DEPARTMENT OF INSURANCE
Bulletin 105
July 10, 2001

VOLUNTARY EXPEDITED FILING PROCEDURES FOR INSURANCE APPLICATIONS TO MEET DISCLOSURE OBLIGATIONS OF DEPOSITORY INSTITUTIONS UNDER SECTION 305 OF THE GRAMM-LEACH-BLILEY ACT

This Bulletin is directed to all insurance companies and other regulated entities subject to the consumer disclosure regulations promulgated by the federal banking agencies under Section 305 of the Gramm-Leach-Bliley Act.

Background

On December 4, 2000, the four principal banking regulatory agencies published final consumer protection rules regarding bank insurance sales pursuant to Section 305 of the federal Gramm-Leach-Bliley Act (GLBA.) The published rules may be obtained from the *Federal Register*, Volume 65, Number 233. Federal regulators recently agreed to postpone the effective date of these rules from April 1, 2001 to Oct. 1, 2001, to give depository institutions more time to implement the regulations.

The regulations require depository institutions that sell insurance products to make certain disclosures and receive consumer acknowledgements, which are intended to reduce consumer confusion in the sale of insurance products by depository institutions. Depository institutions may place these disclosures on insurance application forms. In order to do so, depository institutions that sell insurance products will need to ask insurers to file the necessary applications with this Department of Insurance pursuant to state statutes.

The Indiana Department of Insurance has agreed to adopt an expedited process for reviewing these application forms. The purpose of this Bulletin is to provide regulated entities with the appropriate forms and instructions to receive expedited review of insurance application forms that are revised **only** to add consumer notices, as one way for depository institutions to meet their disclosure obligations under Section 305 of the GLBA. This expedited review process is voluntary. It is up to you to choose whether or not to use this process to expedite filings of such amended insurance applications.

In pertinent part, Section 305 of the GLBA requires:

The Federal banking agencies shall prescribe and publish in final form... customer protection regulations (which the agencies jointly determine to be appropriate) that –

(A) apply to retail sales practices, solicitations, advertising, or offers of any insurance product by any depository institution or any person that is engaged in such activities at an office of the institution or on behalf of the institution; and
(B) are consistent with the requirements of this Act and provide such additional protections for customers to whom such sales, solicitations, advertising, or offers are directed.

Explanation and Instructions for Expedited Review

Below are two model notices for use by depository institutions and other "covered persons" in complying with these consumer disclosure regulations. (In addition to depository institutions, a "covered person" is any other person who sells, solicits, advertises, or offers an insurance product or annuity to a consumer at an office of the depository institution or on behalf of a depository institution.)[1] One notice provides the written disclosures that must be given to a consumer in connection with an initial purchase of an insurance or annuity product that is unrelated to an extension of credit. The other notice provides the written disclosures that must be given to a consumer in connection with the solicitation, offer or sale of an insurance or annuity product that is related to an extension of credit.

The federal banking agencies have reviewed both notices and determined that they meet the requirements of 12 CFR 14.40 (a) and (b) in the case of national banks; 12 CFR 208.84 (a) and (b) in the case of state member banks; 12 CFR 343.40 (a) and (b) in the case of state non-member banks; and 12 CFR 536.40 (a) and (b) in the case of savings associations.

The regulations require that these disclosures be "readily understandable" and in a "meaningful" form. Institutions can call attention to the disclosures by using, for example,: (i) a plain-language heading to the disclosures; (ii) a typeface and type size that are easy to read; (iii) wide margins and ample line spacing; (iv) boldface or italics for key words; or (v) distinctive type style, and graphic devices, such as shading or sidebars, when the disclosures are combined with other information. See 12 CFR 14.40(c)(6) in the case of national banks; 12 CFR 208.84(c)(6) in the case of state member banks; 12 CFR 343.40(c)(6) in the case of state non-member banks; and 12 CFR 536.40(c)(6) in the case of savings associations.

References to "the bank" should be to "the savings association" in the case of a savings association, or may be to the actual name of the bank or savings association.

DISCLOSURE NOTICE 1: Model Written Disclosure for the Initial Purchase of Insurance or Annuity Products that are *Not Sold* in Connection with an Extension of Credit

Insurance products and annuities:

- Are not a deposit or other obligation of, or guaranteed by, the bank or any affiliate of the bank;
- Are not insured by the Federal Deposit Insurance Corporation (FDIC) or any other agency of the United States, the bank, or any affiliate of the bank;

- [Involve investment risk, including the possible loss of value.] *Note: This disclosure may not be required for all products.*

Please sign to acknowledge receipt of these disclosures:
Name of Customer: _____
Customer Signature: _____
Date: _____

DISCLOSURE NOTICE 2: Model Written Disclosure for Insurance Products that *Are Solicited, Offered, or Sold* in Connection with an Extension of Credit

In connection with your credit application, [name of bank or savings association] advises you of the following:

- [Name of bank or savings association] may not condition the extension of credit you are applying for on whether you purchase an insurance product or annuity from the bank or the bank's affiliate.
- [Name of bank or savings association] may not condition the extension of credit you are applying for on your agreement not to obtain, or a prohibition on your obtaining, an insurance product or annuity from an entity not affiliated with the bank.

Insurance products and annuities:

- Are not a deposit or other obligation of, or guaranteed by, the bank or any affiliate of the bank;
- Are not insured by the Federal Deposit Insurance Corporation (FDIC) or any other agency of the United States, the bank, or any affiliate of the bank;
- [Involve investment risk, including the possible loss of value.] *Note: This disclosure may not be required for all products.*

Please sign to acknowledge receipt of these disclosures:
Name of Customer: _____
Customer Signature: _____
Date: _____

Forms with Instructions

With this Bulletin is a uniform filing transmittal form that has been agreed upon by Indiana and other states. An insurer wishing to receive expedited review of its filing shall complete the EXPEDITED FILING—SECTION 305 APPLICATION as directed. In addition, the insurer(s) submitting the filing must certify that the only change made from the previous application form is the addition of the disclosure notices required by Section 305 of the Gramm-Leach-Bliley Act for depository institutions. Certification is made by signing the appropriate blank on the transmittal form.

The filing should be sent to Jerald Wise, Deputy Commissioner for Company Services, Indiana Department of Insurance, and should include:

1. Two copies of the completed, certified Section 305 Application for each insurer.
2. The appropriate filing fee.
3. A postage-paid, self-addressed envelope **large enough to accommodate the stamped return copy of the form.** Note that a comparable filing transmittal form is available in SERFF.

If this filing is for multiple companies, please provide a copy of the Section 305 Application for each company and an extra copy for return to the company. (i.e. 7 companies = 8 copies)

To meet the October 1, 2001, compliance date set forth in the federal regulations, forms should be filed with this Department no later than September 10, 2001.

Effective Date

This Bulletin shall take immediate effect and shall expire on January 1, 2002.

INDIANA DEPARTMENT OF INSURANCE
Sally McCarty, Commissioner

EXPEDITED FILING—SECTION 305 APPLICATION
Form Filing Transmittal Document

Ed. 4/13/01

This page applies to the following state(s) _____

Department Use only

Company Name(s)	Domicile	NAIC #	FEIN #
ABC Insurance Company	NY	0000-99999	99-1234567

Contact Info for Filer

Name and address of Filer(s)	Telephone #	FAX #	e-mail
John Doe (Form Filing) Regulatory Compliance ABC Insurance Co. 12345 Fifth Ave New York, NY 10234	501-555-5555	501-555-5551	John.doe@abcins.com

Filing information

Line of Insurance (see attachment)	Employment Practices
Company Program Title (Marketing title) (if applicable)	
Filing Type ** see note below	Form (Application)
This application is used with:	(Insert policy form number to which the application attaches)
Effective Date Requested	10-01-01 (Enter your desired effective date)
Filing date	(Date Company sends filing)
Company Tracking Number	ABC-EP-2001-01 (Enter your filing tracking number, if applicable)
Date filing approved in domiciliary state	Not approved yet. Filed on same date as this filing.

	Component/Form Name /Description/Synopsis	Form #) Include edition date	Replacement Or withdrawn?	If replacement, give form # it replaces	Previous State Filing Number, if required by state
01	Application for Individual Term Life Insurance	TLA 01234 (Ed. 03/01)	[x] Replacement [ ] Withdrawn [ ] Neither	TLA 01234 (10/99)	
02			[ ] Replacement [ ] Withdrawn [ ] Neither		

To be complete, a form filing must include the following:

4. A completed Form Filing Transmittal Header for each insurer
5. One copy of each application form to be reviewed for the reviewer's records for each insurer.
6. The appropriate filing fees, if required.
7. A postage-paid, self-addressed envelope **large enough to accommodate the return.**

The insurer(s) submitting this filing certifies that the only change made from any previously filed and, if applicable, approved application form is the addition of the disclosure notices required by Section 305 of the Gramm-Leach-Bliley Act

_____ Print Name: _____ Title: _____

If this filing is for multiple companies, please provide a copy of the transmittal header for each company and an extra copy for return to the company. (i.e. 7 companies = 8 copies)

[1] Activities on behalf of a depository institution include activities where a person, whether at an office of the depository institution or at another location sells, solicits, advertises, or offers an insurance product or annuity and at least one of the following applies:

(i) The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the depository institution;

(ii) The depository institution refers a consumer to a seller of insurance products or annuities and the depository institution has a contractual arrangement to receive commissions or fees derived from a sale of an insurance product or annuity resulting from that referral; or

(iii) Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the depository institution.

DEPARTMENT OF STATE REVENUE
INFORMATION BULLETIN #27
INCOME TAX
JUNE, 2001
(Replaces Information Bulletin # 27, dated April 1988)

DISCLAIMER: Information Bulletins are intended to provide nontechnical assistance to the general public. Every attempt is made to provide information that is consistent with the appropriate statutes, rules, and court decisions. Any information that is inconsistent with the law, regulations, or court decisions is not binding on either the Department or the taxpayer. Therefore, information provided in this Bulletin should only serve as a foundation for further investigation and study of the current law and procedures related to its subject matter.

SUBJECT: INDIANA ADJUSTED GROSS INCOME TAX APPLICABLE TO MILITARY PERSONNEL

REFERENCE: IC 6-3-1-3.5; IC 6-3-2-4

INTRODUCTION:

Indiana adjusted gross income tax applies to members of both the active and active reserve components of the United States Army, Air Force, Marines, Navy, Coast Guard, Air National Guard, National Guard, and Navy Merchant Marines. Resident servicemen are taxable on all income, regardless of source. Nonresident servicemen are taxable on all nonmilitary income received from Indiana sources.

I. RESIDENCY

Military personnel who enter the armed forces as Indiana residents remain legal residents of Indiana regardless of duty station until official action is taken to change their legal residence. This can be accomplished by filing a State of Legal Residence Certificate, Form DD 2058, with the military personnel office.

II. FILING REQUIREMENTS

Resident servicemen are required to file an Indiana income tax return if their gross income exceeds their exemptions. Income from all sources, both military and nonmilitary, should be reported on the Indiana Resident Return Form IT-40.

Nonresident servicemen are required to file an Indiana income tax return if they receive any income from an Indiana source. Military earnings for active duty are not considered to be from an Indiana source; however, other compensation for part-time employment would be attributable to Indiana. Nonresident servicemen should file an Indiana part-year or nonresident return, Form IT-40PNR.

Military personnel may be subject to tax by both their state of legal residence and the state in which they are stationed if they have nonmilitary earnings. Persons with income subject to tax by two states are allowed a credit in one state for tax paid to the other state. Information Bulletin #28 provides additional information for taxpayers with income subject to tax by two states.

III. DEDUCTIONS AVAILABLE TO INDIANA RESIDENTS FOR MILITARY SERVICE

Servicemen on active duty or in the active reserves may deduct up to $2,000 of their military pay. If they earned less than $2,000 military pay, they may deduct only the amount of military pay they earned. If the taxpayer and spouse are both in the military, they each may claim the deduction.

Military retirement pay received by an Indiana resident is taxable in the same manner that it is for federal tax purposes. An individual, or an individual's surviving spouse, is allowed an adjustment of up to $2,000 for retirement pay or survivor's benefits received as a result of the individual's active or reserve service in the armed forces, provided that the individual, or the individual's surviving spouse, is at least 60 years of age. The individual need not have been an Indiana resident during active military service to qualify for this adjustment.

Military withholding statements or retirement survivor's benefits statements must be attached to the tax return when these deductions are claimed.

IV. COUNTY INCOME TAXES

Some Indiana counties have adopted one (or a combination) of the three local option income taxes. They include the (1) County Adjusted Gross Income Tax (CAGIT), (2) County Option Income Tax (COIT), and (3) County Economic Development Income Tax (CEDIT). The tax is imposed on residents of adopting counties, and residents of non-adopting counties that work in an adopting county. A list of the adopting counties and their rates are contained in the Individual Income Tax Booklets IT-40, and IT-40PNR.

Resident military personnel are subject to a local option income tax if, on January 1 of the tax year, their county of residence is a county which has adopted a local option income tax. However, a resident serviceman who maintains a household outside the State of Indiana is not subject to a county tax.

The income of a nonresident serviceman's spouse may be subject to county tax if, on January 1 of the tax year, the spouse's legal residence or principal place of work activity was in an Indiana adopting county.

V. ESTIMATED TAX

A serviceman who expects to owe four hundred dollars ($400) or more state and/or county income tax may be required to make quarterly estimated payments. Generally, the military will withhold Indiana State income tax from military earnings of resident

servicemen in an amount sufficient to avoid estimated tax payments on military earnings. However, county tax is not withheld. Other types of income not subject to withholding of tax could result in an amount due of $400 or more of state and/or county tax due for the year.

A taxpayer may be subject to a penalty for underpayment of estimated tax if they do not make the required estimated payments. To establish an estimated account, the first payment must be made and a request for a coupon booklet should be made.

For further information concerning estimated tax, see Income Tax Information Bulletin #3.

VI. DUE DATES AND EXTENSION OF TIME FOR FILING

Indiana individual income tax returns are due on or before April 15 of the year following the tax year. Military personnel on active duty outside of the U.S. and Puerto Rico will be allowed an automatic sixty (60) day extension. A statement must be attached to the return verifying that the taxpayer was outside the U.S. or Puerto Rico on April 15.

Servicemen in a combat zone have an automatic extension of 180 days after they leave the combat zone. If they are hospitalized outside the United States as a result of such service, the 180 day extension period begins upon release. The spouse of such serviceman must use the same method of filing for both Federal and Indiana income tax returns.

Questions concerning Indiana taxation of military personnel should be addressed to the Individual Income Tax Section of the Compliance Division, Indiana Government Center North Room N203, Indianapolis, IN 46204.

Kenneth L. Miller
Commissioner

DEPARTMENT OF STATE REVENUE
INFORMATION BULLETIN #39
INCOME TAX
JUNE, 2001
(Replaces Information Bulletin #39, dated December 1980)

DISCLAIMER: Information Bulletins are intended to provide nontechnical assistance to the general public. Every attempt is made to provide information that is consistent with the appropriate statutes, rules, and court decisions. Any information that is inconsistent with the law, regulations, or court decisions is not binding on either the Department or the taxpayer. Therefore, information provided in this Bulletin should only serve as a foundation for further investigation and study of the current law and procedures related to its subject matter.

SUBJECT: GUIDELINES FOR REPORTING INCOME FROM INDIANA SOURCES BY NONRESIDENT INDIVIDUALS
REFERENCE: IC 6-3-2-2

INTRODUCTION

Nonresident individuals deriving income from Indiana sources are subject to Indiana adjusted gross income tax. To determine Indiana income, the income derived from an Indiana business or profession must be allocated to Indiana. If a trade or business is carried on both within and outside Indiana, the nonresident's business income must be apportioned under a three factor formula.

I. NONRESIDENT INDIVIDUAL FILING REQUIREMENTS

Nonresidents with income from the following Indiana sources are required to file a Part Year/Nonresident Indiana Individual Income Tax Return, Form IT-40PNR:

1. Nonresident individuals with Indiana income from salaries, wages, commissions, sole proprietor income, and professional fees
2. Nonresident partners of Indiana or non-Indiana partnerships that do business both within and outside Indiana;
3. Nonresident shareholders of Indiana or non-Indiana S Corporations that do business both within and outside Indiana;
4. Nonresident members of Indiana or non-Indiana limited liability companies that do business both within and outside Indiana; or
5. Nonresident beneficiaries of Indiana or non-Indiana trusts or estates in which the beneficiaries receive income derived from the operation of a business, rental property, or farm, controlled by the trust or on their own behalf through the value of the trust.

II. NONRESIDENT INDIVIDUAL INCOME ALLOCATED TO INDIANA

Certain types of income of a non-Indiana resident are directly allocated to Indiana.

1. Salaries, wages, fees, commissions, and all other types of income received by a nonresident employee for services performed in Indiana;
2. Income from a trade or business (including professional services) or a farming operation carried on entirely within Indiana;
3. Income and gains received from tangible property both real and personal used in a business which consists mainly of holding property and collecting the income from property held in Indiana;
4. Income from intangibles such as dividends, interest and royalties if the income is derived from the Indiana business operation.

The allocated Indiana income must be reported on the appropriate line of the Nonresident Tax Return, Form IT-40PR.

III. NONRESIDENT INDIVIDUAL INCOME APPORTIONED TO INDIANA

Taxable income from a trade or business carried on within or outside Indiana must be computed using a three-factor formula consisting of property, payroll, and double weighting the sales factor. Apportioned income is determined by taking the total percentage of the three factors and dividing by four. The discussion below lists the three factors and the items that are included in each factor.

SALES FACTOR

The sales factor is determined by dividing the total sales in Indiana by the total sales everywhere, expressed as a percentage. Sales are determined to be Indiana sales if:

1. Sales are shipped to Indiana (assuming Indiana nexus);
2. Sales are shipped within Indiana;
3. Sales are from Indiana to the U.S. Government; or
4. Sales are from Indiana to a purchaser outside of Indiana when the taxpayer is not subject to tax in the state of the purchaser.

PROPERTY FACTOR

The property factor is determined by dividing total tangible property, real and personal, owned or rented and used by the taxpayer in Indiana during the taxable year in connection with a trade or business, by the total tangible property used by the taxpayer everywhere, expressed as a percentage.

PAYROLL FACTOR

The payroll factor is determined by dividing total payrolls paid in Indiana (for officers and employees in connection with a trade or business) by the entire payroll of the trade or business, expressed as a percentage.

An apportionment schedule must be completed when calculating Indiana apportioned income to the nonresident sole proprietor, partner, shareholder of a S Corporation, a member of a limited liability company, or a beneficiary of a trust.

In order to complete the schedule, the following tax information will be used in determining Indiana apportioned income to the nonresident:

1. Nonresident individual proprietors - net income from federal Schedule C;
2. Nonresident partners - Indiana Form IT-65, net income of a nonresident partner;
3. Nonresident shareholders of S Corporations - Indiana Form IT-20S, net income of a nonresident shareholder;
4. Nonresident member of a limited liability company - the appropriate federal form to determine the member's distribution;
5. Nonresident beneficiaries - Indiana Form IT-41, net income of nonresident beneficiary.

