

**Letter of Findings: 01-20170938
Individual Income Tax
For Tax Year 2007**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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's assessment of individual income tax was barred by the statute of limitations because Shareholder demonstrated that loans to Indiana Business were not fraudulent.

ISSUE

I. Statute of Limitations - Fraud.

Authority: I.R.C. § 1361; I.R.C. § 1362; IC § 6-3-1-3.5; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-2.8; IC § 6-8.1-10-4; IC § 6-8.1-5-1; IC § 6-8.1-5-2; *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 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 15-5-7](#).

Taxpayer, shareholder of an Indiana S Corporation, argues that she did not commit fraud by failing to report corporate loan proceeds as income, and therefore the Department's assessment of additional individual income tax was barred by the statute of limitations.

STATEMENT OF FACTS

Taxpayer is a shareholder in an Indiana S Corporation ("Corporation"). In 2016, the Indiana Department of Revenue ("Department") commenced an audit of the Corporation for the 2013 and 2014 tax years. In connection with the audit of the 2013 and 2014 tax years, the Department opened an audit of tax year 2007 to investigate the nature of three loans totaling \$990,000. As a result of the 2007 investigation, the Department determined that the \$990,000 was deemed a taxable distribution to Taxpayer and that she had fraudulently characterized this amount as loans. Although the assessment was made ten years after the year under investigation, the Department concluded that the statute of limitations was not applicable because Taxpayer committed fraud by failing to report the loan proceeds as income.

Taxpayer protested the proposed assessment. An administrative hearing was held. This Letter of Findings ensues and addresses Taxpayer's protest of the proposed assessment for the tax year 2007. Additional facts will be provided as necessary.

I. Statute of Limitations - Fraud.

DISCUSSION

As a result of an audit of Taxpayer's business for tax years 2013 and 2014, the Department opened an investigation into Taxpayer's individual tax liability for tax year 2007. The Department found that there were loans between Taxpayer and Taxpayer's business reported on the business's balance sheet. The Department concluded that these were not true loans to Taxpayer, but rather were taxable distributions to Taxpayer. The Department found that these transactions were fraudulent, thereby allowing the Department to assess additional income tax on Taxpayer beyond the statutory three- or six-year statute of limitations. The Department also imposed a one-hundred percent fraud penalty.

Taxpayer argues that the Department erroneously found that she committed fraud by failing to report the proceeds of three loans totaling \$990,000 as taxable income, thereby issuing her an assessment beyond the

three or six year statute of limitations. Taxpayer asserts that these were valid loans executed in 2007 between the business, Taxpayer, and third-party lenders in order for Taxpayer to purchase the Corporation from its previous owners.

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). 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); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

Indiana imposes an adjusted gross income tax on all residents. IC § 6-3-2-1. A taxpayer's Indiana income is determined by starting with the federal income and making certain adjustments. IC § 6-3-1-3.5. With regard to corporations and nonresidents, IC § 6-3-2-2 specifically outlines what is income derived from Indiana sources and subject to Indiana income tax. For Indiana income tax purposes, the presumption is that taxpayers properly and correctly file their federal income tax returns as required pursuant to the Internal Revenue Code. Thus, to efficiently and effectively compute what is considered the taxpayer's Indiana income tax, the Indiana statute refers to the Internal Revenue Code.

An S Corporation is a small business corporation which must meet certain statutory requirements and properly elect to be exempt from income tax for income tax purposes under I.R.C. §§ 1361 and 1362. An S Corporation generally does not pay taxes on its income. IC § 6-3-2-2.8; *see also* I.R.C. § 1361 *et seq.* Rather, the S Corporation's income subsequently passes through to its shareholders; its shareholders report and pay the income tax when they file their federal or state individual income tax returns. *Id.*

When a taxpayer files a fraudulent return, the Department may impose a one-hundred percent penalty, and the statute of limitations for assessments does not apply. IC § 6-8.1-10-4(a) states that, "If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty. (b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100[percent]) multiplied by: (1) the full amount of the tax, if the person failed to file a return; or (2) the amount of the tax that is not paid, if the person failed to pay the full amount of tax." With respect to the applicable statute of limitations, IC § 6-8.1-5-2 provides, in relevant part:

(a) Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or either of the following:

(1) The due date of the return.

