

**DEPARTMENT OF STATE REVENUE  
INFORMATION BULLETIN #28  
Income Tax  
September 2001**

**(Replaces Information Bulletin #28, 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:** APPLICATION OF STATE AND COUNTY INCOME TAXES TO RESIDENTS WITH OUT-OF-STATE INCOME AND NONRESIDENTS WITH INDIANA SOURCE INCOME

**REFERENCE:** IC 6-3-1-3.5; IC 6-3-1-12; IC 6-3-1-13; IC 6-3-2-2; IC 6-3-3-3; IC 6-3-4-15; IC 6-3-5-1

**INTRODUCTION:**

Full-year Indiana residents must report all income that is reported for federal income tax purposes on their Indiana individual income tax return, (Form IT-40). This includes all income, even if it is derived from sources outside Indiana.

Full-year nonresidents who received income from Indiana sources must file an Indiana individual income tax return, (Form IT-40PNR). They are subject to tax on that part of their total federal income that is derived from or connected with Indiana sources.

Part-year Indiana residents must file an Indiana individual income tax return, (Form IT-40PNR). They are subject to tax on that part of their total federal income that was received while they were residents of Indiana. Also taxable is income from Indiana sources received while they were nonresidents of Indiana.

If a joint federal income tax return is filed, a joint Indiana return is also required. If separate federal income tax returns are filed, separate Indiana returns are also required.

**I. INCOME RECEIVED FROM INDIANA SOURCES**

Income received from Indiana sources is considered Indiana income to nonresidents, except certain types of Indiana source income that are subject to tax only by the taxpayer's state of legal residence. Interest, dividends, royalties and gains from the sale of capital assets are subject to tax only by the taxpayer's state of legal residence unless such income results from the conduct of a trade or business. If a trade or business is conducted in Indiana, the income from such should be reported as Indiana income.

Income from a qualified pension, annuity, profit sharing or stock option plan is subject to tax by the taxpayer's state of legal residence. Lump sum distributions from qualified plans are subject to tax by the state that, at the time of distribution, is the taxpayer's state of legal residence.

Deferred compensation other than from a qualified retirement plan, accumulated vacation, bonus, severance and sick pay are directly attributable to services performed, and is taxable by the state where the services were performed.

**II. STATE TAX AGREEMENTS**

Taxpayers may be subject to individual income tax by both their state of residence and the state from which the income is derived. The State of Indiana has entered into agreements with several states to eliminate the requirement of paying tax to two states on the same income. Tax treatment of out-of-state income depends upon the types of income and the state from which the income is derived.

In the case of tax credits, Indiana only allows credits for individual income tax paid to other states or localities. Other taxes such as property taxes, corporate income taxes, and unincorporated business taxes are not allowed as a basis for claiming such credits. A worksheet indicating how the credit was computed and a copy of the tax return filed with the other state must be attached to the Indiana return. Withholding statements or other evidence of tax payments will not be accepted. A copy of Federal Form 1116, (Computation of Foreign Tax Credit), must be attached if credit is claimed for tax paid to a foreign country.

In computing the credit allowed by Indiana, adjusted gross income that is subject to tax in both states should be used as a basis for calculating the allowable credit. Adjustments that increase or decrease the taxable amount in other states should not be considered in calculating the allowable credit. For example, State A allows a deduction for medical expenses, but Indiana does not; therefore the credit would be based on the income before the medical expense deduction.

**III. RECIPROCAL AGREEMENT STATES**

There are five states that have a reciprocal agreement with the State of Indiana. They are Kentucky, Michigan, Ohio, Pennsylvania, and Wisconsin. All salaries, wages, tips and commissions earned in these states by an Indiana resident must be reported as if it were earned in Indiana. A credit cannot be taken for any taxes withheld by or paid to any of these states in connection with income from salaries, wages, tips and commissions. If taxes have been withheld or paid to any of these states, a claim for refund should be filed with that state by filing that particular state's income tax form for nonresidents.

Residents of Kentucky, Michigan, Ohio, Pennsylvania, and Wisconsin who have Indiana income will report and pay tax on that income to their state of residence. If there is Indiana tax withheld from wages, salaries, tips, or commissions the taxpayer should

file an Indiana Form IT-40RNR to receive a refund of their Indiana withholding. If a resident of one of the above states has income from Indiana other than wages, salaries, tips, or commissions, Form IT -40 PNR must be filed.

#### **IV. REVERSE CREDIT AGREEMENT STATES**

The reverse credit agreement applies to Indiana residents who have income from the following states, and to residents of those states who have income from Indiana. The states included are:

Arizona  
California  
Oregon  
Washington D.C.

For example, a resident of Indiana, with rental income from property owned in a reverse credit state, will file a resident Indiana return and include the rental income on the Indiana return. The taxpayer will file a nonresident return for the state where the income was earned and claim a credit for the taxes paid to Indiana on the rental income.

A resident of a reverse credit state with income from Indiana will file a resident return with his state of residence and include the Indiana income. The taxpayer will then file an Indiana IT-40PNR and claim a credit for taxes paid to the state of residence for the Indiana income.

#### **V. STATES WITH NO AGREEMENT WITH INDIANA**

When a person receives income from any state, possession, or foreign country other than those covered in Sections III and IV, the taxpayer might be required to pay income taxes to both entities. The taxpayer may take a credit for out-of-state taxes paid against the taxpayer's Indiana income tax liability.

The credit is equal to the lesser of:

1. The amount of income tax actually paid to the other state, possession, or foreign country on income from that entity;
2. An amount equal to the Indiana income tax rate multiplied by the adjusted gross income taxed by both Indiana and the entity; or
3. The amount of Indiana adjusted gross income tax due to Indiana for the tax year.

##### List of States With no Agreement

Alabama	Arkansas	Colorado	Connecticut
Delaware	Georgia	Hawaii	Idaho
Illinois	Iowa	Kansas	Louisiana
Maine	Maryland	Massachusetts	Minnesota
Mississippi	Missouri	Montana	Nebraska
New Hampshire	New Jersey	New Mexico	New York
North Carolina	North Dakota	Oklahoma	Rhode Island
South Carolina	Tennessee	Utah	Vermont
Virginia	West Virginia		

#### **VI. NON-INDIANA LOCALITY EARNINGS DEDUCTION**

A non-Indiana locality earnings deduction is allowed for state tax purposes to those who pay tax to a locality outside Indiana. The term "locality" refers to cities, counties, or other political subdivisions, but not other state taxes paid or withheld.

The deduction is limited to the lesser of:

1. The amount of income taxed by the out-of-state locality; or
2. \$2,000

#### **VII. COUNTY INCOME TAX CREDIT**

All Indiana residents who are subject to a county income tax and are also required to pay income taxes to a locality outside Indiana are allowed a credit against their county tax liability. However, this credit is not allowed against the county economic development income tax (CEDIT).

The credit for taxes paid to a locality outside Indiana must be supported by a separate calculation of the credit. If the taxpayer is required to file a return with the locality in another state, a copy of the return must be submitted with the claim for credit. Withholding statements or other evidence of tax payment will be acceptable if no return is required to be filed with the locality outside Indiana.

Persons claiming a county credit for taxes paid to out-of-state localities must add the deduction taken for non-Indiana locality earnings back to their state taxable income after arriving at their county taxable income.

The allowable credit is equal to the lesser of:

1. The amount of income tax actually paid to a locality in another state;
2. The amount of adjusted gross income taxed by the locality outside of the State of Indiana multiplied by the county rate which the taxpayer is subject to; or
3. The amounts of county tax due on the Indiana return.

On a joint return, the credit should be calculated separately for the husband and wife. Any unused credit attributable to one spouse cannot be used to reduce the other spouse's county tax liability.

A resident of a reciprocal state who works in an Indiana adopting county for local income tax purposes, is subject to the appropriate county's non resident county tax rate.

Kenneth L. Miller  
Commissioner

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**DEPARTMENT OF STATE REVENUE  
INFORMATION BULLETIN #52**

**Income Tax  
September 2001**

**(Replaces Information Bulletin #52, dated May 1992)**

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**SUBJECT:** WITHHOLDING INFORMATION FOR PART-TIME EMPLOYEES AND OTHER MISCELLANEOUS WITHHOLDING REQUIREMENTS

**REFERENCE:** IC 6-2.1-6-1; IC 6-3-4-15.7

**I. WITHHOLDING OF TAX FROM PART-TIME, TEMPORARY, OR SEASONAL EMPLOYEES**

Withholding agents are required to withhold both County Tax and State Income Tax at the applicable rate stated on the rate schedules, from the income of all employees, including part-time, temporary or seasonal employees. The fact that the employee will not earn in excess of their one thousand dollar (\$1,000) exemption has no bearing on the withholding by the withholding agent. The Internal Revenue Service which allows an employee to waive withholding for federal tax purposes, when the income is not expected to exceed the federal filing requirements and income allowances, has no bearing on the withholding of taxes from the income of part-time employees for Indiana tax purposes.

**II. WITHHOLDING OF TAX FROM SUPPLEMENTAL UNEMPLOYMENT COMPENSATION BENEFIT INCOME**

Supplemental Unemployment Compensation Benefits paid to an individual are treated as if they were income, to the extent such benefits are includable in the gross income of such individuals, and therefore are subject to withholding by the withholding agent for Indiana tax purposes.

**III. WITHHOLDING OF TAX FROM DISTRIBUTION OF ANNUITY, PENSION, AND RETIREMENT PAYMENTS**

The payor of periodic or nonperiodic distribution under an annuity, pension, retirement, or other deferred compensation plan, as described in Section 3405 of the Internal Revenue Code that is paid to a resident of Indiana shall, upon receipt from the payee of a written request for state and/or county tax withholding, withhold the requested amount from each payment. The request must be dated and signed by the payee and specify the whole dollar amount to be withheld from each payment. The request must also specify the payee's name, current address, taxpayer identification number, and the contract, policy, or account number to which the request applies. The request shall remain in effect until the payor receives in writing from the payee a change in or revocation of the request. The payor is not required to withhold state income tax from a payment if the amount to be withheld is less than ten dollars (\$10) or if the amount to be withheld would reduce the affected payment to less than ten dollars (\$10).

**IV. WITHHOLDING OF TAX FROM AGRICULTURAL EMPLOYEES**

Most compensation earned through agricultural labor is subject to income tax withholding if the compensation is subject to FICA withholding. However, the compensation for services performed in connection with forestry, lumbering, or landscaping is statutorily excluded from wages, and therefore no withholding is required.

**V. WITHHOLDING OF TAX FROM CASUAL EMPLOYEES**

Withholding agents are not required to withhold Indiana state income taxes from payments made to ordained ministers, casual laborers, such as periodic yard workers, and in some cases household employees. Although these types of income do not require withholding, the Internal Revenue Code provides for voluntary withholding. If the payee makes a request for voluntary withholding of Federal Income Tax, the payor is required to withhold. Once this voluntary agreement is entered into, the payor must withhold the Indiana state and county income taxes.

**VI. WITHHOLDING OF TAX FROM HOUSEHOLD EMPLOYEES**

A person is defined as a household employee if the person does household work and you control what will be done and how it will be done. If you pay wages to a household worker who is your employee, you may have needed to withhold state and county income taxes. The withholding can be reported on the IT-40 Individual Income Tax Return.

**VII. WITHHOLDING OF TAX FROM ATHLETES AND ENTERTAINERS**

An individual, firm, organization, or governmental agency of any kind that makes payments to an athlete or entertainer for the performance of any contract shall withhold from such payments the amount of gross income tax owed upon receipt of those payments. A withholding agent who withholds gross income tax need not withhold gross income tax for the first one thousand dollars (\$1,000) paid to the athlete or entertainer during a calendar year. If the athlete or entertainer is not incorporated, the withholding requirements do not apply; however, estimated payments must be made. For further information concerning professional athletes that are members of a professional team, see Information Bulletin #88.

**VIII. INFORMATION RETURN FILING REQUIREMENTS**

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

Information returns that do not report withholding of Adjusted Gross or County Income Taxes 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.

