

TAX APPEAL BOARD OF THE STATE OF DELAWARE

OCT 31 2007

STEPHEN R. SIMPSON and VISIONS UNLIMITED, INC.)
)
 Petitioners,)
)
 v.)
)
 DIRECTOR OF REVENUE,)
)
 Respondent.)

Docket No. 1444

BEFORE: Todd C. Schiltz, Esq. Chairman, and Regina Dudzic,
Cynthia L. Hughes and Joan M. Winters, CPA, Members

Chris D. Galligan, CPA, for Petitioner.

Jos. Patrick Hurley, Esq., Deputy Attorney General for Respondent.

DECISION AND ORDER

This matter comes before the Board on cross motions for summary judgment and presents two questions for resolution. First, did petitioner Visions Unlimited, Inc. ("Visions") receive proper notice of a tax assessment by the respondent Director of Revenue ("Director") such that Visions' failure to protest the assessment within 60 days after the mailing of the Notice of Assessment divests this Board of jurisdiction over this dispute. Second, did the Director properly assess tax, penalty and interest against Visions, a subchapter S corporation, for its failure to report income attributable to its nonresident individual shareholder and to make payments to cover the taxes the individual shareholder must remit to Delaware. For the reasons set forth below, the Board concludes that (i) Visions did not receive adequate notice of the tax assessment because the Director did not mail the Notice of Assessment to Visions' last known address and, therefore, the Board has jurisdiction to consider this matter and (ii) the Director properly assessed tax, penalty and interest against Visions for its failure to comply with 30 *Del. C.* § 1158(a).

FACTS

Visions is a subchapter S corporation with a single stockholder, Stephen R. Simpson. Mr. Simpson is domiciled in Cochranville, Pennsylvania, and therefore a nonresident for purposes of the Delaware Tax Code. 30 *Del. C.* §§ 1103, 1104.

On or about March 12, 2005, Visions sent the Director a request for an extension of time to file its 2004 corporate tax return. This request listed Visions' address as a P.O. Box in West Grove, Pennsylvania ("West Grove Address"). On or about May 15, 2005, Visions filed its 2004 S Corporation Reconciliation and Shareholder Information Return. Visions checked the "change of address" box on this return and listed Mr. Simpson's Cochranville home address ("Cochranville Address") as the company's new address.

Visions' 2005 S Corporation Reconciliation and Shareholder Information Return (the "2005 Return") was due on April 1, 2006. Visions did not file its 2005 Return on that date and did not receive an extension of time to file. On or about May 9, 2006, Visions filed its 2005 Return. The 2005 Return listed the Cochranville Address as the company's address.

The 2005 Return indicated that Visions had earned \$8,738 from operations in Delaware that was available for distribution to Visions' sole shareholder, Mr. Simpson. On the lines of the 2005 Return titled "Percentage of stock owned by non-residents," "Distributive income attributable to non-resident shareholders," and "Tax due on behalf of non-resident shareholders (Line 7 x 5.95%)", Visions put the figures 0.00%, 0.00 and 0.00, respectively. This is incorrect as Mr. Simpson, a nonresident, owns 100% of Visions. Visions should have completed these lines with the following information: 100%, \$8,738.00 and \$520. As shown below, pursuant to 30 *Del. C.* § 1158(a) and the statutes it incorporates, the \$520 is the amount Visions was required to pay Delaware to cover taxes due from Mr. Simpson for 2005.

In April 2006, Mr. Simpson and his wife filed their Individual Non-Resident Income Tax Return Form 200-02 for the year ended December 31, 2005 ("Simpson 2005 Return"). The Simpson 2005 Return indicated that they owed Delaware \$334 for activities occurring in Delaware. If Visions had followed the statutory scheme and paid Delaware the \$520 it was required to pay on behalf of Mr. Simpson, the Simpsons would have been entitled to a refund of the difference between the \$520 paid to Delaware on their behalf and the \$334 that they owed Delaware. As Visions had not submitted the \$520, the Simpsons paid the \$334 that they owed by check dated April 13, 2006.

On or about June 21, 2006, the Director sent Visions a Notice of Assessment indicating that Visions owed tax of \$520, penalties of \$54.60 and interest of \$15.60. The tax, penalties and interest were due as a result of Visions' failure to pay the tax due on Delaware sourced distributions available to Mr. Simpson, a nonresident. The Notice of Assessment was sent to the West Grove Address, not the Cochranville Address. Visions did not receive the Notice of Assessment and it was returned to the Director as undeliverable.

