

Letter of Findings: 01-20160515; 01-20160516R
Individual Income Tax
For the Years 2013, 2014, and 2015

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Indiana Individual was not entitled to claim a credit against Lake County income taxes for income taxes paid to Illinois; Indiana's income tax structure did not violate the dormant Commerce Clause; however, the Department agreed that the 2015 underpayment penalty should be abated because Individual acted with reasonable care and was not willfully negligent.

I. Individual Income Tax - Credit for Taxes Paid to Illinois.

Authority: IC § 6-3.5-1.1-6; IC § 6-3.5-6-23; IC § 6-3.5-7-8.1 (effective January 1, 2015); Comptroller of the Treasury of Maryland v. Brian Wynne et ux, 135 S. Ct. 1787 (2015); Bd. of Comm. of Howard County v. Kokomo City Plan Comm., 263 Ind. 282 (Ind. 1975); Md. State Comptroller of the Treasury v. Wynne, 64 A.3d 453 (Md. 2013); Frey v. Comptroller of Treasury, 29 A.3d 475 (2011); Frank H. Easterbrook, Presidential Review, 40 Case W. Res. L. Rev. 905 (1989); Letter of Findings 76-20060230 (January 10, 2007).

Taxpayer argues that he is entitled to a refund of Indiana income tax because the Department erred in disallowing a credit against Lake County income tax for taxes paid to Illinois.

II. Individual Income Tax - Underpayment Penalty.

Authority: IC § 6-3-4-4.1(b); IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(d); [45 IAC 15-11-2\(b\)](#); [45 IAC 15-11-2\(c\)](#).

Taxpayer argues that he is entitled to an abatement of the underpayment penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana resident who files Indiana income tax returns. During 2013, 2014, and 2015, Taxpayer earned income from an Illinois source and filed Illinois income tax returns. Taxpayer paid Illinois tax and claimed a credit on his Indiana returns for those Illinois taxes.

The Indiana Department of Revenue ("Department") processed the 2013 and 2014 returns but denied Taxpayer a refund of taxes withheld to pay Lake County Income Tax. The amount of the requested refund was approximately \$3,200.

In addition, Taxpayer subsequently filed a 2015 return. The Department processed the 2015 return and assessed a \$210 "underpayment" penalty.

Taxpayer disagreed with both the refund denial and the penalty assessment and submitted a protest to that effect. An administrative hearing was conducted by telephone during which Taxpayer explained the basis for the protest. This Letter of Findings results.

I. Individual Income Tax - Credit for Taxes Paid to Illinois.

DISCUSSION

In this protest, Taxpayer argues that the Department's refusal to grant a credit for Illinois income tax against his

Lake County Income Tax conflicts with the Supreme Court's decision in *Maryland v. Wynne* 135 S. Ct. 1787 (2015). As quoted by Taxpayer, the *Wynne* decision states, "Despite the names that Maryland has assigned to the taxes, both are State taxes and both are collected by the States Comptroller of the Treasury." According to Taxpayer, the Supreme Court's *Wynne* analysis is squarely on point with Indiana's tax regime and that the Department's refund denial is unconstitutional.

A. Maryland v. Wynne

In *Wynne*, the U.S. Supreme Court considered the constitutionality of Maryland's income tax structure. Maryland collected a state income tax, a "special nonresident tax," and a "county" income tax. Maryland required all its counties to impose the county tax, which the state collected, at a rate based on the county in which the individual taxpayer lived. *Maryland State Comptroller of the Treasury v. Wynne*, 64 A.3d 453, 457-58 (Md. 2013). According to a Maryland Court of Appeals, Maryland's county income tax was part of a single state-imposed income tax scheme because the state mandated the income tax, restricted the authority of the counties to set the rate, and distributed the funds collected pursuant to that tax. *Frey v. Comptroller of Treasury*, 29 A.3d 475, 483, 492 (2011); *Wynne*, 135 S.Ct. at 1792. ("Despite the names that Maryland has assigned to these [state and county income] taxes, both are State taxes, and both are collected by the State's Comptroller of the Treasury"). In other words, Maryland's county tax was a mandatory tax imposed by the state, not a local-option tax imposed by localities.

As a result of this system, Maryland created three categories of taxpayers: (1) Maryland residents, who earned all their income in Maryland, paid the state and county income taxes; (2) Maryland residents who earned some of their income outside Maryland, paid the state income tax and the county income tax on all income, and were entitled to a credit against state taxes only for income tax paid to other states; and (3) nonresidents who earned some income in Maryland, paid the state income tax and the special nonresident tax. *Wynne*, 135 S.Ct. at 1792.

In *Wynne*, the taxpayers, a married couple, earned income in Maryland and thirty-nine other states attributable to their ownership interest in a multi-state S Corporation. Maryland refused to give the taxpayers a credit against their Maryland county income tax for income taxes they had paid to other states.

In a 5-4 decision authored by Justice Alito, the Supreme Court held that Maryland's tax structure violated the dormant Commerce Clause. The Court explained that "States are allowed to tax a taxpayer's multistate income if the income is fairly apportioned among taxing jurisdictions," but a State may not impose taxes that "discriminate" against income earned interstate. *Id.* at 1796-98 (citations and quotations omitted). To determine whether a tax discriminates against interstate income, the Court adopted the "internal consistency" test:

This test, which helps courts identify tax schemes that discriminate against interstate commerce, looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate.

By hypothetically assuming that every State has the same tax structure, the internal consistency test allows courts to isolate the effect of a defendant State's tax scheme. This is a virtue of the test because it allows courts to distinguish between (1) tax schemes that inherently discriminate against interstate commerce without regard to the tax policies of other States, and (2) tax schemes that create disparate incentives to engage in interstate commerce (and sometimes result in double taxation) only as a result of the interaction of two different but nondiscriminatory and internally consistent schemes . . . The first category of taxes is typically unconstitutional; the second is not.