If you have any questions concerning the allocation or apportionment of Indiana income to a nonresident, contact the Department of Revenue, Compliance Division, Room N203, Indiana Government Center North, Indianapolis, IN 46204.

Kenneth L. Miller
Commissioner

DEPARTMENT OF STATE REVENUE
INFORMATION BULLETIN # 50
INCOME TAX
JUNE, 2001
(Replaces Information Bulletin #50, dated April, 1991)

DISCLAIMER: Information bulletins are intended to provide nontechnical assistance to the general public. Every attempt is made to provide information that is consistent with the appropriate statutes, rules, and court decisions. Any information that is inconsistent with the law, regulations, or court decisions is not binding on either the Department or the taxpayer. Therefore, the information provided in this Bulletin should only serve as a foundation for further investigation and study of the current law and procedures related to this subject matter.

SUBJECT: REQUIREMENTS FOR CERTAIN INFORMATION RETURNS FOR INDIANA INCOME TAX PURPOSES

REFERENCES: IC 6-2.1-1-17; IC 6-3-4-8; IC 6-3-4-9

INTRODUCTION

Employers who make payments of wages subject to the Indiana Adjusted Gross Income Tax, and who are required to withhold Federal taxes pursuant to the Internal Revenue Code, are **also** required to withhold from employees' wages Indiana Adjusted Gross and County Income Taxes. In an effort to reduce the amount of paper submitted to the Department, information exchange agreements between the Department and the Internal Revenue Service now relieve the taxpayer from having to file a copy of certain information returns with the Department. However, this does not apply if there are state or county taxes withheld or unless requested by the Department.

I. FILING REQUIREMENTS FOR CERTAIN INFORMATION RETURNS

Information returns that indicate the withholding of Indiana Adjusted Gross or County Income Tax must be submitted with Indiana Form WH-3. Forms W-2, 1099R, and WH-18 currently satisfy this requirement.

Information returns that do not report withholding of Indiana Adjusted Gross or County Income Tax should not be submitted to the Department. Forms 1099-B, 1099-DIV, 1099-INT, 1099-MISC, and 1099-S are in this category. These returns must be maintained by the taxpayer, for the statutory time period, and made available to the Department upon request.

II. MAGNETIC FILING INFORMATION

Diskettes, tapes, or cartridges may be used to submit information returns. Diskettes are preferred, but tapes or cartridges are acceptable. Form W-2 should be submitted using the format specified in the latest version of the State Form MNR-1 (Magnetic Media Reporting Specifications and Instructions), also known as the W-2 Booklet. Form 1099-R should be submitted using the current format specified for Federal information return reporting purposes. However, Form WH-18 should not be filed in magnetic format.

Employers who: (1) make payments of salaries, wages, tips, fees, bonuses, and commissions which are subject to Indiana state or county taxes, and (2) are required by the Internal Revenue Code to withhold federal income tax on such payments, are defined as "authorized withholding agents". Such employers are specifically allowed to file by a magnetic medium. While there is no requirement for filing by a magnetic medium, the Department requests those employers with over twenty (20) employees to do so if they are "authorized withholding agents". Prior authorization by the Department is not required to file by a magnetic medium.

A properly completed Form WH-3 in duplicate must accompany all W-2 and/or 1099-R filings, and should be included in the same package as the magnetic media. All withholding amounts, regardless of the form used, must be listed on a single WH-3. Questions concerning use of magnetic tape, requests for Form MMR-1 (W-2 Booklet), or for technical information concerning this type of reporting procedure can be directed to:

Indiana Department of Revenue
Attn.: Magnetic Filing Coordinator
100 N. Senate Av.
Indianapolis, IN 46204-2253
Telephone: (317) 232-5656

Kenneth L. Miller
Commissioner

DEPARTMENT OF STATE REVENUE
INFORMATION BULLETIN # 86
INCOME TAX
JULY, 2001
(Replaces Information Bulletin #86, dated June 1993)

DISCLAIMER: Information Bulletins are intended to provide nontechnical assistance to the general public. Every attempt is made to provide information that is consistent with the appropriate statutes, rules, and court decisions. Any information that is inconsistent with the law, regulations, or court decisions is not binding on either the Department or the taxpayer. Therefore, information provided in this Bulletin should only serve as a foundation for further investigation and study of the current law and procedures related to its subject matter.

SUBJECT: INDEPENDENT CONTRACTORS RESPONSIBILITY FOR INCOME TAX REPORTING AND WITHHOLDING

REFERENCES: IC 6-3-4-2; IC 6-3-7-5; IC 22-3-2-14; and IC 22-3-2-14.5

INTRODUCTION:

The purpose of this Bulletin is to summarize the reporting and withholding requirements for independent contractors. The Bulletin also explains the application procedure for an exemption certificate to be issued to independent contractors that elect not to be covered by workmen's compensation insurance.

I. RESPONSIBILITY OF INDEPENDENT CONTRACTORS FOR PAYING ESTIMATED TAX AND WITHHOLDING INCOME TAX

Independent contractors generally do not have income tax withheld by the parties that they contract with for services. Because of this, the independent contractor is required to file quarterly estimated income tax payments with the Department. The simple guideline is that if there is no Federal withholding and the independent contractor is required to make federal estimated payments, then Indiana requires the independent contractor to make Indiana estimated payments if the annual Indiana liability exceeds four hundred dollars ($400).

If the independent contractor hires employees, the independent contractor is an employer and is required to withhold Indiana adjusted gross income tax and local option income taxes from the employee's wages and remit them to the Department of Revenue.

II. DEFINITION OF INDEPENDENT CONTRACTOR

IC 22-3-6-1(b)(7) states: "A person is an independent contractor in the construction trades and not an employee under IC 22-3-22 through IC 22-3-6 if the person is an independent contractor under the guidelines of the United States Internal Revenue Service."

Because of the link to the Internal Revenue Code that Indiana has adopted, those same definitions apply at the state level.

III. APPLICATION FOR CERTIFICATE OF EXEMPTION WITH THE DEPARTMENT OF REVENUE

Effective July 1, 2001, an independent contractor is required to file with the Department a statement and documentation of the independent contractor's status. The independent contractor must pay a $5.00 filing fee (non refundable) and obtain a clearance from the Department before a certificate of exemption is issued. The certificate is valid for one year. The certificate of exemption is required to be filed with the Worker's Compensation Board and a filing fee of $15.00 must be paid in order for the certificate to be effective. The $20.00 fee is to be paid to the Department of Revenue at the time the independent contractor files an application for the workers' compensation exemption certificate.

The certificate of exemption must be renewed annually with the Department. The certificate of exemption must certify that the independent contractor has worker's compensation coverage for its employees in accordance with IC 22-3-2 through IC 22-3-7, and that the independent contractor desires to be exempt from being able to recover under the worker's compensation policy or self-insurance of a person for whom the independent contractor will perform work.

For further information contact the Collection Division of the Indiana Department of Revenue at (317) 232-5977.

Kenneth L. Miller
Commissioner

DEPARTMENT OF STATE REVENUE

02950431.LOF
02960050.LOF
02960052.LOF
02960053.LOF

LETTER OF FINDINGS NUMBERS: 96-0050; 96-0052; 96-0053; 95-0431
Indiana Corporation Income Tax
For Years 1989, 1990, 1991, 1992, and 1993

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Assessment of Proposed Federal RAR Adjustment Prior to Issuance of the Final Federal RAR – Adjustment of Federal Taxable Income

Authority: IC 6-3-1-3.5(b); IC 6-3-4-6(b); IC 6-5.5-1-2; Cooper Industries, Inc. v. Indiana Dept. of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct. 1996)

Taxpayer is protesting the auditor's determination that taxpayer's 1992 income taxes should be adjusted to reflect the findings of a proposed RAR (Federal Revenue Agent's Report). The Internal Revenue Service issued a final RAR adjustment on December 13, 1998. Taxpayer maintains that it filed amended returns, relating to the final federal RAR adjustment, within the statutory 120 days. Taxpayer argues that the assessment, based on the Federal RAR adjustment of $1,753,000, should be removed from the audit report.

II. Gross Income Tax Credit

Authority: IC 6-2.1-2 et seq.; IC 6-3-2 et seq.; IC 6-3-3-2

The taxpayer argues that the auditor improperly calculated adjusted gross income tax for 1989 and 1990 by failing to give proper credit for gross income tax imposed on the members of the affiliated group.

III. Adjusted Gross Income Calculation

Authority: IC 6-3-2-2(b); IC 6-3-2-2(l); 45 IAC 3.1-1-62

Taxpayer protests the auditor's method of calculating adjusted gross income because the calculation was not completed on an individual entity basis. Taxpayer maintains that the method employed by the auditor resulted in a tax disproportionate to the income derived from Indiana activities. The taxpayer argues that it should be allowed to use an alternative apportionment method in order to produce an adjusted gross income tax that is proportionate to its Indiana source income.

STATEMENT OF FACTS

The taxpayer is a manufacturer of various forms of electric wire and cable. Taxpayer sells its products to automobile and appliance component manufacturers. Taxpayer produces coated wire for construction and general industrial use. Taxpayer also

produces wire and cable for telephone and industrial distribution. The taxpayer files a consolidated Indiana return together with a number of its subsidiaries.

DISCUSSION

I. Assessment of Proposed Federal RAR Adjustment Prior to Issuance of the Final Federal RAR

Taxpayer protests the auditor's decision to adjust its 1992 income to reflect a federal RAR determination for 1990-91. The taxpayer maintains that the adjustment of its income, prior to the issuance of a final RAR adjustment on December 13, 1998, was improper. Taxpayer asserts that once the final RAR was issued, taxpayer timely and properly, pursuant to IC 6-3-4-6(b), filed an amended return to reflect the final federal adjustment.

IC 6-3-1-3.5(b) provides the starting point for determining taxpayer's taxable income stating that the term "adjusted gross income" shall mean "In the case of corporations, the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code)...." *(See also IC 6-5.5-1-2)* The Department's Administrative Rules restates the principle at 45 IAC 3.1-1-8 stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code section 63...." In Cooper Industries, Inc. v. Indiana Dept. of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct. 1996), the court held that the code provision was "plain and unambiguous." Id. at 1213. "Indiana adjusted gross income begins with federal taxable income as defined by I.R.C. § 63, not as reported by the taxpayer." Id. Therefore, "the issue [becomes] not what number appears on line 28 of a taxpayer's federal income tax form 1120 but whether a particular item of income was included in taxable income pursuant to I.R.C. § 63." Id. The taxpayer's income is determined by the standards set forth in I.R.C. § 63 (subject to certain adjustments peculiar to Indiana and irrelevant here) and not by what the taxpayer may or may not have incorrectly or inadvertently reported on its 1990-91 tax forms. When it became apparent that taxpayer misstated its federal taxable income, it was entirely appropriate for the auditor to adjust the taxpayer's Indiana return accordingly.

The Department has reviewed the taxpayer's various filings and finds that taxpayer is incorrect in its assertion that it filed an amended return reflecting the RAR adjustment. Taxpayer did submit correspondence to the Department that reports the relevant RAR together with a payment reflecting the taxpayer's increased liability. Upon review and verification of the RAR's and the correctness of taxpayer's informal submission, taxpayer will be allowed a credit reflecting that payment.

FINDING

Taxpayer's protest is respectfully denied.

II. Gross Income Tax Credit

The taxpayer argues that the auditor improperly calculated adjusted gross income by failing to give proper credit for gross income tax imposed on the members of the taxpayer's affiliated group.

A corporation with Indiana source income is subject to three separate taxes; gross income tax, adjusted gross income tax, and supplemental net income tax. IC 6-3-3-2 permits a credit to corporations against the adjusted gross income tax, imposed under IC 6-3-2 et seq., in the amount equal to any gross income tax, imposed under IC 6-2.1-2 et seq., for the same taxable year. The effect of the credit authorized under IC 6-3-3-2 is to subject the taxpayer to the greater of the adjusted gross income tax or the gross income tax plus the supplemental net income tax.

Taxpayer's original 1989 through 1993 returns included taxpayer affiliates A, B, and C. Taxpayer affiliates D and E did not file returns during the years in question. The audit determined that all five of taxpayer affiliates (A through E) qualified to file adjusted gross income tax and that affiliates A and B qualified to filed consolidated gross income tax. To enable a comparison of the two taxes, separate audits were conducted for affiliates C, D, and E in order to determine gross income tax. The audit then compared the adjusted gross and gross income tax liability for all five affiliates. The comparison was accomplished by comparing the two taxes on a per affiliate basis and calculating the credit based on the greater of the two.

Taxpayer challenges audit's methodology. Under taxpayer's proposed scheme, the total gross income tax of all five affiliates would be computed and applied as the credit. Audit concedes that taxpayer's proposed methodology operates to produce an equitable result because taxpayer is given the treatment it would be allowed if all five affiliates had filed on a consolidated basis.

Under the provisions of IC 6-3-3-2, taxpayer, by utilizing its proposed methodology, should be permitted to receive a full credit against its adjusted gross income for the amount of gross income tax paid.

FINDING

Subject to audit verification, the taxpayer's protest is sustained.

III. Adjusted Gross Income Calculation

Taxpayer argues that the apportionment method employed by audit in calculating taxpayer's adjusted gross income tax liability was incorrect because the method resulted in a tax that was disproportionate to the income derived from taxpayer's Indiana activities.

IC 6-3-2-2(b) provides for a standardized formula for determining the tax liability of a corporation which receives income from sources both within and outside the state. That section states that "if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three...."

Taxpayer argues that, under IC 6-3-2-2(l), it should be permitted to use an alternate method of apportioning its income. That section states that "[i]f the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any of the taxpayer's business activity, if reasonable: (1) separate accounting; (2) the exclusion of any one (1) or more of the factors; (3) the inclusion of (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

Taxpayer argues that the standard three-factor formula results in an increase in its average apportionment factor and an increase in its adjusted gross income. Taxpayer Letter, Oct. 18, 2000, p. 4. As an alternate, taxpayer maintains that, under the provisions of IC 6-3-2-2(l), it should be permitted to use an alternative method of apportioning its income. According to the taxpayer, this results in an adjusted gross income tax that most fairly reflects its Indiana source income. Id.

Taxpayer has clearly established that the use of an alternative apportionment methodology would have the result in taxpayer receiving a more favorable tax treatment. Taxpayer Letter, Oct. 18, 2000, Exhibit B. However, taxpayer has failed to meet the standard set out in 45 IAC 3.1-1-62 that would permit the use of the taxpayer's proposed method of apportionment. That regulation anticipates that such a proposed apportionment methodology would be employed only "in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results." Having failed to establish that the apportionment methodology taxpayer initially selected leads to an "incongruous result[]" and that the particular circumstances surrounding the preparations of taxpayer's 1989 through 1993 tax returns were "unique and nonrecurring," the Department must decline taxpayer's invitation to recalculate its 1989 through 1993 income tax liabilities.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

04960110.LOF

LETTER OF FINDINGS NUMBER: 96-0110 ST
State Gross Retail Tax
For Years 1993, 1994, and 1995

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

Issue I: State Gross Retail Tax – Required environmental control equipment

Authority: IC § 6-2.5-5-30

Taxpayer protests the assessment of tax on environmental control equipment required for compliance with state environmental quality statutes.

Issue II: State Gross Retail Tax – Agricultural equipment

Authority: IC § 6-2.5-1; IC § 6-2.5-5-1(2); IC § 6-2.5-5-3; 45 IAC 2.2-5-1; 45 IAC 2.2-5-3; 45 IAC 2.2-5-6; Indiana Dept. of St. Revenue vs. RCA Corp., (1974) 310 N.E.2d 96, Information Bulletin #9

Taxpayer protests assessment of use tax on items used in farm supply manufacturing and application.

STATEMENT OF FACTS

Taxpayer's business is the buying, processing, reselling, and application of agricultural products, such as seed, fertilizer, and chemicals. Taxpayer does sell some agricultural equipment, primarily to farmers. Taxpayer was audited and assessed use tax on some equipment and office supplies. Taxpayer paid the use tax on office supplies and is protesting the assessment of use tax on several pieces of equipment.

I. State Gross Retail Tax – Required environmental control equipment

DISCUSSION

Taxpayer was assessed state gross retail tax on purchases related to the construction of temporary storage tanks. With regard to such equipment, Ind. Code § 6-2.5-5-30 provides the following:

Sales of tangible personal property are exempt form the state gross retail tax if:

> (1) The property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominantly used and acquired for the purpose of complying with any state local, or federal environmental quality statutes, regulations, or standards; and

(2) The person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

Taxpayer was required to install temporary storage tanks at an outside storage location to comply with Title 355 of the Indiana Commercial Fertilizer Law as part of the environmental protection measure. The temporary storage tanks served no other function than compliance with these standards. Since taxpayer is engaged in manufacturing these purchases are exempt from the state gross retail tax.

FINDINGS

Taxpayer's protest is sustained.

II. State Gross Retail Tax – Agricultural equipment

DISCUSSION

Information Bulletin #9, "Agricultural Production Exemptions," issued by the Department of Revenue, states:

Indiana law provides several exemptions from sales and use tax relating to agriculture production. The exemptions are limited to purchases to be directly used in the direct production of food or *commodities that are sold either for human consumption or for further food or commodity production. (emphasis added)*

Here, the distinction is presented as applying to food produced and sold for human (not animal) consumption or commodities that are sold for further food or commodity production.

As was noted, taxpayer's business was for fertilizer production as well as application. Taxpayer relied on a Department of Revenue's Informational Bulletin to clarify his status and claim the agricultural exemptions, which resulted in the variance with the audit findings. Information Bulletin #9 contains the disclaimer that:

Information bulletins are intended to provide nontechnical assistance to the general public. Every attempt is made to provide information that is consistent with the appropriate statutes, rules and court decisions. Any information that is not consistent with the law, regulations or court decisions is not binding on either the Department or the taxpayer. Therefore, the information provided herein should serve only as a foundation for further investigation and study of the current law and procedures related to the subject matter covered herein.

IC § 6-2.5-5-1, which is the statutory basis for Information Bulletin 9, establishes a state gross retail tax exemption. This language reads:

Transactions involving animals, feed, seed, plants, fertilizer, insecticides, fungicides, and other tangible personal property are exempt from the state gross retail tax if:

(1) the person acquiring the property acquires it for his direct use in the direct production of food or commodities for sale or for further use in the production of food or commodities for sale; and

(2) the person acquiring the property is occupationally engaged in the production of food or commodities which he *sells for human or animal consumption or uses for further food or commodity production. (emphasis added)*

The statute (subsection 2) requires a person receiving the exemption be either selling items for human or animal consumption or actually using the items to create items for sale for human or animal consumption. Producing fertilizer for sale- even if it is to be ultimately used to produce items for human or animal consumption-does not fit this exemption. Taxpayer's assertion that fertilizer production is exempt is not supported by the statutory language.