Questions relating to information contained in this Bulletin should be directed to:

Indiana Department of Revenue  
Compliance Division  
Indiana Government Center North  
Indianapolis, IN 46204-2253

Kenneth L. Miller  
Commissioner

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 95-0625**

**Corporate Income Tax  
For Years 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. Corporate Income Tax – Liability of Taxpayer for Sales to Out-of-State Buyers**

**Authority:** IC 6-2.1-3-3; 45 IAC 1-1-119; Associated Milk Producers, Inc., v. Indiana Department of State Revenue, 534 N.E.2d 715, 718 (Ind. 1989)

Taxpayer protests proposed assessments of Indiana gross income tax.

**II. Tax Administration – Penalty**

**Authority:** IC 6-8.1-10-2.1

Taxpayer protests the assessment of a 10% negligence penalty.

**STATEMENT OF FACTS**

Taxpayer, an Indiana corporation, is engaged in the mining and sales of coal. The mined coal, in the transactions at issue, was sold primarily to utility companies. The majority of the coal was shipped by barge via the Ohio River to out-of-state utility companies (the buyers). Taxpayer delivered its coal to docks on the Ohio River (docks with Indiana situs) and then loaded the coal onto barges—barges hired by the buyers to transport *their* coal from taxpayer's docks to out-of-state locales. (Note: the contract between taxpayer and buyers specified shipment terms "F.O.B. barge.")

Audit characterized these transactions as "taxable outshipments" and included the sales proceeds in taxpayer's Indiana gross income. Taxpayer disagrees. Taxpayer contends such transactions are properly characterized as "nontaxable outshipments" with the proceeds to be excluded from its Indiana gross income.

**I. Corporate Income Tax – Out-of-State Sales**

**DISCUSSION**

Taxpayer protests Audit's determination that proceeds from sales of coal shipped from a dock located in Indiana to out-of-state companies are subject to Indiana gross income tax. Audit determined the receipts from these coal sales were intrastate in nature and therefore, should have been included in taxpayer's Indiana gross income. Specifically, Audit found that since the underlying coal sales were consummated in Indiana, pursuant to IC 6-2.1-3-3 and 45 IAC 1-1-119(2)(b), the receipts were derived from "taxable outshipments."

IC 6-2.1-3-3, in limiting Indiana's statutory "interstate commerce" exclusion to only that which is constitutionally prohibited, provides the Department with the statutory authority to adopt a rather expansive definition of "intrastate commerce." To wit:

Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution.

The Department, therefore, has promulgated regulations to distinguish “interstate” from “intrastate” sales. Specifically, Audit has relied on 45 IAC 1-1-119(2)(b), which defines one particular type of taxable outshipment as:

Sales to nonresidents where the goods are accepted by the buyer or he takes actual delivery within the State. Sales will also be taxable if the goods are shipped out of state on bills of lading showing the seller, buyer or a third party as shipper if the goods were inspected and accepted, or when the sales were completed prior to shipment in interstate commerce. (Internal cites omitted.)

In concluding taxpayer’s sales transactions were completed in Indiana, Audit assigned considerable weight to the shipping terms—“FOB barge”—adopted by the parties. Since each barge was loaded and then embarked from Indiana docks, Audit determined that these sales were completed in Indiana.

Taxpayer, in response, argues the FOB terminology used by the parties is not relevant for purposes of determining whether such receipts should have been included in taxpayer’s Indiana gross income. Rather, taxpayer believes that since the coal was delivered to common carriers (the barges), and these barges subsequently transported the coal to the out-of-state buyers, such proceeds, pursuant to Indiana regulations, must be characterized as nontaxable outshipments. That is, the income from these sales represented receipts derived from interstate commerce and should have been excluded from taxpayer’s Indiana gross income.

Taxpayer offers an example of a nontaxable outshipment:

Sales to nonresidents where the seller, upon receipt of a prior order and as part of the contract, ships the goods from a point within or without Indiana to an out-of-state destination. Such sales are exempt from taxation whether shipment is made by the seller in his own conveyance, by his contract carrier or by common carrier, and whether the shipment is made on bills of lading showing the seller, buyer or a third party as the shipper of record.

45 IAC 1-1-119(1)(a).

The following transaction also represents an example of a nontaxable outshipment:

Sales to nonresidents, where the goods are picked up in Indiana by common carrier which was ordered to do so by the buyer, and delivered to an out-of-state destination.

45 IAC 1-1-119(1)(f).

But the fact that coal was shipped by common carriers from Indiana to the buyers’ out-of-state locations, alone, does not mean these transactions represented nontaxable outshipments. Equally germane to the interstate/intrastate analysis is the existence, or lack thereof, of any indicia suggesting the sales were completed in Indiana—shipping terms notwithstanding. (See Associated Milk Producers, Inc., v. Indiana Department of State Revenue, 534 N.E.2d 715, 718 (Ind. 1989) where the Indiana Supreme Court, with reference to shipping terms, stated that “Indiana’s Uniform Commercial Code is not controlling in determining passage of title for purposes of taxation. . . .”)

The Department notes that the interstate/intrastate commerce analysis hinges neither on the shipping terms adopted nor on the hire of a particular type of carrier. As the Indiana Supreme Court in Associated Milk observed:

The Supreme Court has held that so long as a local transaction is made the taxable event and the event is separate and distinct from the transportation or intercourse which is interstate commerce, the tax will not run afoul of the Commerce Clause of the Constitution (cites omitted).

*Id.* at 717.

Despite these generalized caveats, the Department finds that taxpayer’s sales of coal to out-of-state buyers represented nontaxable outshipments of goods. Conspicuously absent from the evidence at hand was any showing that taxpayer’s sales of coal to its out-of-state buyers were, in fact, completed in Indiana. Additionally, no local “taxable event” could be identified that was “separate and distinct” from the interstate nature of these transactions. Consequently, the proceeds from these sales are properly classified as “receipts derived from interstate commerce” and should be excluded from taxpayer’s Indiana gross income.

#### **FINDING**

Taxpayer’s protest is sustained.

## **II. Tax Administration – Penalty**

#### **DISCUSSION**

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

If a person subject to the penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person’s return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

IC 6-8.1-10-2.1(d).

Taxpayer has shown reasonable cause for not having paid all tax assessed by Audit.

#### **FINDING**

Taxpayer’s protest is sustained.

**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 97-0273**

**Use Tax**

**For the 1995 Tax Year**

**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.

**ISSUE**

**I. Applicability of the Use Tax to Taxpayer's Airplane Purchase**

**Authority:** 45 IAC 2.2-3-4; 45 IAC 2.2-5-15

Taxpayer protests the assessment of the use tax on its purchase of an airplane. Taxpayer believes that the initial purchase of the airplane was exempt from use tax because the airplane was purchased for leasing purposes.

**STATEMENT OF FACTS**

Taxpayer bought an airplane in 1995. At the time of the purchase, taxpayer did not pay sales tax. As a result of the taxpayer's decision not to pay the initial sales tax, the Department assessed the complimentary use tax. After the Department submitted the notice of assessment, taxpayer paid the use tax. Taxpayer requested a refund of the use tax believing that it had been improperly assessed. Upon investigation of taxpayer's refund request, it was determined that the use tax was appropriately assessed and that taxpayer owed additional use tax. In this protest, taxpayer challenges that determination.

Taxpayer entered into an agreement with two lessees for the use of the airplane. The two lessees together were charged \$15,000 per month for the use of the airplane. Lessee One was charged 75% of the \$15,000 while Lessee Two was charged the remaining 25%. Taxpayer, as the lessor, did not contribute to the \$15,000 monthly charge. The \$15,000 was paid over to and retained by taxpayer in an "airplane account."

Taxpayer has paid sales tax on the \$15,000 monthly charges in the belief that these payments constitute lease payments.

Taxpayer's sole owner is also chairman and 74% owner of Lessee One. According to the taxpayer, there is no common ownership between taxpayer and Lessee Two.

In addition to the \$15,000 monthly charge, Lessee One and Lessee Two each pay an additional \$350 hourly charge covering the time when the airplane is actually used by one of the lessees. On those occasions when the taxpayer uses the airplane, it does not pay the \$350 hourly charge. Taxpayer does not pay sales tax on the \$350 hourly charges because it believes these costs are not lease payments but are variable costs outside the lease agreement not otherwise subject to sales tax. The \$350 hourly charges are paid over and retained by Lessee One in an account separate from that in which the fixed, \$15,000 "lease payments" are retained.

Taxpayer does not make the airplane available for lease to parties outside its fixed agreements with the two lessees.

The audit found that the taxpayer's triangular airplane use agreement did not constitute a leasing agreement. Rather, audit determined that taxpayer and the two lessees had entered into an "aircraft partnership" for the purpose of allocating the airplane's fixed operating costs among the three parties.

**DISCUSSION**

**I. Applicability of the Use Tax to Taxpayer's Airplane Purchase**

Taxpayer protests the Department's decision to impose use tax on the purchase of an airplane. The taxpayer is of the opinion that it purchased the airplane for leasing purposes and the initial purchase was not subject to use tax.

Taxpayer was assessed use tax under the authority of 45 IAC 2.2-3-4. The regulation imposes use tax on the purchase of tangible personal property in those instances when the sales tax was not collected at the time of the initial purchase and when the property is "stored, used, or otherwise consumed in Indiana..." 45 IAC 2.2-3-4. In effect, the use tax "piggybacks" on the state sales tax and the relevant sales tax exemptions.

The Department's regulations afford a sales tax exemption for the purchase of property which is leased to others. 45 IAC 2.2-5-15(a) states that "[t]he state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser." In order to qualify for the exemption, the sale must be made to one who (1) purchases the property for reselling, renting, or leasing the property; (2) the purchaser is occupationally engaged in reselling, renting, or leasing the property in the regular course of its business; (3) the property is resold, rented or leased in the same form in which it was purchased. 45 IAC 2.2-5-15(b). 45 IAC 2.2-5-15(c)(2) repeats the admonition that, in order to qualify for the exemption, "[t]he purchaser must be occupationally engaged in reselling, renting or leasing such property in the regular course of his business."

Under a plain reading of 45 IAC 2.2-5-15, taxpayer, Lessee One, and Lessee Two are not engaged in a "lease" transaction whereby taxpayer's initial purchase of the airplane qualifies for the use tax exemption. Although taxpayer has provided certain

superficial indicia of a “lease” agreement between the three parties, the parties are engaged in a closed, cooperative arrangement by which the fixed and variable costs of operating taxpayer’s airplane are apportioned among the parties. In considering the propriety of the parties’ “lease” agreement, it should be noted that the agreement was entered into some six months subsequent to the time that taxpayer first submitted its protest to the Department. In practice, the parties closed arrangement – by whatever term one wish to describe that agreement – may serve to satisfy the parties’ transportation needs and to equitably apportion the costs of satisfying those transportation needs, but the arrangement is not a “lease” as contemplated by the terms of the regulation.

A number of factors lead inevitably to the conclusion that the parties are not engaged in an “arms length” transaction for the lease of an airplane. First, the parties share a degree of common ownership and management. Second, Lessee One and not – as one would expect in a typical lease transaction – taxpayer is designated as the holder of the hourly charges. Third, curiously enough, the \$350 hourly charge is not considered a lease charge and – according to taxpayer – escapes imposition of the state’s sales tax. Fourth, the parties’ arrangement is closed. The airplane is not available to “lease” to those person’s outside the agreement. In summary, taxpayer has entered into an arrangement in which the “lease” payments are fixed, allocable costs. Each “lessee” is simply apportioned a certain percentage of the base costs of maintaining the airplane. This pre-determined apportionment evidences not an agreement by which the parties rent an airplane, but an agreement to jointly share the costs of maintaining the airplane’s availability to those parties within the closed agreement.

After considering facts surrounding the parties’ aircraft use agreement, it becomes plain that the parties’ agreement does not comport with the regulatory standards set out in 45 IAC 2.2-5-15. The regulation requires that the sales tax exemption is available to those purchasers who are “occupationally engaged in reselling, renting or leasing such property *in the regular course of his business.*” 45 IAC 2.2-5-15(c)(2) (Emphasis added). Taxpayer is simply not engaged in renting the airplane in the regular course of its business. Moreover, the regulation admits of no ambiguity in setting forth the requirement. In order to qualify for the exemption, the taxpayer “must” be regularly engaged in the business of renting or leasing. Id.

