business purpose, the Department cannot conclude that these expenses can be properly deducted pursuant to IC § 6-8.1-5-1(c) and I.R.C. § 274(d).

B. Maintenance

Taxpayer protests the Department's disallowance of deductions for some of its maintenance expenses. Taxpayer claims that it operates its restaurant in an older building which creates additional maintenance costs. In the course of the protest process, Taxpayer provided documentation in the form of invoices that show purchases that relate to the maintenance of its building.

The Department refers to Treas. Reg. § 1.162-4(a), which states in part:

> A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized.

Treas. Reg. § 1.263(a)-3(d) further explains:

> A taxpayer generally must capitalize the related amounts (as defined in paragraph (g)(3) of this section) paid to improve a unit of property owned by the taxpayer.

Treas. Reg. § 1.263(a)-3(i) provides in part:

> An amount paid for routine maintenance. . .is deemed not to improve that unit of property.

Therefore, expenses that are for routine maintenance can be deducted. Taxpayer claims that its purchases related to maintaining its building were routine. Taxpayer provided invoices from several service companies, a hardware store, and a kitchen supply store. This documentation establishes that those purchases were for incidental repairs that are routine in Taxpayer's business, and were properly deducted pursuant to Treas. Reg. § 1.162-4. The Department will allow Taxpayer to deduct the maintenance expenses for which it provided invoices. Any other expenses for which Taxpayer did not provide documentation cannot be deducted pursuant to IC § 6-8.1-5-1(c).

C. Uniforms

Taxpayer protests the Department's disallowance of deductions for its uniform costs. Taxpayer claims that several purchases from department stores and a nail salon were for uniforms and properly deducted. The court in Deihl v. C.I.R. explains "The test for the deductibility of clothing costs as ordinary and necessary business expenses under section 162 rests on three criteria: The clothing must be (1) required or essential in the taxpayer's employment, (2) not suitable for general or personal wear, and (3) not so worn." Deihl v. C.I.R., T.C. Memo. 2005-287 (U.S. Tax Ct. 2005) at 25. Taxpayer did not provide any documentation showing that its purchases were for clothes that were essential to its business, that they were not suitable for personal wear, and they were not worn as such. Therefore, Taxpayer has not met the burden of proving the proposed assessments wrong, as

required by IC § 6-8.1-5-1(c).

In conclusion, Taxpayer is sustained in regards to maintenance expenses for which it provided invoices. In all other regards, Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c) and its protest is denied. Therefore, Taxpayer's protest is sustained in part and denied in part.

FINDING

Taxpayer's protest is sustained in part, and denied in part.

SUMMARY

Taxpayer's protest of the Department's sales adjustments in Issue I is denied. Taxpayer's protest in subsection B of Issue II regarding the Department's disallowance of deductions for its maintenance costs is sustained to the extent which it provided invoices establishing a business purpose. Taxpayer's protest in Issue II is denied in all other regards.

Posted: 09/30/2015 by Legislative Services Agency
An html version of this document.