Thus, while taxpayer read this segment of Information Bulletin #9 as granting taxpayer an exemption, given the warning on the bulletin itself, the narrow definition in the bulletin relied on by taxpayer, and the clear language of the statute that the bulletin was based on, taxpayer's sole reliance on the bulletin in this matter was not warranted. Consequently, the application of the agricultural statute will be applied to the items related to the exempt activities as determined by the statute. The actual application of agricultural products, such as seed, fertilizer, and chemicals are the only aspects of taxpayer's business that qualifies for the agricultural exemption created by IC § 6-2.5-5-1(2). The application of the general manufacturing exemption, drawn from IC § 6-2.5-5-3(b), requiring the item in question be for the "direct use in the direct production" of the tangible property, may be applied to the remaining areas of taxpayer's business activity.

Audit proposed assessments of use tax on taxpayer's purchase of a furnace. The taxpayer's business uses chemicals and fertilizers that are in a liquid form, these cannot be allowed to freeze or they become useless. The furnace is used to keep the storage area above freezing. Rule 45 IAC 6-2.2-5-6(c) discusses property that is directly used in the direct production or processing of agricultural commodities. It states that property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process. The State agreed in Indiana Dept. of St. Revenue vs. RCA Corp., (1974) 310 N.E.2d 96 at 98 that heating and cooling systems can be essential and integral to the integrated process, although still not exempt under the manufacturing exemption. 45 IAC 2.2-5-6(c) states:

Purchasers of agricultural machinery, tools, and equipment to be directly used by the purchaser in the direct production, extraction, harvesting, or *processing* of agricultural commodities are exempt from tax provided such machinery, tools, and equipment have a direct effect upon the agricultural commodities produced, harvested, etc. Property is directly used in the direct production, extraction, harvesting, or processing of agricultural commodities if the property in question has an immediate

effect on the article being produced. Property has an *immediate effect* on the article being produced if it is an essential and integral part of an integrated process, i.e. confinement buildings, cooling, heating, and ventilation equipment. The fact that such machinery, tools, or equipment may not touch the commodity or livestock or, by itself, cause a change in the product, is not determinative. *(Emphasis added)*

The furnace keeps the fertilizer viable for application to the fields by *maintaining* the fertilizer in a viable condition- not by processing it or having any immediate effect on it. Therefore, neither the agricultural nor the manufacturing exemption will apply.

Taxpayer was assessed tax on three storage tanks used to hold chemicals prior to their mixing with other chemicals and fertilizers into the required combination for application onto the farmer's fields. 45 IAC 2.2-5-6(7) states that tangible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately or completely produced for resale. Taxpayer maintains the tanks are used for storing commodities that have not completed the production stage and are exempt from the sales/use tax, although the cited regulation requires the storage to occur during production, not prior. The exemption does not apply to the tanks.

Tax was also assessed on a skidloader which is used to move dry chemicals and/or fertilizer from the temporary storage area into the production process. 45 IAC 2.2-5-6(d)(9) exempts machinery, tools, and equipment used to move exempt items such as seeds, plants, fertilizers, insecticides, and fungicides from temporary storage to the location where such will be used in an exempt process. The production process is not treated as agricultural and thus the agricultural exemption does not apply. The skidloader does not fit the manufacturing double direct test and it is not exempt.

Taxpayer purchased plumbing supplies to connect supply tanks to the control panel and the weighing and mixing tanks. 10% of these plumbing supplies were assessed based on their use in carrying the materials prior to the control panel connection, rather than in the production process itself. IC § 6-2.5-5-3(b) requires the item in question be for the "direct use in the direct production" of the tangible property in order for the manufacturing exemption to apply. Additionally, under the statute, the production of fertilizer is not eligible for an agricultural exemption; therefore, the 10% assessment is correct.

Tax was assessed on the repair of a conveyor belt which is used in the dry chemical and fertilizer processing stage. The belt moves the mixed chemicals and fertilizer through the process from the mixing stage to the temporary holding area where the final mixture is then loaded into an applicator which will then spread the mixture onto the field. While 45 IAC 2.2-5-6 (d)(10) exempts replacement parts used to replace worn, broken, inoperative, or missing parts on exempt machinery and equipment, this operation is post production and not exempt under the manufacturing exemption. 45 IAC 2.2-5-6(d)(9) exempts machinery, tools, and equipment used to move exempt items such as seeds, plants, fertilizers, insecticides, and fungicides from temporary storage to the location where such will be used in an (agricultural) exempt process; however the conveyor belt, in this instance is moving the fertilizer to temporary storage. Thus, this item does not fall within the manufacturing or agricultural exemption.

Tax was assessed on a replacement engine for an applicator truck. The truck includes a dry chemical applicator and is designed to ride several feet off the ground to accommodate driving through crop fields. 45 IAC 2.2-5-6(d)(5) exempts the sale of other agricultural machinery and equipment to be directly used by the purchaser in the direct production, harvesting, or processing of agricultural commodities. This item is exempt because it is used in the application of fertilizers and agricultural chemicals by taxpayer. Since the item is exempt, the repair and replacement of the engine is exempt as noted above in 45 IAC 2.2-5-6 (d)(10).

FINDINGS

Taxpayer's protest is sustained in part and denied in part.

DEPARTMENT OF STATE REVENUE

01960144.LOF

LETTER OF FINDINGS: 96-0144
Individual Income Tax
For the 1992, 1993, and 1994 Tax Years

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Taxability of Corporate Officer's Compensation Consisting of the Payment of Life Insurance Premiums

Authority: IC 6-8.1-5-1(b); 45 IAC 3.1-1-1; 45 IAC 3.1-1-2; I.R.C. § 62

Taxpayer protests the audit's determination that payment of life insurance premiums by a corporation, of which the taxpayer was an officer, constituted additional compensation subject to assessment under the state's individual income tax scheme.

STATEMENT OF FACTS

An audit was performed on corporate taxpayer. During the course of that audit, it was determined that individual taxpayer, as an officer of the corporation, received certain compensation from corporate taxpayer. A portion of that compensation included the payment of life insurance premiums on behalf of the individual taxpayer. The audit determined that the premiums constituted part of the individual taxpayer's gross income and was subject to the state's individual income tax. Except for the issue of the taxability of the life insurance premiums, taxpayer has waived all other issues originally raised in his letter of protest.

DISCUSSION

I. Taxability of Corporate Officer's Compensation Consisting of the Payment of Life Insurance Premiums

Taxpayer was assessed additional tax on compensation – received by taxpayer in his capacity as a corporate officer – in the form of life insurance premiums.

45 IAC 3.1-1-1 provides the starting point for defining taxpayer's taxable income. The regulation provides that adjusted gross income for individuals is "defined in Internal Revenue Code § 62 modified as follows: (1) begin with gross income as defined in section 61 of the Internal Revenue Code." Taxpayer is required to "report all income as defined by § 61 of the Internal Revenue Code." 45 IAC 3.1-1-2.

That portion of I.R.C. § 62 relevant to taxpayer states that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived including (but not limited to) the following items: (1) Compensation for services including fees, commissions, *fringe benefits*, and similar items...." (Emphasis added).

Taxpayer's "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 assessment is made." IC 6-8.1-5-1(b). Taxpayer has failed to provide a substantive, legal basis upon which to determine that the payment of taxpayer's life insurance premiums did not constitute a fringe benefit under I.R.C. § 62 or that the payments should be counted as part of the taxpayer's gross income under 45 IAC 3.1-1-2.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

02960301.LOF

LETTER OF FINDINGS NUMBER: 96-0301 ITC
Adjusted Gross Income Tax
For Years 1992, 1993 and 1994

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax – Foreign Dividend Deduction

Authority: IC § 6-3-2-12

The taxpayer protested the auditor's adjustments adding back taxpayer's dividend expense deductions on Federal Form 1118 to taxpayer's foreign dividend income deduction when calculating Adjusted Gross Income.

II. Adjusted Gross Income Tax – Procedural Issues

Taxpayer requests correction of computation error in audit report.

III. Adjusted Gross Income Tax – Business Income

Authority: IC § 6-3-1-20; 45 IAC 3.1-1-60

Taxpayer protests the reclassification of dividends from a subsidiary corporation as business income.

STATEMENT OF FACTS

Taxpayer manufactures and distributes hospital and laboratory products, pharmaceutical, and nutritional products worldwide. Taxpayer has a district sales office in this state. Taxpayer protested based on the addition of taxpayer's foreign operation's expenses to taxpayer's foreign operation's income and the reclassification of dividend income from nonbusiness to business income as well as an arithmetic error.

I. Adjusted Gross Income Tax – Foreign Dividend Deduction

DISCUSSION

In calculating its Indiana tax liabilities, taxpayer, pursuant to IC 6-3-2-12, deducted foreign source dividend income from its Indiana adjusted gross income. Audit, however, disagreed with taxpayer's calculus. Specifically, Audit discovered that taxpayer failed to reduce its foreign source dividend income deduction by the sum of all expenses related (deemed or otherwise) to the earning of such dividend income. To "cure" this oversight, Audit, "netted" taxpayer's dividend deductions by all related expenses. Re-

calculation resulted in an increase in taxpayer's Indiana adjusted gross income and tax. Proposed assessments of Indiana adjusted gross income tax followed.

Taxpayer, in response, contends the language of IC 6-3-2-12 neither commands nor suggests reducing the foreign source dividend deduction by related expenses. To buttress its contention, taxpayer directs the Department's attention to the language of IC 6-3-2-12(b), which states:

> A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. The amount of the deduction equals the product of:
>
> (1) the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by
>
> (2) the percentage prescribed in subsection (c), (d), or (e), as the case may be.

The aforementioned subsections (c), (d), and (e) allow corporate taxpayers to receive a one hundred percent (100%) deduction for foreign source dividends received from corporations in which a taxpayer has an eighty percent (80%) or larger ownership interest; an eighty-five percent (85%) deduction for dividends received from corporations in which a taxpayer has a fifty to seventy-nine percent (50%-79%) percent ownership interest; and a fifty percent (50%) deduction for dividends received from corporations in which a taxpayer has less than a fifty percent (50%) ownership interest. IC 6-3-2-12(c)-(e).

Taxpayer argues that reducing its foreign source dividend deductions by related expenses effectively prevents taxpayer from deducting these statutorily mandated amounts (i.e., percentages). Taxpayer also notes that conspicuously absent from Indiana's taxing scheme is any statutory or regulatory language authorizing the Department, or requiring the taxpayer, to "addback" expenses related to the earning of excluded (i.e., deducted) foreign source dividend income.

The Department finds merit in taxpayer's arguments. Simply stated, IC 6-3-2-12 authorizes pro rata deductions (based on the percentage ownership of the payor by the payee) of certain foreign source dividend income. Neither IC 6-3-2-12 nor any other statute or regulation requires this pro rata deduction to be reduced by related expenses. Absent such authority, the statutorily mandated pro rata deduction may not be "adjusted."

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax – Procedural Issues

DISCUSSION

As part of the appeal, taxpayer requests a computation correction. Taxpayer indicates the reduction of the 1992 nonbusiness income was erroneously increased by $800,000 in carrying the total forward from audit workpaper page 7 to page 13. The adjustment according to page 7 is 89,024,643, not $89,824,643. This request involves no legal issues, rather it is a possible oversight in the computation of liability by the auditor.

FINDINGS

Taxpayer's protest is sustained subject to audit verification.

III. Adjusted Gross Income Tax – Business Income

Taxpayer requests dividends from subsidiary corporation be treated as non-business income. IC § 6-3-1-20 defines business income as:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

45 IAC 3.1-1-60 further defines business income to be:

> Sec. 60 Dividends. Dividends are nonbusiness income if the stock with respect to which the dividends are received did not arise out of or was not acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is not related to or incidental to such trade or business operation.
>
> Examples:
>
> ….
>
> (5) The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

Taxpayer owns 50% of the subsidiary in question. Taxpayer has an agreement with subsidiary to co-promote one of taxpayer's products in the U.S., as well as negotiating separate marketing rights for the product in Latin America.

Taxpayer's ownership in the subsidiary extends beyond a passive investment and is part of taxpayer's business operation. The income was correctly classified as business income.

FINDINGS

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02970043.LOF

LETTER OF FINDINGS NUMBER: 97-0043 ITC
Indiana Corporation Income Tax
For the Tax Periods: 1990 through 1992

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Indiana Gross Income Tax – Inter-company Sales

Authority: IC 6-8.1-5-1

Taxpayer protests the Department's inclusion of inter-company sales in gross income.

II. Indiana Gross Income Tax – Proceeds from Asset Sales

Authority: IC 6-8.1-5-1

Taxpayer protests the Department's inclusion of proceeds from asset sales in gross income.

III. Indiana Adjusted Gross Income Tax – State Income Tax

Authority: IC 6-3-1-3.5; IC 6-8.1-5-1

Taxpayer protests the amounts of state income tax used to calculate gross income tax.

IV. Indiana Adjusted Gross Income Tax – Interest Income from U.S. Obligations

Authority: IC 6-3-1-3.5

Taxpayer protests amount of interest income included in adjusted gross income.

V. Indiana Adjusted Gross Income Tax – Qualifying Dividend Deduction

Taxpayer protests the Department's adjustment regarding qualifying dividend deduction.

VI. Indiana Adjusted Gross Income Tax – Federal Taxable Income Adjustment

Authority: IC 6-8.1-5-1

Taxpayer protests the Department's federal taxable income adjustment.

VII. Indiana Adjusted Gross Income Tax – Non-business Income

Authority: IC 6-3-1-20, IC 6-8.1-5-1, 45 IAC 3.1-1-29

Taxpayer protests the Department's determination regarding business or non-business income.

VIII. Indiana Adjusted Gross Income Tax – Payments

Authority: IC 6-8.1-5-1

Taxpayer protests certain payments that were not refunded.

IX. Indiana Gross Income Tax – Out-of-State Sales

Authority: IC 6-2.1-2-2, 45 IAC 1-1-49, 45 IAC 1-1-120

Taxpayer protests the Department's inclusion of certain wholesale sales in gross income.

STATEMENT OF FACTS

Taxpayer is an international corporation engaged in the production and distribution of computers and computer equipment. Two hearings have been conducted in an attempt to resolve taxpayer's protest. The Department has requested certain documents to substantiate a number of taxpayer's claims. However, taxpayer has not provided the requested documentation on several issues. This Letter of Findings is based upon the Department's discussion with taxpayer at hearings, the information contained in the file, taxpayer's written brief, and the auditor's extensive notes in response to issues raised in taxpayer's original protest.

I. Indiana Gross Income Tax – Intercompany Sales

DISCUSSION

Taxpayer protests receipts included in gross income. Taxpayer argues that certain receipts represented inter-company sales. In taxpayer's written brief, an exhibit is provided with a highlighted portion that taxpayer claims were non-taxable receipts because taxpayer was a member of an affiliated group. However, taxpayer has not provided documentation to substantiate that these sales were in fact "inter-company sales."

"The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Taxpayer has not provided sufficient documentation to rebut the Department's assessment.

FINDING

Taxpayer's protest is denied.

II. Indiana Gross Income Tax – Proceeds from Asset Sales

DISCUSSION

Taxpayer protests proceeds from asset sales included in gross income. The auditor relied on information supplied by the taxpayer to

make this adjustment. The Department requested documentation from taxpayer to support its contention that it did not make the amount of sales assessed in the audit. "The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Taxpayer has not provided sufficient documentation to rebut the Department's assessment.

FINDING

Taxpayer's protest is denied.

III. Indiana Adjusted Gross Income Tax – State Income Tax

DISCUSSION

Taxpayer protests the Department's addback of certain state taxes. Taxpayer argues that certain tax amounts were added back that were not based on income. The Department requested documentation from taxpayer to support its contention. However, taxpayer failed to present any information to support its contention that certain state taxes were erroneously added back. "The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Taxpayer has not provided sufficient documentation to rebut the Department's assessment.

FINDING

Taxpayer's protest is denied.

IV. Indiana Adjusted Gross Income Tax – Interest Income from U.S. Obligations

DISCUSSION

Taxpayer protests the Department's disallowance of certain interest income for the tax years at issue. Taxpayer argues that the following two types of interest income should have been deducted: (1) U.S. Treasury Notes and Bills and (2) Installment sales to the U.S. Government.

The Department finds that interest on U.S. Treasury Notes and Bills should be allowed as a modification against federal taxable income; however, installment sales made to the US Government should not be allowed.

FINDING

Taxpayer's protest is sustained in part and denied in part.

V. Indiana Adjusted Gross Income Tax – Qualifying Dividend Deduction

DISCUSSION

Taxpayer protests the Department's disallowance of a certain deduction. Taxpayer argues that the Department disallowed a qualifying dividend deduction. The Department agrees that an adjustment should have been made for the special deduction. However, the exact adjustment will be made during the supplemental audit.

FINDING

Taxpayer's protest is sustained subject to audit verification.

VI. Indiana Adjusted Gross Income Tax – Federal Taxable Income Adjustment

DISCUSSION

Taxpayer protests an adjustment made to federal taxable income. The Department requested that taxpayer provide documentation to support its contention that such adjustments were made in error. "The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Taxpayer did not provide sufficient documentation to support its position.

FINDING

Taxpayer's protest is denied.

VII. Indiana Adjusted Gross Income Tax – Non-business Income

DISCUSSION

IC 6-3-1-20 defines business income. Taxpayer argues that it was taxed for capital gains that had situs in another state. The Taxpayer was assessed adjusted gross income tax on the sale of real property which Taxpayer characterized as non-business income. The audit characterized the income as business income. Business income is defined as income from transactions and activity in the regular course of the taxpayer's trade or business. 45 IAC 3.1-1-29. "Non-business income means all income other than business income." *Id.*

The Taxpayer did not provide documentation to support its assertion. "The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Taxpayer did not submit documentation to support its contention.

FINDING

Taxpayer's protest is denied.

VIII. Indiana Adjusted Gross Income Tax – Payments

DISCUSSION

Taxpayer protests a payment that was not credited toward its Indiana Corporate Income Tax. During the audit, the auditor relied

on departmental records in calculating the credits. The Department's records indicate that Taxpayer received a refund, which included this credit. Taxpayer has not provided documentation to show that the figures are in error. "The notice of proposed assessment is *prima facie evidence* that the department's claim for unpaid tax is valid, and the burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1 (emphasis added). Taxpayer did not provide documentation to support this contention.

FINDING

Taxpayer's protest is denied.

XI. Indiana Gross Income Tax – Out-of-State Sales

DISCUSSION

Taxpayer sold computers to Company A (an out-of-state corporation) who maintained a warehouse in Indiana. Taxpayer shipped these computers from an out-of-state location to Company A's warehouse in Indiana. Audit proposed assessments of gross income tax on the proceeds from these sales.

Gross income tax is imposed upon the receipt of taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer. IC 6-2.1-2-2. Income is not subject to the Indiana income tax unless the seller was engaged in business activity within the State and such activity was connected with or facilitated the sales. 45 IAC 1-1-120.