The original audit, in determining that taxpayer was not entitled to the use tax exemption, described the parties as having entered into an “aircraft partnership.” Taxpayer has provided information – including citations to the Indiana Code, Indiana and federal case law, and FAA regulations – which purport to establish that taxpayer and the two “lessees” have not entered into a partnership agreement. However, in the final analysis, taxpayer’s citations and the question of whether the parties have entered into a legally recognizable “partnership” are irrelevant. The audit’s characterization of the parties’ agreement may be nothing more than an unfortunate choice of words. Nonetheless, however one may choose describe the parties’ agreement, the agreement is clearly not a “lease” agreement such that the initial aircraft purchase qualified for the sales tax exemption.

**FINDING**

Taxpayer’s protest is respectfully denied.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 98-0010 ITC  
Gross and Adjusted Gross Income Tax  
For Years 1992, 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**

**I. Gross Income Tax – Treasury Stock**

**Authority:** 45 IAC 1-1-32; 45 IAC 1-1-50; 45 IAC 1-1-51; 45 IAC 1-1-119; IC § 6-2.1-1-2; IC § 6-2.1-3-3; *Hoosier Energy* 528 N.E.2d 867 (Ind. Tax 1988); *Complete Auto Transit, Inc. v. Brady* (1977), 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326

Taxpayer protests assessment of gross income tax on receipts from the issuance of treasury stock.

**II. Gross Income Tax – Distributive Shares**

**Authority:** 45 IAC 1-1-51; 45 IAC 1-1-159.1; IC § 6-3-2-2

Taxpayer protests assessment on the distributive share from gross receipts of a corporate partner.

**III. Gross Income Tax – Computational Error**

**Authority:** None cited.

Taxpayer protests assessment of gross income tax on receipts from sales made to partner by taxpayer. Taxpayer maintains certain amounts assessed in this category were erroneously double counted in computing gross income.

**IV. Gross Income Tax – Resource Recovery System**

**Authority:** IC § 6-2.1-4-3

Taxpayer seeks a deduction-based on environmental compliance costs for expense associated with a resource recovery system.

**V. Adjusted Gross Income Tax – Foreign Source Dividends**

**Authority:** IC § 6-3-2-12

Taxpayer protests the disallowance of 15% of its foreign source dividend deduction.

**VI. Adjusted Gross Income Tax – Attribution of Payroll Expenses**

**Authority:** IC § 6-3-2-2

Taxpayer protests reattribution of certain payroll expenses from taxpayer's payroll factor to a related corporation's payroll factor.

**VII. Adjusted Gross Income Tax – Intercompany Transfers**

**Authority:** None cited.

Taxpayer protests the disallowance of deductions for intercompany transfers taken on its Indiana consolidated returns.

**VIII. Adjusted Gross Income Tax – Nonbusiness Income**

**Authority:** None cited.

Taxpayer protests department's reclassification of nonbusiness income.

**IX. Adjusted Gross Income Tax – Treasury Stock Receipts**

**Authority:** IC § 6-3-1-3.5; IC § 6-3-1-24; IC § 6-3-2-2; Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996)

Taxpayer protests inclusion of treasury stock receipts in taxpayer's sales factor.

**X. Gross and Adjusted Gross Income Tax – Research Expense Credit**

**Authority:** None cited.

Taxpayer protests the Calculation of Research Expense Credit.

**XI. Gross and Adjusted Gross Income Tax – Negligence Penalty**

**Authority:** 45 IAC 15-11-12; IC § 6-8.1-10-1

Taxpayer protests negligence penalty assessment.

**STATEMENT OF FACTS**

Taxpayer is a multinational corporation based in Indiana. Taxpayer receives income from sources within Indiana, national, and foreign investments; likewise, taxpayer's expenses are incurred at manufacturing operations located in Indiana and the United States as well as international locations.

**I. Gross Income Tax – Treasury Stock**

**DISCUSSION**

Taxpayer's initial contention is that treasury stock-i.e. stock originally issued by taxpayer and reacquired by taxpayer in the course of business- should be considered equivalent to new issue stock. Taxpayer notes IC § 6-2.1-1-2(c)(14), which states:

(c) 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 the capital thereof;

while IC § 6-2.1-1-2(e) tempers such exclusion:

The exclusion provided by subsection (c) clause (14) does not apply to proceeds that are derived from subsequent transactions in stock of such corporations or organizations or in the interest or shares of the members of any organization.

Taxpayer does not cite IC § 6-2.1-1-2(a)(9), which defines gross income to include gross receipts:

From the surrender, sale, transfer, exchange, redemption of, or distribution upon, stock of corporations or associations;...

Despite the explicit exclusion provided and the inclusion of the transactions in question in the statute defining gross income, taxpayer argues that by its nature, treasury stock should be treated as equivalent to new issue stock. Taxpayer does not address 45 IAC 1-1-32 Income from transfer of stocks, which states in relevant part:

Gross receipts from the sale, transfer or exchange of corporate stock are not subject to tax when received by the corporation from the original issue of its own stock nor from subsequent original issues. However, subsequent transactions in the corporation's own stock, including the sale of treasury stock which has been issued, repurchased or otherwise acquired and then sold, result in taxable gross receipts.

Nor does taxpayer address the language of the exemption itself that states "the receipt of capital..." is excluded. Capital, as defined by Blacks Law Dictionary, Fifth Edition, includes- but is by no means limited to- "the sum total of corporate stock." When taxpayer makes an initial issue of stock, the money raised by its sale would constitute capital raised for the business. Subsequent transactions, as with treasury stock, do not constitute new capital or new additions to taxpayer's total issued stock value, merely the purchase and sale of stock as contemplated by IC § 6-2.1-1-2(a)(9).

Taxpayer's initial contention that treasury stock should be considered equivalent to new issue stock is not supported by statute. Taxpayer then argues that the term "proceeds" in IC § 6-2.1-1-2(e) does not include "gross receipts" from subsequent transactions. Granting, in arguendo, taxpayer's argument that "proceeds" are not equivalent to "gross receipts", it fails, inasmuch as the exclusion



referenced by the IC § 6-2.1-1-2(e) does not include the treasury stock transactions, which fall under the statutory definition of gross income in IC § 6-2.1-1-2(a)(9). The argument that an exemption to an exclusion is applicable to the taxation of a transaction identified by a separate statute as taxable is not persuasive.

As taxpayer further notes in its argument, even if the treasury stock transactions are not considered equivalent to new issue stock, some not all transactions involving treasury stock still may be exempt. In some transactions, employees are allowed to exchange stock for treasury stock at a discounted value. Taxpayer notes that IC § 6-2.1-1-2(c)(16) states:

(c) The term “gross income” does not include:

....

(16) the gross receipts represented by the value of stock of a corporation or association received in a reciprocal exchange by and between the owners of the stock (including the issuing corporation or association) for stock in the same corporation or association to the extent of the value of the stock or the interest therein of which title is surrendered;

Taxpayer’s gross income therefore should exclude gross receipts “to the extent of the value of the stock or the interest therein of which title is surrendered “ in transactions where taxpayer’s employees exchange stock for treasury stock.

Taxpayer presents two related arguments involving out-of-state transactions involving the treasury stock. Taxpayer uses treasury stock as compensation for out-of-state employees working at out-of-state locations, as well as conducting sales of the treasury stock at out of state brokerages and stock exchanges. Taxpayer argues that these transactions are not part of its Indiana gross receipts due to a lack of Indiana nexus.

Taxpayer cites 45 IAC 1-1-50 Out-of-State Business of Indiana Residents, which states in relevant part:

The Gross Income Tax Act specifically exempts from taxation those transactions of a domestic corporation which are connected with a trade or business situated and regularly carried on at a legal situs outside the state or from activities incident thereto...

Taxpayer fails to note the following regulation, 45 IAC 1-1-51 Situs of Intangibles, which states:

The department applies two tests in determining the taxability of income from intangibles. The term “intangible “ or “intangible property,” as used in IC 6-2-1-1(m) [Repealed], means and includes notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, “trading stamps,” final judgments, leases, royalties, certificates of sale, choses(*sic*) in action and any and all other evidences of similar rights capable of being transferred, acquired or sold.

The first test is what may be termed the “business situs” of the taxpayer or the relationship of the income from the intangible to the business activity of the taxpayer in Indiana. If the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana, the total gross income derived from the sale, assignment, transfer or exchange of the rights comprising the intangible property, or from interest, finance charges, dividends or other earnings upon the intangibles of any kind, or from any other source arising from the ownership of intangible property, or from the transfer of ownership to another will be required to be reported for taxation under IC 6-2-1-1(m) [Repealed] at the higher rate under IC 6-2-1-3(g). The test of a “situs” has been defined in Regulation 6-2-1-1(m)(330) and out of-state-business is discussed in Regulation 6-2-1-1(m)(340) [45 IAC 1-1-50].

Therefore, if a taxpayer has a “business situs” in Indiana, as defined by Regulation 6-2-1-1(m)(330) [45 IAC 1-1-49], and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes.

In addition to the case where the owner of the intangible is doing business in Indiana and the intangibles form an integral part of such owner’s business conducted at or through his “business situs” in Indiana, a taxpayer may also be liable for gross income tax from intangible if he is deemed to have established a “commercial domicile” in Indiana. Thus the second test is what may be termed the “commercial domicile” of the taxpayer.

A taxpayer may have many business sities, but has only one commercial domicile. Where that is located must be determined based on all of the facts. Generally speaking, a commercial domicile may be viewed as the location of the majority of all the taxpayer’s activities or business. The commercial domicile may also be called the “nerve” center” or “corporate center” of all the business functions of the taxpayer.

If a taxpayer’s commercial domicile is in Indiana, all of the income from intangibles will be taxed under IC 6-2-1-1(m) [Repealed] except that income which may be directly related to an integral part of a business regularly conducted at a “business situs” outside Indiana. The Department will look to the following types of activities and the location of such activities of a taxpayer in determining the “commercial domicile”; however, such list is not all-inclusive:

- (1) location of management and administrative activities connected with each location, such as policy and investment decisions;
- (2) location of board of directors’ meetings;
- (3) residence of executives and their offices;
- (4) location of books and records;

- (5) location of payment on income from intangibles of the taxpayer; and
- (6) information from annual and quarterly reports of the taxpayer.

If a commercial domicile is established in a state other than Indiana, no income from intangibles will be taxed under IC 6-2-1-1(m)[repealed-now 6-2.1-1-2, 6-2.1-2-8, 6-2.1-4-2, 6-2.1-5-9, 6-2.5-5-5(a), 6-2.5-1-6] unless the taxpayer has also established a business situs in Indiana and the intangible income derived therefrom forms an integral part of that Indiana activity.

....  
Examples of transactions in intangibles which are partially or wholly excluded from taxation are: ... Sales which are totally nontaxable as transactions in interstate commerce (IC 6-2-1-7(a) [Repealed]).... The issuance of bonds or stocks, except with respect to treasury stock (IC 6-2-1-7(a) [Repealed])....

Taxpayer's corporation is based in Indiana and states in its Memorandum in Support of the Protest, received by the Department on 12/21/99, page 16 "[Taxpayer] is an Indiana corporation and is commercially domiciled in Indiana."

The application of the above regulation require the taxation of "all of the income from intangibles will be taxed .... except that income which may be directly related to an integral part of a business regularly conducted at a "business situs" outside Indiana." Taxpayer does not demonstrate how the income from the transfer of treasury stock for a corporation in Indiana, even if the stock transaction ultimately benefits or compensates an out of state employee, is income "directly related to an integral part of a business regularly conducted at a "business situs" outside Indiana." Taxpayer's contention that this should be read to mean that despite the location of taxpayer's commercial situs in Indiana, any income from the corporation's stock that has any connection to an out-of-state business situs is not taxable is not supported.

