DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 01-20150162; 01-20150163; 01-20150164; 01-20150161
Adjusted Gross Income Tax
For Tax Years 2011-2013

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 This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.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 these Letters of Findings.

HOLDING

Shareholders provided sufficient documentation to demonstrate that the Department's proposed assessment was incorrect in part and correct in part

ISSUE

I. Corporate Income Tax–Calculation.

Authority: IC § 6-3-1-3.5; IC § 6-8.1-5-1; I.R.C. § 179; I.R.C. § 168; 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); Indiana Dep't of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); 2012 IT-20S - Indiana S Corporation Income Tax Booklet; Commissioner's Directive 19 (August 2003); Black's Law Dictionary 394 (9th ed. 2009).

Taxpayers protest the denial of a claimed subtraction from Indiana adjusted gross income.

STATEMENT OF FACTS

Taxpayers are shareholders of a Chapter S Corporation ("S-Corp"). S-Corp is a car dealership operating in Indiana. The Indiana Department of Revenue ("Department") audited the S-Corp for the tax years 2011-2013. The Department adjusted S-Corp's return. Because Taxpayers elected pass through treatment, Taxpayers' individual returns were therefore adjusted. Taxpayers protest the proposed assessment and the adjustments. An administrative hearing was conducted and this Letter of Findings results. Further facts will be supplied as required.

I. Corporate Income Tax–Calculation.

DISCUSSION

As a threshold issue, it is the Taxpayers' responsibility to establish that the existing adjusted gross income 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). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, when an agency is charged with enforcing a statute, the courts defer to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." Indiana Dep't of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

An S Corporation-such as Taxpayers' dealership-is "[a] corporation whose income is taxed through its shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009); see also, I.R.C. §§ 1361-62. 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.

The Department adjusted Taxpayers' returns because S-Corp failed to properly add back the excess I.R.C. § 179 deduction taken on the Federal 1120S return for the years 2011 and 2012. The audit report cited to IC § 6-3-1-3.5(a)(19) stating that, ". . . any taxpayer that placed Section 179 property (as defined in Section 179 of the Internal Revenue Code) must add-back the Section 179 deductions in a total amount exceeding twenty-five thousand dollars."

Taxpayers argue that the assessments stem from a prior return preparer's failure to properly account for Section 179 depreciation. Specifically, Taxpayers state "[The] prior accountant netted Section 179 depreciation adjustments with the regular Federal/Indiana adjustment instead of reporting the differences on their respective lines on Form IT-20S. Attached is an e-mail from the prior accountant explaining the differences and how they reported them on the corporate income tax returns for 2011 and 2012." Taxpayers explain that the components of the Federal and Indiana depreciation differences were netted on the Indiana corporate tax return. The email went on to break down the Federal and Indiana depreciation expenses including Section 179 and "bonus depreciation."

To determine a taxpayer's Indiana adjusted gross income, Indiana begins with a taxpayer's federal taxable income, subject to modifications provided under IC § 6-3-1-3.5(a). During the hearing, Taxpayers provided documents modifying Taxpayers' claimed expenses pertaining to depreciation of certain real and personal property. Taxpayers' claims rely on adjustments to federal adjusted gross income allowed under Sections 167, 168, and 179 of the Internal Revenue Code.

IC § 6-3-1-3.5 states in relevant part(s):

> When used in this article, the term "adjusted gross income" shall mean the following:
>
> (a) In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:
> . . .
> (17) Add or subtract the amount necessary to make the adjusted gross income of any taxpayer that owns property for which bonus depreciation was allowed in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168(k) of the Internal Revenue Code to apply bonus depreciation to the property in the year that it was placed in service.
> (18) Add an amount equal to any deduction allowed under Section 172 of the Internal Revenue Code.
> (19) Add or subtract the amount necessary to make the adjusted gross income of any taxpayer that placed Section 179 property (as defined in Section 179 of the Internal Revenue Code) in service in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election for federal income tax purposes not been made for the year in which the property was placed in service to take deductions under Section 179 of the Internal Revenue Code in a total amount exceeding twenty-five thousand dollars ($25,000).
> . . . .

