DEPARTMENT OF STATE REVENUE

01-20171012.LOF

Letter of Findings Number: 01-20171012
Individual Income Tax
For Tax Years 2011-15

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Individual provided sufficient documentation and analysis to establish that a portion of her protest was correct. Individual was correct that payments from a former spouse who is a resident of Japan did not constitute taxable income for her. The other portion of the instant protest was dependent on the outcome of a separate protest regarding a business owned by Individual. The relevant portion of that other protest was denied and so the corresponding portion of this protest was also denied.

ISSUE

I. Individual Income Tax–Adjustment.

Authority: IC § 6-3-1-3.5; 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); *Miles, Inc. v. Indiana Department of State Revenue*, 659 N.E.2d 1158 (Ind. Tax 1995); 45 IAC 3.1-1-1; 26 U.S.C. § 1041; Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, Nov. 6, 2003, S. Treaty Doc. No. 108-14.

Taxpayer protests the imposition of income tax.

STATEMENT OF FACTS

Taxpayers are two individual Indiana residents. As the result of an audit of a business owned by Taxpayers for 2014, 2015, and 2016, and an audit of Taxpayers' individual income taxes for the tax years 2011-15, the Indiana Department of Revenue ("Department") determined that Taxpayers had not reported the correct amount of income for the tax years 2011-15. Taxpayers protested the proposed assessments. Since most of Taxpayers' arguments address the circumstances of one of the taxpayers and not the other, this document will primarily refer to "Taxpayer." An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Individual Income Tax–Adjustment.

DISCUSSION

Taxpayers protest a portion of the proposed assessments for individual income tax for the tax years 2011-15. The Department based its determinations of tax due on a related audit of a business which Taxpayers owned and on the fact that one Taxpayer received payments from a former spouse who resides in a foreign nation which were not included as taxable on Taxpayers' returns. The Department added amounts equal to the business' additional income determined in the audit process and equal to the amounts of payments from the former spouse. Taxpayers protests that the business did not have the amount of additional sales as determined in the sales tax and income tax audits of the business and that the payments from Taxpayer's former spouse were exempt from taxation pursuant to the internal revenue code ("IRC") and a tax treaty between the United States and Japan.

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 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) states:

> (a) Each taxable year, a tax at the following rate of adjusted gross income is imposed upon the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every nonresident person:
> (1) *For taxable years beginning before January 1, 2015, three and four-tenths percent (3.4[percent])*.
> (2) For taxable years beginning after December 31, 2014, and before January 1, 2017, three and three-tenths percent (3.3[percent]).
> (3) For taxable years beginning after December 31, 2016, three and twenty-three hundredths percent (3.23[percent]).
> (*Emphasis added*).

IC § 6-3-1-3.5 defines adjusted gross income as:

> When used in this article, the term "adjusted gross income" shall mean the following:
> (a) *In the case of all individuals, "adjusted gross income" (as defined in Section 62 of the Internal Revenue Code)*, modified as follows:
> . . . .
> (*Emphasis added*).

45 IAC 3.1-1-1 further describes adjusted gross income:

> Adjusted Gross Income for Individuals Defined. For individuals, "Adjusted Gross Income" is "Adjusted Gross Income" as defined in Internal Revenue Code § 62 modified as follows:
> (1) Begin with gross income as defined in section 61 of the Internal Revenue Code.
> (2) Subtract any deductions allowed by section 62 of the Internal Revenue Code.
> (3) Make all modifications required by IC 6-3-1-3.5(a).

Both Taxpayer and the Department refer to section 1041 of the internal revenue code ("IRC").
26 U.S.C. § 1041 provides:

> Transfers of property between spouses or incident to divorce
>
> (a) General rule
> No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)–
> (1) a spouse, or
> (2) a former spouse, but only if the transfer is incident to the divorce.
>
> (b) Transfer treated as gift; transferee has transferor's basis
> In the case of any transfer of property described in subsection (a)–
> (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.
>
> (c) Incident to divorce
> For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer–
> (1) occurs within 1 year after the date on which the marriage ceases, or
> (2) is related to the cessation of the marriage.
>
> (d) Special rule where spouse is nonresident alien
> Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.

(e) Transfers in trust where liability exceeds basis
Subsection (a) shall not apply to the transfer of property in trust to the extent that–
(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds
(2) the total of the adjusted basis of the property transferred.
Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

Taxpayer argues that 26 U.S.C. § 1041(a) ("1041(a)") plainly states that no gain or loss shall be recognized if the transfer of property is between ex-spouses if the transfer is incident to a divorce. In the instant case, the payments were from Taxpayer's ex-spouse to Taxpayer incident to their divorce. Thus, Taxpayer believes, Taxpayer's gain from these payments should not be recognized.

The Department's audit disagreed, pointing to 26 U.S.C. § 1041(d) ("1041(d)"), which states that subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien. The Department is incorrect. The individuals referred to in 1041(d) are two spouses or former spouses. One of those people makes a payment and one of them receives a payment. As discussed in 1041(d), the provisions of 1041(a) do not apply if the former spouse of the individual making the payment is a nonresident alien. In the instant case, the former spouse (Taxpayer) of the individual making the payment (Taxpayer's former husband) is an American citizen, not a nonresident alien. Thus, the Department incorrectly flipped the requirements of 1041(d). Taxpayer is correct that 1041(d) does not nullify the provisions of 1041(a) in her case.