The final argument made by taxpayer involves 45 IAC 1-1-119(1)(e), which states the following are nontaxable:

Sales of stock to nonresidents made through Indiana or nonresident brokers. See *Freeman v. Hewit* 329 U.S. 249 (1946); also margin transactions and dealings in commodities futures carried on through securities exchanges in other states. See *Indian Dep't of State Rev., Gross Income Tax Div. v. Nebeker*, 23 Indiana 58, 116 N.E.2d 104 (1953)

This regulation is superseded by IC § 6-2.1-3-3, which exempts from gross income tax gross income "... to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution." 45 IAC 1-1-119 is an enumeration of the constitutional parameters as established by case law. These cases were overturned by the U.S. Supreme court in *Complete Auto Transit, Inc. v. Brady* (1977), 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 as summarized by the Indiana Tax Court in *Hoosier Energy* 528 N.E.2d 867 (Ind. Tax 1988). This development was reflected in the regulations issued and in force presently. The statute imposes the gross income tax to the extent it is permitted by the Constitution. The regulation sought to codify this extent. The Supreme Court subsequently reversed the decisions relied upon in the regulation; consequently, the statute imposes a boarder imposition of the gross income tax than the regulation would indicate. When a statute and regulation conflict, the statute is controlling.

Taxpayer then argues that the acquisition costs of the stock was used to value the transactions, taxpayer argues that the value received is the correct measurement. The operative statute defining these transactions as taxable is IC § 6-2.1-1-2(9), which states:

From the surrender, sale, transfer, exchange, redemption of, or distribution upon, stock of corporations or associations;...

The statute explicitly identifies the income to be taxed as coming from the distribution, not acquisition, of the stock. The value of the treasury stock should be based on the gross receipts from the disposal of the treasury stock. This issue is discussed and denied in issue IX, Treasury Stock Receipts, and the analysis in that issue is applicable to this circumstance.

#### **FINDINGS**

Taxpayer protest is sustained as to transactions involving exchanges of stock between employees and the company, the remainder of the protest is denied.

#### **II. Gross Income Tax – Distributive Shares**

#### **DISCUSSION**

Taxpayer maintains the appropriate regulation for determining the apportionment of income received as a corporate partner was 45 IAC 1-1-159.1. The auditor allocated the intangibles or interest income based on 45 IAC 1-1-51.

Review of the two regulations reveals an explicit reference in 45 IAC 1-1-159.1, which requires the inclusion of a "sales factor" as defined by IC § 6-3-2-2. 45 IAC 1-1-159.1 states in relevant part:

For purposes of this subsection, all income of the partnership shall be considered business income. If a partnership does business in a state besides Indiana, a partner's distributive share of partnership income which is derived from sources within Indiana, for gross income tax purposes, shall be determined by multiplying the partner's distributive share by a fraction. The numerator of the fraction shall be the sum of:

- (1) the property factor
- (2) the payroll factor; and
- (3) the sales factor;

of the partnership. The denominator of the fraction shall be determined by the number of factors used. The property factor shall be determined under IC 6-3-2-2(c). The payroll factor shall be determined under IC 6-3-2-2(d). The sales factor shall be determined under IC 6-3-2-2(e) and IC 6-3-2-2(f).

IC § 6-3-2-2 states in relevant part:

(e) Sales include receipts from intangible property and receipts from the sale or exchange of intangible property.... Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter....

(f) Sales, 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; or

(2) the income producing activity is performed both within and without this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

45 IAC 1-1-51 discusses at length the attribution of intangible income to an entity based on the entity's business situs or commercial domicile. (See the discussion under issue 1) 45 IAC 1-1-51, Situs of Intangibles, states:

The department applies two tests in determining the taxability of income from intangibles....

Essentially the auditor treated the income from the partnership to the taxpayer as intangible income, which was its nature when flowing into the partnership, rather than treating it as partnership income to the taxpayer. The regulation taxpayer cites requires, by direct reference, the computation of income from intangibles-both in and out of state- as part of the calculation of the taxpayer's partnership income, while the regulation cited by the auditor applies only to the taxability of taxpayer's intangible income, not the computation of the attributive share of the taxpayer's partnership income. Consequently, 45 IAC 1-1-159.1 governs the computation of partnership income from intangibles and not 45 IAC 1-1-51. To this extent, taxpayer protest is sustained and audit is instructed to allocate the partnership income based on 45 IAC 1-1-159.1.

**FINDING**

Taxpayer protest sustained.

**III. Gross Income Tax – Computational Error**

**DISCUSSION**

Taxpayer's protest encompassed multiple aspects of a set of transactions; in summary, the majority of this protest focused on areas that involved refund issues. The taxpayer's protest did not clearly articulate a specific protest of an audit adjustment. Nor was the taxpayer clear in requesting a claim for refund. No supplemental changes can be made based on the documentation supplied.

**FINDING**

Taxpayer protest denied.

**IV. Gross Income Tax – Resource Recovery System**

**DISCUSSION**

Audit denied the resource recovery deductions claimed by taxpayer pursuant to IC 6-2.1-4-3. The auditor required a statement certifying the equipment from the Indiana Department of Environmental Management (hereinafter "IDEM") which taxpayer was unable to present at the time. Taxpayer presents three arguments in support of the deduction. First taxpayer asserts that an equipment system deemed to be for environmental compliance is deductible per statute absent any statutory exclusion. Second, the taxpayer has now presented a certificate of certification, such as was required by the auditor, from IDEM. Third, the taxpayer protested the exclusion of the deduction based on an "Agreed Order" by IDEM involving the equipment and the Department's denial of the deduction in question.

The statute at issue, IC § 6-2.1-4-3, states in relevant part:

(a) For purposes of this section:

....

"Resource recovery system" means tangible property directly used to dispose of solid waste or hazardous waste by converting it into energy or other useful products.

....

(b) If for federal income tax purposes a taxpayer is allowed a depreciation deduction for a particular taxable year with respect to a resource recovery system, and if the resource recovery system processes solid waste or hazardous waste, the taxpayer is entitled to a deduction from his gross income for that same taxable year. The amount of the deduction equals the total depreciation deductions that the taxpayer is allowed, with respect to the system, for that taxable year under Sections 167 and 179 of the Internal Revenue Code.

(c) Notwithstanding subsection (b), a taxpayer is not entitled to the deduction provided by this section for a particular taxable year with respect to a resource recovery system that is directly used to dispose of hazardous waste if during that taxable year the taxpayer:

....

(2) is subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute governing the treatment, storage, or disposal of hazardous wastes that had a major or moderate potential for harm.

The auditor's reliance on IDEM certification is not supported by statute. The legislature was cognizant of the potential overlap

of interest between IDEM and the Department in this area as is evidenced by the explicit requirement to deny the deduction based on actions by IDEM or other environmental regulatory agencies in subsection (c)(2). Rather than place the determination of the deductibility of the equipment in question with IDEM, the legislature provided a statutory definition of the equipment in question under subsection (a) of the statute that does not require an outside agency's confirmation for the department to evaluate or for the taxpayer to provide to claim the deduction.

Inasmuch as taxpayer provided an IDEM certification, albeit for the wrong year and location, the discussion of its applicability is mooted by the above finding.

Taxpayer's next contention is that the deduction should not be denied pursuant to IC 6-2.1-4-3(c)(2) because an Agreed Order did not explicitly find a violation by taxpayer. The taxpayer argues that the order was "(1) ... a settlement decree that was not based on any determination of a violation of federal or state statute, rule, or regulation, and (2) [the deduction should not have been denied] for tax year 1995 because Agreed Order [omitted] had been satisfied and was no longer effective for that year." Taxpayer Protest received 12/21/99 by department page 27.

The Agreed Order, copy provided by taxpayer with the 12/21/99 protest, states:

5. ... (p) Pursuant to 40 CFR 262.34, referencing 40 CFR 265.193(c)(3), secondary containment systems must be provided with a leak detection system capable of detecting leaks within twenty-four (24) hours. Based on information gathered by the IDEM, the secondary containment for the five (5) T-99 tanks and ancillary equipment was not provided with a leak detection system capable of detecting leaks within twenty-four (24) hours.

....  
13. Within thirty (30) days of the effective date of the Order, Respondent shall provide a leak detection system, capable of detecting leaks within twenty-four (24) hours, for the secondary containment and ancillary equipment of the five- (5) T-99 tanks. Respondent shall submit documentation of compliance to the IDEM.

...  
18. Without admitting or denying liability, Respondent agrees to pay a Civil Penalty of \$25,000. Said Penalty amount shall be due and payable to the Environmental Management Special Fund within thirty (30) days of the effective date of this Order as directed by Paragraph #20.

Taxpayer relies upon the language in provision 18, where taxpayer declined to admit or deny liability in support of taxpayer's argument that the Agreed Order was not based on a violation. Numerous citations within the Agreed Order contradict this assertion. In the sample above, section 5(p) specifies an absence of equipment constituting a violation of a cited regulation, while section 13 outlines the required remedial action, in this instance the installation of the required equipment. IC § 6-2.1-4-3(c)(2) does not require an admission of liability, it requires taxpayer to be "...subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute governing the treatment, storage, or disposal of hazardous wastes that had a major or moderate potential for harm." The absence of a finding of liability in this order does not alter the explicitly stated basis for the order, nor does it effect the taxability of the equipment.

Taxpayer submitted a copy of the letter of resolution from IDEM regarding the above referenced Agreed Order. This letter, submitted with the taxpayer protest received by the Department on 12/21/99, states in relevant part:

Based upon documents available to the Office of Enforcement staff during a record review on January 9, 1995, and the results of a reinspection conducted at your facility on December 9, 1994, it has been determined that [taxpayer] has achieved compliance with the terms of the Agreed Order issued to your firm on May 17, 1994.

While the letter confirms the release of the Agreed Order, this release did not occur until January 9, 1995- the date of the final review of taxpayer's documents. IC § 6-2.1-4-3(b)(1) states in relevant part,

... a taxpayer is not entitled to the deduction provided by this section for a particular taxable year with respect to a resource recovery system that is directly used to dispose of hazardous waste *if during that taxable year* the taxpayer:

....  
(2) is subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute  
*(emphasis added)*

Taxpayer was subject to the Agreed Order for at least 9 days of the taxable year in question. The statute explicitly requires the loss of deduction for being subject to an order "during that taxable year." Taxpayer facility was subject to the Agreed Order in 1995 and thus is not permitted the exemption.

#### **FINDING**

Taxpayer protest denied.

#### **V. Adjusted Gross Income Tax – Foreign Source Dividends**

##### **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. Recalculation 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.

**VI. Adjusted Gross Income Tax – Attribution of Payroll Expenses**

**DISCUSSION**

Taxpayer protests the removal of compensation paid to individuals from the numerator and denominator of its payroll factor and the transfer of these amounts to a subsidiary corporation’s payroll factor. Taxpayer cites IC § 6-3-2-2(d), which states:

The payroll factor is a fraction, the numerator of which is the total amount *paid in this state during the taxable year by the taxpayer for compensation*, and the denominator of which is the total compensation paid everywhere during the taxable year. However, with respect to a foreign corporation, the denominator does not include compensation paid in a place that is outside the United States. (*Emphasis added*)

Taxpayer argues that the staff in question, as noted in the emphasized segment above, were paid in Indiana by taxpayer and consequently the statute requires their addition to taxpayer’s payroll factor.

In making the adjustment, the auditor relied on IC § 6-3-2-2(m), which states:

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The issue involves “two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests,” IC § 6-3-2-2(m), and the auditor’s decision was supported in the audit report- cited but not discussed by the taxpayer- as “[t]he basis of this adjustment represents the methodology under which the taxpayer has reported its Indiana Business Income.” Taxpayer argues that for this transaction an ad hoc variation in Taxpayer’s overall reporting of its Indiana Business Income is required.

The auditor cited appropriate statutory authority to make this adjustment. Taxpayer’s exclusive reliance on IC § 6-3-2-2(d) is incorrect given IC § 6-3-2-2(m).

**FINDING**

Taxpayer protest is denied.

