**DEPARTMENT OF STATE REVENUE**

02-20170448.LOF

**Letter of Findings: 02-20170448**
**Income Tax**
**For Tax Year 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 This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Because claimed credit carryforwards were earned by an S Corp, the credit flowed through to the shareholder in the year it was earned and was unavailable to be carried forward by the S Corp. Therefore, the Department's assessment for income tax was correct.

## ISSUE

### I. Income Tax–Credit Carry-Forward.

**Authority:** IC § 6-3-2-2; IC § 6-3.1-4-2; IC § 6-3.1-4-3; IC § 6-8.1-5-1; *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); I.R.C. § 1371; Treasury Regulation § 1.1361-4.

Taxpayer protests the denial of income tax credit carry-forward.

## STATEMENT OF FACTS

Taxpayer is an out-of-state business with Indiana operations. The Indiana Department of Revenue ("Department") reviewed Taxpayer's 2016 Indiana income tax return and determined that Taxpayer had incorrectly claimed a credit carry-forward. The Department adjusted Taxpayer's return to reflect the deletion of the claimed credit, which resulted in additional income for 2016 and therefore resulted in additional Indiana income tax for that year. Since Taxpayer had filed the returns with its original calculations resulting in zero tax due, Taxpayer did not remit any payment with the return. As a result of its recalculations, the Department determined that Taxpayer did owe Indiana income tax for 2016. The Department therefore issued a proposed assessment for 2016 income tax, penalty, and interest. Taxpayer filed a protest of the additional income tax, penalty, and interest. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

### I. Income Tax–Credit Carry-Forward.

## DISCUSSION

Taxpayer protests the Department's imposition of income tax resulting from the disallowance of a claimed credit carry-forward for 2016. The Department determined that Taxpayer had incorrectly claimed the credit, disallowed the credit, recalculated the amount of income for that year, and issued a proposed assessment for income tax, penalty, and interest. Taxpayer protests that the credit was acquired via a second business ("Business 2") becoming a Qualified Subchapter S subsidiary of Taxpayer and that Taxpayer properly carried forward and properly applied to its 2016 Indiana income tax return.

As a threshold issue, it is the Taxpayer's 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 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). 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.

Indiana income tax is established under IC § 6-3-2-2, which states in relevant parts:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> (1) income from real or tangible personal property located in this state;
> (2) *income from doing business in this state*;
> (3) income from a trade or profession conducted in this state;
> (4) compensation for labor or services rendered within this state; and
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section.
> Income from a pass through entity shall be characterized in a manner consistent with the income's characterization for federal income tax purposes and shall be considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income producing activity. Income that is derived from one (1) pass through entity and is considered to pass through to another pass through entity does not change these characteristics or attribution provisions. In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter), only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

Next, IC § 6-3.1-4-2 provides:

> (a) A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year.
> (b) For Indiana qualified research expense incurred before January 1, 2008, the amount of the research expense tax credit is equal to the product of ten percent (10[percent]) multiplied by the remainder of:
> (1) the taxpayer's Indiana qualified research expenses for the taxable year; minus
> (2) the taxpayer's base amount.
> (c) Except as provided in subsection (d), for Indiana qualified research expense incurred after December 31, 2007, the amount of the research expense tax credit is determined under STEP FOUR of the following formula:
> STEP ONE: Subtract the taxpayer's base amount from the taxpayer's Indiana qualified research expense for the taxable year.
> STEP TWO: Multiply the lesser of:
> (A) one million dollars ($1,000,000); or
> (B) the STEP ONE remainder;
> by fifteen percent (15[percent]).
> STEP THREE: If the STEP ONE remainder exceeds one million dollars ($1,000,000), multiply the amount of that excess by ten percent (10[percent]).
> STEP FOUR: Add the STEP TWO and STEP THREE products.
> (d) For Indiana qualified research expense incurred after December 31, 2009, a taxpayer may choose to have the amount of the research expense tax credit determined under this subsection rather than under subsection (c). At the election of the taxpayer, the amount of the taxpayer's research expense tax credit is equal to ten percent (10[percent]) of the part of the taxpayer's Indiana qualified research expense for the taxable year that exceeds fifty percent (50[percent]) of the taxpayer's average Indiana qualified research expense for the three (3) taxable years preceding the taxable year for which the credit is being determined. However, if the taxpayer did not have Indiana qualified research expense in any one (1) of the three (3) taxable years preceding the taxable year for which the credit is being determined, the amount of the research expense tax credit is equal to five percent (5[percent]) of the taxpayer's Indiana qualified research expense

for the taxable year.

Also, IC § 6-3.1-4-3 provides:

(a) The amount of the credit provided by this chapter that a taxpayer uses during a particular taxable year may not exceed the sum of the taxes imposed by IC 6-3 for the taxable year after the application of all credits that under IC 6-3.1-1-2 are to be applied before the credit provided by this chapter. *If the credit provided by this chapter exceeds that sum for the taxable year for which the credit is first claimed, then the excess may be carried over to succeeding taxable years and used as a credit against the tax otherwise due and payable by the taxpayer under IC 6-3 during those taxable years*. Each time that the credit is carried over to a succeeding taxable year, it is to be reduced by the amount which was used as a credit during the immediately preceding taxable year. The credit provided by this chapter may be carried forward and applied to succeeding taxable years for ten (10) taxable years following the unused credit year.
(b) A credit earned by a taxpayer in a particular taxable year shall be applied against the taxpayer's tax liability for that taxable year before any credit carryover is applied against that liability under subsection (a).
(c) A taxpayer is not entitled to any carryback or refund of any unused credit.
(*Emphasis added*).

In the course of the protest process, Taxpayer provided documentation establishing that effective January 1, 2016, Business 2 became a Qualified Subchapter S subsidiary of Taxpayer. Treasury Regulation § 1.1361-4 provides:

(a) Separate existence ignored -
(1) In general. Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), (a)(8), and (a)(9) of this section, for Federal tax purposes -
(i) A corporation that is a QSub shall not be treated as a separate corporation; and
(ii) *All assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation*.
(*Emphasis added*).

Therefore, as provided by Treasury Regulation § 1.1361-4, the credits of Business 2 became the credits of Taxpayer as of January 1, 2016. However, both Taxpayer and Business 2 were S Corps in 2013, which was the year the credit under IC § 6-3.1-4-2 was earned. I.R.C. § 1371 provides in relevant parts:

(a) Application of subchapter C rules.--Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.
(b) No carryover between C year and S year.--
(1) From C year to S year.--No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.
(2) *No carryover from S year.--No carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation*.
(3) Treatment of S year as elapsed year.--Nothing in paragraphs (1) and (2) shall prevent treating a taxable year for which a corporation is an S corporation as a taxable year for purposes of determining the number of taxable years to which an item may be carried back or carried forward.
. . . .
(*Emphasis added*).

Therefore, under I.R.C. § 1371(b)(2), no credit carryforwards were available to Business 2 to transfer to Taxpayer in 2016. Since there was no credit to carryforward, Taxpayer was unable to claim the credit on its 2016 Indiana adjusted gross income tax return. Taxpayer has not met the burden imposed under IC § 6-8.1-5-1(c) of proving the proposed assessment wrong.

**FINDING**

Taxpayer's protest is denied.

*Posted: 01/31/2018 by Legislative Services Agency*
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