Business Situs Defined. For purposes of these regulations *[45 IAC 1-1]*, a taxpayer may establish a "business situs" in ways including, but not limited to, the following:

(1) Use, occupancy or operation of an office, shop, construction site, store, warehouse, factory, agency route or other place where the taxpayers affairs are carried on;
(2) Performance of services;
(3) Maintenance of an inventory or stocks of goods for sale, distribution or manufacture;
(4) Sale or distribution of merchandise from company-owned vehicles where title to the goods passes at the time of sale or distribution;
(5) Acceptance of orders without the right of approval or rejection in another state;
(6) Ownership, leasing, rental or other operation of income-producing property (real or personal); or
(7) Certain activities of resident salesmen.
….

45 IAC 1-1-49

During the audit period, Taxpayer maintained a repair facility in Indiana. Taxpayer states that this facility did not manufacture computers or related items and that Taxpayer did not maintain a warehouse for computers in Indiana. Taxpayer also has sales employees in Indiana; however, Taxpayer claims they do not handle these accounts. Taxpayer has established a business situs. Thus, we turn to see whether the business activity in Indiana was connected with or facilitated the sales.

45 IAC 1-1-120(1)(b) describes a nontaxable in-shipment as; "[s]ales made by a nonresident who has a business situs or business activities within the State, but the situs or activities are not significantly associated with the sales, and the goods are shipped directly to the buyer upon receipt of a prior order."

Taxpayer points out that the contested transactions were characterized as "house account" sales. Taxpayer notes that its sales to Company A were conducted entirely between Taxpayer's California facility and Company A's California facility. That is, Taxpayer's California office accepted all orders and performed all the necessary steps to complete the sale. Taxpayer provided the Department with a memorandum from its Marketing Manager stating that the Indiana personnel were not involved with the solicitation, negotiation or execution of sales to Company A and the Indiana personnel did not perform any post-sales or other ancillary activities in regard to these sales. However, Taxpayer has failed to provide any documentation to support these statements.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

02970175.LOF

LETTER OF FINDINGS NUMBER: 97-0175
Gross and Adjusted Gross Income Taxes
For the Period 1993–95

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the *Indiana Register* and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the *Indiana Register*. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Gross Income Tax – Imposition of Tax on Nonresident or Nondomiciliary Taxpayer – Receipt of Gross Income by Agent – Co-Op Advertising

Authority: IC §§ 6-2.1-1-2, -1-10, -1-11, -2-2(a)(2) (1993); 45 IAC § 1-1-54 (1992); *Oil Supply Co. v. Hires Parts Service, Inc.,* 726 N.E.2d 246 (Ind. 2000); *Derloshon v. City of Ft. Wayne Dep't of Redev.,* 234 N.E.2d 269 (Ind. 1968), *reh'g denied*; *Western Adj. and Insp. Co. v. Gross Income Tax Div.,* 142 N.E.2d 630 (Ind. 1957); *Dep't of Treasury v. Ice Service, Inc.,* 41 N.E.2d 201 (Ind.1942); *United Artists Theatre Circ., Inc. v. Indiana Dep't of State Revenue,* 459 N.E.2d 754 (Ind. Ct. App.), *reh'g and trans. denied* (1984); *Universal Group Ltd. v. Indiana Dep't of State Revenue,* 642 N.E.2d 553 (Ind. Tax 1994)

The taxpayer, a motion picture theater chain, argues that the field auditor erred in assessing gross income tax on reimbursements that it received for joint newspaper advertising in Indiana by it and its film distributors.

II. Adjusted Gross Income Tax – Imposition of Tax on Business Income Derived from Sources within Indiana – Apportionment of Business Income – Sales Factor

Authority: IC §§ 6-3-1-20, -1-24, -2-1(b), -2-2 (1993); 45 IAC §§ 3.1-1-29, -1-34, -1-39, -1-50 to -1-52 (1992); Information Bulletin # 12 (1993)

The taxpayer also contends that the auditor erred in assessing adjusted gross income tax to the extent that the auditor included the reimbursements for advertising in Indiana in the sales factor when the auditor apportioned the taxpayer's business income.

STATEMENT OF FACTS

The taxpayer is a corporation organized and having its principal place of business in a state adjoining Indiana. During the audit period it operated a chain of motion picture theaters in Indiana and two adjoining states, including its state of incorporation. Five of these theaters were in Indiana. The taxpayer, in the regular course of its operations during the audit period, paid for and ran advertisements in newspapers that served the markets in which each of its theaters was located, both in Indiana and in the two adjoining states. The taxpayer's representative indicated in its hearing brief that the taxpayer paid for and placed all newspaper advertisements in its sole name.

In its initial protest letter the taxpayer represented that it ran two kinds of newspaper advertisements. One type, called "directory ads," simply identified the theater in question, the titles of the motion picture/s that theater was then showing, and the show times for each motion picture. The other type, called "display ads," was specific to a given motion picture. The taxpayer submitted no examples of the latter type of advertisement to the Department; however, according to the initial protest letter, a typical display ad consisted of a photograph (for example, of a star of the film). The Audit Summary states that the taxpayer's December financial statements for each year of the audit period indicated that it received financial assistance from various film studios to help pay for the newspaper advertising costs the taxpayer incurred. The initial protest letter states that the taxpayer did not seek or receive any reimbursement from the studios for its directory ads, thereby implying that the assistance the taxpayer received was only for display ads.

However, the taxpayer has not submitted copies of any written contracts between it and the various studios with which it dealt during the audit period that governed, or included terms governing, display ads at any stage of the proceedings before the Department. At the protest hearing, the taxpayer's representative stated that there were no such contracts. Nor has the taxpayer submitted any documentary or other evidence from any of these studios indicating what the rights and duties of each party were concerning display ads. There is thus no evidence before the Department indicating which party had control over the content of the display ads. Nor is there anything in the record before the Department, other than the taxpayer's representative's assertion at the protest hearing, that the various newspapers with which the taxpayer dealt knew they were running the display ads at least in part on behalf of the respective studios.

The taxpayer's initial protest letter asserted that the bulk of the assistance was in the form of reimbursements through reductions of the license or rental fees the taxpayer paid under its various exhibition contracts with the studios. The protest letter stated that only about twenty percent (20%) of the assistance was in cash. The taxpayer set out three formulas by which the studios computed the fee reductions. However, as previously noted, the taxpayer has not submitted copies of any contracts or any other documents concerning display ads, including any terms under which the studios may have assisted the taxpayer during the audit period. There is thus no evidence before the Department that would substantiate the taxpayer's assertions on this subject. The taxpayer did submit two invoices for advertising assistance, one for a deduction from the rental charge for the film in question and another for payment. However, both are dated 1997, after the taxpayer's audit period closed. There is thus no evidence in the record before the Department of the exact form or forms that the assistance took during the audited years.

In contrast to the taxpayer's assertions that the studios reduced the fees, the Audit Summary implies that all of the assistance was monetary. Instead of crediting the assistance to an income account, the taxpayer entered the respective amounts in an operating expense account, entitled "Co-Op Advertising" on the copy of its Income Statement for fiscal 1995 submitted with its protest. The Audit Summary states that the taxpayer would debit cash from this account to pay the advertising expenses that it incurred.

The field auditor assessed the taxpayer gross income tax on the aggregate amount of the advertising assistance. The auditor also used the amounts of the assistance in both the numerator and the denominator of the taxpayer's sales factor in computing its

adjusted gross income derived from sources within Indiana, and its adjusted gross income tax liability on such income. The taxpayer protests all of these adjustments.

I. Gross Income Tax – Imposition of Tax on Nonresident or Nondomiciliary Taxpayer – Receipt of Gross Income by Agent – Co-Op Advertising

DISCUSSION

The taxpayer argues that it is not liable for the gross income tax part of the assessment for two reasons. First, it alleges that the film studios provided the advertising assistance in the form of reimbursements for the taxpayer's advances. Second, the taxpayer asserts that it acted as the agent of each of the various studios in placing and paying for the advertisements.

During the audit period the Department had codified its gross income tax regulation on agency receipts at former 45 IAC § 1-1-54 (1992) (current version at 45 IAC §§ 1.1-1-2 and –6-10 (Cum. Supp. 2000), which read in relevant part as follows:

> Sec. 54. Agents. Taxpayers are not subject to gross income tax on income they receive in an agency capacity. However, before a taxpayer may deduct such income in computing his taxable gross receipts, he must meet two (2) requirements:
>
> *(1) The taxpayer must be a true agent. Agency is a relationship which results from the manifestation of consent by one person to another authorizing the other to act on his behalf and subject to his complete control, and consent by the other to so act.* Agency may be established by oral or written contract, or may be implied from the conduct of the parties. *However, the representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish agency.* Both parties must intend to act in such a relationship.
>
> Characteristic of agency is the principal's right to complete and continuous control over the acts of the agent throughout the entire performance of the contract. This right to control cannot be limited to the accomplishment of a desired result. *In addition, the principal must be liable for the authorized acts of the agent.*
>
> *(2) The agent must have no right, title or interest in the money or property received or transferred as an agent.* In other words, the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit through which the funds pass. *A contractual relationship whereby one person incurs expense under an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist, particularly the element of control, discussed above. ….*
>
> In summary, when applying the above factors to a taxpayer, *the critical factor is that of control. Notwithstanding the fact that the taxpayer acting for another has no right, title or interest in the money or property received, he is not entitled to deduct such income from his gross receipts unless he was acting as a true agent subject at all times to the control of his principal.*

Id (emphases added).

The taxpayer's agency argument by its own terms is governed by subsection (1), while its reimbursement argument is governed by subsection (2), of the former regulation. The taxpayer has the burden of proving each of its assertions. IC § 6-8.1-5-1(b) states that "[t]he 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." *Id.* The statute essentially requires the taxpayer to raise, prove and convince the Department of any affirmative defenses to the assessment that the taxpayer may have. A taxpayer's agency and absence of any right, title or interest in the assessed receipts are such defenses. *See Western Adj. and Insp. Co. v. Gross Income Tax Div.,* 142 N.E.2d 630, 635 (Ind. 1957) (stating that the taxpayer "ha[s] the burden of making out an affirmative [agency or trusteeship] case") ("*Western Adjustment*"). *Cf. Vawter v. Baker,* 23 Ind. 63, 65 (1864) (holding agency to be an affirmative defense in a breach of contract action and placing the burden of proof of agency on the defendant) ("*Vawter*"). However, the last two passages emphasized in the above-quoted regulation make it clear that an agency relationship must be found to exist before the question of a taxpayer's absence of any right, title or interest in receipts becomes material. Accordingly, before the Department can address the taxpayer's reimbursement argument the Department must first find that there were agency relationships between the taxpayer and each of the respective studios for which it alleges it placed the display newspaper advertisements. The Department therefore turns to this latter question first.

The definition of "agency" in subsection (1) of the former regulation is in substantial accord with Indiana judicial definitions of "agent." "An agent is one who acts on behalf of some person, with that person's consent and subject to that person's control. *See Dept. of Treasury v. Ice Service, Inc.,* 220 Ind. 64, [67-68,] 41 N.E.2d 201[, 203] (Ind.1942) ["*Ice Service*"](citing Restatement (Second) of Agency § 1(1) (1958) [sic])." *Oil Supply Co. v. Hires Parts Service, Inc.,* 726 N.E.2d 246, 248 (Ind. 2000) ("*Oil Supply*"). Therefore, "the elements of an actual agency relationship are three: [1] manifestation of consent by the principal; [2] acquiescence by the agent; and [3] control exerted by the principal." *Hope Lutheran Church v. Chellew,* 460 N.E.2d 1244, 1247 (Ind. Ct. App.) ("*Chellew*"), *reh'g and trans. denied* (1984). The principal's right to and exercise of control need not be complete. *Universal Group Ltd. v. Indiana Dep't of State Revenue,* 642 N.E.2d 553, 557-58 (Ind. Tax 1994), *granting reh'g on and withdrawing* 634 N.E.2d 891 (Ind. Tax 1994). However, as former 45 IAC § 1-1-54(1) stated, "[t]his right to control cannot be limited to the accomplishment of a desired result[,]" *id.*, which is the criterion for identifying an independent contractor. "*An agent, on the other hand, is subject to the control of the principal with respect to the details of the work.*" *Western Adjustment,* 142 N.E.2d at 634 (emphasis added).

The only material that the taxpayer has offered to the Department is its uncorroborated assertion that it was acting as the studios' agent. Such statements are not proof of agency under Indiana common law. "It is a well established rule that agency cannot be proven by the declarations of the agent alone." *United Artists Theatre Circ., Inc. v. Indiana Dep't of State Revenue,* 459 N.E.2d 754, 758 (Ind. Ct. App.), *reh'g and trans. denied* (1984). Former 45 IAC § 1-1-54(1) adopted this rule in substance. "[T]he representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish agency." *Id.* The Department cannot presume the existence of agency relationships with the studios based solely on the taxpayer's unsubstantiated assertions in this protest. The Department cannot draw from that argument the inference taxpayer desires. "An administrative tribunal cannot rely on its own information for support of its findings, and an order of the tribunal must be based on *evidence produced in the hearing*…." *Derloshon v. City of Ft. Wayne Dep't of Redev.,* 234 N.E.2d 269, 273 (Ind. 1968) (internal quotation marks omitted; emphasis added), *reh'g denied*. The taxpayer has admitted that it paid for and placed all of the alleged advertisements in its sole name. Given the lack of any evidence of agency, the Department therefore must presume that the taxpayer contracted as a principal with the various newspapers for the display advertisements. Taxpayer, therefore, is liable as the principal for gross income tax on its receipts for those advertisements.

Former 45 IAC § 1-1-54(2) states in part that "an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist, particularly the element of control[.]" *Id.* Since the taxpayer has not provided any evidence of agency to the Department, it is unnecessary for the Department to address the taxpayer's reimbursement argument. However, the Department would note that even if the taxpayer had submitted evidence of agency, its reimbursement evidence is insufficient. The taxpayer issued the invoices it submitted in evidence in 1997, after the audit period had ended. They are therefore irrelevant to prove what the taxpayer's advertising arrangements were with the studios whose films it showed during 1993-95.

Taxpayer, therefore, has failed to sustain its burden of proof that the part of the gross income tax assessment on the co-operative advertising payments was wrong. Those payments were part of the taxpayer's gross receipts or gross income under IC §§ 6-2.1-1-2, -1-10 and -1-11 (1993), former 45 IAC §§ 1-1-8 to -10 (1992) (repealed 1999), and former 45 IAC 1-1-17 (1992)(current version at 45 IAC § 1.1-1-10 (Cum. Supp. 2000). The field auditor was therefore correct to assess the taxpayer, a non-domiciliary corporation, for those receipts because under IC § 6-2.1-2-2(a)(2) (1993) they were taxable gross income derived from activities, businesses or sources within Indiana.

FINDING

The taxpayer's protest is denied as to this issue.

II. Adjusted Gross Income Tax – Imposition of Tax on Business Income Derived from Sources within Indiana – Apportionment of Business Income – Sales Factor

DISCUSSION

IC § 6-3-2-1(b) (1993) imposes the adjusted gross income tax on "that part of the adjusted gross income derived from sources within Indiana of every corporation." *Id.* IC § 6-3-2-2(a)(2) (1993) defines the phrase "adjusted gross income derived from sources within Indiana" in part as including "income from doing business in this state[.]" *Id.* Title 45 IAC § 3.1-1-38(4) and (5) (1992) define the term "doing business" as including "[r]endering services to customers in the state" and "[o]wnership, rental or operation of a business or of property (real or personal) in the state[,]" respectively. The present taxpayer engaged in both of these latter activities in its Indiana operations during the audit period.

As part of its Indiana operation, the taxpayer regularly had the newspapers serving its Indiana theaters' markets run advertisements for the motion pictures that the taxpayer showed in those theaters. It also regularly received co-operative advertising income from the film studios for doing so. IC § 6-3-1-20 (1993) and 45 IAC § 3.1-1-29 (1992) define "business income" in relevant part as "income arising from transactions and activity *in the regular course of the taxpayer's trade or business*…." *Id* (emphasis added). The co-operative advertising income was therefore "business income" as defined in IC § 6-3-1-20 (1993) and 45 IAC § 3.1-1-29 (1992). Information Bulletin # 12 (1993) states that "[i]f a corporation has business income from both within and without Indiana, the corporation must apportion its income by means of the three-factor formula under IC 6-3-2-2. Indiana has generally followed the provisions of the Uniform Division of Income for Tax Purposes Act." *Id.* at 6. The field auditor therefore correctly determined that the co-operative advertising income was subject to apportionment.

IC § 6-3-2-2(b) (1993) and 45 IAC § 3.1-1-39 (1992) set out the formula. The business income from sources both within and without Indiana is multiplied by a fraction, the numerator of which is the sum of the property, payroll and sales factors. *Id.* IC § 6-3-2-2(c) to -2(e) (1993), respectively, indicate that each of these factors is itself a fraction. *See id* (so stating). The sales factor in particular "is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e) (1993). *Accord,* 45 IAC §§ 3.1-1-51 and -1-52 (1992) (respectively describing what the denominator and numerator of the sales factor include). It is the auditor's inclusion of the co-operative advertising benefits in both the numerator and the denominator of the sales factor that is in issue in this protest.

IC § 6-3-1-24 (1993) and 45 IAC §§ 3.1-1-34 and -1-50 (1992) define "sales" broadly as being "*all gross receipts* of the taxpayer not allocated under IC 6-3-3-2(g) through IC 6-3-2-2(k), other than compensation." *Id* (emphasis added). Since the Department has previously found that the co-operative advertising benefits were gross receipts, the auditor was correct to include

those receipts in the denominator of the sales factor.

The auditor was also correct to include the co-operative advertising benefits in the sales factor numerator. IC § 6-3-2-2(f) (1993) sets out the criteria for determining whether such sales occur in Indiana. It states in relevant part that "[s]ales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if: (1) the income-producing activity is performed in this state[.]" *Id.* The activity of the taxpayer in issue during the audit period was its placing of display advertisements in newspapers having their principal places of business in Indiana and circulating in the markets of the taxpayer's Indiana theaters. Including the income received from those activities in the numerator of the sales factor was therefore correct.

FINDING

The taxpayer's protest is denied as to this issue.

DEPARTMENT OF STATE REVENUE

04970500.LOF

LETTER OF FINDINGS: 97-0500
State Gross Retail and Use Tax
For the Tax Years 1988 through 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Calculation and Imposition of the State Gross Retail Tax and Use

Authority: IC 6-2.5-2-1; IC 6-2.5-4-1(b); IC 6-2.5-9-3; IC 6-8-5-1; 45 IAC 2.2-3-20; 45 IAC 2.2-4-2

Taxpayer protests the Department's decision to impose liability for unpaid sales and use taxes on transactions involving the production of videotaped materials. The taxpayer sets forth two arguments. Taxpayer maintains that it operates a service business and should not be collecting sales tax. Taxpayer maintains that the method used by the auditor to extrapolate the taxpayer's tax liabilities, based upon the taxpayer's limited business records, was inaccurate.

II. Abatement of the Ten Percent Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2(c)

Taxpayer argues that the Department should exercise its discretionary authority to abate the ten-percent negligence penalty. Taxpayer argues that it did not consciously attempt to avoid its tax liabilities, but that taxpayer acted upon the erroneous advice of a former CPA in deciding not to charge customers sales taxes or to self-assess use taxes.

