

Letter of Findings: 02-20160571; 02-20160572
Corporate Income Tax
For the Years 2007 through and including 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 Indiana Department of Revenue'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 This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.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

Indiana Medical Center and Pharmacy were not able to document various expenses claimed on their federal corporate income tax returns and failed to file Indiana state corporate income tax returns, and therefore did not show that adjustments made by the Department of Revenue were incorrect.

ISSUE

I. Corporate Income Tax - Imposition.

Authority: I.R.C. § 63; Treas. Reg. § 1.261-1; IC § 6-3-1-3.5; IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; IC § 6-8.1-5-4; IC § 6-8.1-10-1; 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); Indiana Dep't of State Rev. v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); [45 IAC 3.1-1-66](#).

Taxpayers protest the Department's adjustments made to corporate income tax returns.

STATEMENT OF FACTS

Taxpayers, a Medical Center and a Pharmacy with common ownership, are part of an integrative medical practice in Indiana. The practice is a blend of primarily holistic medicine with some traditional medicine and nutrition. The Medical Center is an S Corporation that operates as a medical clinic and therapy treatment center. The Pharmacy is a limited liability company ("LLC") that serves the patients of the Medical Center. The Medical Center's sole shareholder, an individual, is also the sole member of the Pharmacy ("Shareholder"). The building in which Taxpayers are located is wholly owned by Shareholder. The Medical Center and the Pharmacy are not in separate suites of the building, but they are separate legal entities. The Medical Center and Pharmacy are collectively referred to in this Letter of Findings as "Taxpayers."

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayers' businesses. During the course of the audit, the Department discovered that corporate state income tax returns had not been filed for the Medical Center for tax years 2007 through 2013, and for the Pharmacy for tax years 2010 through 2013 (the "Tax Years at Issue"). The Department assessed Taxpayers penalties for failure to timely file returns for each Tax Year at Issue; Taxpayers do not protest the assessment of these penalties. The Department conducted a limited scope investigation of Taxpayers' income for the Tax Years at Issue. During the investigation, the Department discovered expenses that were personal in nature, undisclosed distributions made in excess of the shareholder's basis, of assets acquired for which no supporting documentation was provided, and of the use of accounting methods which are not in line with Generally Accepted Accounting Principles ("GAAP") or any other observed method. The Department utilized information from Taxpayers' adjusted federal income tax returns and Taxpayers' records to prepare corporate state income tax returns for the Tax Years at Issue. Taxpayers' income flowed through to Shareholder. As a result, the Department issued proposed income tax assessments to Taxpayers' Shareholder.

Taxpayers and Shareholder filed the instant protest in response to the proposed assessments, arguing that the audit improperly disallowed certain expenses and depreciation deductions. An administrative phone hearing was held, and this Letter of Findings results for the Medical Center and Pharmacy Taxpayers. Letter of Finding

01-20160570 will be issued separately addressing the Shareholder's protest. Additional facts will be addressed herein as necessary.

I. Corporate Income Tax - Imposition.

DISCUSSION

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). 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); see also *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. IC § 6-3-2-1(b). To compute the income subject to Indiana corporate income tax, Indiana adopts a multistep process to calculate a corporate taxpayer's taxable Indiana adjusted gross income. *Caterpillar, Inc.*, 15 N.E.3d at 581. The federal law requires taxpayers to report and pay their federal income tax when their gross income exceeds a certain amount. The Indiana statute refers to the Internal Revenue Code to efficiently and effectively compute what is considered the taxpayers' Indiana income tax. That is, IC § 6-3-1-3.5(b) simply provides the starting point to determine a corporate taxpayer's taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows" In determining the taxpayer's Indiana adjusted gross income, Indiana first refers to I.R.C. § 63 as the starting point. From there, the taxpayer must follow various enumerated adjustments—additions and/or subtractions—under IC § 6-3-1-3.5(b). Then, the taxpayer makes additional adjustments based on provisions outside IC § 6-3-1-3.5(b). After making the above mentioned adjustments, the taxpayer determines how much of its income is apportioned (i.e., business income) or allocated (i.e. nonbusiness income) to Indiana, based on provisions outlined in IC § 6-3-2-2. Business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." IC § 6-3-1-20 (as in effect for the Tax Years at Issue). Nonbusiness income is "all income other than business income." IC § 6-3-1-21.

Because both Taxpayers are pass-through entities, the income tax obligations flows through to the Shareholder. IC § 6-3-2-2(a) provides, in relevant part:

Income from a pass through entity shall be characterized in a manner consistent with the income's characterization for federal income tax purposes and shall be considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income producing activity. Income that is derived from one (1) pass through entity and is considered to pass through to another pass through entity does not change these characteristics or attribution provisions.

With respect to income tax obligations of S Corporations, [45 IAC 3.1-1-66](#) provides:

Subchapter S Corporations. Corporations electing Subchapter S status under Internal Revenue Code §1372 and which comply with the withholding requirements of [IC 6-3-4-13](#) are exempt from adjusted gross and supplemental net income tax on all income except capital gains subject to tax under Internal Revenue Code §1378. This exemption is effective until the corporation's shareholders terminate the election with the Internal Revenue Service or until the corporation engages in transactions which disqualify it from Subchapter S status. A complete or partial corporate liquidation or the intent to dissolve will not in itself terminate the election.

Subchapter S corporation shareholders are taxed on their distributive shares of income at the individual income tax rate. The character of the income (as capital gains or ordinary income) also passes through to the shareholders.

