DEPARTMENT OF STATE REVENUE

04-20160581.LOF

Letter of Findings: 04-20160581
Corporate Income Tax
For the Years 2013 & 2014

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Convenience Store/Gas Station was entitled to an adjustment of its corporate income tax because it showed that there was an error in the calculation of its income tax liability, but it was not entitled to an adjustment of the Department's calculation of sales because Convenience Store/Gas Station's original point-of-sales records were not accurate; Convenience Store/Gas Station was not entitled to abatement of negligence penalty because it did not demonstrate that it exercised reasonable care.

ISSUES

I. Corporate Income Tax - Estimated Tax Liability.

Authority: I.R.C. § 1361; I.R.C § 1362; IC § 6-3-1-3.5; IC § 6-8.1-5-1; IC § 6-8.1-5-4; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Black's Law Dictionary 394 (9th ed. 2009).

Taxpayer argues that the Department's assessment of corporate income tax liability overstates the amount of taxable income earned during the years at issue, and that the audit failed to account for various deductions and expenses reported on Taxpayer's Federal corporate income tax returns.

II. Tax Administration - Penalty.

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

Taxpayer requests abatement of the negligence penalty on the sales tax assessment.

STATEMENT OF FACTS

Taxpayer is a company that operates a combination gas station and convenience store. Taxpayer sells gasoline, bottled drinks, fountain drinks, and coffee; exempt grocery items such as canned food, chips, crackers, and cookies; and taxable groceries such as paper goods, cleaning supplies, pet food, oil, and over-the-counter medicine. Taxpayer also sells cigarettes, cigars, and other tobacco products. Taxpayer is taxed as an S-Corporation and has two individual shareholders ("Shareholders").

The Indiana Department of Revenue ("Department") conducted simultaneous sales tax and income tax audits on Taxpayer's business for 2013 and 2014. The Department reviewed Taxpayer's business records, sales tax returns, and income tax returns for these years. The Department's audits found that Taxpayer underreported the amount of its sales, and correspondingly, had additional taxable income that flowed through to Shareholders. The Department assessed Taxpayer additional sales tax and additional income tax. Taxpayer disagreed with the income tax assessment and filed a protest of the findings of the income tax audit. An administrative hearing was conducted by telephone during which Taxpayer's representative explained the basis for its objections. This Letter of Findings addresses only Taxpayer's objections to the income tax assessment and request for abatement of the negligence penalty on the sales tax assessment. The additional income tax, penalties and interest assessed to Shareholders will be addressed in a separate Letter of Findings.

I. Corporate Income Tax - Estimated Tax Liability.

DISCUSSION

Taxpayer argues that the income tax assessment is incorrect and should be adjusted. Taxpayer concludes that the proposed assessments are estimates based on "artificially inflated" sales, and that the auditor erred in transferring the change in inventory amount and the total expenses amount from its 2014 Federal 1120S form.

As a threshold issue, it is the Taxpayer's 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." See also 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, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position 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). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong.

An S-Corporation ("S-Corp")–such as Taxpayer's gas station and convenience store–is "[a] corporation whose income is taxed through its shareholders rather than through the corporation itself." Black's Law Dictionary 394 (9th ed. 2009); see also, I.R.C. §§ 1361-62. Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine an individual shareholder's tax liability. Furthermore, any additional income received by the S-Corp as a profit passes through to the individual shareholders as income.

The auditor requested an extensive list of records for both years of the audit, including sales reports and summaries, as well as source documentation including cash register tapes and closing tapes (or "Z tapes"). However, the only records provided by Taxpayer were copies of federal and state income tax returns, bank statements for one bank account, check stubs for the bank account, purchase invoices, register cash payout receipts, and sales tax returns. The auditor used the incomplete records from Taxpayer to verify the returns filed by Taxpayer.

During the review of Taxpayer's records, the auditor determined that Taxpayer had unreported sales. The sales tax audit found that actual cost of goods sold exceeded the total gross receipts reported on the federal income tax return in 2013 and 2014. The audit reviewed Taxpayer's check stub register, bank statement photocopies of cleared checks, cash register payouts, and vendor invoices to estimate the in-store sales for 2013 and 2014. Taxpayer was provided time to review the audit work papers and provide additional documentation, but did not provide any additional records during the audit.

With respect to fuel sales, the audit report used sales reported by Taxpayer on the ST-103MP's for 2013 and 2014, as well as vendor invoices for gasoline purchases. Because the auditor did not have accurate sales records, the audit relied upon the best information available to calculate fuel sales.

