DEPARTMENT OF STATE REVENUE

Letter of Findings: 01-20150173
Individual Income Tax
For the Year 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Shareholder of an Indiana S Corporation was not entitled to a reduction on the gain from the sale of stock because his assumption of the S Corporation's debt did not increase his basis and the related distribution was not a return of capital.

ISSUE

I. Shareholder Basis - Assumption of Debt.

Authority: I.R.C. § 1361; I.R.C. § 1362; I.R.C. § 1366; I.R.C. § 1368; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-2.8; IC § 6-3-1-3.5; IC §6-8.1-5-1; 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); 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); Miller v. Commissioner, T.C.M. 2006-125 (2006); Gleason v. Commissioner, T.C.M. 2006-191 (2006).

Taxpayer, shareholder of an Indiana S Corporation, argues that he is not responsible for additional income tax because his assumption of the Corporation's debt should be treated as an increase in basis or a return of capital.

STATEMENT OF FACT

Taxpayer is a shareholder in an Indiana S Corporation ("Corporation"). During the tax year of 2012 Taxpayer owned 49 percent of Corporation's outstanding shares. On December 31, 2012 Taxpayer and Corporation executed three agreements simultaneously. In the Shareholder Assignment and Assumption of Company Debt Agreement ("Assignment Agreement"), Taxpayer assumed Corporation's $450,000 loan ("Loan") as a capital contribution. Taxpayer agreed to "pay and perform the indebtedness and obligations of [Corporation] evidenced by or arising in connection with the [Loan]." In the Shareholder Agreement, Taxpayer sold his stock in the Corporation back to the Corporation in exchange for $800,000. Corporation also agreed to reimburse Taxpayer for assuming Corporation's Loan pursuant to the Assignment Agreement. Finally, the Amended and Restated Shareholder Promissory Note ("Note"), memorialized Taxpayer's promise to assume the Loan.

Taxpayer was subject to an income tax audit by the Indiana Department of Revenue ("Department") for tax years 2008 through 2012. The Department determined that, in exchange for his stock, Taxpayer received just under $1,200,000 comprised of the stock sales price plus reimbursement of the Note. The Department offset this gain with cumulative suspended losses of approximately $950,000. As a result, the Department's audit determined that Taxpayer had capital gain income of over $200,000 for tax year 2012, resulting in additional Indiana income tax.

Taxpayer protested the proposed assessment. An administrative hearing was held. This Letter of Findings ensues and addresses Taxpayer's protest of the proposed assessment for the tax year 2012. Additional facts will be provided as necessary.

I. Shareholder Basis - Assumption of Debt.

DISCUSSION

The Shareholder Agreement mistakenly referred to the Loan amount as $400,000. The Department's audit relied on that figure when it calculated the $1,200,000 gain. Pursuant to the audit, the Department determined that

Taxpayer had an additional $200,000 gain which was taxable income.

Taxpayer first argues that the Loan should be considered an increase in basis rather than gain. A $400,000 increase in Taxpayer's basis would eliminate the $200,000 capital gain calculated by the Department. Alternatively, Taxpayer argues that if his assumption of debt isn't an increase in basis, reimbursement from the Corporation should be considered a return of capital "with no gain." Taxpayer therefore argues that he is not responsible for additional income tax assessed.

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). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. 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).

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. With regard to corporations and nonresidents, IC § 6-3-2-2 specifically outlines what is income derived from Indiana sources and subject to Indiana income tax. For Indiana income tax purposes, the presumption is that taxpayers properly and correctly file their federal income tax returns as required pursuant to the Internal Revenue Code. Thus, to efficiently and effectively compute what is considered the taxpayer's Indiana income tax, the Indiana statute refers to the Internal Revenue Code.

An S Corporation is a small business corporation, which must meet certain statutory requirements and properly elect to be exempt from income tax for income tax purposes under I.R.C. §§ 1361 and 1362. An S Corporation generally does not pay taxes on its income. IC § 6-3-2-2.8; see also I.R.C. § 1361 et seq. Rather, the S Corporation's income subsequently passes through to its shareholders; its shareholders report and pay the income tax when they file their federal or state individual income tax returns. Id.

Taxpayer here argues that he is not responsible for income tax on the additional $200,000 gain for the year 2012 because he increased his basis when he assumed the Corporation's debt. Alternatively, Taxpayer argues that if his basis remains unchanged, the Corporation "reimbursement" to Taxpayer should be considered a return of capital "with no gain."

A. Change of Shareholder's Basis based on Assumption of Corporation's Debt

I.R.C. § 1366 addresses the treatment of certain pass-thru items to shareholders. Under this section, "a shareholder of an S corporation shall take into account his pro rata share of the S corporation's items of income, loss, deduction, or credit. . . ." Miller v. Commissioner, T.C. Memo. 2006-125, *8 (2006). "[A] shareholder may deduct his share of the S corporation's losses only to the extent of his adjusted basis in his stock of the S corporation [] and 'the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder' . . . ." Id. (Emphasis in original) (Internal citations omitted).

