

**Letter of Findings Number: 01-20120457  
Individual Income Tax  
For The Tax Years 2007-09**

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**ISSUES**

**I. Individual Income Tax - Calculation.**

**Authority:** IC § 6-8.1-3-1; IC § 6-3-1-3.5; IC § 6-8.1-3-2.2; IC § 6-8.1-5-1; IC § 6-8.1-5-4.

Taxpayer protests the Department's calculation of individual income tax.

**II. Tax Administration - Fraud Penalty.**

**Authority:** IC § 6-8.1-5-1; IC § 6-8.1-10-1; IC § 6-8.1-10-2.1; IC § 6-8.1-10-4; [45 IAC 15-11-2](#); [45 IAC 15-5-7](#).

Taxpayer protests the imposition of a one hundred percent fraud penalty.

**STATEMENT OF FACTS**

Taxpayer is an Indiana resident. The Indiana Department of Revenue ("Department") determined that Taxpayer had not reported the proper amount of income on her Indiana individual income tax returns for the tax years 2007, 2008, and 2009. The Department issued proposed assessments for individual income tax, interest, and penalty for each of these years. This Letter of Findings addresses those proposed assessments. Taxpayer protested the Department's calculations of income tax and the imposition of fraud penalty for these years. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

**I. Individual Income Tax - Calculation.**

**DISCUSSION**

Taxpayer protests the Department's calculations of additional individual income tax for the tax years 2007, 2008, and 2009. In the course of an investigation of Taxpayer's compliance with sales and use taxes with regards to sales of dogs and puppies during the tax years, the Department determined that Taxpayer had unreported sales which in turn resulted in additional income from those sales. The Department based its calculations on the best information available to it at the time. Taxpayer argues that the Department over-stated the volume and value of the sales. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Indiana individual income tax is imposed under IC § 6-3-1-3.5. Also, IC § 6-8.1-3-1(a) states:

The department has the primary responsibility for the administration, collection, and enforcement of the listed taxes. In carrying out that responsibility, the department may exercise all the powers conferred on it under this article in respect to any of those taxes.

Also, IC § 6-8.1-3-2.2 provides:

- (a) This section does not:
  - (1) apply to an otherwise lawful investigation concerning organized crime activities; or
  - (2) prohibit, restrict, or prevent the exchange of information if a person is being investigated for multiple violations of [IC 6-2.5](#) (state gross retail and use taxes).
- (b) As used in this section, "investigation" means an oral or written inquiry directed to a person, organization, or governmental entity.
- (c) As used in this section, "surveillance" means the monitoring of a person, place, or event by:

- (1) electronic interception;
  - (2) overt or covert observations;
  - (3) photography; or
  - (4) the use of informants.
- (d) The commissioner or an employee of the department may not knowingly authorize, require, or conduct:
- (1) an investigation; or
  - (2) a surveillance;
- unless the purpose of the investigation or surveillance is reasonably related to the administration of a listed tax.  
(Emphasis added).

Another relevant statute is IC § 6-8.1-5-1(b), which provides:

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. The amount of the assessment is considered a tax payment not made by the due date and is subject to [IC 6-8.1-10](#) concerning the imposition of penalties and interest. The department shall send the person a notice of the proposed assessment through the United States mail.  
(Emphasis added).

Next, IC § 6-8.1-5-4 states:

(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. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

(b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:

- (1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or
- (2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction.

In addition, if the limitation on assessments provided in section 2 of this chapter is extended beyond three (3) years for a particular tax liability, the person must retain the books and records until the assessment period is over.

Therefore, IC § 6-8.1-3-2.2 explains that the Department may conduct an investigation if it is reasonably related to the administration of a listed tax. In this case, the Department conducted an investigation which was reasonably related to the administration of sales tax and individual income tax, which in turn resulted in the individual income tax assessments at issue in this protest.

As a result of the investigation, the Department determined that Taxpayer had not included the income from the sales of the dogs and puppies in her Indiana individual income tax calculations for the tax years in question, as required under IC § 6-3-1-3.5. Since Taxpayer did not keep books and records available for the Department to review, as required by IC § 6-8.1-5-4, the Department based the proposed assessments on the best information available to it at the time it issued the liabilities in question, as provided by IC § 6-8.1-5-1(b).