STATEMENT OF FACTS

Taxpayer operates a business in which customers bring motion picture film, slides, and photographs for the purpose of transferring those materials to videotape. Additionally, the taxpayer provides its customers videotape editing and videotape duplication services. During the tax years at issue, the taxpayer was not registered to collect sales taxes. Department Form AD-40, p. 11. Nonetheless, on certain transactions the taxpayer chose to collect sales tax. Id. The auditor determined that transactions involving the duplication of videotapes were subject to the imposition of the state sales tax. Because the taxpayer was unable or unwilling to provide more complete records, the auditor employed a projection method to determine the taxpayer's sales tax liability. Because the taxpayer's 1996 records were the most complete, the auditor selected 1996 as the base year from which to extrapolate liabilities for 1988 through 1995. The auditor employed a similar methodology to determine the taxpayer's use tax liability but chose 1995 as the base year.

DISCUSSION

I. Calculation and Imposition of the State Gross Retail Tax and Use Tax

A. Applicability of Gross Retail Tax

Under IC 6-2.5-2-1, Indiana imposes a gross retail (sales) tax on retail transactions made within the state. A retail transaction, the pre-requisite to the imposition of the tax, is the transfer, in the ordinary course of business, of tangible personal property for consideration. IC 6-2.5-4-1(b). 45 IAC 2.2-4-2 describes those situations in which a service provider, such as the taxpayer, conducting transactions involving the transfer of tangible personal property, is liable for sales tax on those transactions. The regulation states that "[w]here, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail...." 45 IAC 2.2-4-2(a).

Distinguished from those transactions in which taxpayer transfers various media to videotape or edits videotaped information,

taxpayer also provides videotape duplication services. In these transactions, taxpayer creates multiple copies of pre-recorded and pre-formatted videotape cassettes. These transactions are subject to the state's gross retail tax because the customer's primary objective is the receipt of an end product consisting of tangible personal property. The taxpayer's duplication of videotapes is analogous to the duplication of photographic prints described in Information Bulletin # 34. That bulletin states that, "In making additional photographic prints from an original negative or photograph, the photographer is producing and selling tangible personal property and the [sales] tax applies to the selling price of the prints...." Undoubtedly, a certain skill and knowledge is involved in duplicating either photographic prints or videotape cassettes. However, the objective of either duplicating photographic prints or videotape cassettes is the transfer of tangible personal property. Accordingly, the state's gross retail tax is applicable to those transactions in which the objective of the transaction is the production of copies of videotape cassettes.

B. State Use Tax

Having found that certain of the taxpayer's transactions are not subject to the state's gross retail tax by virtue of 45 IAC 2.2-4-2(a)(3), taxpayer necessarily falls within the associated limitation imposed by 45 IAC 2.2-4-2(a)(4). That regulation requires that taxpayer "pay[] gross retail tax or use tax upon the tangible personal property at the time of acquisition." IAC 2.2-4-2(a)(4). Therefore, for service transactions in which taxpayer transfers various media to videotape or edits videotape information – for which taxpayer is not responsible for collecting sales tax – taxpayer is responsible for self-assessing use tax against tangible personal property purchased to effectuate those transactions and for which taxpayer did not initially pay sales tax. In addition, the original audit determined that taxpayer, pursuant to 45 IAC 2.2-3-20, was subject to the imposition of use taxes on purchases of personal property stored, used, or consumed in Indiana. Taxpayer does not contest the applicability of the use taxes generally but does aver as to those transactions conducted at large retail establishments where – as taxpayer contends – it was unlikely that taxpayer failed to pay the initial sales tax. However, where taxpayer is unable to substantiate its assertions concerning specific transactions, taxpayer is unable to overcome the presumption of correctness afforded the original audit under IC 6-8-5-1. That statutory provision states that "[i]f the department reasonably believes [the taxpayer] has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department." IC 6-8-5-1(a). Once the Department makes a "best information available" assessment, the "proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." IC 6-8-5-1(b).

C. Audit's Projection Methodology

For the tax years 1988 through 1995, because taxpayer's financial records were incomplete, the audit employed a projection method to determine taxpayer's sales tax liability. Department Form AD-40, p. 11. The audit used 1996 as the basis for making that projection. Taxpayer has prepared and presented an alternative basis for determining its 1988 through 1995 liabilities. In this alternative projection, taxpayer has assembled financial records for 1996 through 1999 and used those years to extrapolate the absent 1988 through 1995 records. Taxpayer asserts that the original sales tax assessment should be abandoned, be replaced with taxpayer's alternative calculation, and that its 1988 through 1995 sales tax be recalculated.

Under IC 6-8.1-5-1(b), the original audit determination, based upon the best information then available and under the authority of IC 6-8.1-5-1(a), is presumed valid and taxpayer bears the burden "of proving that the proposed assessment is wrong...." Taxpayer fails to meet that statutory burden. In effect, taxpayer has proposed an alternative calculation of its sales tax liability. However, no matter how well prepared and carefully calculated that proposed alternative may be, taxpayer has failed to demonstrate that audit's original projection – based entirely on taxpayer's own 1996 records – is erroneous. Taxpayer has failed to meet its burden of "*proving* that the proposed assessment is wrong....' IC 6-8.1-5-1(b).

D. Sales Taxes Collected by Taxpayer

Information provided within the original audit indicates that taxpayer unilaterally chose to collect sales taxes prior to the time taxpayer was registered, authorized, or required to do so. Department Form AD-40, p. 11. Setting aside the otherwise indelicate legal issues raised by that decision, taxpayer remains personally liable to the state for sales taxes it collected. IC 6-2.5-9-3 provides that taxpayer, having collected sales taxes, "holds those taxes in trust for the state and is personally liable for the payment of those taxes, *plus any penalties and interest attributable to those taxes*, to the state." IC 6-2.5-9-3 (Emphasis added).

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten Percent Negligence Penalty

Taxpayer asks the Department to exercise its discretionary authority to abate the ten- percent negligence penalty assessed pursuant to IC 6-8.1-10-2.1. Taxpayer sets forth five arguments: taxpayer operates a small business; the taxpayer received incorrect tax advice; the taxpayer was undergoing its first audit; the taxpayer did not intend to avoid its tax liabilities; and the taxpayer was not negligent in its actions. Under IC 6-8.1-10-2.1(d), the Department is empowered to waive the ten-percent negligence penalty if the taxpayer can establish that failure to pay the deficiency was due to reasonable cause and not due to willful neglect. Under 45 IAC 15-11-2(c), 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. Ignorance of the listed tax laws, rules, and/or regulations is treated as negligence.

Factors which may be considered to determine reasonable cause include the nature of the tax involved, judicial precedents set by Indiana courts, judicial precedents established by jurisdictions outside Indiana, published department instructions, information bulletins, letters of findings, rulings, and letters of advice. 45 IAC 15-11-2(c).

It is apparent from taxpayer's various arguments that it is unable to establish a "reasonable cause" for its failure to properly self-assess use taxes or to justify a decision to randomly collect sales taxes prior to the time taxpayer was authorized to do so. Taxpayer can offer no substantive rationale to justify the methodology employed in determining its state tax liability. Taxpayer can point to no precedents, instructions, bulletins, statutes, or regulations which would have rationally led taxpayer to arrive at the decisions it reached.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02980105.LOF

LETTER OF FINDINGS NUMBER: 98-0105
Income Tax
FOR TAX PERIODS: 1994

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

1. Income Tax – Imposition of Gross Income Tax

Authority: IC 6-2.1-2-2, IC 6-2.1-1-2 (c), IC 6-8.2-5 (b), 26 USCA 707 (a) (2) (B), 26 CFR Sec. 1 707-3(c), (d), Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651

The taxpayer protests the imposition of Gross Income Tax on certain receipts.

2. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-3-16

Taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

The taxpayer, an operator of retail clothing stores, files a consolidated return which includes several related retail clothing stores. After a routine audit, the Indiana Department of Revenue assessed income tax, interest and penalty against the taxpayer. The taxpayer timely protested the assessment and a hearing was subsequently held. Further facts will be provided as necessary.

1. Income Tax – Imposition of Gross Income Tax

DISCUSSION

Indiana imposes a gross income tax on the receipt of gross income pursuant to the provisions of IC 6-2.1-2-2 as follows:

(a) An income tax, known as the gross income tax, is imposed upon the receipt of:

***

(2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana.

An exclusion from the gross income tax is provided at IC 6-2.1-1-2 (c) as follows:

The term "gross income" does not include:

***

(14) The receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to capital thereof...."

This statute is further explained at 45 IAC 1-1-58 as follows:

Contributions of capital to a corporation, joint venture or partnership are exempt from gross income tax. No gross receipts result to the recipient of the capital and none result to the donee upon his receipt of stock in exchange for the capital.

Indiana Department of Revenue assessments are presumed to be correct and the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b). All exemptions must be strictly construed against the party claiming the exemption. Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.

The taxpayer, and two other corporations, corporation "A" and corporation "B", contracted to transfer assets to a limited partnership. The taxpayer and corporations "A" and "B" received cash from the limited partnership as a result of the transfer. The Indiana Department of Revenue assessed gross income tax against the total amount received by the taxpayer in the transaction. The

taxpayer contends that the receipts are not subject to the gross income tax because they were received in exchange for a contribution of capital. The issue to be determined is whether the taxpayer's receipts were taxable gross income or nontaxable contributions of capital.

Pursuant to the law and regulation, contributions of capital do not result in gross income to either the recipient of the capital or the contributor. Therefore, the taxpayer is correct when saying that if the transfers were contributions of capital to a partnership, the monies received in exchange for those capital contributions would not be subject to gross income tax. The facts in this instance, however, do not support the conclusion that the situation under examination was in reality a contribution of capital.

Rather, the facts indicate that the taxpayer actually sold assets to the partnership. The taxpayer reported the funds received as income on its Federal Income Tax return. The partnership's Securities and Exchange Commission Annual Report for fiscal year ended January 29, 1994 referred to the transfer of assets as an "acquisition" by the partnership. Page 7 of that Annual Report states as follows, "Financial data for the twenty-six weeks ended January 29, 1994 reflects the effects of adjustments to historical asset values as required by the purchase accounting method, interest expense relative to the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition..." As income received from a sale, the taxpayer's income is subject to the gross income tax.

In the alternative, the taxpayer contends that if there is no contribution of capital to the partnership treatment, then the income must be treated as a distribution from a partnership. However, that does not comport with the federal law and regulations. Pursuant to IRC Sec, 707 (a)(2)(B), when a partner transfers property to a partnership and there is a related transfer of money to that partner from the partnership, it is a disguised sale rather than a contribution of capital or partnership distribution. The selling partner is required to recognize gain or loss on the disguised sale. Whether a transfer constitutes a disguised sale is a question of fact. Pursuant to 26 CFR Sec. 1.707-3 (c) and (d), such a transfer is presumed to be a disguised sale rather than a partnership distribution if the contributions and distributions are made within a two year period. The taxpayer and the partnership made the contributions and distributions within a two year period. Therefore, the Department finds the transaction to be a disguised sale. The taxpayer owes gross income tax on the income received in the transaction.

FINDING

The taxpayer's first point of protest is denied.

2. Tax Administration – Penalty

DISCUSSION

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The taxpayer, a member of an affiliated group of corporations with a large tax department, clearly had Indiana income and was required by law to file an Indiana income tax return on that income. The taxpayer's failure to file a return was a breach of that duty and constitutes negligence.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02980142.LOF

LETTER OF FINDINGS NUMBER: 98-0142
Income Tax
For Tax Periods: 1994

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

1. Income Tax – Imposition of Gross Income Tax

Authority: IC 6-2.1-2-2, IC 6-2.1-1-2 (c), IC 6-8.2-5 (b), 26 USCA 707 (a) (2) (B), 26 CFR Sec. 1 707-3(c), (d), Gross Income Tax

Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651

The taxpayer protests the imposition of Gross Income Tax on certain receipts.

2. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-3-16

Taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

The taxpayer, an operator of retail clothing stores, files a consolidated return which includes several related retail clothing stores. After a routine audit, the Indiana Department of Revenue assessed income tax, interest and penalty against the taxpayer. The taxpayer timely protested the assessment and a hearing was subsequently held. Further facts will be provided as necessary.

1. Income Tax – Imposition of Gross Income Tax

DISCUSSION

Indiana imposes a gross income tax on the receipt of gross income pursuant to the provisions of IC 6-2.1-2-2 as follows:

(a) An income tax, known as the gross income tax, is imposed upon the receipt of:

***

(2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana.

An exclusion from the gross income tax is provided at IC 6-2.1-1-2 (c) as follows:

The term "gross income" does not include:

***

(14) The receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to capital thereof...."

This statute is further explained at 45 IAC 1-1-58 as follows:

Contributions of capital to a corporation, joint venture or partnership are exempt from gross income tax. No gross receipts result to the recipient of the capital and none result to the donee upon his receipt of stock in exchange for the capital.

Indiana Department of Revenue assessments are presumed to be correct and the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b). All exemptions must be strictly construed against the party claiming the exemption. Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.

The taxpayer, and two other corporations, corporation "A" and corporation "B", contracted to transfer assets to a limited partnership. The taxpayer and corporations "A" and "B" received cash from the limited partnership as a result of the transfer. The Indiana Department of Revenue assessed gross income tax against the total amount received by the taxpayer in the transaction. The taxpayer contends that the receipts are not subject to the gross income tax because they were received in exchange for a contribution of capital. The issue to be determined is whether the taxpayer's receipts were taxable gross income or nontaxable contributions of capital.

Pursuant to the law and regulation, contributions of capital do not result in gross income to either the recipient of the capital or the contributor. Therefore, the taxpayer is correct when saying that if the transfers were contributions of capital to a partnership, the monies received in exchange for those capital contributions would not be subject to gross income tax. The facts in this instance, however, do not support the conclusion that the situation under examination was in reality a contribution of capital.

Rather, the facts indicate that the taxpayer actually sold assets to the partnership. The taxpayer reported the funds received as income on its Federal Income Tax return. The partnership's Securities and Exchange Commission Annual Report for fiscal year ended January 29, 1994 referred to the transfer of assets as an "acquisition" by the partnership. Page 7 of that Annual Report states as follows, "Financial data for the twenty-six weeks ended January 29, 1994 reflects the effects of adjustments to historical asset values as required by the purchase accounting method, interest expense relative to the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition..." As income received from a sale, the taxpayer's income is subject to the gross income tax.

In the alternative, the taxpayer contends that if there is no contribution of capital to the partnership treatment, then the income must be treated as a distribution from a partnership. However, that does not comport with the federal law and regulations. Pursuant to IRC Sec, 707 (a)(2)(B), when a partner transfers property to a partnership and there is a related transfer of money to that partner from the partnership, it is a disguised sale rather than a contribution of capital or partnership distribution. The selling partner is required to recognize gain or loss on the disguised sale. Whether a transfer constitutes a disguised sale is a question of fact. Pursuant to 26 CFR Sec. 1.707-3 (c) and (d), such a transfer is presumed to be a disguised sale rather than a partnership distribution if the contributions and distributions are made within a two year period. The taxpayer and the partnership made the contributions and distributions within a two year period. Therefore, the Department finds the transaction to be a disguised sale. The taxpayer owes gross income tax on the income received in the transaction.

FINDING

The taxpayer's first point of protest is denied.

2. Tax Administration – Penalty

DISCUSSION

Taxpayer's final point of protest concerns the imposition of the ten percent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The taxpayer, a member of an affiliated group of corporations with a large tax department, clearly had Indiana income and was required by law to file an Indiana income tax return on that income. The taxpayer's failure to file a return was a breach of that duty and constitutes negligence.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02980247.LOF

LETTER OF FINDINGS NUMBER: 98-0247
Income Tax
For Tax Periods: 1994-1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

1. Income Tax – Imposition of Gross Income Tax

Authority: IC 6-2.1-2-2, IC 6-2.1-1-2 (c), IC 6-8.2-5 (b), 26 USCA 707 (a) (2) (B), 26 CFR Sec. 1 707-3(c), (d), Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651

The taxpayer protests the imposition of Gross Income Tax on certain receipts.

2. Income Tax – Construction Allowances

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2(b)

The taxpayer protests the imposition of tax on construction allowances.

3. Income Tax – Taxation of Corporate Partner

Authority: IC 6-3-4-14, 45 IAC 3.1-1-153

Taxpayer protests the method used to compute its share of partnership income attributable to Indiana.

4. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-3-16

Taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

The taxpayer, an operator of retail clothing stores, files a consolidated return which includes several related retail clothing stores. After a routine audit, the Indiana Department of Revenue assessed income tax, interest and penalty against the taxpayer. The taxpayer timely protested the assessment and a hearing was subsequently held. Further facts will be provided as necessary.

1. Income Tax – Imposition of Gross Income Tax

DISCUSSION

Indiana imposes a gross income tax on the receipt of gross income pursuant to the provisions of IC 6-2.1-2-2 as follows:

(a) An income tax, known as the gross income tax, is imposed upon the receipt of:

***

(2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana.

An exclusion from the gross income tax is provided at IC 6-2.1-1-2 (c) as follows:

The term "gross income" does not include:

***

(14) The receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such

corporation, partnership, firm, or joint venture, or contributions to capital thereof...."

This statute is further explained at 45 IAC 1-1-58 as follows:

Contributions of capital to a corporation, joint venture or partnership are exempt from gross income tax. No gross receipts result to the recipient of the capital and none result to the donee upon his receipt of stock in exchange for the capital.

Indiana Department of Revenue assessments are presumed to be correct and the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b). All exemptions must be strictly construed against the party claiming the exemption. Gross Income Tax Division v. National Bank and Trust Co., (1948) 226 Ind. 298, 79 N.E. 2d 651.

The taxpayer, and two other corporations, corporation "A" and corporation "B", contracted to transfer assets to a limited partnership. The taxpayer and corporations "A" and "B" received cash from the limited partnership as a result of the transfer. The Indiana Department of Revenue assessed gross income tax against the total amount received by the taxpayer in the transaction. The taxpayer contends that the receipts are not subject to the gross income tax because they were received in exchange for a contribution of capital. The issue to be determined is whether the taxpayer's receipts were taxable gross income or nontaxable contributions of capital.

Pursuant to the law and regulation, contributions of capital do not result in gross income to either the recipient of the capital or the contributor. Therefore, the taxpayer is correct when saying that if the transfers were contributions of capital to a partnership, the monies received in exchange for those capital contributions would not be subject to gross income tax. The facts in this instance, however, do not support the conclusion that the situation under examination was in reality a contribution of capital.

Rather, the facts indicate that the taxpayer actually sold assets to the partnership. The taxpayer reported the funds received as income on its Federal Income Tax return. The partnership's Securities and Exchange Commission Annual Report for fiscal year ended January 29, 1994 referred to the transfer of assets as an "acquisition" by the partnership. Page 7 of that Annual Report states as follows, "Financial data for the twenty-six weeks ended January 29, 1994 reflects the effects of adjustments to historical asset values as required by the purchase accounting method, interest expense relative to the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition..." As income received from a sale, the taxpayer's income is subject to the gross income tax.

