

Letter of Findings: 01-20232059
Individual Indiana Income Tax For the Year 2021

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Nonresident Individuals, who were S Corporation shareholders, met their burden of establishing that they were entitled to a reconsideration of their original refund request. Nonresident Individuals established that the assessment of additional income tax was incorrect because the Department erred in calculating the amount of "flow-through" Research Expense Credits available to the Nonresident Individuals.

ISSUES

I. Indiana Individual Income Tax - Credits and Withholding Amounts.

Authority: [IC 6-3-1-3.5](#); [IC 6-3-2-1](#); [IC 6-3.1-4-7](#); [IC 6-3-4-12](#); [IC 6-3-4-13](#); [IC 6-8.1-5-1](#); *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); Income Tax Information Bulletin 72 (October 2023); Income Tax Information Bulletin 72 (February 2020); *State Taxation of Pass-Through Entities and Their Owners*, 2013 WL 4105563; 33 Am. Jur. 2d *Federal Taxation* ¶ 4773; *Considerations for Filing Composite Tax Returns, RSM Research Credit Limitations*, <https://rsmus.com/insights/services/business-tax/research-credit-limitations.html>.

Taxpayers argue that the Department failed to correctly account for research and expense credits attributable to their ownership interest in five different pass-through companies.

II. Tax Administration - Penalties.

Authority: [IC 6-8.1-5-1](#); [IC 6-8.1-10-2.1](#); [45 IAC 15-11-2](#).

Taxpayers ask that the Department exercise its authority to abate a ten-percent penalty.

STATEMENT OF FACTS

Taxpayers reside in Florida and have ownership interests in various businesses located within and outside Indiana. Those businesses were organized as S Corporations and Partnerships.

Taxpayers filed a 2021 "Indiana Part-Year or Full-Year Individual Income Tax Return" (IT- 40PNR), reporting income received from sources within Indiana. On that return, Taxpayers claimed an approximately \$68,000 credit withheld on their behalf.

On that same return, Taxpayers also claimed an approximately \$172,000 credit for qualified research and expense credits ("RECs") stemming from qualified research conducted by a business in which Taxpayers had an ownership interest.

Taking into account the amount of Indiana tax, the amount of withholding taxes, and the amount of RECs, Taxpayers expected to receive a refund of about \$35,000.

The Indiana Department of Revenue ("Department") reviewed Taxpayers' return. The Department made various "adjustments" to Taxpayers' return and notified Taxpayers of those adjustments.

The adjustments led to a denial of the \$35,000 refund. In addition, the Department assessed Taxpayers approximately \$96,000 in additional tax, approximately \$13,000 in penalties, and approximately \$3,600 in interest charges.

Taxpayers found fault with the Department's adjustments, the \$35,000 refund denial, and the \$112,600 in additional assessments. Taxpayers submitted a protest to that effect. An administrative hearing was conducted during which Taxpayers' representatives explained the basis for the protest. Although Taxpayers raised both refund and assessments issues, this decision is designated as a "Letter of Findings."

I. Indiana Individual Income Tax - Credits and Withholding Amounts.

DISCUSSION

The issue is whether Taxpayers have met their burden of establishing that the Department made a mistake when it denied their refund and when it assessed additional Indiana taxes.

As with any assessment of Indiana listed taxes, it is Taxpayers' responsibility here to establish that the proposed assessments of tax, interest, and penalty are incorrect. As stated in [IC 6-8.1-5-1\(c\)](#) and Indiana case law, "The notice of proposed assessment is prima facie evidence that the [D]epartment'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." See also *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).

Indiana imposes a tax "on the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every nonresident person." [IC 6-3-2-1\(b\)](#). [IC 6-3-1-3.5\(a\)](#) provides the starting point in determining the taxpayer's taxable income and calculating what would be their Indiana income tax after applying any particular additions and subtractions. The statute provides in small part that Indiana adjusted gross income starts with "'adjusted gross income' (as defined in Section 62 of the Internal Revenue Code) . . ." *Id.*

On their 2021 IT-40PNR, Taxpayers claimed two forms of credit attributable to their ownership with respect to several pass-through entities, such as S corporations and partnerships, which conducted business in Indiana: (1) Withholding Tax Credits and (2) Indiana Research and Expense Credits ("RECs").

Pass-through entities are required to withhold tax and file composite adjusted gross income tax returns on behalf of Taxpayers, nonresident owners or partners. [IC 6-3-4-12](#); [IC 6-3-4-13](#). Taxpayers claimed a credit for Indiana taxes withheld on their part. Those withholding amounts derived from the various businesses' and partnerships' composite returns. Taxpayers also claimed the pass-through RECs pursuant to [IC 6-3.1-4-7\(b\)](#). This Letter of Findings addresses the issues in turn as follows:

A. Taxpayers' Income Reported on Pass-Through Entities Composite Returns.

A composite return is an individual return filed by the pass-through entity that reports the state income of all the nonresident owners or, in some cases, the electing members, as one group. *State Taxation of Pass-Through Entities and Their Owners*, 2013 WL 4105563.

A shareholder or partner's income tax is reported on a Schedule K-1. The Schedule is a federal tax document used to report the income, losses, and dividends for a business or financial entity's partners or an S corporation's shareholders. 33 Am. Jur. 2d *Federal Taxation* ¶ 4773.

Pass-Through entities include S corporations, trusts and estates, or partnerships and their shareholders, beneficiaries, or partners, respectively. Income Tax Information Bulletin 72 (October 2023) 20240124 Ind. Reg. 045240037NRA.