**VII. Adjusted Gross Income Tax – Intercompany Transfers**

**DISCUSSION**

Taxpayer notes that the adjustments were made to two entities (hereinafter identified as taxpayer and subsidiary corporation). Taxpayer’s protest is based on an argument that these adjustments were not double deductions. After review of the returns, the auditor concurs that the adjustments on the taxpayer’s return were not supported. However, the adjustments for the subsidiary

corporation were taken by taxpayer without explanation or supporting information. No error has been identified. Therefore, absent any justification for these adjustments, taxpayer protest is denied.

**FINDING**

Taxpayer's protest is sustained, subject to audit verification, as to taxpayer corporation and denied as to the subsidiary corporation.

**VIII. Adjusted Gross Income – Nonbusiness Income**

**DISCUSSION**

Taxpayer asserted two entities of taxpayer (hereinafter the holding company and the subsidiary) had business income reclassified as nonbusiness income. Taxpayer protested requesting an explanation for the adjustments and/or their removal. The holding company reclassification was based on the 15 percent foreign dividend expense-rendered moot by the finding in Issue VI- and an income adjustment based on the finding of a non-unitary relationship. The subsidiary's income reclassification actually resulted in a decrease to taxpayer's nonbusiness income- the adjustment was a positive adjustment to a deduction. With the holding company, the protest of the 15% dividend expense adjustment is sustained based on the earlier finding in this LOF. The finding of a non-unitary relationship for the holding company is supported by findings within the Audit report and is consequently denied.

**FINDING**

Taxpayer protest of the income reclassification is sustained for the foreign dividend addback for the holding company, the protest is denied for the holding company adjustment based on the non-unitary relationship and for the subsidiary.

**IX. Adjusted Gross Income – Treasury Stock Receipts**

**DISCUSSION**

Audit included treasury stock receipts in the sales factor of the apportionment formulas used to calculate taxpayers adjusted gross income. Taxpayer questions these adjustments.

Taxpayer argues that inasmuch as IC § 6-3-1-3.5 requires "adjusted gross income" as defined in the Internal Revenue Code and modified by IC § 6-3-1-3.5 be used as the starting value for the calculation of a taxpayer's Indiana Adjusted Gross Income tax liability, the inclusion of treasury stock receipts in taxpayer's sales factor as applied to taxpayer's Adjusted Gross Income Tax should also be governed by these IRS provisions.

While Taxpayer notes IC § 6-3-1-24 defines "sales" as "all gross receipts of the taxpayer not allocated under IC § 6-3-2-2(g) through IC § 6-3-2-2(k)," the Department recognizes IC § 6-3-2-2, the controlling statute for this issue, which states in relevant part:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

...

(5) *income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.*

...

(e) *The sales factor 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. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana under section 2.2 of this chapter. (emphasis added)*

IC § 6-3-2-2.2, cited in IC § 6-3-2-2 also discusses income sources attributable to Indiana. This statute states in relevant part: Interest income, discounts, and receipts attributable to state

...

(g) Receipts in the form of dividends from investments are attributable to this state if the taxpayer's commercial domicile is in Indiana.

Taxpayer's corporation is based in Indiana and states in its Memorandum in Support of the Protest, received by the Department on 12/21/99, page 16 "[Taxpayer] is an Indiana corporation and is commercially domiciled in Indiana."

The application of the above statute requires the taxation of stock transactions for a corporation commercially domiciled in Indiana. There is no reference in the above statutes to the IRS code as determinative to these calculations and no linkage has been provided by taxpayer.

The taxpayer next argues that the auditor's adjustment was based on the auditor's theory that receipts from treasury stock transactions that are subject to Gross Income Tax should be included in the sales factor. Taxpayer's contention that regulations applicable to the Gross Income Tax should be read to mean that despite the location of taxpayer's commercial situs in Indiana, income from the corporation's stock that has any connection to an out of state business situs is not taxable under the Adjusted Gross Income Tax is not supported.

Taxpayer then cites Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996) as support for the exclusion of the treasury stock receipts. This case deals exclusively with receipts from investments- not stock transactions- of an out-of-state taxpayer, and is not applicable to the issue at hand.

Taxpayer also protests that the acquisition costs of the stock was used to value the transactions. Taxpayer believes the value received is the correct measurement of the stock value. Inasmuch as the operative statute defining these transactions as taxable is IC § 6-3-2-2, which-as noted earlier- states in relevant part:

(a) With regard to corporations and nonresident persons, “adjusted gross income derived from sources within Indiana”, for the purposes of this article, shall mean and include:

...  
(5) *income from stocks*, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property...

The statute identifies the income to be taxed as coming from the distribution, not acquisition, of the stock. The value of the treasury stock should be based on the gross receipts from the disposal of the treasury stock. A review of the information provided by the taxpayer to the auditor demonstrates that this was the value used; consequently, no adjustment is required.

**FINDING**

Taxpayer protest is denied.

**X. Gross and Adjusted Gross Income – Research Expense Credit**

**DISCUSSION**

Taxpayer’s protest of the Calculation of Research Expense Credit was resolved prior to hearing.

**FINDING**

Issue was resolved prior to hearing.

**XI. Gross and Adjusted Gross Income Tax – Negligence Penalty**

**DISCUSSION**

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC 6-8.1-10. The Indiana Administrative Code further provides:

(b) “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.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

45 IAC 15-11-2.

For the four years of this audit period, taxpayer engaged in numerous activities that gave rise to the preceding issues. While taxpayer’s positions were not uniformly upheld, most were based, at least in part, on reasonable interpretations of Indiana’s tax statutes. Issue 4, the Resource Recovery System, is a notable exception to taxpayer’s generally reasonable interpretation of Indiana’s tax statutes. Consequently, the negligence penalty will be waived for the tax years 1992 and 1995, but not for the years involving the Resource Recovery System, 1993 and 1994.

**FINDING**

Taxpayer protest sustained in part and denied in part.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 98-0236**

**Sales/Use 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. Sales/Use Tax – Hangers and Pant Grippers**

**Authority:** IC 6-2.5-5-9; *Sales Tax Information Bulletin #26: Dry Cleaning and Laundry Establishments Rental and NonRental Services* (April 4, 1983)

Taxpayer protests proposed assessments of use tax on purchases of hangers and pant grippers.

##### **II. Sales/Use Tax – Mop Treatment Concentrate**

**Authority:** IC 6-2.5-5-8; 45 IAC 2.2-4-27(d)(4)

Taxpayer protests proposed assessments of use tax on its purchase of mop treatment concentrate.

##### **III. Sales/Use Tax – Sample Population**

**Authority:** IC 6-2.5-2-1; IC 6-8.1-4-2

Taxpayer protests the inclusion of certain items in the sample population used by audit to project compliance ratios.

##### **IV. Sales/Use Tax – Name Tags, Emblems, Bar Codes, and Equipment**

**Authority:** IC 6-2.5-2-1

Taxpayer protests proposed assessments of use tax on its purchase of nametags, emblems, bar codes, as well as the equipment required to attach these items to its rental uniforms.

##### **V. Sales/Use Tax – Computer Hardware and Software**

**Authority:** IC 6-2.5-5-3; 45 IAC 2.2-5-8(g)(7)

Taxpayer protests proposed assessments of use tax on its purchase of computer hardware and software.

##### **VI. Sales/Use Tax – Missing Invoices**

**Authority:** 45 IAC 2.2-3-27

Taxpayer protests proposed assessments of use tax on its purchase of items from a particular vendor based solely on taxpayer's inability to locate relevant invoices.

#### STATEMENT OF FACTS

Taxpayer rents uniforms. Taxpayer also rents dust mops, doormats, and assorted rags. The rental uniforms, in some instances, may require emblems or logos. When requested, taxpayer will either design or scan, manufacture, and then attach (sew) the emblems and logos onto the rented uniform.

The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of taxpayer's business for the calendar years 1994 through 1996. This audit resulted in proposed assessments of Indiana sales and use tax. Taxpayer now protests these additional assessments.

##### **I. Sales Tax – Hangers and Pant Grippers**

#### DISCUSSION

Taxpayer places garments on hangers and pant grippers, presumably to maintain their freshly laundered appearance, prior to rental and delivery. Because taxpayer failed to pay sales tax on its purchases of hangers and pant grippers, Audit proposed assessments of use tax pursuant to 45 IAC 2.2-4-27(d)(4), which instructs:

A person engaged in the business of renting or leasing tangible property is considered the consumer of supplies, fuels, and other consumables which are furnished with the property which is rented or leased.

Taxpayer directs the Department's attention to *Sales Tax Information Bulletin #26: Dry Cleaning and Laundry Establishments Rental and NonRental Services* (April 4, 1983). In section II, entitled "Clean Linen, Towel and Uniform Rental Services," the Department explains the scope of the sales and use tax exemptions. *Bulletin #26* states:

Tangible personal property purchased expressly for rental use, such as linens, towels, uniforms and other garments as well as wrapping materials in which such rented property is furnished to customers is exempt from sales and use tax liability on the purchase thereof.

In the context of providing uniform rentals, the Department finds that taxpayer's hangers and pant grippers do not represent exempt "wrapping materials and containers." Consequently, these items do not qualify for an exemption pursuant to IC 6-2.5-5-9. Rather, taxpayer's hangers and pant grippers are best characterized as nonexempt "supplies...furnished with the property which is rented or leased." 45 IAC 2.2-4-27(d)(4).

#### FINDING

Taxpayer's protest is denied.

##### **II. Sales Tax – Mop Treatment Concentrate**

#### DISCUSSION

In addition to renting uniforms, taxpayer also rents dust mops. The mops are "treated" with a chemical concentrate prior to rental. According to taxpayer, treatment is required because dust will not adhere to its dust mops otherwise. Taxpayer explains:

The mop treatment concentrate significantly improves the dust mop in that it attracts the dust to the mop and captures the dust on the mop. Without the concentrate, the mop simply moves the dust around and does not hold the dust in the mop nearly as



well. Customers would not be as likely to rent the mops if they were not treated with the concentrate.... In our opinion, the mop treatment concentrate is a material part of the mop and significantly changes the characteristic of the mop and should not be subject to sales tax....

Audit proposed assessments of use tax on taxpayer's purchases of mop treatment concentrate pursuant to 45 IAC 2.2-4-27(d)(4), which instructs:

A person engaged in the business of renting or leasing tangible property is considered the consumer of supplies, fuels, and other consumables which are furnished with the property which is rented or leased.

Audit contends the mop treatment concentrate represented a consumable "furnished with the property [dust mop] which is rented." Rather than "consumed", perhaps "applied" would be a more accurate description of taxpayer's use of its mop treatment concentrate. But regardless of characterization, taxpayer does not "rent" its mop treatment concentrate. See IC 6-2.5-5-8. In this instance, taxpayer's mop treatment concentrate represents a taxable supply pursuant to 45 IAC 2.2-4-27(d)(4).

#### **FINDING**

Taxpayer's protest is denied.

### **III. Sales Tax – Sample Population**

#### **DISCUSSION**

Computing an error percentage from a sample population and then applying this percentage to sales made in other periods is a commonly understood and accepted accounting practice. Audit explains the methodology used for this taxpayer:

A sample period was selected which consists of March 1994, December 1995, and September 1996. Purchase invoices from expense accounts were examined.... The errors were totaled. The totals from sample period accounts were totaled. Errors found were then divided by sample period totals to obtain a percentage of error. The percentage of error was then applied to yearly totals of the sample accounts. The result [represented]...purchases subject to use tax. [ ] Capital Asset purchases...were not included in the projection.

While taxpayer does not object to the methodology used by audit, taxpayer objects to the inclusion of certain items in the sample population. Taxpayer believes "the following items—printer, wall bracket, poly-taper truck, rail support and tube, and computer terminal and keyboard—should have been capitalized" rather than expensed. That is, these items should have been excluded from the sample population. Additionally, taxpayer notes that Audit included a two-year purchase of pens in the sample population.

Concerning taxpayer's purchases of printer, wall bracket, poly-taper truck, rail support and tube, and computer terminal and keyboard—taxpayer chose not to capitalize and depreciate these items; rather, these items were expensed. Consequently, Audit properly included them in the sample population.