In the alternative, the taxpayer contends that if there is no contribution of capital to the partnership treatment, then the income must be treated as a distribution from a partnership. However, that does not comport with the federal law and regulations. Pursuant to IRC Sec, 707 (a)(2)(B), when a partner transfers property to a partnership and there is a related transfer of money to that partner from the partnership, it is a disguised sale rather than a contribution of capital or partnership distribution. The selling partner is required to recognize gain or loss on the disguised sale. Whether a transfer constitutes a disguised sale is a question of fact. Pursuant to 26 CFR Sec. 1.707-3 (c) and (d), such a transfer is presumed to be a disguised sale rather than a partnership distribution if the contributions and distributions are made within a two year period. The taxpayer and the partnership made the contributions and distributions within a two year period. Therefore, the Department finds the transaction to be a disguised sale. The taxpayer owes gross income tax on the income received in the transaction.

FINDING

The taxpayer's first point of protest is denied.

2. Income Tax – Construction Allowances

DISCUSSION

Shopping center owners/developers often grant construction allowances to desirable tenants to induce them to locate in their shopping centers. In this instance, the mall developer gave to the taxpayer, as a construction allowance, money to cover the taxpayer's expenses in modifying the leasehold to suit the business purposes of the taxpayer. The Indiana Department of Revenue assessed tax on those receipts. The taxpayer contends that the construction allowances are capital contributions and not subject to tax. IC 6-2.1-1-2 (c)(14).

The regulations promulgated by the Indiana Department of Revenue in effect during the tax period, 1994-1996, did not contain any examples. However, the most recently promulgated regulations concerning capital contributions do contain examples. Specifically 45 IAC 1.1-6-5 (c) (3) gives the following example of a contribution to capital.

(3) A contribution by a shopping center developer of land and building costs to a corporation to attract it as the anchor tenant for a shopping center.

This example of a non taxable capital contribution is similar to the contribution received by the taxpayer. Therefore, the construction allowances qualify as non taxable capital contributions. The money received by the taxpayer which was in excess of the actual costs of the modification of the leasehold is not, however, a contribution of capital. Rather, it is income subject to tax.

FINDING

The taxpayer's second point of protest is sustained in part and denied in part.

3. Income Tax – Taxation of Corporate Partner

DISCUSSION

The taxpayer, a corporate member of a partnership, has characterized the income received from the partnership as business

income from a unitary business. As such, the taxpayer computed its partnership income attributable to Indiana pursuant to 45 IAC 3.1-1-153(b).

During the last two years of the audit period, 1995 and 1996, the Department made an adjustment on the audit to reflect the Department's conclusion that the partnership's activities no longer constituted a "unitary business under established standards." Specifically, in 1994, partnership rental income was allocated to the corporate partners in proportion to each partners' equity interest. But in 1995 and 1996 this method of allocation changed. One hundred percent (100%) of the post-1994 partnership rental income was allocated to a non Indiana partner. This change led the Department to conclude that the taxpayer and the partnership were no longer engaged in a unitary business. Consequently, the Department recomputed the taxpayer's partnership non-rental income (actually deductions) attributable to Indiana pursuant to 45 IAC 3.1-1-153(c).

After reviewing the file and subsequent correspondence, the Department agrees with the taxpayer that the partnership's activities or the partnership's relationship with its corporate partners, including the taxpayer, did not change enough to deny a unitary business filing status for the audit years 1995 and 1996.

FINDING

The taxpayer's third point of protest is sustained.

4. Tax Administration – Penalty

DISCUSSION

Taxpayer's final point of protest concerns the imposition of the ten percent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

In this instance, the taxpayer was negligent in including a value for certain Indiana property in the denominator of the property factor and making no attempt to include any amounts in the numerator even though the company was based in Indiana.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04980390.LOF

LETTER OF FINDINGS NUMBER: 98-0390
Sales/Use Tax
For Tax Periods: 1995 through 1997

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales/Use Tax – Packaging and Shipping Supplies

Authority: IC 6-2.5-5-3; IC 6-2.5-5-3; IC 6-2.5-4; IC 6-2.5-5-5.1; 45 IAC 2.2-5-16; 45 IAC 2.2-5-8; *General Motors v. Dept. of State Revenue*, 578 N.E.2d 399 (Ind.Tax 1991)

Taxpayer protests proposed assessments of use tax on purchases of packaging and shipping supplies.

II. Sales/Use Tax – Utilities

Authority: IC 6-2.5-44(c)(3); IC 6-2.5-4-5**;** 45 IAC 2.2-4-13; 45 IAC 2.2-5-12(b)

Taxpayer protests proposed assessments of use tax on a fraction of its utility purchases.

III. Sales/Use Tax – Gloves

Authority: IC 5-2.5-3(b); 45 IAC 2.2-5-8(c)(2)

Taxpayer protests proposed assessments of use tax on its purchase of gloves.

STATEMENT OF FACTS

Taxpayer, an industrial processor, applies plastic coatings to tangible personal property owned by its customers. During the audit period (1995 through 1997), taxpayer purchased a variety of supplies and utilities. At issue are Audit's proposed assessments of use tax on several of these purchases.

I. Sales Tax – Packaging and Shipping Supplies

DISCUSSION

Taxpayer's customers manufacture tangible personal property. At some point in their respective production processes, the manufacturers send product to taxpayer for application of plastic coatings. Once taxpayer has completed its work, these "coated" products are returned to the manufacturers. To facilitate this transfer of product, taxpayer purchased a variety of packaging and shipping items.

Audit based its proposed assessments on 45 IAC 2.2-5-16. The relevant portion of 45 IAC 2.2-5-16 reads:

(a) The state gross retail tax [i.e., sales tax] shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added....

* * * * *

(d) Application of the general rule.

(1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:

(A) The purchaser must add contents to the containers purchased; and

(B) The purchaser must sell the contents added.

Taxpayer (according to Audit) is engaged as an industrial processor. As such, taxpayer "does not own the products that are coated and placed in the [purchased] containers...[therefore] taxpayer fails the second requirement [B] that it must sell the contents added."

Taxpayer also has purchased a variety of pallets. Half are used to move work-in-process while the other half are used for shipping "coated" products back to the manufacturers. Audit did not propose assessments on pallets used to move work-in-process within taxpayer's facility. Proposed assessments were made, however, on the pallets used in taxpayer's post-production shipping activities. (see IC 6-2.5-5-3 and 45 IAC 2.2-5-8.)

Taxpayer contends Audit's analysis and conclusions are incorrect. Taxpayer argues that its shipping and packaging materials, as well as its pallets, should be exempt from Indiana sales and use taxes because they are essential an integral to an integrated production process. Taxpayer compares its situation to that of General Motors. Taxpayer explains:

> In *General Motors v. Dept. of State Revenue* [578 N.E.2d 399 (Ind.Tax 1991)], both parties agreed that an integrated production process ends when a finished marketable product is produced, and the court ruled that an integrated process ends when the most marketable finished product is produced. The taxpayer [in this instance] is part of its customer's integrated production processes since the taxpayer produced no finished marketable products. The court [in *General Motors*] further stated that unless the parts are carefully transported from component plant to assembly plant no marketable automobiles could result. This is also true in the business of the taxpayer. If the coated products are shipped back to the customer without protection the parts would be scratched, broken or otherwise damaged, consequently, unusable by the customers in its finished product. Therefore, the boxes and pallets used in the taxpayer's packaging and shipping are an essential and required part of the integrated process of the taxpayer.

Taxpayer's *Protest Letter*, June 22, 1998, pp 3,4.

The Tax Court of Indiana ("court"), in *General Motors*, was asked to determine whether General Motors' (GM's) purchases of expendable packing materials—materials used to package and protect products during transport from component to assembly plants—were used within an integrated production process. The court, in holding for GM, explained:

> GM's component parts are unfinished work in process when actually used in GM's finished most marketable product, fully assembled automobiles. The end of an integrated production process is not signaled by the production of unfinished work in process merely because it is potentially a finished marketable product. **An integrated production process terminates upon the production of the most marketable finished product, e.g., the product actually marketed.** Consequently, GM's manufacture of finished marketable automobiles is accomplished by one continuous integrated production process within which the transport of parts from component plants to assembly plants is an essential and integral part. (emphasis added.)

Id. at 404.

General Motors stands for the general proposition that an integrated production process terminates only when the most marketable product has been produced. Application of this general rule requires, by its very terms, identification of a "most marketable product." In *General Motors*, the item denominated as "most marketable product" was a fully assembled automobile rather than manufactured component parts. This determination resulted in a "redefinition" of taxpayer's integrated production process (by the Department) to the extent that GM's geographically dispersed multi-facility processes were now considered part of GM's continuous integrated production process. Consequently, the packaging purchased to facilitate the transfer of parts from taxpayer's component plants to assembly plants were found to be essential and integral to the transfer of works in process.

In finding GM's integrated production process encompassed manufacturing activities performed at multiple sites, the court identified several significant factors. Specifically, the court observed:

The facts in the case [FN3] as well as previous judicial findings [FN4] indicate GM's production process is by nature ***highly integrated***. The court's sole concern, however, is whether GM's manufacture of finished automobiles qualifies ***as one continuous integrated production process.*** (emphasis added.)

Id. at 402.

The aforementioned footnote 3 (FN3) brings to light evidence the court relied on in reaching its conclusion that GM's production process was both "continuous" and "integrated;" to wit, "GM's component plant personnel collaborate with the assembly plant personnel" in a variety of functional manufacturing areas. Additionally, the court noted that "a continuity of production exists between GM's different plants [which is] demonstrated by the standard practice of shifting certain production operations back and forth between component and assembly plants when necessary...."

In footnote 4 (FN4), the court cited a variety of cases for the proposition that labor unrest at one plant affects operations at all plants. "The strike had the expected effect of disrupting the company's automotive operations at all locations, which are admittedly ***highly integrated and interdependent***." (emphasis added.) *Aaron v. Review Board of the Indiana Employment Security Division*, 416 N.E.2d 125, 129 (Ind.App 1981).

In the context of these facts and findings, the court found that GM's manufacture of automobiles represented, in toto, one "continuous integrated production process." *General Motors* at 404. Consequently, the court deemed GM's assembled automobiles, and not the component parts, to be the most marketable product.

As the court's analysis illustrates, determination of a "most marketable product" cannot be divorced from an evaluation of the processes involved in the creation of the product. As we learned from *General Motors*, to qualify for any of the industrial exemptions, the processes used must not only be "essential" and "integral" with regard to the production of the marketed product, but must be performed within a continuous integrated production process.

The popularity of the "most marketable product" analysis proceeds unabated. Such analysis has been embraced in increasing numbers—especially by those taxpayers engaged in decentralized, vertically integrated businesses. These entities, for exemption purposes, have attempted to construct a singular continuous integrated production process via annexation of smaller, disparate production processes.

Pursuant to the "industrial exemptions" provided by IC 6-2.5-5-3 through IC 6-2.5-5-5.1, the boundaries of any particular entity's production process or processes cannot extend beyond the boundaries of the entity itself. Such limitation effectively prohibits inclusion of a subsidiary's production processes with that of its sister or parent. Additionally, this limitation serves to prohibit taxpayer (as an industrial processor) from annexing its customers' (i.e., the manufacturers') processes for purposes of claiming the industrial exemptions.

The court in *General Motors* relied on facts as well as previous judicial findings in reaching its conclusion that GM's manufacturing process was both "continuous" and "highly integrated." Consequently, absent evidence of the existence of a "continuous and highly integrated process", an identification of the "most marketable product," without more, is insufficient for purposes of claiming any of Indiana's industrial exemptions.

FINDING

Taxpayer's protest is denied.

II. Sales Tax – Utilities

DISCUSSION

Taxpayer, an industrial processor, consumes varying amounts of water, electricity, and natural gas (collectively referred to as "utilities"). Each utility is predominately used by taxpayer in its processes. Taxpayer, invoking IC 6-2.5-4-5(c)(3), believes it is entitled to the one hundred percent (100%) "predominant use" exclusion for these utility purchases. Taxpayer reasons it is entitled to this statutory exclusion "[b]ecause...taxpayer's process is part of an integrated process that manufactures a finished marketable [product]. Audit, however, has approved taxpayer's utility exemptions on a pro rata basis.

"[T]he furnishing of electricity, gas, water...services by public utilities to consumers is subject to the gross retail tax. 45 IAC 2.2-4-13. But an exemption is provided for those sales of tangible personal property (including water, electricity, and natural gas) "directly consumed in direct production by manufacturing, processing, refining, or mining." 45 IAC 2.2-5-12(b). Additionally, a one hundred percent exclusion applies when the utility purchases have not been separately metered (as in this case) and the services have been "predominately used" by the purchaser for excepted purposes. As IC 6-2.5-4-5(c)(3) instructs:

> [T]his exclusion for sales of services and commodities only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses listed in this subdivision, or if those sales are not separately metered but are predominately used by the purchaser for the excepted uses listed....

The excepted "uses" mentioned are afforded to only those utility purchasers engaged in "manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture." *Id*.

Taxpayer believes that as a provider of processes essential and integral to the manufacture of tangible personal property, taxpayer should be entitled to this "predominate use" exclusion. As taxpayer explains:

Because the taxpayer's process is part of an integrated process that manufactures a finished marketable tangible personal property, 100% of the taxpayer's utility purchases are exempt from the Indiana Retail Sales Tax.

In other words, taxpayer wishes to be included in its customer's production processes in order to qualify for the predominant use utility exclusion. The Department has already responded to similar arguments with regard to taxpayer's industrial exemption claims. As previously stated:

[T]he boundaries of any particular entity's production process or processes cannot extend beyond the boundaries of the entity itself. Such limitation effectively prohibits inclusion of a subsidiary's production processes with that of its…[sibling] or parent. Additionally, this limitation serves to prohibit taxpayer (as an industrial processor) from annexing its customers' (i.e., the manufacturers') processes for purposes of claiming the industrial exemptions.

Such logic applies equally to taxpayer's "predominant use" utility claims.

Taxpayer may not annex its customers' production processes for purposes of claiming statutory exclusions and exemptions. Unfortunately for taxpayer, not even the most expansive definition of "integrated production process" anticipates or suggests that the boundaries of such processes should exceed those of the entities claiming them.

FINDING

Taxpayer's protest is denied.

III. Sales Tax – Gloves

DISCUSSION

Audit proposed assessments of use tax on taxpayer's acquisition of gloves worn by its employees. As Audit explains, "taxpayer acquired...gloves (thin knit offering no protection to employees) exempt from tax." (Presumably, Audit was responding to taxpayer's argument that the gloves were required so taxpayer's employees could perform their work.)

"Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture...processing, refining, or finishing of other tangible personal property. IC 5-2.5-3(b). Items that are "essential and integral" to an integrated production process meet this "double direct" standard. As 45 IAC 2.2-5-8(c)(2) notes:

The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt....

(F) Safety clothing or equipment which is required to allow a worker to participate in the production process without injury or to prevent contamination of the product during production.

45 IAC 3.3-5-8(c)(2).

Taxpayer contends the gloves serve as a barrier to prevent the possibility of product contamination. Taxpayer's explanation of the utility of its gloves for the prevention product contamination is plausible and convincing.

FINDING

Taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

04980405.LOF

LETTER OF FINDINGS NUMBER: 98-0405
Sales and Use Tax
For Tax Periods: 1994-1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

1. Sales and Use Tax – Rental of Tangible Personal Property

Authority: IC 6-2.5-2-1(a), IC 6-2.5-3-7

Taxpayer protests the imposition of sales tax on certain rentals of tangible personal property.

2. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2(b)

Taxpayer protests the imposition of the penalty.

STATEMENT OF FACTS

The taxpayer sells, rents and services material handling equipment, especially forklifts. The taxpayer has a location in Louisville, Kentucky that serves the southern Indiana area. After a routine audit, the Indiana Department of Revenue assessed the

taxpayer with additional sales and use tax, interest and penalty. The taxpayer protested a portion of this assessment. Further facts will be provided as necessary.

1. Sales and Use Tax – Rental of Tangible Personal Property

DISCUSSION

Pursuant to the provisions of IC 6-2.5-2-1(a), the Indiana sales tax is imposed on "retail transactions made in Indiana." IC 6-2.5-4-10 defines the rental of tangible personal property as a retail transaction subject to the sales tax. Taxpayer rented forklifts to several Indiana concerns and failed to collect sales tax for remittance to Indiana on some of those sales. The audit assessed additional sales tax to Taxpayer on those sales.

Taxpayer produced an Indiana Department of Revenue exemption certificate for the assessment that it protests. Pursuant to IC 6-2.5-3-7, a retailer is not obligated to collect and remit sales tax on any retail transaction when it has an Indiana Department of Revenue exemption certificate from that purchaser.

FINDING

Taxpayer's protest is sustained.

2. Tax Administration – Penalty

DISCUSSION

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

> "Negligence", on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence.

The rules concerning the collection of sales tax on rental contracts are clear and easily accessible in Indiana Department of Revenue publications. Although Taxpayer's protest was sustained, Taxpayer failed to collect and remit sales tax on other rentals and sales. Additionally, Taxpayer failed to self assess and remit use tax on materials used to fulfill its maintenance agreements. Taxpayer's failures constitute negligence.

FINDING

Taxpayer's final point of protest is denied.

DEPARTMENT OF STATE REVENUE

02980779.LOF

LETTER OF FINDINGS NUMBER: 98-0779
Income Tax
Fiscal Years ending December 23, 1992, January 31, 1993, January 31, 1994, January 31, 1995, January 31, 1996, and January 31, 1997

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1(d); 45 IAC 15-11-2

The taxpayer protests the negligence penalty.

STATEMENT OF FACTS

The negligence penalty was assessed on an income tax assessment resulting from a Department audit conducted for the fiscal years December 23, 1992, January 31, 1993, January 31, 1994, January 31, 1995, January 31, 1996, and January 31, 1997.

The taxpayer is a manufacturer of wheels for the automotive industry (cars and light trucks). Wheels are shipped to customer assembly plants in several states and foreign countries.

I. Tax Administration – Penalty

DISCUSSION

The taxpayer is protesting the negligence penalty based on the premise the taxpayer has conducted tax duties in a good faith manner, and, the penalty should be waived as this audit is a first-time audit. The taxpayer also argues the controlling Code statute, IC 6-8.1-10-2.1(d) states negligence penalty is to be only assessed when the taxpayer has conducted tax duties with willful

negligence.

The error discovered in the audit is the result of the taxpayer relying on an unrelated third party (the former parent corporation) to prepare tax returns. The taxpayer relied on the incorrect tax returns to the taxpayer's detriment.

The Department agrees the taxpayer has acted in a good faith manner without willful negligence, However, the Department points out IC 6-8.1-10-2.1(d) also states the taxpayer must act with reasonable care as described by 45 IAC 15-11-2(b).

45 IAC 15-11-2(b) states, "Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer."

The Department finds the taxpayer did not act with reasonable care in that the taxpayer
Was careless in relying on an unrelated third party. As such, the Department finds the taxpayer was negligent and negligence is subject to penalty. As such, the taxpayer's penalty protest is denied.

