DEPARTMENT OF STATE REVENUE

01-20170801.LOF

Letter of Findings: 01-20170801
Individual Income Tax
For the Years 2014 and 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

The Department agreed with Business Owner that the Department erred in assessing additional individual income tax because Business Owner did not include personal expenses in his business's "cost of goods sold."

ISSUE

I. Individual Income Tax - Business and Personal Expenses.

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).

Taxpayer argues that the Department's assessment of additional income tax was incorrect because the Department's audit erred in finding that Taxpayer incorrectly reduced his income tax by claiming personal expenses in order to reduce the net profit received from his swimming pool business.

STATEMENT OF FACTS

Taxpayer is an Indiana individual who is the sole owner of a business which sells swimming pools, pool supplies, hot tubs and which also provides pool cleaning and pool maintenance services.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's swimming pool business and his individual income tax returns. The Department's audit found that Taxpayer had underpaid his 2014 and 2015 income tax because he had improperly deducted personal expenses which had been paid for out his business's bank account.

When reviewing the Taxpayer's credit card statements and bank account statements, the audit found where the taxpayer was paying for personal expenses using these accounts. During the audit, it was requested that the Taxpayer provide its General Ledger to demonstrate where these expenses were being recorded and then reported. However, the taxpayer failed to provide the requested documentation.

As explained in the Department's audit report:

> A review of the [T]axpayer's bank statements and credit card statements revealed the [T]axpayer was deducting some personal expenses. The personal expenses paid out of the business bank account included clothing, concert tickets, daycare and travel expenses. The [T]axpayer was unable to document these expenses.

As explained in the audit report, "The disallowance of these expenses resulted in proposed [individual income] tax assessments."

Taxpayer disagreed with the 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. Individual Income Tax - Business and Personal Expenses.

DISCUSSION

The issue is whether Taxpayer has established that he paid the correct amount of 2014 and 2015 income tax and did not incorrectly reduce the income reported from his swimming pool business by deducting personal expenses.

Taxpayer explains the financial relationship between himself and his swimming pool business.

- [Taxpayer] reports his income and expenses on his IRS Form 1040 Schedule C. He files jointly with his wife.
- In his business he regularly purchases items for re-sale to his customers and hires labor to complete jobs.
- These purchases and expenses are listed as Cost of Goods Sold on Schedule C page 2 and then carried to page 1 where they offset Gross Sales to arrive at his Gross Profit.
- This correctly reduces his income before claiming his other business expenses to arrive at his Net Profit. Income tax is then calculated on his Net Profit from Schedule C and their other sources of income.
- The audit report states that many personal items purchased were claimed as business expenses. The auditor adjusted (reduced) the Cost of Goods Sold contending that these personal expenses were included as business expenses. This adjusted reduced the Cost of Goods Sold, increasing the [Taxpayer's] Gross Profit and the Net Profit. This is not correct.

The Department's audit reviewed Taxpayer's business records and found that Taxpayer's business had been paying for purchases from Pottery Barn, Old Navy, Amazon retail, Marriott Hotel, and US Airways. Taxpayer bought items such as shoes, concert tickets, drapes, a trampoline, costumes, food, quilts, and cosmetics. The Department's audit disallowed the questionable expenses which had the effect of increasing the income Taxpayer derived from his business.

Taxpayer argues that the Department erred in making the adjustment and asks that the Department take an entirely different approach in determining Taxpayer's individual income. As explained by Taxpayer:

> Instead of using the audit report, we ask that [the Department] examine the QuickBooks reports submitted. . . .Your examination will demonstrate that the expenses claimed are for ordinary and necessary expenses for [Taxpayer's] business. There are no personal expenses listed. The numbers from the Profit/Loss Statement . . . correspond with Schedule C. By applying this method of verification there will be no change to the tax return as originally filed, and there is no additional income tax duel.

Taxpayer provided copies of its QuickBooks statements providing "Transaction Detail by Date." The "cost of goods" sold indicated by Taxpayer's statement totals approximately $144,000 during 2014 which corresponds - according to Taxpayer - to the amount claimed as expenses on Taxpayer's Schedule C. The "cost of goods" sold indicated by Taxpayer's statement totals approximately $140,000 during 2015 which corresponds - according to Taxpayer - to the amount claimed as expenses on Taxpayer's Schedule C. Together with purchases of items which were resold in the business along with labor expenses, the amounts (approximately $153,000 and $155,000) claimed on Taxpayer's Schedule C reflect legitimate business costs ("cost of goods sold").

As a threshold issue, it is the Taxpayer's responsibility to establish that the assessment of 2014 and 2015 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, fn. 9 (Ind. Tax Ct. 2012). 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 investigation, are entitled to deference.

Taxpayer concludes that the audit's methodology mixed "apples and oranges." Taxpayer states that the hotel, concert tickets, shoes, and other personal expenses were never included in the business's cost of goods sold. A review of the QuickBooks statement largely bears out Taxpayer's contention because most of the expenses listed on those records are for purchases of pool supplies, equipment, or items readily associated with a swimming pool business.

The Department's Audit Division is requested to review the supplementary documentation provided by Taxpayer and to make whatever adjustments to the individual income tax assessments that are justified by that documentation and Taxpayer's accompanying explanation.

FINDING

Subject to review by the Department's Audit Division, Taxpayer's protest is sustained.

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