

Letter of Findings: 02-20210028
Indiana Corporate Income Tax
For the Years 2017 and 2018

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

By operating its business on a substantially cash basis and because of what the Department's audit concluded were inadequate sales and purchase documentation, the Department was unable to agree with Indiana Coin Dealer that it met its burden of establishing that the imposition of additional corporate and individual income tax should be abated.

ISSUE

I. Indiana Corporate Income Tax - Calculating Gross Revenue.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; IC § 6-8.1-5-4; IC § 6-8.1-10-2.1; *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); [45 IAC 3.1-1-66](#); [45 IAC 3.1-1-67](#).

Taxpayer argues that the Department erred in assessing it additional corporate income tax after finding that Taxpayer underreported gross sales on its Indiana income tax.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of buying and selling rare and collectible coins. Taxpayer is organized as a limited liability company and elected to be taxed as an S-Corporation. Taxpayer is owned by two shareholders. Taxpayer routinely files IT-20S returns. (Indiana S Corporation Income Tax Return).

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records, Indiana returns, and its federal returns. In conducting that routine review, the Department examined "workpapers, bank statements, general ledgers, sales tax returns and purchase invoices."

The audit concluded that Taxpayer "underreported its gross sales on the 1120S" (U.S. Income Tax Return for an S Corporation.) After consulting with Taxpayer's representative, the Department chose to closely review "sampled months" and calculated an error percentage of approximately 6 percent for 2017 and approximately 5 percent for 2018. In addition, the audit found that Taxpayer was unable to account for all business checks written out to "cash."

As a result, the Department issued Taxpayer a minor assessment of additional Indiana income tax; more significantly, the audit's adjustment resulted in an assessment of individual income tax for one of the two shareholders. That individual Shareholder adjustment is addressed separately.

Nonetheless, 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. Indiana Corporate Income Tax - Calculating Gross Revenue.

DISCUSSION

The issue is whether Taxpayer has met its burden of establishing the assessment of additional tax was wrong

because its original tax returns correctly reported the amount of its gross retail sales.

A. Burden of Proof.

As a threshold issue, it is the Taxpayer's responsibility to establish that the corporate tax assessments are 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).

With that threshold burden in mind, 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, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

B. Indiana's Corporate Tax for S-Corporations and their Shareholders.

IC § 6-3-2-1(b) imposes a tax on every corporation's "adjusted gross income derived from sources within Indiana." IC § 6-3-2-2 provides that a corporation has "adjusted gross income from sources within Indiana" when the corporation's Indiana apportionment factors result in deemed Indiana business income or nonbusiness income that is allocated to Indiana. IC § 6-3-1-3.5(b) defines adjusted gross corporate income "the same as 'taxable income' as defined in Section 63 of the Internal Revenue Code)" with certain adjustments or modifications as required under Indiana law.

As provided for in [45 IAC 3.1-1-66](#) and [45 IAC 3.1-1-67](#), S-Corporations are generally not subject to tax but S-Corporations, incorporated in Indiana or receiving Indiana source income, must file annual returns. Those annual returns report income passed through to the shareholders; those shareholders are subject to tax on their distributive shares of the S-Corporation's income.

The Department's audit noted that Taxpayer failed to file a 2017 composite return for its nonresident shareholder but chose not to assess the IC § 6-8.1-10-2.1(j) "failure to file penalty."

C. The Department's Audit Findings.

In general, the Department's audit found that Taxpayer's gross earnings were understated and adjusted the amount of earnings originally reported. In attempting to correct that error, the audit first addressed Taxpayer's "cost of goods sold" (COGS).

Taxpayer calculated its COGS "by taking total purchases by check plus checks written to 'cash from the business bank account.'" Taxpayer believed that its COGS was understated due to underreported cash purchases. Taxpayer believed this was appropriate because "using the [T]axpayer's method of calculating COGS all cash purchases would be accounted in the total." The audit found fault stating "the [T]axpayer is considering all written to 'cash' to be used for purchasing inventory." The audit report summarizes its objection as follows:

Without substantiation, the [T]axpayer is also asking to use all the cash from unreported sales as cost of goods sold as well. However, the [T]axpayer's representative could not provide source documentation which definitively showed that there were unreported cash purchases.

The audit report reflects Taxpayer's efforts to clarify the issue.

The Taxpayer's representative sent a summary of purchases, printouts of the general ledger and some scanned copies of invoices to point out the underreported cash purchases.

The audit's response was that the additional information contained "purchases mentioned that the auditors had not recorded during the audit, either as a purchase OR as a sale indicating that not all invoices were provided during the audit examination."

The Department's audit concluded as follows:

In conclusion, the [T]axpayer's records were deemed to be unreliable due to the many irregularities noted. These included the incomplete records for each month's sales and the fact that there were purchase invoice tickets mixed in with sales invoices and these purchases were not originally marked as purchases. The auditors did give the [T]axpayer the benefit of the doubt on these items and duly adjusted the sales down as discussed above. *However, without source documentation the auditors cannot agree that the exact same amount of unreported cash sales equals unreported cash purchases. (Emphasis added).*

D. Indiana's Record Keeping Requirements.

Because the audit raised issues regarding Taxpayer's record keeping process, this is an appropriate spot in which to set out Indiana's requirements.