On or about September 21, 2006, the Director sent Visions a letter indicating that it owed Delaware a tax debt and that the Director intended to submit this debt to the U.S. Department of Treasury for offset against any federal income tax refund that may be available to Visions. This letter was sent to Visions at the Cochranville Address, and was the first notice Visions received regarding its failure to pay taxes on behalf of Mr. Simpson. The letter advised Visions to contact the Division of Revenue if it felt the tax was not due and included pertinent contact information.

Upon receipt of this letter, Visions promptly contacted the Division of Revenue indicating that it did not owe the amounts in dispute. By letter dated October 31, 2006, the Director responded to this inquiry by sending Visions a Notice of Determination which rejected

Visions' protest. Visions then filed a timely petition before the Board claiming, among other things, that the Director erred by assessing it with tax, penalties and interest. The Director answered the petition by denying its material allegations and asserted as affirmative defenses that the Board lacked jurisdiction over this matter as Visions had failed to respond to the Notice of Assessment within 60 days of its mailing and, thus, the assessment became final pursuant to 30 *Del. C.* § 522.

The parties have engaged in discovery and Visions has now received a copy of the Notice of Assessment the Director sent to the West Grove Address. The Notice of Assessment details that, as of June 21, 2006, the Director was seeking \$520 in tax, "2 months penalty at 5.000000% per month", "1 month failure to pay penalty at 0.500000% per month" and "3 months interest at 1.000000% per month."

The parties have cross moved for summary judgment on the Director's affirmative defenses and on Visions' contention that it does not owe the tax, penalty or interest at issue. This is the Board's final decision on these issues.¹

¹ Visions' petition raises a number of issues regarding to the tax, interest and penalties assessed by the Director. Most of these issues were not raised in Visions' brief in opposition to the Director's cross motion for summary judgment and, as a result, are deemed to have been abandoned. *Martinez v. General Motors*, 919 A.2d 561 (Table), 2007 WL 521906 at *3, n. 28 (Del. 2007); *Reeder v. State*, 900 A.2d 101 (Table), 2006 WL 1210986 at *2 (Del. 2006); *Forsythe v. ESC Fund Management Co. (U.S.), Inc.*, 2007 WL 2982247 at *11, n. 64 (Del. Ch.) ("[i]t is settled Delaware law that a party waives an argument by not including it in its brief" (internal quotations, citations omitted)); *State v. Zebroski*, 2001 WL 1079010 at *1 (Del. Super. 2001).

Even if Visions had not abandoned these issues and had raised them in response to the Director's motion for summary judgment, they would not alter the result here. For example, Visions' request that the Board declare Section 1158 unconstitutional is not within the power of the Board. *M. Fierro & Sons, Inc. v. Division of Revenue*, 1998 WL 109306 at *1 (Del. Super. 1998); *Delaware Bankers Ass'n v. Division of Revenue*, 298 A.2d 352, 356-57 n.2 (Del. Ch. 1972). Likewise, Visions' assertion that Section 1158(a) violates 30 *Del. C.* § 1621(a) is simply incorrect. Section 1621(a) prohibits the imposition of income taxes on pass through entities such as subchapter S corporations.

ANALYSIS

A. The Director's Notice Was Not Sent To Visions' Last Known Address and, Therefore, Visions' Failure to Timely Contest the Assessment Does Not Deprive the Board of Jurisdiction

The process the Director and taxpayers must follow with respect to asserting and responding to tax assessments is set forth at 30 *Del. C.* §§ 521-545. These statutory provisions require the Director to examine returns and determine the correct amount of tax due and provide the taxpayer with notice of any proposed assessment. The taxpayer, in turn, must protest any assessment within 60 days (in most instances) from the date the assessment is mailed. The failure to protest the assessment within 60 days results in the assessment becoming final. When the assessment is final, this Board lacks jurisdiction to hear a taxpayer's appeal of the assessment.

If the taxpayer timely protests the assessment, then the Director must reconsider the assessment and make a final determination on the issue. Once a final determination has been issued, the taxpayer has 60 days (in most instances) to file a petition with the Board challenging the Director's final determination. If the taxpayer does not file a timely petition, the determination is final and the Board lacks jurisdiction to hear any appeal of the determination.