Although Subchapter S corporations are generally not subject to adjusted gross income tax, they are subject

to use tax and intangibles tax, and must report and pay such tax at the time the annual return is filed.

Subchapter S corporations must also withhold adjusted gross income tax on any nonresident shareholder's share of corporate income. See Regulation 6-3-4-13(010) [[45 IAC 3.1-1-109](#)] et seq.

In the audit report, the Department disallowed several expenses claimed by Taxpayers. Taxpayers provided copies of their completed federal income tax returns for the Tax Years at Issue, as well as unsigned copies of Indiana corporate income tax returns, which the audit determined did not constitute valid returns under IC § 6-8.1-10-1(d). Taxpayers also provided general ledgers and bank statements for 2011, 2012, and 2013, but failed to provide other requested documents by the agreed upon deadline. Based upon the federal returns and documentation that were provided, the Department created state income tax returns on behalf of Taxpayers. However, the auditor concluded that certain expenses reported on Taxpayers' federal tax returns were not "ordinary and necessary" expenses of carrying on a trade or business under Treas. Reg. § 1.261-1, and therefore disallowed them. The audit report disallowed expense deductions related to assets, automobile expenses, cost of goods sold, depreciation, gross receipts, interest expense, janitorial services, meals and entertainment, repairs and maintenance, travel, office and miscellaneous expenses. Because these deductions were disallowed, these expenses were reclassified as income in the year they were claimed, resulting in additional income tax assessed to the shareholder/member.

The Department's audit made "general adjustments starting with the [Taxpayers'] originally filed federal adjusted gross income . . ." and found that "specific Indiana adjusted gross income calculation adjustments were needed." Taxpayers disagreed with seven of these adjustments as follows:

1. The Department's audit disallowed depreciation expenses for a number of Taxpayers' assets. Taxpayers argue that they were entitled to depreciate these assets because they were legitimate business assets and the depreciation deduction related to these assets should be allowed.
2. The audit disallowed claimed "janitorial expenses" for the years 2011, 2012, and 2013. Taxpayers disagree with the disallowance of these expenses on the ground that they represented "legitimate janitorial services." As such, Taxpayers conclude that these deductions should be allowed pursuant to Treas. Reg. § 1.261-1.
3. The Department's audit disallowed claimed "repair and maintenance" expenses. According to Taxpayers, they were disallowed solely "because they were paid to a single vendor" and that there "is no support for [the Department's] position on this." According to Taxpayers, "Repairs and maintenance do not have to be paid to multiple vendors in order to be deductible." Taxpayers further explain that their building was left "in a significant and increasing state of disrepair" through no fault of their own and that resultant "repairs and maintenance were necessary and legitimate business expenses and should be allowed."
4. Taxpayers disagree with the audit's disallowance of certain travel expenses. Taxpayers explain that the expenses were attributable to Shareholder's attendance at "training conferences." Taxpayers disagree and cite to Treas. Reg. § 1.261-1 as supporting their contention that the travel expenses were "legitimate business expenses"
5. Taxpayers disagree with the audit's disallowance of "costs of goods sold." Taxpayers state that the expenses were disallowed because they "deducted the payments [] made on its [bank] credit card." Taxpayers explain that the expenses were deducted "when it paid on the card not when the charge was incurred." Nonetheless, according to Taxpayers, "The payments on the card reflect legitimate purchases of costs of goods to be sold and should be allowed as a cost of goods sold deduction."
6. Taxpayers also disagree with the audit's disallowance of previously claimed interest expenses arguing that the interest was paid "was on legitimate business loans and [were] legitimate business expenses under [Treas. Reg. § 1.261-1]." Taxpayers explain that they entered into loan agreements with an investment company and with a local bank and that the "funds borrowed were used on the leasehold improvements, [for] meeting payroll and other legitimate business purposes." According to Taxpayers, the amounts claimed constituted "legitimate ordinary and necessary business interest expenses and should be allowed under [Treas. Reg. § 1.261-1]."
7. Finally, Taxpayers argue that the Department erred when it reclassified loans to Shareholder as "distributions" and that the amounts constituted "legitimate shareholder loans." Taxpayers explain that the amounts were made to cover Shareholder's personal expenses and provided a "shareholder loan document evidencing this loan."

It must be emphasized 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). In addition, IC § 6-8.1-5-4(c) provides that, "A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times." When Taxpayer repeatedly failed to provide relevant documentation, the audit issued "proposed assessments" based upon the limited information available.

The Department's authority to determine an estimated amount of taxable income and assess additional income tax is based upon IC § 6-8.1-5-1(b) which states that, "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."

Taxpayers have the burden of demonstrating that the proposed assessment of income tax for each entity was incorrect. IC § 6-8.1-5-1(c) in part states that, "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."

Taxpayers failed to provide adequate documentation to substantiate the various expenses claimed on their corporate income tax returns that were disallowed by the Department. Taxpayers were repeatedly asked for invoices, receipts, and loan documentation detailing the claimed expenses, but failed to provide the relevant documentation as requested. Documentation provided during the protest was the same as that provided during the audit, and therefore did not satisfy the burden of showing that the assessments issued as a result of the audit were wrong. The Department cannot substitute its findings with unsubstantiated estimates from Taxpayers. Therefore, Taxpayers have not shown that the Department's adjustments were incorrect.

FINDING

Taxpayers' protest is respectfully denied.

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