FINDING

The taxpayer's penalty protest is denied.

DEPARTMENT OF STATE REVENUE

18990140.LOF

LETTER OF FINDINGS NUMBER: 99-0140 FIT
Financial Institutions Tax
For Tax Periods: 1994 through 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Financial Institutions Tax – "Add back" of State and Local Taxes

Authority: IC 6-5.5-1-18, IC 6-5.5-5-1(b); 45 IAC 17-2-1, 45 IAC 17-3-2, 45 IAC 17-3-5

Taxpayer protests proposed assessments of Indiana's Financial Institutions Tax.

STATEMENT OF FACTS

Taxpayer is a wholly owned subsidiary of a Delaware corporation ("Taxpayer's Parent"). Taxpayer's Parent and Subsidiaries (including taxpayer) file a consolidated return for federal income tax purposes. Taxpayer's Parent and other Subsidiaries also file a consolidated return for Indiana adjusted gross income tax purposes. Taxpayer has several wholly owned subsidiaries with which its files a combined Indiana Financial Institution Tax return.

The Indiana Department of Revenue ("Department") audited taxpayer for tax years 1994 through 1996. The audit resulted in additional proposed assessments of Indiana Financial Institution Tax ("FIT"). These assessments were based on taxpayer's failure to add back—to its Indiana tax base— certain expenses deducted from federal adjusted gross income. Taxpayer now protests these assessments.

I. Financial Institutions Tax – "Add back" of State and Local Taxes

DISCUSSION

Taxpayer and Taxpayer Subsidiaries filed a combined FIT return with the state of Indiana for tax periods covering years 1994 through 1996. In order to compute its Indiana FIT liabilities, Taxpayer prepared (and submitted) federal pro forma returns. Audit explains the relationship between the *filed* Indiana FIT return and the *prepared* federal pro forma returns:

> The [Indiana] FIT return line 1…[represents the] Federal taxable income [taken] from the [federal] pro forma returns. *The taxpayer's calculation of federal taxable income includes a deduction from gross income for income tax expenses which were included in the "other deductions" total of the pro forma return*, therefore the taxpayer has taken a deduction for income tax when starting the Indiana tax returns (emphasis added).

Taxpayer's federal pro forma returns, according to Audit, indicate that taxpayer deducted from its federal gross income expenses representing payments of state and local taxes. Taxpayer, however, in contravention of IC 6-5.5-1-2(a)(1)(C), failed to "add back" these deducted amounts in computing its Indiana FIT liabilities. Consequently, Audit proposed additional assessments of Indiana FIT.

Taxpayer contends the expenses at issue (and, of course, the related deductions), do not represent the payment of taxes *levied*

by a state. Specifically, according to taxpayer, these taxes were neither levied upon nor paid by *this particular taxpayer*. Taxpayer explains:

> [Taxpayer's Parent], Taxpayer, and the Taxpayer Subsidiaries are parties to a certain Tax Allocation Agreement (the "Agreement"). [Taxpayer's Parent] files consolidated and/or combined income tax returns in many states. The consolidated and/or combined state income tax returns filed by [Taxpayer's Parent] in some cases include the income of Taxpayer and the Taxpayer Subsidiaries. In those cases, the applicable state income tax for the consolidated/combined group is levied by the states upon [Taxpayer's Parent], who must pay the state income tax for the group.
>
> Under the Agreement…, the Taxpayer Subsidiaries each pay to Taxpayer a management fee representing the amount each Taxpayer Subsidiary would otherwise be required to pay (but is not required by state law to pay) AS IF it were a stand-alone state taxpayer and not part of the consolidated and/or combined state returns filed by [Taxpayer's Parent]. Taxpayer collects these management fees from the Taxpayer Subsidiaries, and then remits them to [Taxpayer's Parent].

Additionally, taxpayer has argued that the payments Audit seeks to addback do not represent taxes based on or measured by income, but rather represent "a management fee charged by [Taxpayer's Parent] which is deductible as an ordinary and necessary business expense under Section 162 of the IRC.

Notwithstanding taxpayer's arguments to the contrary, taxpayer may not avoid the prescriptions of IC 6-5.5-1-2(a)(1)(C) by attempting to re-characterize "taxes based on or measured by income and levied at the state level" as management fees paid to its parent. That Taxpayer's Parent chose to file combined and/or consolidated returns that included income from Taxpayer and Taxpayer Subsidiaries does not change the source of the income earned or the allocation of taxes paid. In this instance, Audit has relied on taxpayer's own pro forma returns to identify those taxes deducted from taxpayer's federal taxable income. Absent a showing that these state and local taxes were neither paid nor deducted by the filing entity, Audit's reliance on taxpayer's pro forma return was proper.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04990462.LOF

LETTER OF FINDINGS NUMBER: 99-0462
State Gross Retail Tax
For the 1996, 1997, and 1998 Tax Years

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position regarding a specific issue.

ISSUES

I. Calculation of Taxpayer's Gross Retail Tax Liability Based Upon the Best Information Available

Authority: IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 2.2-6-8(a)

Taxpayer protests the audit's determination, based upon a "best information available" assessment, that taxpayer is liable for a certain amount of unpaid gross retail (sales) tax. Taxpayer argues that, based upon more recent sales figures, it is possible determine a more accurate – and lesser – sales tax liability.

II. Request for Abatement of the Ten Percent Negligence Penalty

Authority: IC 6-8.1-5-1(b); IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-(c)

The taxpayer has asked the Department to exercise its discretion to abate the ten-percent negligence penalty. Taxpayer maintains that its failure to retain complete financial records was a simple oversight made by an inexperienced businessperson.

STATEMENT OF FACTS

Taxpayer owns two taverns both of which are essentially bar and liquor stores. The taverns also market food and certain related items. One of the taverns sells enough food to entitle it to a Sunday liquor license. During the tax years 1996, 1997, and 1998, the taxpayer failed to keep cash receipts or other information documenting the sales at either of the establishments. The audit assessed sales tax based upon the best information available. Audit compared the taxpayer's reported cost of goods sold and the taxpayer's reported taxable sales with a published source, Dr. Leo Troy, ALMANAC OF INDUSTRIAL AND FINANCIAL RATIOS (29th ed. 1998), but determined that the result was unrealistically high. Instead the audit calculated taxpayer's sales by determining the taxpayer's cost of goods sold and "grossing up, the figure by a factor of two. The Department's past practice, in previous cases with similar facts, was to utilize a factor between 2 and 7. In taxpayer's situation, the audit decided that the facts did not justify using a factor other than two.

DISCUSSION

I. Calculation of Taxpayer's Sales and Use Tax Liability Based Upon the Best Information Available

Taxpayer protests the determination of its sales tax liability for 1996, 1997, and 1998 because it claims that the "percentages do not accurately reflect of the operations of [taxpayer]." Taxpayer Letter, March 1, 2001, p. 1. Among other reasons, the taxpayer claims that the audit determination does not take into account a realistic apportionment between the taxpayer's bar sales and package liquor sales and the variance in the profit margins of the two taverns. Taxpayer further claims that the audit's determination does not account for certain variables such as "local economic conditions, location, patron demographics, and market pressures." Id. at p. 2. Taxpayer does not claim that it is able to assemble actual records for the years at issue. Instead, taxpayer presents a competing estimate of its taxable sales for 1996 through 1998. Taxpayer arrives at this estimate by extrapolating backwards from those years in which complete sales records are available. Taxpayer used a 21-month period, between April 1999 and December 2000, as a base period in which to calculate its taxable sales for 1996, 1997, and 1998. Taxpayer maintains that there is no reason to believe that there has been a substantive change of the ratio of sales to cost of sales between the tax years at issue and the taxpayer's 21-month base period.

Taxpayer utilized the following procedure to calculate its estimated sales tax liability. Taxpayer summarized cash register receipts ("Z" tapes) by categories including bar sales, package goods, food, and miscellaneous sales. Id. at 2. This summary of sales was compared with taxpayer's purchases made during the same 21-month time period. The comparison between sales and actual purchases resulted in a "mark-up" factor of 1.52 for tavern one and a mark-up factor of 2.10 for tavern two. Taking into account the fact that tavern one's sales exceed that of tavern two by a factor of 2.5, the taxpayer reached a combined mark-up factor of 1.65 for the two establishments.

In addition, the taxpayer has submitted information relating to the applicability of a "shrinkage" factor in determining the its sales tax liability. Taxpayer Letter, March 1, 2001, p. 3; Taxpayer Facsimile, March 7, 2001. Taxpayer maintains that, due to the nature of its business, a certain amount of loss can be attributed to employee dishonesty. Taxpayer maintains that "cost of shrinkage" must be removed from any initial calculation of its sales to reflect the true cost of sales. Based upon the taxpayer's research, the "cost of shrinkage" can be reasonably calculated at between 23% for hard liquor and draft sales, 10% for wine sales, and 2% on bottled beer. Taxpayer has estimated its own shrinkage at 15% and has applied that figure in arriving at an estimate of its taxable sales.

45 IAC 2.2-6-8(a) states that "[i]n determining the retail merchants' tax liability for a particular reporting period, the retail merchant shall multiply the retail merchant's total gross retail income from taxable transactions made during period.... *"* The rule is straightforward but complicated by the fact that records of the taxpayer's "taxable transactions" do not exist. In those situations in which the taxpayer has not maintained adequate records, the Department is authorized to reach an assessment based upon the best information available. IC 6-8.1-5-1(a) states that "[i]f the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the *best information available.*" (Emphasis added). The Department made such an assessment by considering published information, the records provided by the taxpayer, and the Department's own past practices. The audit considered those factors, discarded the unrealistically high initial result, and eventually adopted a multiplier of two.

The initial audit determination of taxpayer's liabilities arrives with a presumption of correctness. IC 6-8.1-5-1(b) states that "[t]he 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." As the "person against whom the proposed assessment [was] made," taxpayer has met its burden of submitting information – based upon adequately maintained financial records – which raises the question of whether audit's determination most accurately reflects taxpayer's taxable sales. Taxpayer has provided - for the 21-month base period - original cash register receipts, monthly summaries of those receipts, and workpapers which purport to establish the reliability of the taxpayer's proposed 1.65 multiplier and its consequent sales tax liability.

However, taxpayer's request to include a "shrinkage factor" in the final calculation of its sales tax liability is unwarranted. Taxpayer's argument fails for two reasons. First, losses based on inventory shrinkage are highly variable, dependent on the unique circumstances of each individual business, and difficult to determine with any reasonable degree of certainty. Second, taxpayer is asking the Department to approve a method of determining its past sales in which the "shrinkage factor" is already an inherent component. Taxpayer asks the Department to adopt a 1.65 multiplier in calculating the taxpayer's sales. This means that, in those years in which taxpayer failed to maintain adequate records, for every $100 in goods taxpayer purchased, the taxpayer will be assessed tax on $165 in sales. Whatever shrinkage or other losses the taxpayer may have experienced occurred between the time taxpayer purchased the $100 in goods and sold those goods for $165. The inventory shrinkage is already an essential component in that final sales calculation. Whether taxpayer experienced 1%, 50%, or 99% in inventory shrinkage, taxpayer purchased $100 in goods and then sold those same goods – minus whatever losses were incurred – for $165. Audit may review taxpayer's records and find that the 1.65 multiplier is entirely reasonable, but taxpayer is not entitled to piggy-back an additional "shrinkage factor" on that multiplier.

The audit division is requested to perform a supplemental audit to verify the reliability and factual basis of the taxpayer's

proposed determination of its sales tax liability.

FINDING

Subject to the results of the supplemental audit, taxpayer's protest is sustained.

II. Request for Abatement of the Ten Percent Negligence Penalty

The taxpayer has requested that the ten-percent negligence penalty, assessed by audit under authority of IC 6-8.1-10-2.1, be abated. The Department's regulations provide guidance in determining those instances in which imposition of the ten-percent negligence penalty is appropriate. 45 IAC 15-11-2(b) defines negligence as "the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." The taxpayer's negligence may be inferred from its "carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." Id. IC 6-8.1-10-2.1(d) requires that the Department waive the penalty upon a showing that the taxpayer's failure to pay the tax delinquency was due to "reasonable cause and not due to willful neglect." In order to establish "reasonable cause," 45 IAC 15-11-2(c) requires that the taxpayer 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...."

Taxpayer maintains that its failure to retain accurate sales records was the result of an erroneous decision of a novice, unsophisticated businessperson. Further, the taxpayer argues that any mistakes it made were due to unfamiliarity with its responsibilities under the relevant tax code and not due to willful neglect.

The taxpayer has failed to set forth a basis for establishing that it exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Taxpayer's assertion, requesting that the penalty be abated based upon the taxpayer's own naivete, is insufficient to overcome the presumption of correctness afforded the audit's determination under IC 6-8.1-5-1(b). 45 IAC 15-11-2(b) states that "[i]gnorance of the listed tax laws, rules and/or regulations is treated as negligence."

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0220000359P.LOF

LETTER OF FINDINGS NUMBER: 00-0359P
Income Tax
Calendar Year Ended 1998

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE(S)

I. Tax Administration – Penalty

Authority: IC 6-3-4-4.1

Taxpayer protests the penalty assessed.

STATEMENT OF FACTS

Taxpayer was assessed a civil penalty for the underpayment of estimated income taxes. Taxpayer made one payment in the amount of $12,000 for the first quarter. Taxpayer made no subsequent payments for the remaining quarters, with a final payment of $50,000 on March 15, 1999. Taxpayers required to make estimated payments must remit either 100% of the prior year's tax or 80% of the current year's tax in four estimated payments to avoid the penalty.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the penalty assessed because it changed ownership on September 16, 1998 and elected for federal tax purposes section 338(h)(10) that resulted in a large amount of income on that date due to the sale of the company. Taxpayer further states that the estimated quarterly tax payments made, matched the income of the company throughout the year. Taxpayer requests a refund of the penalty paid.

The penalty was assessed in this instance because the Taxpayer did not meet either of the exceptions from penalty for the underpayment of estimated taxes. The Taxpayer remitted neither 100% of the prior year's tax nor 80% of the current year's tax in a timely manner.

Taxpayer has not provided reasonable cause to allow a waiver of the penalty. Taxpayer did not timely remit its quarterly estimated taxes.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120010096P.LOF

LETTER OF FINDINGS NUMBER: 01-0096P
Individual Income Tax
Calendar Year 1997 and 1999

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE(S)

I. Tax Administration – Underpayment Penalty

Authority: IC 6-8.1-10-2.1(d); 45 IAC 15-11-2

Taxpayer protests the penalty assessed.

STATEMENT OF FACTS

Taxpayer protests the penalty assessed and states that the penalty was never applied to previous years. Taxpayer faxed information on May 15, 2001 regarding the Underpayment penalty for 1997 that reduced the amount of tax carried forward to 1998. A discussion regarding the tax was held on May 16, 2001 via telephone.

In reviewing the taxpayer's file, it was noted that the taxpayer actually protested the 1999 underpayment penalty for which a hearing was scheduled. Taxpayer was forwarded a copy of an IT-2210 prepared by the department that showed an underpayment penalty of $312.72. The hearing officer has reviewed the prepared IT-2210 and has determined that it was correctly prepared. The taxpayer was mailed a copy of the IT-2210 and a copy of *The Collection Process* brochure.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer requests the department waive the penalty assessed because it had been paying its tax consistently with the same method for several years and no one had explained the underpayment penalty after consistent requests.

The 1997 Indiana Resident Individual Tax Booklet, page 29, and the 1999 Indiana Resident Individual Tax Booklet, page 30, clearly state who must make estimated income tax payments. An ES-40 Estimated Tax Payment coupon and an Estimated Income Tax Worksheet are included in the booklet. The instructions are clear.

IC 6-3-4-4.1 (c) states:

Every individual who has gross income subject to the tax imposed by this article and from which tax is not withheld under the requirements of section 8 of this chapter shall make a declaration of estimated tax for the taxable years. However, no such declaration shall be required if the estimated tax can reasonably be expected to be less than four hundred dollars ($400). In the case of an underpayment of the estimated tax as provided in Section 6654 of the Internal Revenue Code, there shall be added to the tax a penalty in an amount prescribed by IC 6-8.1-1-2.1 (b).

The IT-40 return line 31 also clearly lists penalty for underpayment of estimated tax for 1997 and line 32 for 1999.

Taxpayer has not provided reasonable cause to allow a waiver of the underpayment penalty.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220010098P.LOF

LETTER OF FINDINGS NUMBER: 01-0098P
Adjusted Gross Income Tax - Penalty
For Fiscal Year Ended March 31, 1999

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE(S)

I. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1(d); 45 IAC 15-11-2

Taxpayer protests the penalty assessed.

STATEMENT OF FACTS

Taxpayer was audited for fiscal years 1997, 1998, and 1999. Upon audit it was discovered that the taxpayer failed to include in the numerator of the sales factor, the sales from Indiana to a state in which the taxpayer is not taxable under PL 86-272. The taxpayer correctly reported the sales in 1997 and 1998. The adjustment amounted to twenty-eight percent (28%) of the tax due for 1999.

Taxpayer protests the penalty and states that the underestimate was purely an oversight on the part of the Taxpayer and it prepares a schedule of sales by state with a separate column for states to which it does not have nexus and are therefore subject to sales throwback rules. Taxpayer further states that it was its intent to properly apply the sales throwback rules of Indiana and the oversight was disclosed to the auditor.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer states reasonable cause exists because it discovered the oversight prior to the auditor's arrival and disclosed the information promptly to the auditor.

Taxpayer was assessed a negligence penalty because it failed to properly report sales subject to apportionment. The deficiency amounted to more than twenty-eight percent (28%) of the total tax due. A review of the information on the taxpayer's apportionment schedule would have shown that the apportionment schedule for 1999 did not include PL 86-272 income as in prior years. Taxpayer has the responsibility to assure that tax returns are properly filed.

The department finds that a negligence penalty is proper.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220010105P.LOF

LETTER OF FINDINGS NUMBER: 01-0105P
Gross and Adjusted Gross Income Tax
Fiscal Years Ended 9/30/89, 9/30/90, 9/30/91, 9/30/92, 9/30/93, 9/30/94, 9/30/95, 9/30/96, 9/30/97, and 9/30/98

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE(S)

I. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1

Taxpayer protests the penalty assessed.

STATEMENT OF FACTS

Taxpayer was assessed a negligence penalty for its failure to file tax returns for fiscal years 1989 through 1994. Taxpayer began filing income tax returns in 1995 after a sales tax audit revealed that it rented and sold tools in the state of Indiana. Taxpayer made no attempt to file returns in the previous years.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the penalty assessed because it was unaware of tools being maintained in Indiana. A review by the hearing officer of taxpayer's working papers, however, found that capitalized and rented tools in Indiana were on taxpayer's own in-house listings for the years at audit.

Taxpayer's representative states it was unaware of the tools being in Indiana and its income tax filing obligation in Indiana until the taxpayer underwent a sales and use tax audit in 1995. Taxpayer has timely filed its income tax returns since 1995.