I.R.C. § 179 for the relevant years, provides in relevant part:

> **(a) Treatment as expenses.**--A taxpayer may elect to treat the cost of any section 179 property as an expense which is not chargeable to capital account. Any cost so treated shall be allowed as a deduction for the taxable year in which the section 179 property is placed in service.
> **(b) Limitations.--**
> **(1) Dollar limitation.**--The aggregate cost which may be taken into account under subsection (a) for any taxable year shall not exceed--
> **(A)** $250,000 in the case of taxable years beginning after 2007 and before 2010,
> **(B)** $500,000 in the case of taxable years beginning after 2009 and before 2015, and
> **(C)** $25,000 in the case of taxable years beginning after 2014.
> [**(D)** Redesignated (C)]
> **(2) Reduction in limitation.**--The limitation under paragraph (1) for any taxable year shall be reduced (but

not below zero) by the amount by which the cost of section 179 property placed in service during such taxable year exceeds--

(A) $800,000 in the case of taxable years beginning after 2007 and before 2010,

(B) $2,000,000 in the case of taxable years beginning after 2009 and before 2015, and

(C) $200,000 in the case of taxable years beginning after 2014.

[**(D)** Redesignated (C)]

(3) Limitation based on income from trade or business.--

(A) In general.--The amount allowed as a deduction under subsection (a) for any taxable year (determined after the application of paragraphs (1) and (2)) shall not exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the active conduct by the taxpayer of any trade or business during such taxable year.

(B) Carryover of disallowed deduction.--The amount allowable as a deduction under subsection (a) for any taxable year shall be increased by the lesser of--

(i) the aggregate amount disallowed under subparagraph (A) for all prior taxable years (to the extent not previously allowed as a deduction by reason of this subparagraph), or

(ii) the excess (if any) of--

(I) the limitation of paragraphs (1) and (2) (or if lesser, the aggregate amount of taxable income referred to in subparagraph (A)), over

(II) the amount allowable as a deduction under subsection (a) for such taxable year without regard to this subparagraph.

(C) Computation of taxable income.--For purposes of this paragraph, taxable income derived from the conduct of a trade or business shall be computed without regard to the deduction allowable under this section.

. . . .

(**Emphasis original**).

Bonus depreciation is defined under I.R.C. § 168(k), which states in relevant part:

(1) Additional allowance.--In the case of any qualified property--

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to 50 percent of the adjusted basis of the qualified property, and

(B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

. . . .

(**Emphasis original**).

To determine how to calculate Taxpayers' Indiana Adjusted Gross Income Tax ("AGIT") the Department looks to S Corporation Income Tax Booklet and Commissioner's Directive 19, 26 Ind. Reg. 3762 (August 2003).

Although the years at issue are 2011 and 2012 the 2012 IT-20S - Indiana S Corporation Income Tax Booklet is substantially similar to the 2011 IT-20S booklet for Addback for bonus depreciation and I.R.C. § 179 excess expense. The 2012 IT-20S - Indiana S Corporation Income Tax Booklet states in relevant part:

• **Addback for bonus depreciation -** An amount attributable to bonus depreciation in excess of any regular depreciation that would be allowed if an election under IRC Section 168(k) had not been made as applied to property in the year that it was placed into service should be added or subtracted. Taxpayers who own property for which additional first-year special depreciation for qualified property was allowed in the current taxable year or in an earlier taxable year must add or subtract an amount necessary to make their adjusted gross income equal to the amount computed without applying any bonus depreciation. This includes 50[percent] bonus depreciation. The subsequent depreciation allowance is calculated on the state's stepped-up basis until the property is disposed. Enclose a statement explaining any adjustment. **(3-digit code: 104)**

Example: If the IRC Section 179 deduction was elected on business equipment acquired during 2010 and costing $200,000, the capital expensing deduction was $100,000 with a remaining basis of $100,000. An additional 50[percent] bonus depreciation of $50,000 was elected, leaving a basis of $50,000 for a five-year Modified Accelerated Cost Recovery System (MACRS) property (half-year convention) depreciation deduction of 20[percent] ($10,000). The total amount of the federal deduction was $160,000.

