

Letter of Findings: 01-20181655
Individual Income Tax
For The Tax Years 2014, 2015, and 2016

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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Married couple provided sufficient documentation to support their position that they earned a lower amount of income during the investigation period. Therefore, the Department's assessment will be recalculated.

ISSUES

I. Individual Income Tax—Adjustment.

Authority: IC § 6-3-1-3.5; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014); *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*, 897 N.E.2d 289, 292 (Ind. Tax Ct. 2007); [45 IAC 2.2-6-8](#).

Taxpayers protest the Department's calculation of additional income tax.

II. Tax Administration—Penalty.

Authority: IC § 6-8.1-5-4; IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayers protest the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayers are a married couple who owned a restaurant. As a result of an investigation, the Indiana Department of Revenue ("Department") determined that Taxpayers underreported their individual Indiana income for tax years 2014, 2015, and 2016 ("Tax Years"). During the Tax Years, Taxpayers owned one restaurant ("Restaurant") that changed from a sole proprietorship to an LLC. From January 1, 2014, through October 31, 2015, Restaurant filed as a sole proprietorship. From November 1, 2015, through December 31, 2016, Restaurant filed as an LLC. The Department conducted separate sales tax audits for the sole proprietorship and for the LLC and as a result assessed sales tax for 2015-16.

The Department also conducted an investigation of Taxpayers' income tax for 2014-16 as a result of its determination that Restaurant had additional sales which would flow through to Taxpayers' individual income. Restaurant filed protests challenging the accuracy of the Department's assessments for sales tax for each audit. Restaurant waived its right to hearings and requested that the Department make its determinations based on the additional information it provided. Restaurant was partially sustained in both protests. Taxpayers in the instant protest argue that, since Restaurant successfully protested the Department's calculations of additional sales, there must also have been a lower amount of income to flow through to them. Taxpayers also elected to waive the administrative hearing in this protest. This Letter of Findings results and is based on the materials in the protest file. Further facts will be supplied as required.

I. Individual Income Tax—Adjustment.

DISCUSSION

The Department conducted an investigation based on two related sales tax audits showing that Restaurant failed to report all gross sales receipts for the tax years 2015 and 2016. Because Taxpayers operated as a sole

proprietorship and as an LLC, which are both pass-through entities, income from sales conducted at Restaurant flowed through to Taxpayers as individual income for purposes of income tax. Since the additional gross receipts yielded additional income for Taxpayers, the Department recalculated Taxpayers' income and determined that Taxpayers were disqualified from three tax exemptions. Also, since 2014 was not at issue in the sales tax audits, the Department averaged the amounts of additional sales for 2015 and 2016 and applied that number to Taxpayers' 2014 income calculations. Taxpayers protest the Department's calculation of additional income tax and also the resulting disqualification from the tax exemptions. The Department based its assessment on the best information available to it. Taxpayers state that they have other information which they believe supports their position.

As a threshold issue, it is the Taxpayers' 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 [D]epartment'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 (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.

Income tax liability for sole proprietors and LLCs is calculated at the individual level. IC § 6-3-1-3.5. Thus, Taxpayers' income tax liability during the Tax Years was always calculated at the individual level because Taxpayers operated Restaurant as a sole proprietor and then as an LLC. Because the two audits preceding this investigation showed that Restaurant underreported its taxable gross sales receipts, the Department concluded that Taxpayers must have underreported their adjusted gross income as well, since Taxpayers' income derived from sales at Restaurant.

While conducting the investigation, the Department determined that Taxpayer underreported its total income. IC § 6-8.1-5-1(b) provides that:

If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department.

Taxpayer must also provide documentation establishing that the Department's calculations were incorrect. IC § 6-8.1-5-4 states that:

(a) *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 canceled checks.*

(b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:

(1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or

(2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction.

In addition, if the limitation on assessments provided in section 2 of this chapter is extended beyond three (3) years for a particular tax liability, the person must retain the books and records until the assessment period is over.

(c) A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times.

(d) A person must, on request by the department, furnish a copy of any federal returns that he has filed. (*Emphasis added*).