"Extraordinary expenses" generally will be excluded from sample populations to ensure the validity of the calculated error percentages. Taxpayer's purchase of pens, however, does not qualify as such an expense because taxpayer's acquisition of office supplies represents necessary, anticipated, and recurring expenses. It is to be expected that such expenses would be incurred on a regular basis. That one such expense was "captured" in the sample population is neither unusual nor unanticipated.

#### **FINDING**

Taxpayer's protest is denied.

### **IV. Sales Tax – Bar Codes and Sewing Equipment**

#### **DISCUSSION**

Taxpayer designs, manufactures, and subsequently attaches (sews) logos, emblems, and name tags to rental garments. Taxpayer also purchases and attaches "bar codes" to each rental garment. Taxpayer contends its purchase of bar codes should be exempt from sales and use tax. According to taxpayer:

Bar codes are of the same nature as logos and name tags. They are attached to each garment and change the garment significantly in that it makes each garment unique. The bar code specifically identifies each garment and benefits the customer in this regard. Therefore, in our opinion, the bar codes qualify for the incorporation exemption.

The bar codes are used by taxpayer for inventory control and tracking purposes. While some method of identifying goods received, inventoried, and rented is essential, such use does not qualify for a recognized sales and use tax exemption—despite the fact that taxpayer charges (and collects sales tax on) "prep charges" for these services.

Taxpayer also protests proposed assessments of use tax on "thread and the equipment required to attach the items [name tags, emblems, and bar codes] to the uniforms [rented]. Specifically, taxpayer argues that thread, "the blindstitch machine and the Juki 206 Auto Darner should not be subject to sales [and therefore use] tax."

The contested materials (thread) and equipment are used to attach either *purchased* or *manufactured* tags, labels, and logos to rented garments. Regardless of whether taxpayer is attaching *purchased* items to rental garments or attaching *manufactured* items, taxpayer is neither continuing a manufacturing process nor incorporating materials into a manufactured or rented product. Rather, taxpayer is performing a service—preparing its garments prior to rental. The materials and equipment, therefore, qualify for no exemptions.

#### **FINDING**

Taxpayer's protest is denied.

**V. Sales Tax – Computer Hardware and Software****DISCUSSION**

When requested by its customers, taxpayer will design, manufacture, and attach logos and emblems to its rental garments. To assist in the design and subsequent manufacture of logos and emblems, taxpayer purchased computer hardware and graphics software. Specifically, the hardware and software allows taxpayer to create a heat transfer pattern. According to taxpayer, “the products of the design are sold to the customer and sales tax is charged on the sale.” Consequently, “[w]e are of the opinion the purchase of the Ultragraphics Computer Kit, Monitor and Software are exempt from sales and use tax.”

Audit characterized the utility of taxpayer’s hardware and software as that of “computer aided design.” Audit, therefore, proposed assessments of use tax pursuant to 45 IAC 2.2-5-8(g)(7), which states that “[c]omputers which produce designs which are not sold as products are not exempt. Thus, computer-aided design is a non-exempt function.”

In the context of taxpayer’s business activities, the fact that taxpayer charges its clients an “emblem charge” (and collects sale tax on this charge) will not transform nonexempt design equipment into exempt manufacturing equipment. Taxpayer creates designs as a necessary pre-condition to its manufacture of logos and emblems. While taxpayer may present its billing charges to reflect each step in the “logo/emblem” process—i.e., design, manufacture, and attachment—such billing does not affect the substance of the activities actually performed.

The Department, therefore, finds that taxpayer’s hardware and software were purchased for, and utilized in, pre-production computer aided design activities. Such usage does not qualify for sales and use tax exemptions. (*Also see IC 6-2.5-5-3.*)

**FINDING**

Taxpayer’s protest is denied.

**VI. Sales Tax – Missing Invoices****DISCUSSION**

Audit included two expense items in the sample period for which no invoices could be located. Since no invoices were available for examination, Audit assessed use tax on these purchases. Audit cites 45 IAC 2.2-3-27, which discusses documentation requirements:

The person who stores, uses or consumes tangible personal property in Indiana may avoid paying the use tax to the Department if such person retains for inspection by the Indiana Department of Revenue a receipt evidencing payment of the tax.

Taxpayer identified the contested expenses as two purchases (for \$188.02) from a particular vendor (American Heat Seal). Although unable to locate the invoices associated with the contested purchases, taxpayer has provided other invoices from the same vendor. Taxpayer contends that “the attached invoices support the fact that exempt items [patches for shirts and pants] are purchased from this vendor.”

A review of the provided invoices shows that taxpayer purchased certain items from this particular vendor. The Department, however, is unable to identify what particular items were purchased—or ascertain the utility of such items. Additionally, the Department is unable to conclude that these documented purchases were representative of taxpayer’s undocumented purchases.

**FINDING**

Taxpayer’s protest is denied.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 98-0360****Gross Income Tax****For the Tax Periods: 1987 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. Gross Income Tax – Intangibles**

**Authority:** IC 26-1-1-201, 45 IAC 1-1-17, 45 IAC 1.1-2-10, 45 IAC 1-1-29, 45 IAC 1-1-49, 45 IAC 1-1-51, 45 IAC 1-1-118, 45 IAC 15-3-2, IRC §7701, *United Leaseshares v. Citizens Bank & Trust*, 470 N.E.2d 1383 (Ind. App. 1984), *First National Leasing and Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992)

The Taxpayer protests the assessment of gross income tax on lease and interest income.

**II. Gross Income Tax – Penalty**

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

The Taxpayer protests the imposition of the negligence penalty.

**STATEMENT OF FACTS**

Taxpayer, incorporated and domiciled out-of-state, owns diesel trucks licensed and titled in Indiana. The vehicles are leased to an Indiana dealer, who in turn, leases the vehicles to the consumer. More facts will be supplied as necessary.

**I. Gross Income Tax – Intangibles**

**DISCUSSION**

Taxpayer is the owner of vehicles licensed and titled in Indiana. These vehicles are leased to an Indiana franchisee, who in turn leases the vehicles to the consumer. During the audit, Taxpayer was determined to be a non-filer for gross income tax. Audit concluded from Taxpayer’s books and records that Taxpayer has been receiving lease revenues from their Indiana franchisee for leases of vehicles. The audit included those lease receipts received from the Indiana franchisee in Taxpayer’s Indiana gross income.

Gross income includes all income actually or constructively received. 45 IAC 1-1-17. Lease income is considered an intangible for gross income tax purposes. Intangible means a personal property right, which exists only in connection to something else. 45 IAC 1-1-51. Generally, receipts derived from an intangible are included in gross income. *Id.* However, “[t]he Gross Income Tax Act [IC 6-2.1] exempts income from transactions in interstate commerce, but only to the extent that the State is prohibited from taxing such income by the Constitution of the United States. Therefore, not all receipts derived from interstate commerce are afforded this exemption....” 45 IAC 1-1-118. Indiana may tax the lease income if it forms an integral part of a trade or business regularly conducted at a business situs in Indiana. 45 IAC 1-1-51.

Business situs is created when possession and control of a property right have been localized in some business activity away from the owner’s domicile. 45 IAC 1-1-49. Taxpayer maintains that even if the income is characterized as income from operating leases, its connection with Indiana is still insufficient to establish a business situs.

**LEASE VERSES FINANCING ARRANGEMENT**

Taxpayer contends the audit incorrectly characterized Taxpayer’s contracts with the dealers as operating leases. Pursuant to 45 IAC 1.1-2-10 (formerly 45 IAC 1-1-29):

- (a) Except as provided in subsection (b), rental income derived from leasing real or personal property is taxable as a service under section 5 of this rule.
- (b) If the leasing agreement is a financing device for a sale of tangible personal property that is normally sold in the regular course of the taxpayer's retail business, the receipts from the contract are taxable as a retail sale.
- (c) The department will consider many factors in determining the intent of the parties, including the following;
  - (1) Whether the lease payments are to be applied to an equity to be acquired by the lessee
  - (2) Whether the lessee will acquire title to the goods upon the lessor's receipt of a stated amount of payments under the contract.
  - (3) Whether the total lease payments for a relatively short period of use make up an inordinately large proportion of the total payment needed for the lessee to secure title.
  - (4) Whether the lease payments exceed the current fair rental value of like goods.
  - (5) Whether the lease contains an option to buy at a price nominal in comparison to the value of the property when the option may be exercised.
  - (6) Whether a part of the lease payments is designated or recognizable as interest or its equivalent.

45 IAC 1.1-2-10

Taxpayer states regardless of the fact that they do not sell tangible personal property in the ordinary course of business, the above regulation applies in principle. Taxpayer offers a Terminal Rental Adjustment Clause (TRAC) in addition to the standard operating lease agreement. Although the Indiana Code does not define TRAC, I.R.C. §7701(2001) states:

...

**(h) MOTOR VEHICLE OPERATING LEASES**

- (1) **IN GENERAL.**—For purposes of this title, in the case of a qualified motor vehicle operation agreement which contains a terminal rental adjustment clause—
  - (A) such agreement shall be treated as a lease if (but for such terminal rental adjustment clause) such agreement would be treated as a lease under this title, and
  - (B) the lessee shall not be treated as the owner of the property subject to an agreement during any period such agreement is in effect...
- (3) **TERMINAL RENTAL ADJUSTMENT CLAUSE DEFINED.**—
  - (A) **IN GENERAL.**—For purposes of this subsection, the term “terminal rental adjustment clause” means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

Taxpayer treats the contracts as operating leases for federal income tax purposes. The TRAC clause is simply an agreement between Taxpayer and dealer that the vehicle will be sold upon termination of the lease. Taxpayer and dealer both maintain the right to sell the vehicle to a third party at the end of the lease. Thus, Taxpayer fails to demonstrate that they sale tangible personal property in their normal course of business.

Taxpayer next argues that the lease is intended as security. They cite *United Leaseshares v. Citizens Bank & Trust*, 470 N.E.2d 1383 (Ind. App. 1984). In *United Leaseshares*, the court pointed to Uniform Commercial Code (IC 26-1-1-201) to determine whether a lease is intended as security.

IC 26-1-1-201(37) states:

“Security interest” means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (IC 26-1-2-401) is limited in effect to a reservation of a security interest...

Whether a transaction creates a lease or security interest is determined by the facts of each case. However, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee and:

- (a) the original term of the lease is equal to or greater than the remaining economic life of the goods;
- (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
- (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or
- (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest merely because it provides that:

- (a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than fair market value of the goods at the time the lease is entered into; (*emphasis added*)
- (b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods;
- (c) the lessee has an option to renew the lease or to become the owner of the goods;
- (d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or
- (e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

IC 26-1-1-201(37)

The lease agreement states that either party (Taxpayer or dealer) may terminate the agreement with sixty days notice. Thus, the lessee may terminate the lease. As stated above, the TRAC supplement is an agreement between Taxpayer and dealer in addition to the lease agreement that the vehicle will be sold at the end of the lease, regardless of who purchases the vehicle. Taxpayer notes that if they sell the vehicle, dealer will be charged a 15% selling commission. Nevertheless, Taxpayer maintains the option. The lessee (dealer) is not required to renew the lease or become the owner of the vehicle. Although Taxpayer may receive 100% of the cost of the vehicle via the TRAC supplement, the original term of the lease is not necessarily equal to or greater than the remaining economic life of the goods. A security interest is not established merely if the present value of the consideration the lessee is obligated to pay the lessor for the right to possession of the vehicles is equal to or greater than the fair market value of the vehicles. Hence, the Taxpayer has not shown that the TRAC clause acts as a security interest.

#### OPERATING LEASE

Taxpayer argues that if the Department finds that the lease agreements should not be treated as financing arrangements, they still would not have business situs if treated as operating leases. 45 IAC 1-1-49(6) states that “business situs” may be established by: “[o]wnership, leasing, rental, or other operation of income-producing property (real or personal).” Here, Taxpayer owns and leases trucks to Indiana customers.

