

**Letter of Findings: 01-20191343  
Individual Income Tax  
For the Years 2016 and 2017**

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Food Delivery Business Owner was not entitled to deduct as "ordinary and necessary business expenses," voluntary gratuities paid to his S-Corporation's independent delivery persons. However, the S-Corporation was required to remove from his business's adjusted gross income the amount of gratuities intended for the delivery persons and to issue corrected 1099 forms reflecting those amounts.

### ISSUES

#### **I. Individual Indiana Income Tax - S-Corporation Business Expenses.**

**Authority:** IC § 6-3-1-3.5(b); 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); I.R.C. 162(a); Treas. Reg. § 1.162-1; [45 IAC 3.1-1-8](#).

Taxpayer argued that the Department erred in disallowing business expenses claimed by his S-Corporation.

#### **II. Individual Indiana Income Tax - Ten-Percent Penalty.**

**Authority:** IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); [45 IAC 15-11-2\(b\)](#); [45 IAC 15-11-2\(c\)](#).

Taxpayer maintains that he is entitled to abatement of the ten-percent penalty.

### STATEMENT OF FACTS

Taxpayer is an Indiana individual who is sole owner of a food delivery business ("Delivery Business"). Delivery Business is organized as an S-Corporation. Delivery Business delivers restaurant meals to customers. The meals are purchased from various local restaurants. Delivery Business's employees collect the food from the local restaurants and deliver it to the individual customers.

Delivery Business charges its customers for the cost of the restaurant meals along with a delivery charge. The delivery charge is a fixed fee which increases incrementally depending on the distance from the restaurant providing the food to the customer's address. Depending on the distance from the source restaurant to the customer's front door, Delivery Business charges its customers a minimum delivery fee of \$5.99 up to \$20.00. Upon receiving the food, the customer may decide to include a gratuity for the delivery person. The amount of the gratuity - if any - is entirely discretionary with the customer. Customers may decide to pay the delivery person in cash or may use a credit card.

In an audit review of Delivery Business's tax returns and tax records, the Department determined that Delivery Business over-stated the amount of business expenses claimed on Delivery Business's 2016 and 2017 tax returns. A subsequent decision disallowing a portion of the expenses claimed by Delivery Business increased the amount of income which flowed through from the Delivery Business to Taxpayer. The Department assessed Taxpayer additional individual income tax.

Taxpayer disagreed with the proposed assessment and submitted a protest to that effect. An administrative

hearing was conducted during which Taxpayer explained the basis for the protest. This Letter of Findings results.

## **I. Individual Indiana Income Tax - S-Corporation Business Expenses.**

### **DISCUSSION**

The issue is whether Taxpayer has established that it is entitled to claim the entire amount of "ordinary and necessary" expenses originally claimed on its Delivery Business's tax returns.

Taxpayer states that his Business's delivery persons are paid two amounts for each delivery. According to Taxpayer, the delivery person is entitled to a fixed five-dollar portion of each "delivery charge." The delivery person is also entitled to the entire gratuity amount whether that gratuity is provided in cash or designated as such on the customer's credit card receipt.

For example, assuming a customer is charged \$50 for the price of a restaurant meal delivered to the customer's front door. That \$50 amount includes the price of the meal along with the delivery charge. Whether the delivery charge is \$5.99 or \$20.00 or increments in between, the delivery person is paid \$5 for his or her trouble.

At the end of each week, Delivery Business pays its delivery persons in cash reflecting the total weekly \$5.00 delivery charges and each delivery person's own gratuities reflected on the credit card receipts.

The Delivery Business's tax return claimed approximately \$1,000,000 each year for both 2016 and 2017 as reflected on the returns' IRS Form 1125-A (Cost of Goods Sold - Cost of Labor). According to the audit report, the Delivery Business's representative explained that the \$2,000,000 expense represented "the total paid to delivery drivers (independent contractors). The [\$2,000,000] shown on this schedule represents all payments to drivers including trip fees and tips." The Department's audit found fault with Taxpayer's claim to the \$2,000,000 cost of goods sold/labor expense. As explained in the Delivery Business's audit report:

A review of the 1099's [Miscellaneous Income] revealed that the 1099's did not match the amount deducted in the Cost of Goods sold. The audit is making adjustments to the cost of labor to reduce it to the verifiable amount (the 1099's) . . . . As a result . . . an audit adjustment is being made to disallow these expenses which have been improperly deducted in determining the [Delivery Business's] Indiana adjusted gross income, which were not ordinary and necessary business expenses under IRC 162.

The Department disallowed approximately \$870,000 of the originally claimed labor expenses which represented the difference between the expenses claimed on the Delivery Business's IRS Form 1125-A and the total amount included on the Form 1099s.