Section 1158(a) does not impose income tax on *Visions* or any other subchapter S corporation. Rather, Section 1158(a) merely requires subchapter S corporations to remit payments on behalf of and for the benefit of their nonresident individual shareholders. These payments cover the income tax these individuals otherwise would have to pay on their own behalf and are not a tax on *Visions'* income.

Here, Visions did not protest the Notice of Assessment within 60 days after the date it was mailed. The Notice of Assessment was mailed to the West Grove Address, not the Cochranville Address. Section 521(c) of the Delaware Tax Code requires the Director to mail the notice "to the taxpayer at the taxpayer's last known address." 30 *Del. C.* § 521(c). Prior to the mailing of the Notice of Assessment, Visions had filed two tax returns listing the Cochranville Address as its address and one of those tax returns expressly indicated that Visions was changing its address. Under these circumstances, Visions' last known address at the time the Director sent the Notice of Assessment was the Cochranville Address.

Given the Director sent the Notice of Assessment to the incorrect address, he cannot be heard to complain that Visions did not timely protest the assessment. Hence, summary judgment is awarded in favor of Visions on the Director's affirmative defenses.

B. The Director Properly Assessed Tax, Penalty and Interest against Visions

Visions argues that any failure by it to comply with Delaware law regarding the payment of income taxes on behalf of its nonresident individual shareholder is of no moment because, in the end, Mr. Simpson paid Delaware \$334, the full tax that he will owe for 2005. This payment, Visions believes, effectively negates any claim the Director has against Visions because if it were to pay the taxes at issue, then Mr. Simpson could then file an amended 2005 tax return pursuant to which he would be entitled to a refund of any difference between what Visions pays and \$334, the full amount Mr. Simpson owes in Delaware income taxes for 2005. Visions' argument fails to take into consideration the penalties and interest which can be assessed against it and relies on the faulty premise that a subchapter S corporation can ignore the statutory scheme Delaware has established with respect to such corporations so long as its nonresident shareholder directly pays any taxes he/she owes.

1. The Statutory Scheme

Subchapter S corporations are exempt from Delaware corporate income tax. 30 *Del. C.* § 1902(b)(9). However, to the extent such corporations derive income from within Delaware as determined in accordance with 30 *Del. C.* § 1124 and to the extent corporations have nonresident individual shareholders, then such corporations must pay Delaware estimated and final taxes for such nonresident shareholders. The amount such corporations must pay is based on the nonresident shareholders' share of the Delaware derived distributive income of the corporation. In particular, section 1158(a) of the Delaware Tax Code provides in pertinent part:

Every corporation that is an S corporation for federal income tax purposes . . . which . . . has any shareholder who is a non-resident individual . . . shall pay, at the times and in the percentages set forth in § 1905 . . . , on behalf of each such nonresident, tax in an amount equal to the highest rate of tax set forth in § 1102(a) . . . multiplied by such nonresident's distributive share of the income of such corporation determined in accordance with § 1124

30 *Del. C.* § 1158(a).

Section 1905 requires the payment of estimated taxes in the percentages and on the schedule set forth in that section and the payment of all additional taxes at the time of the filing of the annual tax return with the Director.² As Section 1158(a) expressly incorporates Section 1905, subchapter S corporation must look to the schedule set forth in Section 1905 to determine the timing and percentages of estimated and final tax payments due on behalf of nonresident individual shareholders. The tax rate used to determine the amount of estimated taxes the S corporation must pay on behalf of the nonresident individual shareholders is "the highest rate of tax set forth in § 1102(a)" 30 *Del. C.* § 1158(a). Here the applicable rate is 5.95%.

² For calendar year corporations, 50% of the estimated tax liability for the tax year is payable on April 1, 20% on June 15, 20% on September 15 and 10% on December 15. 30 *Del. C.* § 1905(1). Any additional tax owed beyond the estimated payments must be calculated and paid with the filing of the annual corporate return. 30 *Del. C.* § 1905(3).

Section 1158(c) addresses what happens when a S corporation fails to pay either the Section 1905 estimated or final return taxes that it is required to submit on behalf of its nonresident individual shareholders.

If an S corporation fails to pay any tax required to be paid by such corporation under subsection (a) of this section, such corporation shall be liable for any penalties, interest and additions to tax applicable to such failure in the same manner as if such tax were required to be paid by the corporation on its own behalf.

30 *Del. C.* § 1158(c).