Taxpayer states that they merely maintain passive control over the vehicles. They cite *First National Leasing and Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992). In *First National Leasing*, the Indiana Tax Court held that the income earned by an out-of-state corporation from leasing train derailment equipment to its wholly owned out-of-state subsidiary, who in turn, independently located the equipment in Indiana was not derived from Indiana sources. They found that First National only maintained passive control of the equipment. The subsidiary did not make a lease payment to First National Leasing from Indiana.

Here, unlike *First National* where property was leased to an out-of-state subsidiary, Taxpayer is leasing to Indiana customers i.e., the dealers. Taxpayer receives rental income from tangible personal property leased to the Indiana customer. Although Taxpayer

does not maintain office space, perform services, or retain inventory in Indiana and approves contracts out-of-state, Taxpayer does not show that control is merely passive. Pursuant to the lease agreement, Taxpayer's customers may not sell the vehicle (unless agree to TRAC) and sublease only upon written authorization from Taxpayer. The customer can only get insurance from companies authorized by the Taxpayer and the policy cannot be canceled or changed without Taxpayer's consent. Taxpayer is also authorized to take depreciation deductions and assumes recognition as the owner for federal tax purposes. Taxpayer's control of its Indiana vehicles is more than passive. Such property represents a business situs with Indiana.

We next must determine whether Taxpayer maintains tax situs. Taxpayer will be found to have tax situs if the intangible or income derived therefrom forms an integral part of the business conducted at the Indiana business situs. 45 IAC 1-1-51. Again, Taxpayer analogizes the situation here with *First National* and states that the mere ownership of leased property in Indiana is insufficient to subject the entire lease transaction to the gross income tax. Nevertheless, the facts in this case differ. As stated above, *First National* involved the leasing of equipment from an out-of-state company to its wholly owned out-of-state subsidiary. The court found that First National did not have a business situs. For Taxpayer's purposes, *First National* is inapposite. As stated above, Taxpayer maintains income producing property, which it maintains more than a passive control, in the state of Indiana.

The lease income in this case is an integral part of Taxpayer's business activity in Indiana. Here, Taxpayer's primary business is the leasing of vehicles and the income in question is directly connected with the leasing of the vehicles in Indiana. Therefore, Taxpayer's business activities fall within the ambit of 45 IAC 1-1-51.

**FINDING**

The Taxpayer's protest is respectfully denied.

**II. Tax Administration – Penalty**

**DISCUSSION**

IC 6-8.1-10-2.1(d) allows a penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Also, 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayers must show that they exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. The Department finds that the Taxpayers demonstrated reasonable cause for their failure to pay tax.

**FINDING**

The Taxpayers' protest of the penalty is sustained.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 98-0410**

**Sales and Use Tax**

**For the Years 1995, 1996, and 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Applicability of Exemption Certificates to Sales Transactions with Two of Taxpayer's Customers**

**Authority:** IC 6-2.5-8-8; IC 6-2.5-8-8(a); IC 6-2.5-8-8(c)

Taxpayer protests the audit's determination that taxpayer should have collected sales tax on certain transactions made with two of the taxpayer's customers. The taxpayer maintains that because those customers issued blanket sales tax exemption certificates, transactions made with those two customers were not subject to the state's gross retail (sales) tax.

**II. Applicability of the Gross Retail Tax on Taxpayer's Purchase of Reporting Services**

**Authority:** IC 6-8.1-5-1(b); 45 IAC 2.2-4-2; 45 IAC 2.2-4-2(a); 45 IAC 2.2-4-2(a)(1); 45 IAC 2.2-4-2(a)(2)

Taxpayer protests the audit's determination that taxpayer should have paid sales tax on subscriptions to publications which the taxpayer characterizes as "Industry Reporting Services."

**III. Imposition of the State Gross Retail Tax on Taxpayer's Purchase of Crane Rental Services**

**Authority:** IC 6-8.1-5-1(b); 45 IAC 2.2-4-27; 45 IAC 2.2-4-27(d); 45 IAC 2.2-4-27(d)(3)(A); 45 IAC 2.2-4-27(d)(3)(B)

Taxpayer protests the audit's determination that five invoices for crane rental services were subject to the state's gross retail tax.

**IV. Imposition of the State Gross Retail Tax on an Invoice for Repair of Equipment**

**Authority:** IC 6-2.5-2-1(a); IC 6-2.5-2-1(b); IC 6-2.5-4-1(b); 45 IAC 2.2-4-2(a); 45 IAC 2.2-4-2(a)(2); 45 IAC 2.2-4-2(c)

Taxpayer protests the audit's determination that an invoice for the repair of an item of taxpayer's equipment was subject to the state's gross retail tax.

**V. Request for Abatement of the Ten Percent Negligence Penalty**

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

Taxpayer requests that the Department exercise its discretion to abate the ten percent negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is a provider of specialized construction and fabrication services. Among other large-scale industrial projects, taxpayer constructs boilers, environmental control equipment, power plant equipment, and the buildings which enclose that equipment. Taxpayer is headquartered in Indiana but performs work for both in-state and out-of-state customers.

**DISCUSSION**

**I. Applicability of Exemption Certificates to Sales Transactions with Two of Taxpayer's Customers**

Taxpayer has on file Indiana General Sales Tax Exemption Certificates for two of its customers. One of the exemption certificates is marked as a "blanket" exemption. The second is not marked as either a "blanket" or "single purchase" exemption but simply states that it is applicable for "various purchases."

The audit determined that the certificates were inapplicable to certain of taxpayer's sales made with two of the issuing customers and that taxpayer should have collected sales tax on those particular transactions. The transactions at issue were those for which the customer issued a purchase order stating that the particular transaction was not exempt from sales tax. The audit determined that the taxability statement on the individual purchase order overrode the blanket exemption certificate.

The taxpayer disagrees with the audit's assessment and argues that the two Indiana General Sales Tax Exemption Certificates were sufficient on their own accord to relieve taxpayer of any and all duty to collect sales tax on all transactions made with the two issuing companies.

IC 6-2.5-8-8 allows certain "persons" to issue exemption certificates. IC 6-2.5-8-8(a) states that, "A person... who makes a purchase in a transaction which is exempt from the state gross retail and use taxes, may issue an exemption certificate to the seller instead of paying the tax." That same code section describes the responsibility of the person receiving such a certificate stating that, "A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross retail or use tax on that purchase." *Id.*

Taxpayer maintains that it is entitled to rely exclusively on the two exemption certificates in determining the applicability or inapplicability of the state's gross retail tax for sales transactions conducted with the two issuing customers. Taxpayer misapprehends the dimensions of the blanket exemption certificate. IC 6-2.5-8-8(a) states that exemption certificates may be issued for "transaction[s] which [are] exempt from the state gross retail and use taxes..." *Id.* (Emphasis added). That particular caveat is emphasized again at IC 6-2.5-8-8(c) which states that "[t]he department may also allow a person to issue a blanket exemption certificate to cover *exempt purchases* over a stated period of time." *Id.* (Emphasis added). An exemption certificate is not a universal declaration of sales tax immunity, globally inclusive for each and every transaction conducted with the issuing party. In the case of the first exemption certificate, customer has clearly indicated that the certificate is applicable to the "[s]ale of manufacturing machinery, tools and equipment to be used directly in direct production." Sales Tax Exemption Certificate, Customer One. In the case of the second exemption certificate, the customer has erroneously indicated that the exemption is applicable "[f]or purchases shipped out of state by vendor." Sales Tax Exemption Certificate, Customer Two.

As set out in IC 6-2.5-8-8(a), taxpayer is entitled to rely on the customers' exemption certificates for those transactions "which [are] exempt from the state gross retail and use taxes..." The taxpayer, as the recipient of a blanket exemption certificate, is not expected to determine the validity of each and every purchase order issued by the exemption holder. However, when the issuing customer submits a purchase order clearly stating that the transaction is for a non-exempt purchase, customer is indicating the transaction does not come within the orbit of its exemption certificate. Rather, the customer is indicating – for reasons entirely irrelevant to taxpayer – the transaction is for the sale of tangible personal property properly subject to the state's gross retail tax and that it is taxpayer's responsibility to collect the sales tax on that particular transaction.

**FINDING**

Taxpayer's protest is respectfully denied.

**II. Applicability of the Gross Retail Tax on Taxpayer's Purchase of Reporting Services**

Taxpayer protests the assessment of sales tax on its purchase of two reporting services. The two reporting services provide the taxpayer with up-to-date information allowing taxpayer to assess prospective jobs. Taxpayer maintains that under 45 IAC 2.2-4-2, the reporting services supply a service which does not come within the purview of the state's gross retail tax.

45 IAC 2.2-4-2 contains a provision exempting the purchase of services from sales tax. 45 IAC 2.2-4-2(a) states that, "Professional services, personal services, and services in respect to property not owned by the person rendering such services are 'not transactions of a retail merchant constituting selling at retail,' and are not subject to gross retail tax." However, "[w]here, in conjunction with rendering professional services... the serviceman also transfers tangible personal property for a consideration, this *will* constitute a transaction of a retail merchant constituting selling at retail..." *Id.* (Emphasis added). This rule governing transactions for services and tangible personal property contains a number of exceptions including one for which "[t]he serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property." 45 IAC 2.2-4-

2(a)(1). Another exception is found at 45 IAC 2.2-4-2(a)(2) which exempts from sales tax “tangible personal property purchased [and] used or consumed as a necessary incident to the service.” Conceivably, taxpayer’s purchase of the reporting services falls within one of the exceptions. However, the audit determined that taxpayer’s purchase of the reporting services was simply the purchase of a publication otherwise subject to sales tax. Under IC 6-8.1-5-1(b), audit’s determination is presumed correct 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(b). Absent any evidence that the purchase of the reporting services falls within one of exceptions, taxpayer has failed to meet its statutorily imposed burden of proof.

**FINDING**

Taxpayer’s protest is respectfully denied.

**III. Imposition of the State Gross Retail Tax on Taxpayer’s Purchase of Crane Rental Services**

On five occasions, taxpayer rented a crane. Pursuant to its agreement with lessor, the crane rental service also provided taxpayer an operator for that crane. Taxpayer argues that, under the provisions of 45 IAC 2.2-4-27(d)(3)(B), the price of the crane rental and associated operator is not subject to sales tax.

Taxpayer rents cranes for two purposes. The cranes are rented to perform installation of components and building materials which taxpayer’s own equipment is unable to accomplish. The cranes are also rented to make “point-to-point” transfer of components and building materials. In a “point-to-point” transfer, the components and materials are not being installed, they are simply being moved from one place at the construction site to another. Taxpayer maintains that while its own employees are involved in performing all of this work, the crane operator – the person most familiar with the operation and capabilities of the equipment – exercises control over the manner in which the work is accomplished. According to taxpayer, the operator has the discretion to refuse to perform that work which the operator believes is unsafe or which exceeds the capabilities of the crane equipment then being used.

45 IAC 2.2-4-27 provides the starting point for determining the taxability of transactions for the rental of tangible personal property. That section states “[i]n general, the gross receipts from renting or leasing tangible personal property are taxable.” An exception to that general rule is found at 45 IAC 2.2-4-27(d)(3)(B) which states “[t]he rental of tangible personal property together with an operator as part of a contract to perform a specific job in a manner to be determined by the owner of the property or the operator shall be considered the performance of a service rather than a rental or lease *provided the lessee cannot exercise control over such property and operator.*” (Emphasis added). The exemption is clearly qualified and limited to those transactions in which the lessee (taxpayer) does not exercise control over the manner in which the crane operator conducts the work. Taxpayer argues that its rental transactions fall within the exemption.

45 IAC 2.2-4-27(d)(3)(A) provides the flip side of the exemption, stating that, “[t]he renting or leasing of tangible personal property, together with the services of an operator shall be subject to the tax when control of the property is exercised by the lessee. Control is exercised when the lessee has exclusive use of the property, and the lessee has the right to direct the manner of the use of the property. If these conditions are present, control is deemed to be exercised even though it is not actually exercised.” 45 IAC 2.2-4-27(d)(3)(A).

