DEPARTMENT OF STATE REVENUE

02-20170434.LOF

Letter of Findings: 02-20170434
Corporate Income Tax
For the Year 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

The Department denied Indiana Restaurant's protest challenging the assessment of additional corporate income tax because the Department's Special Investigation Division found that the Restaurant failed to maintain accurate financial records, failed to file sales tax returns, and failed to accurately report its sales. The Department's assessment of tax was based on a "reasonable belief" that the Restaurant under-reported its income.

ISSUE

I. Corporate Income Tax - Best Information Available Assessment.

Authority: IC § 6-3-4-13(a); IC § 6-3-4-13(j); IC § 6-8.1-5-1(b); IC § 6-8.1-5-1(c); IC § 6-8.1-5-2(b); IC § 6-8.1-5-4(a); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); 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); 45 IAC 15-5-1; Letter of Findings 04-20170103 (June 8, 2017).

Taxpayer argues that the Department's assessment of corporate income tax was unwarranted because the Department could not have reasonably believed Taxpayer underreported its income.

STATEMENT OF FACTS

Taxpayer is an Indiana restaurant which sells food and alcohol. The Indiana Department of Revenue ("Department") initiated an investigation of Taxpayer's business practices and tax returns. The Department's "Special Investigation Division" executed search warrants of Taxpayer's business location in November 2013. The Department simultaneously subpoenaed Taxpayer's bank account information. In addition, the Department executed a search warrant of the business which prepared Taxpayer's tax returns. The investigation resulted in the issuance of a "Case Report" dated December 2014. The Case Report concluded that during 2010 through 2012, Taxpayer failed to report the full amount of its sales. Accordingly, the Department issued assessments of additional sales tax for those years based on the best information available.

Subsequently, the Department issued proposed assessments of 2013 corporate income tax. Taxpayer disagreed with the 2013 assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Best Information Available Assessment.

DISCUSSION

Taxpayer argues that the Department's assessment of 2013 income tax is not based on a "reasonable belief" that it underreported its income. Instead, Taxpayer maintains that the amount of income Taxpayer originally reported on its 2013 tax return was correct.

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." 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). 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, interpretations of Indiana tax law contained within this decision, as well as the preceding audit and investigative report, are entitled to deference.

Indiana law imposes on S Corporations (as defined in IC § 6-3-4-13(a)) the responsibility of filing a "composite income tax return." IC § 6-3-4-13(j) provides as follows:

> A corporation described in subsection (a) shall file a composite adjusted gross income tax return on behalf of all nonresident shareholders. The composite return must include each nonresident shareholder regardless of whether or not the nonresident shareholder has other Indiana source income.

Indiana law, IC § 6-8.1-5-4(a), requires 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 that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and cancelled checks."

In the absence of what it determines are complete or accurate records, Indiana law requires that the Department issue a proposed assessment based on the best information the Department can obtain. "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." IC § 6-8.1-5-1(b) (emphasis added). See also 45 IAC 15-5-1.

In the 2014 "Case Report" issued by the Department's "Special Investigation Division," the Department found that Taxpayer underreported the amount of sales which occurred at Taxpayer's business location. As explained in Letter of Findings 04-20170103 (June 8, 2017) addressing Taxpayer's - and two related business locations' - challenge of the original sales tax assessments:

> The Department's investigation found that Taxpayers failed to maintain "source documents" and that it was Taxpayers' practice to destroy "guest check tickets" on a regular basis. In addition the audit questioned the accuracy of Taxpayers' daily summary register tapes ("z-tape") because the cash register daily tapes were not retained. The audit report also indicates that it was the practice of Taxpayers' employees to "register a lesser amount than the actual sales price," use the "no sale" register button to ring up particular transactions, and routinely "left the cash register drawer open between customers." Further, the audit found that a review of Taxpayers' bank accounts established "that there were no cash deposits for many months, and often there were no cash deposits for years."
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> In reviewing Taxpayers' general ledgers, the Department found that Taxpayers' "[r]evenues were increased and cash on hand was increased in order to balance [] accounting entries." According to the Department's investigative report, Taxpayers' practice of adjusting the general ledger entries "indicates the business was not reporting all their sales" and that Taxpayers' records were incomplete and unreliable.

In explaining the basis for calculating the assessment, the June 8, 2017, Letter of Findings cited directly to the Department's 2014 Case Report:

> There is sufficient convincing evidence to support the conclusion of under-reporting of sales by [Taxpayers] to the Indiana Department of Revenue. However, the percentage of under-reporting varies among the restaurants. Therefore, an indirect method must be utilized to determine the amount of under-reporting by each restaurant.
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> A fundamental principle restaurants often utilize is a cost of goods method to determine menu pricing. Cost of goods sold is defined as the direct costs attributable to the production of goods. Restaurants measure the cost of ingredients and mark them up in order to cover their fixed overhead costs such as rent or advertising and variable overhead costs such as utilities or labor. This cost accounting concept is utilized, not only in restaurants but also manufacturing concerns because a direct relationship exists between cost of goods and the associated sales.
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> . . .

> A very reasonable estimate of under-reported sales has been calculated by applying the modest markup of 3.5 to the cost of food and beverages purchased. The cost of goods sold amount is obtained from the year-end financial statement for each location. The costs for food and beverage are then marked up 3.5 times to determine total sales. Reported sales are then subtracted from total sales to determine unreported sales.

The income tax assessment considered here is for the year 2013 while the original criminal investigation addressed the 2010 through 2012 years. However, the income tax audit report explains "[r]ecords obtained from the criminal investigation included [T]axpayer records for tax periods through October 2013."

Taxpayer objects to the 2013 income tax assessment because the Department failed to "state specifically how the Department came to 'reasonably believe' how this specific [T]axpayer under-reported sales tax for 2013, and the proposed assessment is therefore outside the authority granted to the Department by statute." In addition, Taxpayer maintains the assessment "is inaccurate, grossly overstates the amount of sales made by the [T]axpayer for 2013, contradicts the information previously provided by the [T]axpayer on its filed tax return, [and] is insufficiently articulated as to the formulation and determination to use [a] 3.5 multiplier . . . ."

The Department is unable to agree with Taxpayer that the assessment of additional tax was meritless or that the Department had no basis upon which to issue the assessment. Instead, the Department acted reasonably in fulfilling the responsibility imposed upon it by IC § 6-8.1-5-1(b) which mandates that the Department issue proposed assessments when there is a reasonable belief a taxpayer has not reported the correct amount of tax due. As explained in the audit report, "The Department could not rely on the [T]axpayer's records . . . ." Taxpayer has produced no substantive, contemporaneous documents which would directly - or even indirectly - refute the Department's conclusion that the Taxpayer's record keeping practices were questionable at best. Taxpayer raises numerous objections but has proposed no reasonably well-documented alternative to the assessment. If there are records accurately detailing Taxpayer's 2013 sales, Taxpayer has not produced them.

Taxpayer also suggests that the assessment is barred by the three-year statute of limitations. Taxpayer is incorrect. Taxpayer's originally filed return reported "zero" income. The Department's assessment was approximately $29,000. Faced with that discrepancy, IC § 6-8.1-5-2(b) extends the statute of limitations from three to six years in instances in which adjusted gross income tax is understated by twenty-five percent.

FINDING

Taxpayer's protest is denied.

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An html version of this document.