The audit totaled the in-store and fuel sales for both 2013 and 2014 to arrive at the total sales per audit, and utilized amounts for reported gains and losses, as well as other income, as reported by Taxpayer. The total receipts/income per audit was the same as the total sales per audit. The audit report cited to the Internal Revenue Service ("IRS") guidelines on audits of convenience stores, which references Bizstats as its source, to determine the average gross profit margin of the in-store sales. The Department concluded that Taxpayer owed additional sales tax and income tax.

Taxpayer does not directly object to the calculation of sales tax in the audit, but argues, in the calculation of income tax, that the Department overstated the amount of gasoline sales. Taxpayer concludes that - based on its own analysis - that it owes no additional income tax. To that end, Taxpayer has provided copies of a spreadsheet that purports to show the credit card sales of gasoline that were remitted to Taxpayer's gasoline vendor, and Taxpayer "estimates" that 90 percent of gasoline sales are made via credit card and 10 percent are made with cash. As with the audit, Taxpayer provided no additional documentation to support this estimation. Taxpayer asks the Department to substitute its own calculations with an alternative calculation; however, Taxpayer's calculation is also based upon incomplete business records.

It should be pointed out that, "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 tax by reviewing those books and records." IC § 6-8.1-5-4(a). The very basis for that requirement is that Taxpayer maintain demonstrably accurate reports. Taxpayer has failed to do so, and now is in a position that makes it difficult for Taxpayer to overcome its statutory threshold that it prove that any portion of the assessment was wrong. IC § 6-8.1-5-1(c). Therefore, the Department concludes that Taxpayer has not met its burden of showing that the audit report's calculations of sales and gross profit were incorrect.

Taxpayer also argues that the audit report failed to accurately account for the change in inventory and total expense amounts for 2014, and did not factor in the bonus depreciation deduction for both 2013 and 2014. In calculating Taxpayer's taxable income, the audit report states that it used corresponding amounts from Taxpayer's Federal 1120S form. Taxpayer provided copies of the relevant pages from its 2014 Federal 1120S showing that it reported a $5,000 change in inventory, not $521 as stated in the audit report, and $222,426 in total expenses, not $185,503 as stated in the audit report work papers.

With respect to the bonus depreciation deduction, Taxpayer states that it reported $2,946 in bonus depreciation for 2013, and $2,230 for bonus depreciation for 2014, and argues that the audit report does not include these amounts.

In the calculation of Indiana adjusted gross income, I.C. § 6-3-1-3.5(a)(15) provides:

> (15) Add or subtract the amount necessary to make the adjusted gross income of any taxpayer that owns property for which bonus depreciation was allowed in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168(k) of the Internal Revenue Code to apply bonus depreciation to the property in the year that it was placed in service.

The audit report properly shows that these amounts as add-backs in the calculation of adjusted gross income, and thus there was no error with respect to the audit report's treatment of bonus depreciation.

After reviewing documentation provided by Taxpayer, the Department finds that the audit erred in (1) the 2014 change in inventory amount, and (2) the 2014 total expenses amount. However, the audit did not err in its calculation of total sales. Therefore, the Department will recalculate Taxpayer's income based upon the correct amounts, and that income will flow through to Shareholders pursuant to I.R.C. §§ 1361-62 and IC § 6-3-1-3.5. Shareholders' income tax liability are addressed in a separate Letter of Findings 01-20160758; 01-20160759.

FINDING

Taxpayer's protest is denied in part and sustained in part, subject to supplemental audit.

II. Tax Administration - Penalty

DISCUSSION

Taxpayer protests the imposition of penalties pursuant to IC § 6-8.1-10-2.1. Penalty waiver is permitted if the taxpayer shows 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:

(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.

Taxpayer has not shown that it had reasonable cause for the late payment. The Department notes that Taxpayer was audited in 2011 and the Department concluded that Taxpayer had underreported sales. Taxpayer was put on notice regarding its incomplete recordkeeping, yet continued to improperly maintain its business records. Taxpayer has not affirmatively established that it exercised ordinary business care in this case. Therefore, waiver of penalties is not warranted under 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest with respect to the abatement of negligence penalties is respectfully denied.

SUMMARY

Taxpayer's Issue I protest is denied in part and sustained in part, subject to supplemental audit. Taxpayer's Issue II protest regarding abatement of the negligence penalty is denied.

Posted: 04/26/2017 by Legislative Services Agency
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