Id. at 1802 (citations and internal quotations omitted).

As the court explained, if every state had a scheme identical to Maryland's - which allowed no credit for county income tax paid out-of-state - then no taxpayer in any state could obtain a credit for county taxes paid in another state. Everyone earning interstate income in any state would be taxed at a higher rate than those earning only intrastate income. The disparate treatment of interstate income in Maryland was an intrinsic feature of Maryland's tax structure and not merely the result of the interaction of differing state tax structures. This violated the internal consistency principle.

Based on this analysis, the Court held that Maryland's tax scheme violated the dormant Commerce Clause because it "inherently" subjected interstate income to higher taxes than intrastate income. *Id.* at 1804.

B. Comparison of Maryland and Indiana

The tax regimes of Maryland and Indiana differ in several key respects. Like Maryland, Indiana imposes a state income tax, taxes residents on income earned elsewhere, and taxes non-residents on income earned in Indiana.

Unlike Maryland, however, Indiana allows credits for out-of-state taxes at both the state and local levels. Indiana allows a credit for out-of-state income taxes against Indiana's state income tax, and a credit for out-of-state local income taxes against local income taxes owed in Indiana. IC § 6-3.5-1.1-6; IC § 6-3.5-6-23; IC § 6-3.5-7-8.1 (effective January 1, 2015). Although Indiana does not permit out-of-state state income taxes to offset Indiana county income taxes, or allow out-of-state local income taxes to offset Indiana state income taxes, Indiana maintains symmetry in allowing credits at both the state-to-state level and the county-to-county level. According to the Supreme Court, had Maryland offered credits for out-of-state taxes, Maryland's tax system would have survived constitutional scrutiny: "To be sure, Maryland could remedy the infirmity in its tax scheme by offering, as most States do, a credit against income taxes paid to other States. If it did, Maryland's tax scheme would survive the internal consistency test and would not be inherently discriminatory." *Id.* at 1805.

Moreover in Indiana, unlike in Maryland, each county chooses whether to impose a county-level income tax, and each county's governing body must independently approve both the tax and the rate. Until 2013, at least one county in Indiana imposed no county-level income tax at all. Accordingly, Indiana's local-option income taxes are not part of a single state-imposed income tax scheme.

C. Analysis

Contrary to the Taxpayer's argument, Wynne suggests that Indiana's tax structure passes constitutional muster. Unlike Maryland, Indiana credits taxpayers for out-of-state income taxes at both the state-to-state level and the county-to-county level. According to Wynne, such credits allow a state's tax system to "survive the internal consistency test" because the tax system "would not be inherently discriminatory." Wynne, 135 S.Ct. at 1805.

Applying the internal consistency principle as the Court did in Wynne, if every state adopted a tax structure identical to Indiana's, then every state would impose state and county taxes, and taxpayers in every state would be entitled to claim credits for both state and county taxes paid on income earned out-of-state. Everyone earning interstate income would be taxed at the same rate as those earning only intrastate income. Any disparate treatment of interstate income in Indiana could only result from the interaction of differing state tax structures, not from anything inherent in Indiana's tax structure. A straightforward application of Wynne's internal consistency principle demonstrates that Indiana's tax structure fully comports with the dormant Commerce Clause. Taxpayer is not entitled to claim a credit against Lake County income taxes for income taxes paid to Illinois; Indiana's income tax structure does not violate the dormant Commerce Clause.

D. Prudential Considerations

In general, the Department of Revenue is not the best forum in which to evaluate a constitutional question. Of course, every departmental employee, and every member of the executive branch, has an inherent responsibility to construe and interpret the constitution as it bears on the exercise of his responsibilities. See generally Frank H. Easterbrook, *Presidential Review*, 40 Case W. Res. L. Rev. 905 (1989). Nevertheless, "all statutes are presumptively rational and constitutional." *Bd. of Comm. of Howard County v. Kokomo City Plan Comm.*, 263 Ind. 282, 286-87 (Ind. 1975). As a result, as a practical matter, the Department of Revenue usually denies challenges to a statute's constitutionality. In one typical decision, the Department concluded the following: "The Department takes note of Taxpayers' constitutional and statutory protests. However, Taxpayers raise issues which are beyond the purview of administrative review by the Department. Taxpayers' constitutional challenges will not be addressed here because the Department will not overturn a tax scheme enacted by the Indiana General Assembly based upon Taxpayers' facial constitutional and statutory challenges." Letter of Findings 76-20060230 (January 10, 2007), 20070328 Ind. Reg. 045070178NRA.

FINDING

Taxpayer's protest is respectfully denied.

II. Individual Income Tax - Underpayment Penalty.

DISCUSSION

The Department assessed Taxpayer an "underpayment penalty" pursuant to IC § 6-3-4-4.1(b). Taxpayer objects to the imposition of this penalty and asks that the Department exercise its discretion to abate the penalty.

For the year 2015, the Department assessed a \$210 penalty for failing to pay a sufficient amount of individual income tax.

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 waive 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 the negligence penalty - is presumptively valid.

Taxpayer's underpayment of 2015 taxes stems directly from the position he took on his 2013 and 2014 Indiana returns in which he argued that he is entitled to offset Lake County local income taxes by the amount of taxes paid to Illinois.

As discussed in Part I above, the Department disagrees with Taxpayer's substantive argument. However, there is sufficient information to conclude that Taxpayer "exercised ordinary business care and prudence . . ." and that the penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The Department disagrees with Taxpayer's argument that he is entitled to offset local county income taxes by the amount of state income tax paid in Illinois. However, the Department agrees that the 2015 "underpayment" penalty should be abated.

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