In the course of the protest and hearing process, Taxpayer provided documentation previously unavailable to the Department in support of her position that the number and value of dogs and puppies sold was lower than the Department's original calculations. This documentation lists the number of dogs and puppies sold and the amount charged for each sale. The Department's audit division will use this documentation to conduct a supplemental calculation of income tax due for the tax years at issue. Therefore, some income tax will still be due. Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c), subject to the results of the supplemental audit.

### FINDING

Taxpayer's protest is sustained to the extent of the pending recalculation of income tax due.

## II. Tax Administration—Fraud Penalty.

### DISCUSSION

The Department imposed one hundred percent fraud penalties and interest for each tax year at issue. Under IC § 6-8.1-10-1(e), the Department may not waive interest. Taxpayer protests the imposition of a one hundred percent fraud penalty. Taxpayer argues that, while income tax is due on the income from the dog/puppy sales, the failure to report the income from these sales was not intentional and not fraudulent. The Department notes that the fraud penalty is imposed under IC § 6-8.1-10-4, which states:

- (a) If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty.
- (b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100[percent]) multiplied by:
  - (1) the full amount of the tax, if the person failed to file a return; or
  - (2) the amount of the tax that is not paid, if the person failed to pay the full amount of the tax.
- (c) In addition to the civil penalty imposed under this section, a person who knowingly fails to file a return with the department or fails to pay the tax due under [IC 6-6-5](#) or [IC 6-6-5.5](#) commits a Class A misdemeanor.
- (d) The penalty imposed under this section is imposed in place of and not in addition to the penalty imposed under section 2.1 of this chapter.

The fraud penalty is further explained by [45 IAC 15-5-7](#)(f)(3), which states:

A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.

(A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the department's regulations. Any failure to correctly report such information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.

(B) Scienter: This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.

(C) Deception: Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the department to believe a given set of facts which are not true, the person has deceived the department.

(D) Reliance: Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the department to rely on these acts to the detriment or injury of the department, the reliance requirement of fraud will be met.

(E) Injury: The fraud instituted upon the department must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the department not to have collected the money which properly belongs to the state of Indiana.

In order to demonstrate fraud, the department is required to prove all of the above elements are present. This must be shown by clear and convincing evidence. (Emphasis added).

The negligence penalty is imposed under IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

...

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

...

the person is subject to a penalty.

The Department refers to [45 IAC 15-11-2](#)(b), which states:

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.

A review of the documentation in the file shows that Taxpayer clearly demonstrated carelessness, thoughtlessness, disregard or inattention to duties placed upon Taxpayer by the Indiana Code or Departmental regulations. This is negligence as defined by [45 IAC 15-11-2\(b\)](#). Taxpayer does not dispute this, and in fact argues that it is subject to this penalty for each of the tax years at issue.

While negligence and fraud share some similarities as defined by statutes and regulations, there are also distinct differences. In the course of the administrative protest process, a review of the documentation in the file shows that the Department has not clearly and convincingly demonstrated fraud by proving all five elements of: misrepresentation of a material fact, scienter, deception, reliance, and injury, by clear and convincing evidence, as required by [45 IAC 15-5-7\(f\)\(3\)](#). However, the Department hereby notifies Taxpayer that further failure to comply with taxing requirements in a timely and accurate manner may subject future assessments to the one hundred percent fraud penalty. Through its experience via the billing and protest process and the listing of the elements of fraud explained in this Letter of Findings, Taxpayer is on notice of its duties regarding taxation. Failure to comply with those duties may be determined to be fraud under Indiana's taxing statutes and regulations.

Having established Taxpayer's future duties, in the instant protest Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c). Taxpayer will not be subject to the one hundred percent fraud penalty for the years at issue. Rather, Taxpayer will be subject to the ten percent negligence penalty. That penalty will be ten percent of the base tax after recalculation as discussed in Issue I above.

### **FINDING**

Taxpayer's protest of the fraud penalty is sustained. Negligence penalty will be imposed in its place.

### **CONCLUSION**

Taxpayer is sustained on Issue I to the extent that a supplemental audit based on documentation supplied by Taxpayer during the protest process recalculates Taxpayer's income for the tax years 2007, 2008, and 2009. Taxpayer is sustained on Issue II to the extent that negligence penalty will be imposed and fraud penalty will not be imposed, as described above.

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