For state purposes, the bonus depreciation of $50,000 was not allowed and must be added back. The IRC Section 179 deduction was capped at $25,000. Therefore, the $75,000 excess amount must be added back. These adjustments result in a stepped-up basis of $175,000 for the state return on which to figure the allowable first-year MACRS property depreciation deduction of 20[percent] ($35,000) for 2010. This was a total state deduction of $25,000 more than already deducted under the General Depreciation System (GDS). The additional depreciation can be excluded in subsequent years from the amounts to be added back when excess IRC Section 179 deduction or bonus depreciation was elected.

Commissioner's Directive #19 (www.in.gov/dor/3617.htm) explains this initial required modification on the allowance of depreciation for state tax purposes.

• **Addback for Section 179 expense excess -** Enter any IRC Section 179 adjustment claimed for federal tax purposes that exceeds the amount recognized for state tax purposes. **(3-digit code: 105)**.
. . . .

In addition, Commissioner's Directive 19 provides further guidance to taxpayers on how taxpayers are to calculate bonus depreciation as defined under I.R.C. §168.

I. DEFINITION OF BONUS DEPRECIATION
Bonus depreciation is defined in IC 6-3-1-33 to be an amount equal to that part of any depreciation allowance allowed in computing the taxpayer's federal adjusted gross income or federal taxable income that is attributable to the additional first year special depreciation allowance (bonus depreciation) for qualified property allowed under Section 168(k) of the Internal Revenue Code.

II. MODIFICATION TO ADJUSTED GROSS AND TAXABLE INCOME
IC 6-3-1-3.5 is the section of the Indiana Code that defines adjusted gross income and taxable income. Both terms start with the federal definition and then are modified for Indiana purposes. The modification that has occurred for 2003 and thereafter provides an adjustment for any taxpayer that owns property for which bonus depreciation was allowed in the current or an earlier taxable year. The adjustment is equal to the amount that would have been computed if an election had not been made to apply the bonus depreciation to the property in the year that it was placed in service.

This provision along with language in HEA [House Enrolled Act] 1728 SECTION 6, also prohibits a taxpayer from deducting any part of a depreciation allowance used to compute the additional first year special depreciation allowance for any taxable year that began before January 1, 2003.

The depreciation allowance that is permitted will be the same calculation and schedule that was in effect for taxable years beginning before 2001. This is done through a three step process.

1. Add-back the thirty percent (30[percent]) bonus depreciation in the first year so that Indiana depreciable values are one hundred percent (100[percent]) of acquisition cost.
2. An adjustment must be made to all additional years of the life of the asset. The federal depreciation basis is seventy percent (70[percent]) of cost for those years. The adjustment is necessary to bring the original basis for Indiana depreciation to one hundred percent (100[percent]) of cost.
3. When the asset is sold, bonus depreciation is added back to the value when calculating a capital gain or depreciation recapture. An Indiana adjustment is necessary to reflect the correct amount of Indiana depreciation.

Taxpayers' explanations and documentation are sufficient to show how the previous preparer calculated Taxpayers' original returns. Taxpayers also provided previous returns along with depreciation schedules. Taxpayers' documentation shows the Department's assessment is incorrect; however, Taxpayers' documentation and explanation do not reflect the changes they want to change to the proposed assessment. In this instance, the adjustments will be for the entity's return based on its audit report (Control Number 531010) and the shareholders' proposed assessments will be adjusted accordingly in a supplemental audit. Taxpayers provided their previous returns to show no depreciation expenses under I.R.C. §§ 168(k) and 179 were taken in previous years. For 2011 the Department incorrectly allowed Taxpayers' reported deduction of $6,694 in bonus depreciation. In the depreciation schedules provided by Taxpayers, there is no indication of bonus depreciation taken. Therefore, the Department will remove the $6,694 addback. However, the Department's adjustment of the $23,033 as an addback for I.R.C. § 179 deprecation taken on the 2011 federal return is correct. For 2012, Taxpayers were able to show that they did take $8,000 in bonus depreciation on the 2012 federal return. Therefore, the $21,205 bonus deprecation is incorrect and needs to be adjusted to $8,000. The I.R.C. § 179 addback was proper for 2012.

Taxpayers were able to provide federal returns and depreciation schedules to prove that the proposed assessments are correct in part and incorrect in part. The Department will conduct a supplemental audit based on the above calculations for each shareholder.

FINDING

Taxpayers' protest is sustained in part subject to a supplemental audit.

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