DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 01-20150103
Individual Income Tax
For Tax Years 2011-13

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Individuals established that the Department's calculations of individual income tax were incorrect. Therefore, the Department's proposed assessments for individual income tax are incorrect.

ISSUES

I. Income Tax–Individual Income.

Authority: IC § 6-3-2-1; 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); 45 IAC 3.1-1-3.

Taxpayers protest proposed assessments for additional income tax.

II. Tax Administration–Penalties and Interest.

Authority: IC § 6-8.1-10-1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayers protest the imposition of penalties and interest.

STATEMENT OF FACTS

Taxpayers are married individuals ("Husband" and "Wife") who live in Indiana. Husband operated a paving and excavating business ("Business") as a sole proprietorship. As the result of a sales tax audit, the Indiana Department of Revenue ("Department") determined that for the tax years 2011, 2012, and 2013 Business' checking account had several payments listed for transactions which did not appear to be business-related. The Department therefore adjusted the amounts of business expenses listed on Business' federal Schedule C forms. This adjustment resulted in a reduction of business expenses available for Business, which resulted in higher amounts of taxable income for Business for the tax years. The increased taxable income for Business flowed through to Taxpayers. The Department consequently decided that Taxpayers' income was higher than originally reported for the tax years 2011, 2012, and 2013. The Department issued proposed assessments for individual income tax, penalty, and interest for those years. Taxpayers protested that some of the Department's adjustments to Business' Schedule C business expenses were incorrect and that they did not owe as much individual income tax as determined in the audit. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Income Tax–Individual Income.

DISCUSSION

Taxpayers protest the Department's determination of additional income tax due for the tax years 2011, 2012, and 2013. Specifically, Taxpayers protest that the Department incorrectly determined that certain purchases by Business were not qualified business expenses and that the Department also decreased the amounts listed on Business' federal Schedule Cs by adding back into the Schedule C calculations some expenses that were not claimed on the Schedule Cs in the first place. The Department based its determinations on the grounds that Business had claimed certain amounts of qualified business expenses on its federal income tax returns. The Department reviewed Business' records and found several purchases listed which the Department deemed to be

of a personal nature and not qualified business expenses. The Department's audit states that during the audit Taxpayers did not provide requested documentation such as, but not limited to, detailed receipts of purchases made at auction, federal Schedule C workpapers, and explanations of purchases which listed the address shared by Business and Taxpayers. Without such documentation, the Department was unable to verify that Business' claimed qualified business expenses were actually qualified business expenses and so added those unverified amounts back to Business' federal taxable income. The increased amount of taxable income flowed through to Taxpayers and resulted in proposed assessments for additional Indiana individual income tax.

Taxpayers protest that the documentation was available but was not reviewed by the Department. Taxpayers also protest that the transactions determined not to be qualified business deductions were either properly included as qualified business deductions in the first place or that entries listed by the Department as non-qualified business deductions were not included in the amounts listed on Business' Schedule C forms for the years at issue. The result, Taxpayers assert, is the improper reduction of amounts of properly claimed qualified business expenses on Business' Schedule Cs or the improper reduction of amounts claimed on the Schedule Cs by adding back expenses which were never claimed in the first place.

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 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.

IC § 6-3-2-1(a) provides for the imposition of individual income tax. Also of relevance is 45 IAC 3.1-1-3, which provides:

> The following deductions contained in Internal Revenue Code Section 62 are allowed in determining Indiana Adjusted Gross Income:
> (1) Trade and business deductions
> (2) Certain trade or business deductions of employees
> (3) Long-term capital gains deduction (Internal Revenue Code § 1202)
> (4) Losses from the sale or exchange of property (Internal Revenue Code § 161 and following)
> (5) Deductions attributable to rents and royalties (Internal Revenue Code § 161 and following, § 212, and § 611)
> (6) Certain deductions of life tenants and income beneficiaries of property (Internal Revenue Code § 167 and § 611)
> (7) Pension, profit-sharing, annuity, and bond purchase plans of self-employed individuals [Internal Revenue Code § 401(c)(1), § 404, and § 405 (c)]
> (8) Moving expense deduction-Indiana residents may take a deduction against gross income for moving expenses incurred in a move into or within Indiana, provided that the requirements outlined in Section 217 of the Internal Revenue Code are met. If a taxpayer moves out of Indiana he is not allowed to take this deduction. An exception to this rule occurs when the taxpayer remains a resident of Indiana after he changes locations. For example, an Indiana resident who is in the military remains an Indiana resident regardless of where he is stationed. If such person's duty station is changed he may take this deduction for expenses incurred in the move.
> (9) Pension, profit-sharing, annuity, and bond purchase plans of electing small business corporations [Internal Revenue Code § 1379 (b) (3)]
> (10) Retirement savings [Internal Revenue Code § 219 and § 220]
> (11) Certain portions of lump-sum distributions from pension plans taxed under Internal Revenue Code § 402 (e) [IRC § 402 (e) (3)]
> (12) Penalties for premature withdrawal of funds from time savings accounts or deposits (IRC § 165)
> (13) Alimony (Internal Revenue Code § 215)

Therefore, Indiana does allow certain business expenses to be deducted from a taxpayer's income, if those expenses are allowed to be deducted as provided by the Internal Revenue Code ("IRC"), as explained by 45 IAC 3.1-1-3.

In the course of the protest and hearing process, Taxpayer provided additional documentation and analysis in support of its position that some of the amounts added back by the Department were qualified business expenses and should not have been added back. Since the Department's sole reason listed in the audit report was that there was no supporting documentation to explain that certain amounts listed on Business' federal Schedule Cs were qualified business expenses, and since Taxpayers have now supplied that supporting documentation, Taxpayers have met the burden imposed by IC § 6-8.1-5-1(c).

Similarly, Taxpayers provided documentation and analysis to support their position that some of the expenses added back to the amounts deducted by Business on its federal Schedule Cs were not in fact included by Business on its federal Schedule Cs in the first place. As explained above, the only reason listed in the audit report for adding back some purchases from Business' checking account to the amounts Business deducted on its federal Schedule Cs was that Business had not provided documentation to show that those purchases were qualified business expenses. In the course of the protest process, Taxpayer was able to show that, for some categories listed on Business' federal Schedule Cs, the amounts added back by the Department exceeded the amount deducted. Also, Taxpayers were able to show that some purchases paid via Business' checking account were not deducted on Business' federal Schedule Cs at all. Therefore, Taxpayers have met the burden imposed by IC § 6-8.1-5-1(c) for these protested items.

In conclusion, Taxpayers argue that the Department's adjustments to Business' federal Schedule C were incorrect. Taxpayers have provided documentation supporting their position and have established that the payments made from Business' checking account were either (1) qualified business expenses which were eligible to be included on Business' Schedule Cs or (2) were not included in the amounts listed on Business' Schedule Cs in the first place and so could not be added back into the Schedule C calculations. Since they have established that the adjustments to Business' returns were incorrect, and since that was the only reason listed by the Department for the adjustments, Taxpayers have met the burden imposed by IC § 6-8.1-5-1(c) of proving the proposed assessments for individual income tax wrong.

FINDING

Taxpayers' protest is sustained.

II. Tax Administration– Penalties and Interest.

DISCUSSION

Taxpayers protest the imposition of penalties and interest. The Department notes that it is not permitted to waive interest, as provided by IC § 6-8.1-10-1(e). Taxpayers protest the imposition of penalties pursuant to IC § 6-8.1-10-2.1. Penalty waiver is permitted if the taxpayers show that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> "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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) 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:
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> (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.

In this case, Taxpayers were sustained in whole regarding the imposition of base income tax. Therefore, the imposition of penalties and interest is moot.

FINDING

Taxpayer's protest to the imposition of penalties and interest is sustained.

SUMMARY

Taxpayer's Issue I protest regarding the imposition of individual income tax is sustained. Taxpayer's Issue II protest regarding the imposition of penalties is denied.

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An html version of this document.