...

(b) If a person files a return for the . . . adjusted gross income tax ([IC 6-3](#)) . . . that understates the person's income, as that term is defined in the particular income tax law, by at least twenty-five percent (25 [percent]), the proposed assessment limitation is six (6) years instead of the three (3) years provided in subsection (a).

...

(f) If a person files a fraudulent, unsigned, or substantially blank return, or if a person does not file a return, there is no time limit within which the department must issue its proposed assessment.

In order to make a finding that a taxpayer has committed fraud, the pertinent Indiana regulation, [45 IAC 15-5-7\(f\)\(3\)](#), states:

A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.

(A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the [D]epartment's regulations. Any failure to correctly report such

information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.

(B) **Scienter:** This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.

(C) **Deception:** Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the [D]epartment to believe a given set of facts which are not true, the person has deceived the [D]epartment.

(D) **Reliance:** Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the [D]epartment to rely on these acts to the detriment or injury of the [D]epartment, the reliance requirement of fraud will be met.

(E) **Injury:** The fraud instituted upon the [D]epartment must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the [D]epartment not to have collected the money which properly belongs to the state of Indiana.

In order to demonstrate fraud, the department is required to prove all of the above elements are present. **This must be shown by clear and convincing evidence. (Emphasis added).**

The Department relied upon IC § 6-8.1-5-2(f) in issuing an assessment ten years after the tax year at issue, necessarily relying upon its conclusion that Taxpayer engaged in fraud in failing to report the loan proceeds as income.

The Department has failed to substantiate its conclusion that Taxpayer committed fraud, as required by [45 IAC 15-5-7\(f\)\(3\)](#), by clear and convincing evidence. During the protest, Taxpayer provided copies of loan documents for the \$630,000 loan between a third-party lender and the Corporation, including a Corporate Resolution to Borrow/Grant Collateral/Subordinate Debt, Business Loan Agreement, Negative Pledge Agreement, Commercial Security Agreement, and Subordination Agreement. Taxpayer also provided a copy of the Installment Promissory Note documenting an installment loan between Taxpayer and the Corporation's sellers, in the amount of \$315,000. There is no other evidence that the entire \$990,000 loan proceeds were transferred to Taxpayer aside from the Corporation's internal accounting entries, which, as noted by the auditor, were subsequently amended. Additionally, the Installment Promissory Note is incorporated by reference into a Stock Purchase Agreement, which supports Taxpayer's assertion that the loan proceeds were used to acquire the Corporation and did not go to her personally. The loan documents are consistent with Taxpayer's assertion that she and the Corporation borrowed money from third-party lenders and the sellers in order to purchase the business in 2007. The promissory note, created at the behest of the auditor, cannot now be used as a basis for a finding of fraud and circumventing the statute of limitations, particularly where such promissory note was not required to document the nature of the loans executed by the Corporation and Taxpayer as borrowers in order to acquire the business. The inconsistent accounting entries, while concerning, are not sufficient to establish that the transactions were fraudulent by clear and convincing evidence.

The audit report also failed to substantiate a finding of scienter. The auditor stated that Taxpayer worked for a Certified Public Accountant ("CPA") in 2006 and 2007, and therefore should have "accounting knowledge." There is no connection between Taxpayer's work in a CPA's office—where she may or may not have been performing accounting work—and a finding of guilty knowledge of false information reported to the Department regarding her acquisition of a business. These facts do not constitute "clear and convincing evidence" that there was scienter, an element necessary for a finding of fraud.

The Department concludes that the loan proceeds at issue were borrowed by the Corporation and Taxpayer in order to purchase the Corporation from its previous shareholders. Because the audit investigation failed to substantiate a finding of fraud by clear and convincing evidence, the Department concludes that the associated assessment of income tax, interest and fraud penalty is barred by the statute of limitations.

FINDING

Taxpayer's protest is sustained.

June 1, 2018

Posted: 08/29/2018 by Legislative Services Agency

An [html](#) version of this document.