DEPARTMENT OF STATE REVENUE

01-20160161.SLOF

Supplemental 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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. Income Tax - Shareholder Basis and Assumption of Debt.

Authority: I.R.C. § 1361; I.R.C. § 1362; I.R.C. § 1366; I.R.C. § 7872; 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); 45 IAC 3.1-1-66; I.R.S. Shareholder Loan Audit Techniques Guide, June 2001; I.R.S. Gov., Small Business Paying Yourself.

Taxpayer protests the Department's income tax assessment.

STATEMENT OF FACTS

Taxpayer and his wife are the only shareholders in an Indiana S Corporation ("Corporation") that Taxpayer 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 assigned income to Taxpayer based on the invalidity of the "Promissory Notes."

Taxpayer protested the proposed assessment contending that the transfers the Department treated as distributions were actually loans from the Company. An administrative hearing was held. The Department held the hearing and issued a Letter of Findings, 01-20160161.LOF, denying Taxpayer's protest. Representative timely requested a rehearing. This Supplemental Letter of Findings ensues and addresses Taxpayer's protest of the proposed assessment for the tax years 2012 and 2013. Additional facts will be provided as necessary.

I. Income Tax - Shareholder Basis and 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 business corporation, which must meet certain statutory requirements and properly elect to be exempt from income tax 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 and § 1366.

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 individual income tax returns. 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 situation 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. Taxpayer explained that the "refinancing" of S-Corp's building into Taxpayer's name constitutes as repayment for loans. In the alternative Taxpayer argues that "on demand" loans are valid loans pursuant to the IRS.

In this instance, during the rehearing Representative provided documentation showing that Taxpayer "repaid" the "loans" at issue in 2016. Representative explained that in 2016 the S-Corp sold a major asset, its building, to Taxpayer. Taxpayer then allowed S-Corp to conduct business in the building while Taxpayer bore the responsibility and liability for the mortgage on the building. It should be noted however that S-Corp guaranteed the mortgage and the building is part of a security agreement between Taxpayer and lender. Representative argued that this "refinancing" constitutes a repayment of his loans from S-Corp. Furthermore, Representative argues that the IRS deems "payment on demand loans" as valid loans pursuant to an IRS audit guide.

The Department is not persuaded by Representative's arguments on multiple grounds. First, as stated in the LOF that at the time the "loans" occurred there was no repayment schedule provided nor any full or partial repayment of the "loans", **prior to the Department's assessment**. A retroactive attempt to repay loans does not validate the loans. Furthermore, the 2016 transaction that Representative refers to, is merely a straight sale of an asset for which any gain or loss for the S-Corp would flow to the Shareholder/Taxpayer. Therefore the sale does not in any way demonstrate a repayment of the "loans" at issue.

Second, while "on demand" loans are a valid form of loans, the loans must meet the following terms pursuant to IRC § 7872(f)(5): "If the benefits of the interest arrangements of the loan are nontransferable and are conditioned on the further performance of substantial services by an individual, the loan will be treated as a demand loan." I.R.S. Shareholder Loan Audit Techniques Guide June 2001. The loans in questions do not mention any type of service to be rendered by Taxpayer thus, cannot be construed as a valid "demand loan."

Third, Representative was questioned regarding the varied amounts of each "loan," which ranged from $9.79 to $75,741.45 to "$200-25.59=174.11." Representative responded that, "We made [Taxpayer/Shareholder] sign loan documents every time he took money from the corporation no matter the amount." This is only evidence that Taxpayer/Shareholder was using the S-Corp as his own personal line of credit. Thus the Department cannot agree that these "loans" were not distributions to Taxpayer.

Furthermore, as stated in the LOF, 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. (last accessed Jan. 4, 2017).

The "loans" at issue do not meet the standard laid out by the IRS above. 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 from S-Corp in the form of distributions, not loans. The Department thus is not able to agree that Taxpayer met his burden.

FINDING

Taxpayer's protest is denied.

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