An extensive body of case law establishes certain principles relating to a shareholder's limitation of deductible S corporation losses and the situations in which a shareholder acquires basis with respect to indebtedness. First, "a shareholder may obtain or increase basis in an S corporation only if there is an economic outlay on the part of the shareholder that leaves him or her poorer in a material sense." Gleason v. Commissioner, T.C. Memo. 2006-191, *9 (2006).

An economic outlay for this purpose includes a use of funds for which the taxpayer is directly liable in a purchase of S corporation shares, in an actual contribution of cash or property by the shareholder to the S corporation, or in a transaction that leaves the corporation indebted to the shareholder. Stated otherwise, the shareholder must make an actual 'investment' in the entity . . . thereby incurring a true 'cost'. . . . Id. (Emphasis added) (Internal citations omitted).

Second, the shareholder must directly incur the indebtedness of the S corporation. The federal tax court in Gleason explained, in relevant part:

> In general, no form of indirect borrowing, . . . guaranty, surety, accommodation, comaking, pledge of collateral, etc., will give rise to the requisite economic outlay unless, until, and to the extent that the shareholder pays all or part of the obligation. Gleason, T.C. Memo. 2006-191 at *10. (Emphasis Added).

That is, "[p]rior to that crucial act, 'liability' may exist, but not debt to the shareholders." Miller, T.C. Memo. 2006-125 at *7. (Internal citation omitted). The federal tax court in Miller further illustrated in relevant part:

> Basis-generating "direct" indebtedness of the S corporation to the shareholder . . . generally arises when a shareholder makes a loan to [the] S corporation. . . . However, where the source of the funding . . . is a related party instead of an independent third-party lender . . . courts have often found that a shareholder made no economic outlay sufficient to create basis . . . ."
>
> Where a shareholder substitutes his note for the note of an S corporation, basis is created "so long as the S corporation's indebtedness to the third-party lender is extinguished, so that the shareholder becomes the sole obligor to the lender . . . ." Id. at *8.

Here, Taxpayer agreed to assume and pay Corporation's debt obligations as memorialized in the Note. At the same time, Corporation agreed to reimburse Taxpayer for this assumption in exchange for Taxpayer's stock. This arrangement leaves the Taxpayer financially unchanged. Taxpayer has obliged himself to debt which he will pay with Corporation's money. Even if the arrangement had left Taxpayer "poorer in a material sense," there was no economic outlay. Taxpayer started making payments towards the Loan in February of 2014. As such, the requisite economic outlay took place in 2014, not 2012.

Further, while the Assignment Agreement purports to release Corporation from any liability under the Note, there is no indication in either document that the third-party lenders whose loans comprise the liability are aware of or agreed to the assumption. The documents are not signed by the lenders and they are not parties to either. Therefore, while on its face the arrangement between Taxpayer and Corporation appears to make Taxpayer the "sole obligor" to the lenders, there is no evidence that, in the lender's eyes, the Corporation's debt is extinguished.

B. Return of Capital

As an alternative, Taxpayer argues that if his assumption of debt is not an increase in basis, the related reimbursement from the Corporation should be considered a return of capital "with no gain."

I.R.C. § 1368 discusses the tax treatment of S Corporation distributions. A distribution to a shareholder of an S Corporation with no accumulated earnings and profits "shall not be included in gross income to the extent that it does not exceed the adjusted basis of the [shareholder's] stock." I.R.C. § 1368(b)(1). If the amount of the distribution exceeds the shareholder's basis, the excess is treated as taxable gain. I.R.C. § 1368(b)(2). A distribution to a shareholder of an S Corporation with accumulated earnings and profits is treated similarly as long as the distribution does not exceed the accumulated adjustments account. I.R.C. § 1368(c)(1). Any amount which exceeds the accumulated adjustments account will be treated as a dividend "to the extent is does not exceed the accumulated earnings and profits of the S corporation." I.R.C. § 1368(c)(2). Any portion which exceeds the accumulated earnings and profits of the S corporation is taxable to the extent it exceeds the shareholder's stock basis. I.R.C. § 1368(c)(3).

Therefore, whether an S Corporation has accumulated earnings and profits or not, its distribution will be considered a gain if the recipient shareholder has no stock basis. Pursuant to the audit, the Department determined that Taxpayer had no stock basis in 2012 and thus Taxpayer is required to show the audit was incorrect. Taxpayer, however, has not provided evidence to demonstrate otherwise. The Department thus is not able to agree that Taxpayer met its burden.

FINDING

Taxpayer's protest is respectfully denied.

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