The penalty was assessed in this instance because the Taxpayer did not attempt to correct the prior filings after it was made aware of its tax obligations. Returns should have been filed for all of the audit years.

Taxpayer has not provided reasonable cause to allow a waiver of the penalty.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220000256.SLOF

SUPPLEMENTAL LETTER OF FINDINGS NUMBER 00-0256
Financial Institutions Tax
For the Tax Years 1996 and 1997

NOTICE: Under IC 4-22-7-7, this document is to be published in the Indiana Register and is effective on the date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Taxpayer's Qualifications to File Under Indiana's Financial Institutions Tax

Authority: IC 6-5.5 et seq.; IC 6-5.5-1-17(d)(1); IC 6-5.5-1-17(d)(2)(A), (B); IC 6-5.5-3-1; 45 IAC 17-2-1(a); 45 IAC 17-2-4(b); 45 IAC 17-2-4(b)(1); 45 IAC 17-2-4(b)(2); 45 IAC 17-2-4(b), (c); 45 IAC 17-2-4(b)(1)-(3); 45 IAC 17-2-4(d)(1), (2); 45 IAC 17-2-4(e)(1); 45 IAC 17-2-4(e)(2); Rev. Rul. 55-540, § 162(4) 1955-2 CB 39; Rev. Proc. 75-21, § 4, 1975-1 CB 715

Taxpayer protests the determination, contained within the original Letter of Findings, that taxpayer did not qualify to file under Indiana's Financial Institutions Tax. That determination affirmed the audit's previous decision to change taxpayer's filing status from a FIT-20 status to that of an IT-20 regular filer.

STATEMENT OF FACTS

Taxpayer is in the business of leasing and financing the purchase of construction equipment and engines. Taxpayer does this by entering into various forms of transactions between itself, taxpayer's local dealerships, municipalities, or individual customers. The taxpayer is a Delaware Corporation headquartered in Illinois.

A hearing was originally held on the issues raised by taxpayer, a determination was reached that taxpayer did not qualify to file under the Financial Institutions Tax, and a Letter of Findings to that effect was issued by the Department. The taxpayer requested and was granted an opportunity for a rehearing during which the taxpayer presented documentary evidence purporting to establish that the taxpayer was qualified to file under the Financial Institutions Tax. This Supplemental Letter of Findings revisits the issue.

I. Taxpayer's Qualifications to File Under Indiana's Financial Institutions Tax

DISCUSSION

Taxpayer's protest initially stemmed from audit's decision to change the taxpayer's filing status from that of an FIT-20 filer to an IT-20 filer. Audit made this decision because it determined that taxpayer did not provide sufficient proof to demonstrate that taxpayer's leases – transactions around which taxpayer's business is centered – were true financial leases. The taxpayer disagreed and continues to disagree with that conclusion. The taxpayer maintains that, because of the particularized manner in which conducts its business of leasing and financing the purchase of construction equipment, it comes within the definition of a financial institution pursuant to 45 IAC 17-2-4(d)(1), (2).

Taxpayer makes this claim for two reasons. First, the taxpayer argues that, pursuant to 45 IAC 17-2-4(d)(1), it is conducting the business of a financial institution because it is "extending credit." *See also* 45 IAC 17-2-4(e)(1). Second, the taxpayer argues that, pursuant to 45 IAC 17-2-4(d)(2), it undertakes leasing transactions which are "the economic equivalent of extending credit." Id. Taxpayer maintains that by accumulating those transactions which consist of extending credit together with those transactions which are the economic equivalent of extending credit, it reaches the 80 percent benchmark – set out in 45 IAC 17-2-4(b) – which allows it to claim FIT filing status.

Indiana imposes a franchise tax, known as the Financial Institution Tax (FIT), on corporations transacting the business of a financial institution inside the state. IC 6-5.5 et. seq. The FIT is imposed on resident financial institutions, nonresident financial institutions, and to certain non-bank entities that transact the business of a financial institution. 45 IAC 17-2-1(a). Non-resident corporations, such as the taxpayer, transacting the business of a financial institution, are included in the FIT, when they first meet one of the eight tests set out in IC 6-5.5-3-1 whereby the non-resident corporation demonstrates that it has established an economic presence in Indiana. It was not disputed at the time of the original Letter of Findings, and it is not disputed here, that taxpayer has established an economic presence in Indiana. That issue will not be revisited.

Because the taxpayer is not conducting the business of a traditionally regulated financial institution as defined in IC 6-5.5-1-

17(d)(1), the taxpayer predicates its claim to FIT status under the provisions of IC 6-5.5-1-17(d)(2)(A), (B) which grant FIT status to those corporations which obtain 80 percent of their gross income from the "[m]aking, acquiring, selling, or servicing loans or extensions of credit" or from the "leasing [of] real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes".

The benchmark for determining whether a taxpayer is "conducting the business of a financial institution" is if 80 percent of the corporation's gross income is derived from the economic equivalent of extending credit. 45 IAC 17-2-4(b), (c). The taxpayer may reach this 80 percent benchmark in one of three ways. It may do so by deriving 80 percent of its income from "(1) Extending credit... (2) Leasing that is the economic equivalent of extending credit [or] (3) Credit card operations." 45 IAC 17-2-4(b)(1)-(3).

An explanation of "the economic equivalent of the extension of credit" is found within the Department of Revenue regulations. 45 IAC 17-2-4(b), (c). The corporation must not only derive 80 percent of its income from collecting interest, that interest must be derived from a lease that is "*not* treated as a lease for federal income tax purposes." 45 IAC 17-2-4(e)(2) (Emphasis added). Therefore, to satisfy the requisite 80 percent benchmark, the interest must be both "the economic equivalent of the extension of credit" and from a lease "*not* treated as a lease for federal income tax purposes."

The taxpayer, looking to reach the 80 percent benchmark by "[l]easing that is the economic equivalent of extending credit" (45 IAC 17-2-4(b)(2)) is required to demonstrate that the transactions from which it derives interest income are not true leases but financing leases. A financing lease appears on the surface to be a lease – and may be labeled as such – but in substance is simply a device which enables the lessor to retain a security interest in the property until the purchase price is paid by lessee. IRS Revenue Ruling 55-540 provides the guidelines used in determining the treatment of equipment leases for use in the trade or business of the lessee. Whether a lease agreement is a lease, or in reality a conditional sale (financing lease) depends on the provisions of the agreement in light of the facts and circumstances existing at the time the agreement was executed. Rev. Rul. 55-540, § 162(4) 1955-2 CB 39. In the "absence of compelling persuasive factors" demonstrating otherwise, a transaction is a conditional sales contract if one or more of the following factors are present.

(1) Portions of the periodic payments are specifically applicable to the equity to be acquired by lessee;

(2) the lessee acquires title upon a payment of a stated amount of rentals which under the contract the lessee is required to make,

(3) the total amount paid by the lessee for a relatively short period of use constitutes an inordinately large proportion of the total payments required to secure transfer of title,

(4) the rental payments materially exceed the fair rental value,

(5) the property can be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time the option may be exercised or which is a relatively small amount when compared to the total,

(6) some portion of the payments is specifically designated as interest or is otherwise recognizable as the equivalent of interest. Id.

IRS Revenue Procedure 75-21 expands on Revenue Ruling 55-540 by elaborating on the facts and circumstances that indicate whether a transaction is, in contrast to a conditional sale, a true lease. Such true leases may not be used by the taxpayer to reach the 80 percent benchmark because they are not the "economic equivalent of extending credit." A transaction will constitute a true lease if *all* of the following conditions are met;

(1) The lessor must have a minimum unconditional risk investment in the property at the inception of the transaction,

(2) the lessor must maintain the minimum at risk investment throughout the lease and that risk must remain at the end of the lease,

(3) the minimum at risk investment must be equal to at least 20% of the cost of the property and must remain at 20% throughout the entire lease term,

(4) and, there must be a residual investment of at least 20% at the end of the lease term. Rev. Proc. 75-21, § 4, 1975-1 CB 715.

Taxpayer conducts its business by means of seven different forms of transactions. For purposes of this discussion, these will be grouped into one of two different categories. "Qualifying Transactions" are those transactions which fall within the purview of 45 IAC 17-2-4(b)(1)-(3) and which can be accumulated to bring the taxpayer to the 80 percent benchmark required to qualify taxpayer as a FIT filer. "Non-qualifying Transactions" are those transactions which cannot be accumulated to bring the taxpayer to the 80 percent benchmark.

A. Non-Qualifying Transactions

Taxpayer's first two forms of transactions are described by the taxpayer as "operating leases" and "conditional sales contracts." Taxpayer Information, Feb. 7, 2001, p. 1-2. These two forms of contracts are Non-Qualifying Transactions because they are not "the economic equivalent of the extension of credit." 45 IAC 17-2-4(b), (c). For the tax years at issue, these two transactions purportedly represent 6.66% and 6.75% of the taxpayer's gross income. Taxpayer Information, Feb. 7, 2001, Attachment A. Because the taxpayer does not assert, and because that assertion is not disputed here, the transactions are Non-Qualifying Transactions which do not assist the taxpayer in achieving the 80 percent benchmark needed to qualify for FIT status.

B. Qualifying Transactions

Taxpayer bases its claim to FIT status on the remaining five transactional forms set out as follows. Taxpayer labels those purportedly Qualifying Transactions as; conditional sales contracts, installment sales, municipal sales, dealer/customer notes, and "other non-rental/lease income."

1. Conditional Sales Contracts

In taxpayer's conditional sales contracts, taxpayer purchases an item of equipment from one of its local dealers and simultaneously sells the machine to the customer by executing a "conditional sales contract" with the customer. This arrangement allows the customer to purchase the equipment at the end of contract for a nominal amount. Taxpayer describes a "conditional sales contract" as a means by which the taxpayer finances a customer's purchase of equipment. In a "conditional sales contract," the customer owns the equipment but taxpayer maintains a security interest in the equipment during the term of the contract. Taxpayer provides a specific example of a "conditional sales contract." Taxpayer Information, Feb. 7, 2001, Attachment D-1, D-2. In that example, the original cost of the equipment is $113,500. The customer makes 36 monthly payments of $3,794 with the total payments equaling $136,619. At the end of the three-year contract, the customer has the option to purchase the equipment for $1.00. Under Rev. Rul. 55-540, taxpayer's "conditional sales contracts" are Qualifying Transactions" (conditional sales contracts) because; (1) the lessee acquires an equity interest in the equipment during the lease, (2) the customer acquires title to the equipment upon payment of a stated amount of rentals, (3) the amount paid by the customer constitutes an inordinately large proportion of the total payments required to secure transfer of the title, and (4) at the end of the lease, the equipment can be purchased by the customer at a bargain. Id. Accordingly, the taxpayer's "conditional sales contracts" are Qualifying Transactions for the purposes of acquiring FIT status.

2. Installment Sales Contracts

In an "installment sales contract," one of taxpayer's local dealers sells an item of equipment to a customer and enters into the "installment sales contract" with the customer. The taxpayer then purchases the "installment sales contract" from the local dealer. The "installment sales contract" is an arrangement by which the customer owns the equipment but taxpayer maintains an interest in that equipment as security for the customer's obligations under the "installment sales contract." Taxpayer has provided an example of a "installment sales contract." Taxpayer Information, Feb. 7, 2001, Attachment E-1, E-2. Under the example, the original cost of the equipment is $221,845. The customer makes 60 monthly payments of $4,650 consisting of principal and interest. At the end of the 60 months, the customer has made total payments of $279,037. After the last monthly payment has been made, the taxpayer no longer has a security interest in the equipment. Under Rev. Rul. 55-540, taxpayer's "installment sales contracts" are Qualifying Transactions because; (1) the customer acquires an equity interest in the equipment by means of the down payment and the monthly payments, (2) the customer acquires title upon a payment of a stated amount of rentals which the customer is required to make, (3) a portion of the payments is specifically designated as interest, and (4) portions of the monthly payments are specifically applied to the equity which is acquired by the customer. Accordingly, the taxpayer's "installment sales contracts" are Qualifying Transactions for the purpose of acquiring FIT status.

3. Municipal Sales

In taxpayer's "municipal sales" transactions, the customer is a municipality and the transaction itself is structured the same as a "conditional sales" contract. The taxpayer has provided an example of a "municipal sales" contract. Taxpayer Information, Feb. 7, 2001, Attachment F-1, F-2. In the example provided, the original cost of the equipment is $71,103 less a trade-in valued at $25,000. The municipal customer will make two annual payments of $16,560 and a mandatory third payment of $1.00. The total principal and interest – including the down payment – is equal to $73,768. Upon receiving the third payment, the taxpayer no longer has a security interest in the equipment. Under Rev. Rul. 55-540, taxpayer's "municipal sales" contracts are Qualifying Transactions because; (1) portions of the periodic payments are specifically applicable to the equity to be acquired by the municipal customer, (2) the municipal customer acquires title upon a payment of a stated amount of rentals which the municipal customer is required to make, and (3) the equipment is acquired by the municipal customer for a price which is nominal when compared to the value of the equipment at the time the equipment is acquired. Accordingly, the taxpayer's "municipal sales" contracts are Qualifying Transactions for the purpose of acquiring FIT status.

4. Dealer/Customer Notes

The taxpayer's "dealer/customer notes" are straightforward promissory notes entered into between the taxpayer and either one of the taxpayer's local dealers or directly with the customer. On occasion, the taxpayer will enter into a "dealer/customer note" by purchasing the promissory note from a third party. These "dealer/customer notes" are entered into for two purposes. The "dealer/customer" notes can be used by the local dealer to acquire working capital. Normally, the working capital is then used to provide the local dealer with a stock of readily available equipment. The "dealer/customer notes" can also be entered into with either a customer or a local dealer for the purpose of allowing either the customer or dealer to acquire a specific item of equipment. For whatever purpose, the equipment itself is irrelevant to the transaction. Taxpayer has provided an example of a "dealer/customer note." Taxpayer Information, Feb. 7, 2001, Attachment G-1, G-2, G-3. The "dealer/customer notes" are straightforward promissory notes and constitute "Qualifying Transactions" because they fall within the purview of 45 IAC 17-2-4(b)(1). The "dealer/customer notes" are extensions of credit by which the taxpayer acquires interest payments. The taxpayer is "extending credit" because, by

means of the "dealer/customer notes" the taxpayer is "[m]aking, acquiring, selling, or servicing loans or extensions of credit... includ[ing] secured or unsecured consumer loans... [or] secured and unsecured commercial loans of any type." 45 IAC 17-2-4(e)(1). Accordingly, the "dealer/customer notes" are Qualifying Transactions for the purpose of acquiring FIT status.

5. Other non-rental lease income

The taxpayer has presented a amalgam of miscellaneous transactions which it has grouped under the category of "other non-rental lease income." For purposes of this discussion, these miscellaneous transactions are addressed separately. The first transactions consist of interest income earned on loans to related parties. These transactions are inter-company loan agreements. These inter-company loan agreements constitute Qualifying Transactions. Under 45 IAC 17-2-4(e)(1), the agreements constitute the business of "extending credit" because they constitute "secured and unsecured commercial loans of any type... (or) other transactions with a comparable economic effect." Accordingly, the interest derived from inter-company loan agreements can be used to reach the 80 percent benchmark figure needed to attain FIT status.

The second miscellaneous transaction consists of "wholesale finance income." This income is derived from loans to the taxpayer's local dealerships for the purpose of acquiring inventory. These transactions are similar to "dealer/customer notes" and, therefore also constitute Qualifying Transactions for the purpose of allowing taxpayer to attain FIT status.

The third miscellaneous transaction taxpayer labels as "insurance finance income." These transactions are straightforward loans made to customers who have purchased, from one of the taxpayer's local dealers, an item of equipment. These loans are made to the customer to enable that customer to purchase insurance for that particular item of equipment. The insurance is necessary because the customer has entered into a purchase agreement – either with taxpayer, local dealer, or a third-party – whereby the agreement mandates the equipment be insured during the term of the purchase agreement. The interest represents income from a Qualifying Transaction because the income is the result of extending credit for "loans and extensions of credit include[ing] secured or unsecured consumer loans...." 45 IAC 17-2-4(e)(1).

The fourth miscellaneous transaction taxpayer labels as "service fee income on securitizations." This income results when taxpayer markets to a third-party loans taxpayer previously entered into with various local dealers and customers. Although the taxpayer has sold a particular loan to a third-party, taxpayer continues to service the loan by collecting monthly payments and doing whatever necessary to enforce the terms of the original loan. From the point of view of the customer or local dealer, the transaction whereby taxpayer sold the loan to a third-party is entirely transparent. Customer and local dealer continue to deal directly with the taxpayer. The "service fee income on securitizations" is derived from the "spread" (difference) between what taxpayer collects from customer or local dealer and what the taxpayer then pays over to the third-party. As an example, taxpayer collects monthly payments from a customer or local dealer consisting of principal and 5 percent interest. Taxpayer, in turn, forwards to third-party the amount of principal and 4 percent interest. Taxpayer retains 1 percent interest for itself. The 1 percent retained interest represents, in the taxpayer's jargon, "service fee income on securitizations." The "service fee income on securitizations" does not represent income from a Qualifying Transaction. By marketing the original loans to a third-party, taxpayer has removed itself from the business of extending credit and places itself in the business of providing certain loan services on behalf of the third-party. It is the third-party who is extending credit. The taxpayer, now on the periphery of the original loan transaction, is in the business of providing services ancillary to the loan transaction itself.

The fifth miscellaneous transaction is described as "late charges and document fees." This is income earned by the taxpayer when payments for Qualifying Transactions are received late and income received for the preparation of documents related to those Qualifying transactions. The income derived from late charges and document fees represents income from a Qualifying Transaction because the income is derived from the business of extending credit.

Taxpayer has submitted evidence purporting to establish that it derives at least 80% of its income from Qualifying transactions. As set out in the information provided by taxpayer, taxpayer's income from Qualifying Transactions constitutes approximately 93% of its income for both of the two relevant tax years. Taxpayer Information, Feb. 7, 2001, Attachment A. However, taxpayer misapprehends the basis upon which the 80% benchmark figure is calculated. The regulation provides that taxpayer "is deemed to be conducting the business of a financial institution and therefore subject to the FIT if eighty percent (80%) or more of the [taxpayer's] *gross income during the taxable year* is derived from... leasing that is the economic equivalent of the extension of credit...." 45 IAC 17-2-4(b), (c) (Emphasis added). Even if the Department were to accept the taxpayer's specific characterizations of its interest income, using the taxpayer's "Total Income" as represented on line 11 of its 1996 and 1997 federal tax returns and disregarding the determination that "service fee income on securitizations" is not derived from a Qualifying Transaction, taxpayer's income from Qualifying Transactions represents approximately 59% and 64% of its gross income for the two tax years at issue. Alternatively, using taxpayer's gross receipts as a basis for calculating the FIT benchmark figure, taxpayer's income from Qualifying Transactions represents approximately 24% of its gross income for the two tax years at issue. No matter upon which basis the numbers are calculated, the percentages fall short of the 80% FIT benchmark. Taxpayer is not qualified to file under the state's Financial Institutions Tax.

FINDING

Taxpayer's protest is respectfully denied.