In the course of the sales tax audits, the Department determined that Restaurant underreported sales for January through December 2015. Restaurant provided 183 days of z tapes for 2015. The Department determined that Restaurant was open for 313 days in 2015, reflecting that it was not open on Sundays. The Department used the available documentation to calculate average daily sales for 2015 and applied that amount to the total working

days in November and December 2015. The Department then subtracted the amount of sales tax which Restaurant had already reported for those months. The remaining amounts constituted the amounts of base sales tax in the proposed assessments. This process was repeated for the entire year of 2016, but with 217 days of z tapes.

Restaurant protested that the Department overstated the number of days the restaurant was open. In the course of the protest process, Restaurant provided a calendar which lists the days it states that it was open. Also, Restaurant provided a daily sales ledger which lists the total sales for each day that it was open. Restaurant states that the days with sales entries were days which the restaurant was open, while days with no entries were days which it was closed. This ledger, Restaurant argued, provides a much more accurate record of which days the restaurant was open and which days it was closed. Taking the daily average as calculated by the Department times the working days reflected in the sales ledger results in a lower amount of sales tax due.

After review of the material sent in during the protest process, the Department partially agreed with Restaurant's position. When read together with the available z tapes, the calendar and sales ledger satisfy the requirements of IC § 6-8.1-5-1(c). Restaurant was able to establish, through other documentation, the number of working days for the restaurant for those two years. Thus, the Department will use the daily sales amount as determined in the audit and the number of working days for 2015 and 2016 as established by Restaurant in the course of the protest process to recalculate the amount of unreported sales. Also, since 2014 was not at issue in the sales tax audits, Restaurant did not establish a specific number of days it was open that year. Therefore, the Department will average the amount of additional sales from 2015 and 2016 after recalculating those amounts as determined in the two sales tax Letters of Findings. That amount will then be applied to the Department's calculations of income that should have been reported by Taxpayers for 2014.

Because the Department will recalculate the amount of sales at Restaurant for 2014-16, it will also recalculate the amount of income tax Taxpayers owe since Restaurant's sales flow through as Taxpayers' income. If the recalculated assessment qualifies Taxpayer for the income tax exemptions previously denied by the Department, the Department will readjust those exemptions as well. Taxpayers have met the burden of proving the proposed assessments wrong, as provided by IC § 6-8.1-5-1(c), to the extent that Restaurant's sales are reduced as a result of Restaurant's two sales tax protests.

FINDING

Taxpayers' protest is sustained in part.

II. Tax Administration—Penalty.

DISCUSSION

Taxpayers request that the Department waive the negligence penalty. Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a negligence penalty if the taxpayer:

- (1) fails to file a return for any of the listed taxes;
- (2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;
- (3) *incurs, upon examination by the department, a deficiency that is due to negligence;*
- (4) fails to timely remit any tax held in trust for the state; or
- (5) is required to make a payment by electronic funds transfer (as defined in [IC 4-8.1-2-7](#)), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.
(*Emphasis added*).

[45 IAC 15-11-2](#)(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty when a taxpayer establishes that its failure to pay a tax was due to reasonable cause and not due to negligence. [45 IAC 15-11-2\(c\)](#). The taxpayer must demonstrate that it exercised ordinary business care in carrying out or failing to carry out a duty giving rise to the penalty. Reasonable cause is fact sensitive and will vary based on the facts of each individual case.

In this instance, Taxpayers have not demonstrated that their actions were reasonable as described in [45 IAC 15-11-2\(c\)](#). Restaurant was operated as a sole proprietorship and an LLC. Taxpayers did not ensure that Restaurant kept adequate records, as required by IC § 6-8.1-5-4(a). As a result of the inadequate record-keeping, Taxpayers did not report an accurate amount of income tax. This constitutes negligence under [45 IAC 15-11-2\(b\)](#). Therefore, penalty was properly imposed under IC § 6-8.1-10-2.1(a). However, since the base tax will be reduced, as provided in Issue I above, penalty will be recalculated to reflect that reduced amount of income tax due.

FINDING

Taxpayers' protest of the negligence penalty is denied.

SUMMARY

Taxpayers are sustained in part and denied in part on Issue I regarding the imposition of additional income tax. Taxpayers are denied on Issue II regarding the imposition of penalty.

July 31, 2018

Posted: 09/26/2018 by Legislative Services Agency
An [html](#) version of this document.