In Indiana, those entities are "required to file composite adjusted gross income tax returns on behalf of all nonresident owners." See [IC 6-3-4-12](#) and [6-3-4-13](#).

If the nonresident owner files an Indiana return, all Indiana income, losses, and other tax attributes must be reported on that return even if a pass-through entity files a composite return. For example, if an owner has \$20,000 of income from a pass-through entity and \$40,000 from an unrelated sole proprietorship, the owner must report all \$60,000 of income. Any composite tax remitted by the pass-through entity is then treated as tax withheld on behalf of that owner. Income Tax Information Bulletin 72 (February 2020) 20200226 Ind. Reg. 045200065NRA; See also Income Tax Information Bulletin 72 (October 2023) 20240124 Ind. Reg. 045240037NRA.

As mentioned, although Taxpayers are nonresidents, money was withheld on their behalf to cover any tax liability that arose from their ownership interest in Indiana "pass-through" entities. Taxpayers filed the requisite returns and reported the income tax withheld on their part as indicated on the various composite returns.

Taxpayers reported approximately \$68,000 on "Schedule F, Line 1 [on their] IT-40PNR." They did so in reliance on the W-2s and 1099-Rs issued by the withholding entities.

B. REC's Attributable to Pass-Through Entities.

As mentioned, Taxpayers also claimed \$172,000 in RECs. Those credits were derived from five different Indiana companies. Taxpayers reported the \$172,000 on their IT-40PNR on "[s]chedule G, line 6A....."

The credit is apportioned pro rata on a per-share, per-day basis among shareholders. (1) For estates and trusts, the credit is apportioned between the estate or trust and the beneficiaries on the basis of the income that is allocable to each. (2) Credit allocations for partnerships are a bit more complicated. If a partnership pays or incurs qualified research expenses in carrying on a trade or business under section 41(b)(1), the credit is computed at the partnership level and is allocated to partners in accordance with section 704 and related regulations. *RSM Research Credit Limitations*, <https://rsmus.com/insights/services/business-tax/research-credit-limitations.html> (last visited October 24, 2023).

C. Taxpayers' Original 2021 Indiana Return and the Department's Adjustments.

On their original return, Taxpayers had credits for withholding and research credits. On their original return, Taxpayers initially reported "\$68,100] in Indiana state tax withheld." The Department indicated that Taxpayers were entitled to \$68,000 in "Indiana state tax withheld." The Department's analyst saw that a certain amount of the RECs had been claimed by one of the S Corporations then reduced the Taxpayers' RECs allowable by the amounts previously claimed.

On Taxpayer's original return, Taxpayer claimed a total of \$172,000 in "state credits reported" (e.g. "withholding" and "RECs"). The Department adjusted that amount and determined that Taxpayers had available \$42,000 in "state credits."

D. Why did the Department Make This Adjustment?

The Department initially identified RECs that had been claimed by one of the S Corporations and therefore reduced the Taxpayers' RECs by the amounts previously claimed. [IC 6-3.1-4-7](#) is a statute which governs the allocation of RECs and a provision which prevents "double dipping".

(a) If a passthrough entity does not have state income tax liability against which the research expense tax credit may be applied, a shareholder, partner, or member of the pass through entity is entitled to a research expense tax credit equal to:

- (1) the research expense tax credit determined for the pass through entity for the taxable year; multiplied by
- (2) the percentage of the pass through entity's distributive income to which the shareholder, partner, or member is entitled.

(b) The credit provided under subsection (a) is in addition to a research expense tax credit to which a shareholder, partner, or member of a pass through entity is otherwise entitled under this chapter. However, a pass through entity and a shareholder, partner, or member of the pass through entity may not claim a credit under this chapter for the same qualified research expenses.

IC6-3.1-4-7 permits the pass through of RECs to owners to be used for their own benefit on their individual income tax returns. Subsection (b) prevents double-dipping. The business entity and its owners can only use the credits once. If the credit passes through to an individual owner/shareholder, that credit disappears from the business's balance sheet.

However, to the extent that a pass-through entity (1) has a credit and (2) applies the credit to reduce nonresident withholding tax, that does not run afoul of [IC 6-3.1-4-7\(b\)](#).

The Department reviewed the S Corporation's returns and found that the S Corporation originally overreported the amount of RECs available and reduced the RECs claimed by Taxpayers. In this case, the error traces back to one

of the 2021 S Corporation returns and the Department's adjustments to that return. In this case, the Department has since reviewed the S Corporation's return and determined that approximately \$118,000 in RECs remain available.

To the extent that the Department failed to allow the full amount of RECs available, Taxpayers' protest is sustained. As required under [IC 6-8.1-5-1\(c\)](#), Taxpayers have met their burden of establishing that the Department erred in calculating the RECs available to Taxpayers.

FINDING

To the extent outlined in this decision, Taxpayers' protest is sustained.

II. Tax Administration - Penalties.

DISCUSSION

As mentioned at the outset, the Department also assessed an approximately \$13,000 penalty.

[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 a negligence penalty - is presumptively valid.

Although the Department initially believed Taxpayers overreported the credits on their individual returns, the Department here finds that Taxpayers' actions did not constitute "willful neglect." [IC 6-8.1-10-2.1\(d\)](#). In this instance, Taxpayers "exercised ordinary business care and prudence" and met their burden of establishing that the penalty should be abated. [45 IAC 15-11-2\(c\)](#); [IC 6-8.1-5-1\(c\)](#).

FINDING

Taxpayers' protest is sustained.

SUMMARY

Taxpayers are entitled to a reconsideration of the RECs claimed on their 2018 individual income tax return. The Department agrees that the ten-percent penalty should be abated.

February 26, 2024

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