DEPARTMENT OF STATE REVENUE

01-20150516.LOF

Letter of Findings Number: 01-20150516
Individual Income Tax
For Tax Years 2012-2013

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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 did not establish that the Department's calculations of individual income tax were incorrect. Therefore, the Department's proposed assessments for individual income tax are correct.

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 and file a federal married joint income tax return. Taxpayers are sole shareholders and principally involved in day-to-day operations of an automotive company. As the result of a tax audit, the Indiana Department of Revenue ("Department") determined that for the tax years 2012 and 2013, payments were being made on behalf of the shareholders as compensation in lieu of wages and the Business's checking account had several payments listed for transactions which did not appear to be business-related. During the audit, it was determined that bills were paid from the Business's checking account for personal expenses at the home of the shareholders, such as, septic services, plumbing and toilet repair, lawn care, pool filter repair, window cleaning, satellite television, home phone service, water service, electrical services, trash service, gas service, washer/dryer repairs, payments on furniture, wall coverings, ornamental trees, cleaning expenses, and personal cell phones for the shareholders' children. The business account also paid for expenses at restaurants, nail salons, dry cleaners, athletic club membership dues, for ballet tickets, professional football tickets, boat repairs, shareholders' home insurance policy, personal auto insurance policy, health insurance policy, and life insurance policy. Income tax payments were also made to the federal and state governments on behalf of the shareholders from the corporation's business checking account.

The Department therefore adjusted the amounts of business expenses listed. 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 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 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 2012 and 2013. Specifically, Taxpayers protest that the Department incorrectly determined that certain purchases by Business were not qualified business expenses. 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's 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 provide some requested documentation such as, but not limited to, detailed receipts of purchases, and explanations of purchases. After review, the Department determined that the documentation was not credible. In one instance the Taxpayer provided a computer generated bill of sale showing that the acquisition of a motorcycle by the business was after the date of sale. Additionally, the bill of sale was only signed by the shareholder and it was not possible to determine the disposition of the motorcycle. Additionally, cash withdrawals were also being made from the business check accounting account at ATM-machines by the shareholders with no records identifying whether the cash was used on ordinary and necessary business expenses. Without such documentation, the Department was unable to verify that Business's claimed qualified business expenses were actually qualified business expenses and so added those unverified amounts back to Business's 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 accepted by the Department. Nevertheless, the documentation provided was not sufficient to substantiate the corporation's claim that the charges were ordinary and necessary business expenses.

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 documentation 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. The documents provided were the same documents provided during the Audit and previously deemed not to substantiate the claim of business expenses. After a second review in the protest process, the Department remains unconvinced of the documents' credibility. Taxpayers have not met the burden imposed by IC § 6-8.1-5-1(c).

In conclusion, Taxpayers argue that the Department's adjustments to their gross income were incorrect. However, Taxpayers have not provided sufficient documentation supporting their position and have not established that the payments made from Business's checking account were qualified business expenses which were eligible to be included. Since they have not established that the adjustments to Business's returns were incorrect, Taxpayers have not 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 denied.

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, due to Taxpayers' negligence in reporting all income, the penalty remains.

FINDING

Taxpayers' protest to the imposition of penalties and interest is denied.

SUMMARY

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

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