DEPARTMENT OF STATE REVENUE

01-20170609.LOF

Letter of Findings: 01-20170609
Individual Income Tax
For the Years 2008 through 2015

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Out-of-state S Corporation Shareholder was unable to establish that management and consulting fees did not constitute income attributable to and taxable to him in the state of Indiana or that the S Corporation sustained the losses claimed by the Shareholder.

ISSUE

I. Individual Income Tax - Management and Consulting Fees.

Authority: IC § 6-8.1-5-1(c); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 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); 45 IAC 3.1-1-2(14); 45 IAC 3.1-1-55; 45 IAC 3.1-1-55(d).

Taxpayer argues that the Department erred in imputing as his income money received for providing management and consulting services to Taxpayer's Indiana restaurants.

STATEMENT OF FACTS

Taxpayer is an out-of-state resident who owns - as the sole shareholder of various S Corporations - restaurants located inside Indiana and outside Indiana. Before 2008, Taxpayer filed Indiana income tax returns but did not file 2008 through 2013 returns. Taxpayer resumed filing Indiana returns for 2014 and 2015.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's Indiana tax returns and business records. The audit found that Taxpayer reported on his federal return income categorized as "management" and "consulting" fees. Taxpayer received these fees from his S Corporations including those entities which operated restaurant and other businesses in Indiana. According to the report prepared by the Department's Audit Division, Taxpayer reported "no expenses associated with this 'management fee' income."

Beginning in 2014, the management and consulting fees were routed through a "new S [C]orporation . . . of which the [T]axpayer is sole shareholder."

The Department's audit concluded that the management and consulting fees constituted Indiana source income attributable to Taxpayer's activities in this state. That conclusion resulted in an assessment of additional Indiana income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Individual Income Tax - Management and Consulting Fees.

DISCUSSION

The issue is whether the Department erred in concluding that the management and consulting fees constituted Indiana source income subject to this state's adjusted gross income tax.

As a threshold issue, it is the Taxpayer's responsibility to establish that the assessment of individual income tax 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, 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. 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, are entitled to deference.

A. The Department's Audit Conclusion.

The audit found that Taxpayer was required to report the management and consulting fees as Indiana source income subject to this state's individual income tax. In doing so, the audit cited to 45 IAC 3.1-1-55 which provides in part:

> The term "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit.
> . . .
> Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered.

Despite requests for information to that effect, the auditor was unable to determine "what constituted the services which generated these fees" and was unable to determine "how the management fee was calculated and whether the metric used to figure the management fee was objective or systemic."

The audit found that the fees "would qualify as 'service revenue' or revenue arising from the 'sale of services." Further, the audit determined that, under 45 IAC 3.1-1-55, the "income producing activing *[sic, activity]*" was "'deemed performed' in Indiana." The audit report concluded:

> Presumably the "acts" of "management" (or "consulting") with respect to the Indiana locations was to maintain or enhance the operating profits of these S [C]orporations. As such, it is attributable to Indiana and taxable as such."

Because Taxpayer was the sole shareholder of the S Corporations, the management and consulting fees "flowed through" to Taxpayer as the "distributive share of taxable income from an electing small business corporation." 45 IAC 3.1-1-2(14).

B. Taxpayer's Objections to the Additional Assessment.

Taxpayer does not object to the audit's substantive finding recognizing that "the manner by which these management fees were originally structured disadvantaged the state of Indiana." However, Taxpayer maintains that he provided the S Corporations valuable "higher level management duties" for which he was legitimately entitled to compensation. As explained by Taxpayer:

> These duties include the substantial task of conforming to the franchise agreements in place, meeting the various loan covenants, negotiation of leases and terms, employing lower level managers, forming and maintaining business plans, and ensuring the continued success of the companies.

Taxpayer explains that these activities were performed outside Indiana and the income derived should not be entirely sourced to this state. To that end, Taxpayer cites to 45 IAC 3.1-1-55(d) which states:

> Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state. If the services are performed partly within and without this state, such receipts shall be attributed to this state based upon the ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere. Time spent in performing

services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, is excluded from the computations.

Taxpayer determined that the extent to which the Department imputed the income to Taxpayer was overstated. Taxpayer states that he has "researched what a typical agreement might look like . . . . [and that] a management company dealing with an operation of this size would expect to receive fees of 2[percent] of gross revenue." As a result, Taxpayer "modified the audit findings to allow for reasonable management fees."

In addition, Taxpayer explains that the assessment is overstated because the audit failed to take into consideration "rental losses in the final two years of the audit." Taxpayer states that the audit did not take into consideration approximately $800,000 in rental losses.

Taxpayer concludes that the assessment should be decreased because a portion of the management and consulting services were performed outside Indiana and because the audit failed to factor into its calculation losses incurred by one of the S Corporations.

C. Analysis and Conclusion.

Taxpayer has prepared detailed, amended income tax returns which reflect the adjustments to which he believes he is entitled. However, the Department is unable to agree that Taxpayer is entitled to the relief sought by means of the amended returns. As noted at the outset, IC § 6-8.1-5-1(c) imposes on Taxpayer "[t]he burden of proving that the proposed assessment is wrong . . . ." Taxpayer's calculations may be entirely correct - or wholly incorrect - but based on the information provided, there is no practical means of arriving at one of those decisions. Did Taxpayer perform his management services in this state or outside the state? If the services were performed outside Indiana, did Taxpayer pay the foreign state's income tax on fees attributable to that state? Did Taxpayer actually perform the services claimed or did the "fees" simply constitute a taxable distribution of income earned by the Indiana restaurants? Did the Taxpayer's S Corporation sustain $800,000 in rental losses or $80 in losses?

Taxpayer asks the Department to accept the amended returns setting out - to the extent sought by Taxpayer - the income and loss adjustments requested. The Department is unable to do so. Taxpayer has not met his statutory burden of establishing that the original assessment was "wrong" and has not "[p]rovide[d] documentation explaining and supporting his or her challenge that the Department's position is wrong."

FINDING

Taxpayer's protest is respectfully denied.

Posted: 11/29/2017 by Legislative Services Agency
An html version of this document.