"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 tax by reviewing those books and records." IC § 6-8.1-5-4(a). In addition, IC § 6-8.1-5-4(c) provides that, "A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times."

E. Taxpayer's Arguments that it Correctly Reported Gross Receipts on its Original Returns.

(1) The Particulars.

Taxpayer outlined its accounting of unrecorded cash disbursements and whether or not the disbursements were for the purchase of goods during 2017 and 2018.

Taxpayer finds fault with the audit report's argument that not all "documents were made available during the initial stage of field work and copies [of] purchase tickets were then provided by email at a later date." Taxpayer emphasizes that, "No documents were withheld at any point in time during the audit." Taxpayer asserts that it supplied the audit with over 1,800 documents which were provided both on paper and again electronically.

Taxpayer claims that its "cash purchases" were well documented on "manually prepared documents." Each purchase was "checked to indicate whether it is a consignment sale, an appraisal, a layaway, a return, a purchase, plus whether it is a cash transaction or if a check is paid or received." Taxpayer points out that all the cash purchase documents "were available to the auditors during the initial field work stage."

Taxpayer questions the audit's analysis of Taxpayer writing checks out to "cash." Taxpayer disagrees with the audit's assertion that they represent "claimed unrecorded cash purchases." Taxpayer explains:

The source of this cash was [from] the Company's checking account which came from deposited cash, check, and credit card sales; drawing on the Company's line of credit; and from direct owner contributions [such as] redeposited paychecks and expense reimbursement checks . . .

In addition, Taxpayer explains that owner of the store periodically wrote personal checks out to "cash" amounts which were then "used in the store for making purchases."

Another remaining source of checking account money "would be cash retained from cash sales and later used to make purchases."

Taxpayer objects to the audit's assertion "that [T]axpayer is also asking to use all the cash received from these unreported sales as cost of goods sold as well." Taxpayer disagrees explaining that one of the sources of the cash used to make cash purchases was from checks written to 'cash' and posted to the account as 'shop cash.'" As to this issue, Taxpayer concludes "that unrecorded cash purchases was perhaps a better measure of unreported sales [then] the projection obtained from using block samples."

Taxpayer vehemently objects to the audit's statement that "the [T]axpayer's records were deemed to be unreliable due to the many *irregularities* noted." (*Emphasis added*). Taxpayer complains it had "no such intent nor were actions taken with the intent to perpetuate by the [Taxpayer] at any point in time prior, during, or after the course of the audit."

(2) In General.

Taxpayer states firmly that it supplied "**all records** to the auditors, both during the initial field work and also by email" (**Emphasis in original**) Taxpayer states its accounting records "were reconciled to cash and credit card statements and a physical inventory" Moreover, Taxpayer defends its accounting methods stating that, "Procedures for tracking purchases, while manual, were in place and the available evidence in the sheer volume of them suggests [the] procedures were routinely used to document a purchase thereby increasing the reliability of the claim the existence of for cash purchases."

The result was that Taxpayer has reexamined its purchases, sales, cash transactions, and bank accounts and concluded that both original returns were in error. Not only does it not owe additional tax, but it actually sustained business losses during both 2017 and 2018. Presumably, both Shareholder and Taxpayer are owed refund amounts or credits.

F. Analysis and Conclusion.

Taxpayer admits it conducted approximately \$140,000 in cash transactions during 2017 and approximately \$136,000 in cash transactions during 2018. During 2017, Taxpayer reported approximately \$400,000 in total sales, and approximately \$315,000 in 2018 sales. This means that approximately 35 percent of Taxpayer's 2017 transactions were conducted on a cash basis; approximately 43 percent of Taxpayer's 2018 transactions were conducted on a cash basis. In addition, Taxpayer intermingled the Shareholder's own assets (paychecks and personal reimbursements) into Taxpayer's business account.

This practice has the potential to render an accurate accounting difficult and imprecise. The Department questions whether Taxpayer has fulfilled its statutory obligation under IC § 6-8.1-5-4(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 tax by reviewing those books and records.

IC § 6-8.1-5-4(a) specifically requires that a business's "books and records" must be such that the Department can determine "*the* amount" of taxes due not "*an* amount" of taxes due. The Department determined that Taxpayer and its Shareholder owe additional tax while Taxpayer has set forth a competing calculation in which both Taxpayer and its Shareholder are entitled to a refund or credit.

This administrative protest has three possible outcomes: (1) the Department's audit was correct and both Taxpayer and its Shareholder owe additional tax money; (2) Taxpayer's recalculation is correct, and the Department owes Taxpayer and its Shareholder refunds or credits; or (3) this Letter of Findings must - by relying on its unique insight, experience, and wisdom - pick a number somewhere in between and conclude that particular number represents the correct amount of tax due.

Taxpayer makes thoughtful and detailed arguments, but the Department is unable to agree that Taxpayer has met its burden of establishing that assessment was *wrong* as required under IC § 6-8.1-5-1(c). Furthermore, the Department must decline to exercise the "pick a number" option. Therefore, the Department's original assessment remain correct, as provided by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is respectfully denied.

July 8, 2021

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