

**Letter of Findings: 01-20160161**  
**Individual Income Tax**  
**For the Year 2012 and 2013**

**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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 could not show that corporate loans were valid loans and therefore, not income to Shareholder.

**ISSUE**

**I. Shareholder Basis - Assumption of Debt.**

**Authority:** I.R.C. § 1361; I.R.C. § 1362; I.R.C. § 1366; IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-2.8; 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); Jondahl v. Comm'r., T.C. Memo. 2005-55; [45 IAC 3.1-1-66](#); I.R.S. Gov., Small Business Paying Yourself.

Taxpayer protest the Department's income tax assessment.

**STATEMENT OF FACT**

Taxpayer and his wife are the only shareholders in an Indiana S Corporation ("Corporation") that husband owns. In 2012 and 2013 Taxpayer executed "Promissory Notes" lending himself money from the Corporation at an interest rate of 3 [percent]. Taxpayer executed eight loans in 2012 and fifteen loans in 2013. Taxpayer signed each loan as himself under "borrower" and as president under "lender."

Taxpayer was subject to an income tax audit by the Indiana Department of Revenue ("Department") for tax years 2012-2013. Based on the audit adjustments, the Department disallowed losses, assessed income tax on personal expenses, and assessed income to Taxpayer based on the invalidity of the "Promissory Notes."

Taxpayer protested the proposed assessment. An administrative hearing was held. Neither Taxpayer nor Taxpayer's representative appeared at the first hearing. Taxpayer's representative requested to reschedule. This Letter of Findings ensues and addresses Taxpayer's protest of the proposed assessment for the tax year 2012 and 2013. Additional facts will be provided as necessary.

**I. Shareholder Basis - Assumption of Debt.**

**DISCUSSION**

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 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.

[45 IAC 3.1-1-66](#), states that, "Corporations electing Subchapter S status under Internal Revenue Code § 1372 . . . are exempt from adjusted gross and supplemental net income tax on all income except capital gains . . ." Rather than taxing the income at the business level, the S corporation's income is passed through to the shareholders. The shareholders then must report the income on their own income tax return. [45 IAC 3.1-1-66](#) states that, "Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate." This is the dilemma in which Taxpayer finds himself; because certain of the S-Corporation's deductions were disallowed, additional taxable income flowed through to the taxpayer as the S-Corporation's shareholder. It was this additional "flow through" income which led to the imposition of additional, individual income taxes.

Taxpayer argues that the "Promissory Notes" were valid loans to Taxpayer from the Company. If the loans were considered valid then Taxpayer would not owe additional income.

Guidance on this issue is found at the United States Tax Court decision in *Jondahl v. Comm'r.*, T.C. Memo. 2005-55, 2005 WL 675444 (2005).

Whether a withdrawal of funds from a corporation creates a true debtor-creditor relationship is a factual question to be decided on the basis of all of the relevant facts and circumstances. For disbursements to constitute true loans, there must have been an unconditional obligation on the part of the transferee to repay the money and an unconditional intention on the part of the transferor to secure repayment at the time that the funds were transferred. Courts have focused on certain objective factors to distinguish bona fide loans from disguised dividends, compensation, and contributions to capital. The factors considered relevant for purposes of identifying bona fide loans include (1) the existence or nonexistence of a debt instrument; (2) provisions for security, interest payments, and a fixed payment date; (3) treatment of the funds on the corporation's books; (4) whether repayments were made; (5) the extent of the shareholder's participation in management; and (6) the effect of the "loan" on the transferee's salary. When the individual is in substantial control of the corporation . . . special scrutiny of the situation is necessary. *Id.* at \*16 (Internal citations omitted).

Additional guidance is provided by the Internal Revenue Service which explains as follows:

A loan by a corporation to a corporate officer should include the characteristics of a loan made at arm's length. That is, there should be a contract with a stated interest rate, a specified length of time for repayment, and a consequence for failure to repay the loan. Collateral would also be an indication of a loan. A below-market loan is a loan which provides for no interest or interest at a rate below the federal rate that applies. If a corporation issues you, as a shareholder or an employee, a below-market loan, the lender's payment to the borrower is treated as a gift, dividend, contribution to capital, payment of wages, or other payment, depending on the substance of the transaction.

I.R.S. Gov., Small Business Paying Yourself,  
<http://www.irs.gov/businesses/small/article/0,,id=101038,00.html>.

In this instance, Taxpayer provided the "Promissory Notes" and a letter from a third party reviewer stating that the reviewer/attorney "did not see anything in the promissory note which would invalidate them." The letter was dated after the notes were executed and after the audit took place, and this letter is not a factor considered in *Jondahl*. More importantly, the "Promissory Notes" do not provide a repayment schedule, state any collateral by the borrower, or proof of repayment. In addition, the fact that Taxpayer and his wife are the only shareholders of a company Taxpayer owns is a factor taken into consideration according to *Jondahl*. Taxpayer has failed to meet his burden under IC § 6-8.1-5-1(c) of establishing that the audit's original decision was incorrect. The audit correctly concluded that Taxpayer received taxable income. The Department thus is not able to agree that

Taxpayer met his burden.

**FINDING**

Taxpayer's protest is denied.

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