According to Taxpayer, the \$870,000 represents the amount of gratuities paid to its delivery persons during 2016 and 2017. The discrepancy exists because Delivery Business did not include tips paid its delivery persons on the original 1099s. Nonetheless, Taxpayer asserts that the Delivery Business is entitled to claim the \$870,000 as an ordinary and necessary business expense and that the Department's position to the contrary is unwarranted. As explained by Taxpayer:

[T]he information and documentation provided illustrates the [Delivery Business] received tips on certain deliveries and those tips were passed along to the drivers that made the delivery. As a result [Delivery Business] included the tips received as an income item on its federal and state returns, and also properly took a deduction for such amounts since they were paid to the drivers. There is no question that such costs are ordinary and necessary business expenses for [Delivery Business], and the company has provided more than sufficient information to verify such expenses.

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, fn. 9 (Ind. Tax Ct. 2012).

In considering Taxpayer's argument, the Department bears in mind that "when [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 are entitled to deference.

As noted above, the issue is attributable to amounts claimed by Delivery Business as "ordinary and necessary" business expenses. Under Treas. Reg. § 1.162-1, a taxpayer, whether a corporation, an individual, partnership, or a trust or estate, generally may deduct from its gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred during the tax year.

Specifically, I.R.C. § 162(a) provides in part:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered[.]

Indiana law, IC § 6-3-1-3.5(b), provides the starting point for determining Taxpayer's taxable income, stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows . . . ." The Department's Administrative Rules repeat this basic principle at [45 IAC 3.1-1-8](#) stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code - section 63) with three adjustments . . . ." Thus, a taxpayer's federal "adjusted gross income" is merely the starting point to calculate what would be the taxpayer's Indiana income tax; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point.

Taxpayer claims that it can document the \$870,000 in gratuities it paid its delivery persons. To that end, it has provided a copy of its "Driver Training Guide" which explains that "Your earnings consist of Delivery Fees (\$5.00), Distance Fees and Tips." The written agreement with those delivery persons states:

As full compensation for the services rendered pursuant to this Agreement, the Company shall pay the Driver a Delivery Fee which is determined by the Company and may not be the actual fee charged to the customer. The amount is the driver's fee for making the run. In addition, all tips and distances accrued will be retained by the Driver. The current amount of the fee provided to the Driver is \$5.00 per restaurant/per run, subject to change.

Taxpayer also provided a list of its 90-some delivery persons detailing the amounts paid each employee. That list separates amounts paid by delivery fees and gratuities.

In addition, Taxpayer provided a written example of how it calculates each delivery person's payment. The example lists amounts of cash tips, credit card tips, and total delivery fees.

After considering the audit report and Taxpayer's protest, the Department does not agree that Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that the original assessment was wrong based on the arguments raised. Admittedly, Taxpayer's Delivery Business remitted to its drivers both the amount of delivery fees and the cash and credit card tips. However, the payments do not constitute "salaries or other compensation for personal services" under Treas. Reg. § 1.162-1, because the gratuities do not constitute "labor" costs. Instead the gratuities are not part of the adjusted gross income received by Taxpayer's business; the voluntary gratuities belong - and always belonged - to the delivery persons even though held by the business on behalf of the delivery persons.

However, the Department's holding permits Taxpayer to amend his business's 2016 and 2017 income tax removing the \$870,000 in tips from the reported amount of adjusted gross income. Taxpayer must also issue its delivery persons corrected 1099s reflecting the amounts paid those persons during the years at issue.

The Department does not agree with Taxpayer's analysis of the issue. Subject to the results of a supplemental audit review of Taxpayer's records verifying the \$870,000 reduction in 2016 and 2017 adjusted gross income, the amended returns will fairly and accurately reflect the income received by the business.

## FINDING

As to the substantive issues raised in his protest, Taxpayer's protest is respectfully denied. However, the Department concludes that removing the discretionary gratuities from the business's adjusted gross income properly addresses Taxpayer's underlying concerns.

## **II. Individual Indiana Income Tax - Ten-Percent Penalty.**

### **DISCUSSION**

The issue is whether Taxpayer has provided sufficient grounds which would justify the Department abating the ten-percent negligence penalty.

Taxpayer believes that it is entitled to abatement of the ten-percent negligence because the penalty was "illegal and contrary to law," because Taxpayer consistently exercised the care and diligence expected of any ordinary taxpayer, and because the Department has not met its own burden of "substantiat[ing] the imposition of penalties."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "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."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation [45 IAC 15-11-2](#)(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

Departmental regulation [45 IAC 15-11-2](#)(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including any negligence penalty - is presumptively valid.

The Department does not agree that Taxpayer "exercised ordinary business care and prudence" in reporting his individual income because Taxpayer initially failed to file his 2010 Indiana income tax return. Although the resulting 2010 assessment is not directly addressed in this Letter of Findings, the sheer failure to file a 2010 return was only discovered during the audit which led to this protest. In addition, Taxpayer - as Delivery Company's sole owner - substantially under-reported the amount of income paid to his 90-some delivery persons.

As a practical consequence, the penalty is applicable to the amount - if any - that remains upon completion of the supplemental audit called for in Part I above.

### **FINDING**

Taxpayer's protest is denied.

### **SUMMARY**

Taxpayer's Delivery Business is not entitled to claim as a necessary and ordinary business expense of the amount gratuities paid to his Business's independent drivers. Taxpayer did not establish it was entitled to abatement of any residual negligence penalty.

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