Also, the Department's audit report and Taxpayer's protest both refer to the Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, Nov. 6, 2003, S. Treaty Doc. No. 108-14 ("Tax Treaty"). In that document, Articles 17 and 18 provide:

ARTICLE 17

1. Subject to the provisions of paragraph 2 of Article 18, pensions and other similar remuneration, including social security payments, beneficially owned by a resident of a Contracting State shall be taxable only in that Contracting State.

2. Annuities derived and beneficially owned by an individual who is a resident of a Contracting State shall be taxable only in that Contracting State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during the life of the individual, or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

3. *Periodic payments, made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, including payments for the support of a child, paid by a resident of a Contracting State to a resident of the other Contracting State shall be taxable only in the first-mentioned Contracting State. However, such payments shall not be taxable in either Contracting State if the individual making such payments is not entitled to a deduction for such payments in computing taxable income in the first-mentioned Contracting State.*

ARTICLE 18

1. (a) Salaries, wages and other similar remuneration, other than a pension and other similar remuneration, paid by a Contracting State or a political subdivision or local authority thereof to an individual in respect of services rendered to that Contracting State or political subdivision or local authority thereof, in the discharge of functions of a governmental nature, shall be taxable only in that Contracting State.
(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other Contracting State and the individual is a resident of that other Contracting State who:

(i) is a national of that other Contracting State; or
(ii) did not become a resident of that other Contracting State solely for the purpose of rendering the services.

2. (a) Any pension and other similar remuneration paid by, or out of funds to which contributions are made by, a Contracting State or a political subdivision or local authority thereof to an individual in respect of services rendered to that Contracting State or a political subdivision or local authority thereof, other than payments made by the United States under provisions of the social security or similar legislation, shall be taxable only in that Contracting State.
(b) However, such pension and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other Contacting State.

3. *The provisions of Articles 14, 15, 16 and 17 shall apply to salaries, wages and other similar remuneration, and to pensions and other similar remuneration, in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof.* (*Emphasis added*).

The Department and Taxpayer agree that paragraph three (3) of Article 17 ("17(3)") of the Treaty provides that payments made by a spouse or former spouse pursuant to a separation or divorce are only taxable in the country of the spouse or former spouse making the payment and that this means that the income from these payments to Taxpayer are therefore exempt from taxation in the United States.

The Department, however, also referred to paragraph three (3) of Article 18 ("18(3)") of the Treaty, which provides that the provisions of Articles 14, 15, 16, and 17 shall apply to salaries, wages and other similar remuneration, and to pensions and other similar remuneration, in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof. The Department therefore considered that 18(3) limited the exemption provided in paragraph three 17(3) to salaries, wages and other similar remuneration, and to pensions and other similar remuneration. This, the Department concluded, did not include the payments made to Taxpayer since those payments did not arise as salaries, wages and other similar remuneration, and to pensions and other similar remuneration.

Taxpayer protests that the Department misapplied the provisions of the Treaty and that 17(3) is the only provision that applies to the payments at issue. After review of the two Treaty Articles in question, the Department agrees with Taxpayer. Article 18 of the Treaty clearly is designed to explain that salaries, wages and other similar remuneration, and pensions and other similar remuneration, are taxable in the contracting state in which they were paid, even if those salaries, wages, and pensions arose from an individual's employment by the government or political subdivision of one of the contracting states. In other words, under the Treaty, government employees' income is subject to tax by the country that employs them.

Under the fact pattern of the instant protest, the provisions of 18(3) are plainly designed to apply to paragraphs one (1) and (2) of Article 17 of the Treaty. Those paragraphs discuss salaries, wages, and pensions in general. 17(3) discusses the wholly different concept of payments resulting from a divorce or separation agreement, from one spouse or former spouse to another across international lines. To apply 18(3) to 17(3) would nullify 17(3). As the Indiana Tax Court explained in *Miles, Inc. v. Indiana Dept. of State Revenue*, 659 N.E.2d 1158, 1164 (Ind. Tax 1995), "The Court cannot presume the legislature intended to enact a nullity." Similarly, the Department will not presume that the United States government intended to ratify a treaty with the government of Japan that included a nullity. Therefore, Taxpayer is correct that 17(3) establishes that the payments from Taxpayer's former spouse do not constitute taxable income for Taxpayer.

The other protested category regarding individual income tax is the increase in income to the business owned by Taxpayer via a sales tax audit in which the Department determined that the business had unreported sales and thus unreported income from those sales. Since the business was an S corporation, the business' income passed-through to Taxpayer and was taxable on Taxpayer's individual return. Taxpayer protested, and the Department addressed, the issue of unreported business sales in a separate Letter of Findings. In that Letter of Findings, the Department partially sustained Taxpayer's protest and partially denied Taxpayer's protest. The portion of the protest which was denied was in regard to the Department's adjustment to underreported sales. The Department concluded that Taxpayer had not established that what it claimed were double-entries for credit card sales were actually double-entries. Therefore, since Taxpayer was denied in the Letter of Findings which discussed increased business sales, Taxpayer's protest of additional income passed-through to her as an individual is also denied.

In conclusion, Taxpayer is sustained regarding payments from her former husband. Those payments are not subject to income tax under both 26 U.S.C. § 1041(a) and paragraph three (3) of Article 17 of the Treaty. Taxpayer is denied regarding the additional income from additional sales for the S corp which Taxpayer owned. The Department will recalculate the amount of individual tax due and will issue new assessments.

FINDING

Taxpayer's protest is sustained in part and denied in part.

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An html version of this document.