The penalty an S corporation must pay for failing to pay estimated taxes is set forth in Section 535(c)(1). Specifically, such an S corporation is subject to a penalty equal to 1.5% per month (calculated on 80% of the tax as shown on the final tax return). 30 *Del. C.* § 535(c)(1) ("In the case of any underpayment of . . . estimated tax required by Chapter 19 . . . , there shall be added to the tax . . . an amount equal to [1.5]% per month . . . of the amount of such underpayment for the period of the underpayment").³

Different penalties and interest arise when a subchapter S corporation files an untimely return and/or fails to pay taxes that are due under Sections 1158/1905 with the year end tax return. Any S corporation that files an untimely return owes a penalty equal to 5% per month of the amount of tax due. 30 *Del. C.* § 534(a). Prior to July 10, 2006, an S corporation that fails to

³ Chapter 19 of the Delaware Tax Code contains the provisions related to the taxation of corporations in Delaware. Section 1905, the provision expressly referred to in Section 1158(a) as setting the timing and percentages of the estimated taxes, is part of Chapter 19. As Section 1905 establishes when the estimated taxes must be paid and their percentages and as Section 1905 is part of Chapter 19, the estimated taxes a subchapter S corporation must pay on behalf of nonresident individual shareholders are "estimated taxes required by Chapter 19 of this title." 30 *Del. C.* § 535(c)(1). This conclusion is consistent with the language in Section 1158(c) which recognizes that a subchapter S corporation's failure to pay any taxes due under Section 1158(a) gives rise to a corporate liability "applicable to such failure in the same manner as if such tax were required to be paid by the corporation on its own behalf." 30 *Del. C.* § 1158(c).

pay the taxes due with a return also is subject to a penalty equal to 0.5% of the taxes due per month. 30 *Del. C.* 534(b)(1).⁴ Finally, if a subchapter S corporation fails to pay with the return the taxes required to be paid by Sections 1158(a)/1905(3), interest accrues at a rate of 1% per month on the unpaid tax. 30 *Del. C.* § 533(a).

2. Application of the Statutory Scheme to this Case

It is undisputed that Visions did not pay estimated taxes as required by Sections 1158(a)/1905(a). Although this failure allows the Director to impose a penalty equal to 1.5% per month (calculated on 80% of the tax as shown on the final tax return) pursuant to Section 535(c)(1), the Director has not sought to impose such penalties on Visions in this case.

It is likewise undisputed that Visions did not file its 2005 Return in a timely manner. As set forth in the Notice of Assessment, the Director has imposed a two month penalty at 5% per month for Visions' failure to file a timely return. This penalty is consistent with Section 534(a) and will be upheld.

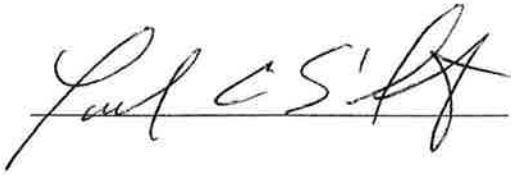
At the time it filed its 2005 Return, Visions also failed to pay any tax on behalf of Mr. Simpson as required by 1158(a)/1905(3). This failure gives rise to a penalty under Section 534(b)(1) equal to 0.5% of the tax due per month. The Director assessed this penalty against Visions. The assessment of this penalty against Visions is permitted under Section 534(b)(1) and will be upheld.

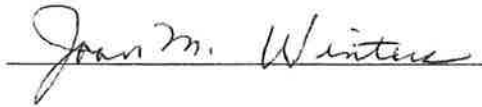
Visions' failure to pay the tax due on behalf of Mr. Simpson also gives rise to an interest calculation. Here, the Director assessed 3 months of interest at a rate of 1% per month on the taxes due. This interest assessment is in accordance with Section 533(a) and will not be set aside by the Board.

⁴ Effective July 10, 2006, the penalty for failure to pay taxes due increased to 1% per month.

CONCLUSION

For the reasons stated, we hold that the Directors' affirmative defense of lack of jurisdiction must be denied but that the tax, penalties and interest the Director assessed against Visions must be upheld in all respects.⁵ This is a final order on all issues raised in this matter and the issuance of this order brings all proceedings before the Board in Docket No. 1444 to a close.





Date: October 31, 2007

⁵ Whether Mr. Simpson can file an amended 2005 return in order to recover any excess taxes Visions paid on his behalf is not an issue before the Board at this time.

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Regina C. Dudgeon 10/18/07

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