IC 6-8.1-5-1(b) provides the presumption which taxpayer must overcome. That section states that, “The notice of proposed assessment is prima facie evidence that the department’s claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.” IC 6-8.1-5-1(b). Taxpayer has failed to meet that statutory burden because it failed to provide factual information sufficient to establish that the five crane rental transactions fell within the sales tax exemption provided within 45 IAC 2.2-4-27(d)(3)(B). Taxpayer’s bare assertion that it exercises no control over the crane and its operator is insufficient to bring itself within the exemption. 45 IAC 2.2-4-27(d) states that, “The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.”

Given the scale and complexity of the construction, engineering, and fabrication projects undertaken by the taxpayer – and absent specific information to the contrary – it would be difficult to envision a circumstance under which taxpayer would rent a crane and then fail to retain “the right to direct the manner of the use of the [crane]” or fail to reserve for itself “the exclusive use of the [crane]....” 45 IAC 2.2-4-17(d)(3)(A).

**FINDING**

Taxpayer’s protest is respectfully denied.

**IV. Imposition of the State Gross Retail Tax on an Invoice for Repair of Equipment**

Taxpayer hired vendor to repair the computer controls on an article of its machinery. The taxpayer argues that the invoice for this repair work represents the purchase of a service and is not subject to sales tax.

The vendor invoiced taxpayer for the provision of both services and materials. Vendor Invoice 500617, Oct. 8, 1996. The price of the vendor-provided materials – including keypad, software, memory modules, on/off assembly – is listed separately from the price of vendor’s services. The price of the materials is \$1,306.64 and the price of the vendor’s labor is \$600.00. The audit determined that the \$1,306.64 was subject to sales tax.

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## Nonrule Policy Documents

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Under IC 6-2.5-2-1(a), the state imposes the state gross retail (sales) tax on retail transactions made in Indiana. Under IC 6-2.5-2-1(b), “[t]he person who acquires property in a retail transaction is liable for the tax on the transaction....” A retail transaction, the prerequisite 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). Therefore, absent the transfer of tangible personal property, the transfer of services alone is not subject to the state gross retail tax. 45 IAC 2.2-4-2(a) states that “[p]rofessional services, personal services, and services in respect to property not owned by the person rendering such services are not ‘transactions of a retail merchant constituting selling at retail,’ and are not subject to gross retail tax. Where, 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....” Therefore, where the vendor transfers property together with services, the entire transaction is subject to the sales tax. However, an exception to that general rule is provided at 45 IAC 2.2-4-2(a)(2) which exempts “[t]he tangible personal property purchased [which] is used or consumed as a necessary incident to the service.” In addition, 45 IAC 2.2-4-2(c) states that “[p]ersons engaging in repair services are servicemen with respect to the services which they render and retail merchants at retail with respect to repair or replacement parts sold.”

Vendor sold taxpayer services and tangible personal property and – fortunately for taxpayer – listed the cost of each separately. As correctly determined by the audit, sales tax is properly due on the taxpayer’s purchase of tangible personal property and is not due on taxpayer’s purchase of services.

### FINDING

Taxpayer’s protest is respectfully denied.

#### V. Request for Abatement of the Ten Percent Negligence Penalty

Taxpayer has requested that the ten-percent negligence penalty, imposed under authority of IC 6-8.1-10-2.1(a), be abated with respect to additional taxes assessed during the years encompassed with the audit period. Taxpayer argues that it was not careless in its duty to collect and remit the state sales and use tax but used ordinary business care and prudence in determining its state tax liability. Taxpayer further states that it has timely paid its tax liability and was not negligent in complying with the state tax code and regulations.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2.1(a) can show that the failure to file a return, pay the full amount of tax shown on the person’s return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 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. Negligence results from a taxpayer’s carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations. *Id.*

In order to waive the negligence penalty, the taxpayer must prove that its failure to pay the full amount of tax due was due to “reasonable cause.” 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by “demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed....” *Id.* In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. *Id.*

Taxpayer has provided no substantive, statutory, or factual basis upon which the Department can justifiably be expected to find a reasonable cause for taxpayer’s failure to pay sales and use taxes.

### FINDING

Taxpayer’s protest is respectfully denied.

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## DEPARTMENT OF STATE REVENUE

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### LETTER OF FINDINGS NUMBER: 98-0448

#### Income Tax

#### Fiscal Years ending October 31, 1992, October 31, 1993, October 31, 1994, and October 31, 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.

### 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.



**II. Tax Administration – Interest**

**Authority:** IC 6.8-1-10.1

The taxpayer protests the interest assessment.

**STATEMENT OF FACTS**

The negligence penalty and interest were assessed on an income tax assessment that resulted from a Department audit conducted for the fiscal years October 31, 1992, October 31, 1993, October 31, 1994, and October 31, 1995.

The taxpayer is a general contractor providing construction, engineering, procurement, construction management, and technical services. The taxpayer is wholly owned by another corporation. Taxpayer reports on accrual basis of accounting. The taxpayer uses the services of a related corporation for tradesmen and craftsmen payroll. The taxpayer has no locations in Indiana other than construction sites.

**I. Tax Administration – Penalty**

**DISCUSSION**

The taxpayer argues the negligence penalty should be waived as the taxpayer did not attempt to evade Indiana tax laws.

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 was inattentive to tax duties. Inattention is negligence and negligence is subject to penalty. As such, the Department finds the penalty proper and denies the penalty protest.

**FINDING**

The taxpayer’s penalty protest is denied.

**II. Tax Administration – Interest**

**DISCUSSION**

The taxpayer protests the interest assessed.

IC 6.8-1-10.1 does not allow the waiver of interest. As such, the Department finds the assessment of interest proper and denies the interest protest.

**FINDING**

The taxpayer’s interest protest is denied.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 98-0500**

**Sales and Use Tax**

**For the Tax Years 1995, 1996, and 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 the document will provide the general public with information about the Department’s official position concerning a specific issue.

**ISSUE**

**I. Applicability of the State Gross Retail Tax on Items of Equipment Leased to Taxpayer**

**Authority:** IC 6-2.5-2-1; IC 6-2.5-5-3(b); 45 IAC 2.2-4-27; 45 IAC 2.2-5-8; 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(g)

Taxpayer argues its lease of certain items of equipment – consisting of metal fabricating machinery – is exempt from imposition of the sales tax because the leased equipment is entitled to the manufacturing exemption.

**STATEMENT OF FACTS**

Taxpayer is a self-styled “farm supply” dealer. Taxpayer also fabricates certain items related and unrelated to farm equipment. Taxpayer produces, sells, and installs grain handling, storage, and conditioning equipment. Taxpayer also fabricates sprayer equipment, parts for recreational vehicles, parts for horse trailers, parts for grain handling equipment, metal farm gates, and certain other specialized metal parts. Taxpayer protests the assessment of sales tax on the lease of 20 items of metal fabricating equipment used in constructing these various metal parts.

This equipment was initially purchased by taxpayer’s “sister” corporation and then “leased” to taxpayer. The audit determined that because the lease of tangible personal property was a retail transaction, taxpayer, as the lessee, was responsible for paying sales

tax on the “leased” equipment. During the initial review of the taxpayer’s protest, the appeals analyst found that the “leasing” of the equipment was a taxable transaction because taxpayer and sister corporation (lessor) were separate tax entities. Other than the issue of whether the lease payments are subject to the imposition of the sales tax, taxpayer does not challenge the audit’s factual determinations concerning the nature of the transactions with the lessor. Rather, taxpayer maintains that the 20 items of equipment fall within the manufacturing exemption and that, as a result, taxpayer’s lease of the equipment should not be subject to sales tax.

#### **DISCUSSION**

##### **I. Applicability of the State Gross Retail Tax on Items of Equipment Purchased and Then Leased to Taxpayer**

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. In addition, 45 IAC 2.2-4-27 imposes the sales tax on gross receipts derived from the renting or leasing of tangible personal property. That same regulation exempts those lease payments which would be exempt in an equivalent sales transaction.

Under IC 6-2.5-5-3(b), 45 IAC 2.2-5-8, an exemption from the state gross retail tax is provided for transactions involving manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. 45 IAC 2.2-5-8(c) defines “direct use” as that use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(g). Therefore, in order to qualify for the manufacturing exemption, taxpayer must establish that the functions performed by the leased metal fabricating equipment constitute an essential and integral manufacturing process that produces tangible personal property as defined within IC 6-2.5-5-3(b) and 45 IAC 2.2-5-8(g).

Taxpayer argues that 20 items of metal fabricating equipment are used in the direct production of taxpayer’s various products. To that end, the taxpayer has provided information which describes the manner in which 20 items of equipment are employed by the taxpayer and the number identifying the particular part being manufactured. A Lincoln 250 Wire Welder, Lincoln Welder, Lincoln 150 Welder, and Lincoln 255 Welder are employed by the taxpayer to assemble saddle rack weldments (PN: BIS103) for a horse trailer manufacturer. These four items of equipment are further identified as E9702, E9716, E9718, and E9732.

Taxpayer uses a Wysong Brake Press and Verson Break Press to form straps (PN: 33LDTRL) for a boat trailer manufacturer. These two items of equipment are identified as E9708 and E9723.

Taxpayer uses Niagra Shears to cut steel sheet in the manufacture of grain equipment hoppers (PN: DG3800). This item of equipment is identified as E9724.

Taxpayer uses a Hydro Mech 8-20 Band Saw is used to cut hopper cone legs (PN HO24-40) for grain equipment dealers. This item of equipment is identified as E9729.

Taxpayer uses a Uni-Hydro Iron Worker to shear and punch the front fork (PN: 10183) for a lawn mower manufacturer. This item of equipment is identified as E9703.

Taxpayer uses a Alva Allen Punch Press and a 40 Ton Punch Press to shear and form window bars (PN: B18143) for a horse trailer manufacturer. These two items of equipment are identified as E9704 and E9722.

Taxpayer uses a Boyer Schultz Surface Grinder, a Millport Milling Machine, a South Bend Lathe, a Surface Grinder, and a Bison Chuck for machining and finishing a slam latch (PN: BIS001A) for a horse trailer manufacturer. These five items of equipment are identified as E9705, E9706, E9710, E9713, and E9717.

Taxpayer uses a Torch Table and Plasma Arc to cut shapes (PN: LHS016) for a lawn ornament manufacturer. These two items of equipment are identified as E9711 and E9712.

Taxpayer uses a Power Roller to roll transitions rings (PN: DG1610) for grain equipment dealers. This equipment is identified as E9725.

Taxpayer uses an Airless Paint Sprayer to paint sprayer trailers (PN: TRL71) for spray equipment dealers. This item of equipment is identified as E9731.

Taxpayer has provided evidence purporting to establish that the preceding 20 items of equipment are involved in the direct production of tangible personal property. Based upon the evidence provided by the taxpayer, taxpayer has set out an argument that the 20 items of equipment are employed as essential components in an integrated process by which taxpayer produces various metal fabrications. According to taxpayer, the use of the equipment is confined to taxpayer’s business site and is not used in the final assembly or installation process at the customer’s location. According to taxpayer, the 20 items of equipment act in such a way as to have an immediate effect on the tangible personal property being produced. Therefore – subject to verification by a supplemental audit – the leasing of the 20 items of equipment is entitled to the sales tax manufacturing exemption afforded under IC 6-2.5-5-3(b).

#### **FINDING**

Subject to the determination of the supplemental audit, taxpayer’s protest is sustained.

**DEPARTMENT OF STATE REVENUE**

04980576.LOF

**LETTER OF FINDINGS NUMBER: 98-0576**

**State Gross Retail Tax**

**For Tax Years 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. State Gross Retail Tax – Exemption Certificates**

This issue has been resolved, subject to verification by the Audit Division.

**II. State Gross Retail Tax – Unitary Transactions**

**Authority:** *Cowden & Sons Trucking, Inc. v. Indiana Dept. of State Revenue*, 575 N.E.2d 718 (Ind.Tax Ct. 1991); *Monarch Beverage v. Indiana Dept. of State Revenue*, 589 N.E.2d 1209, 1212 (Ind.Tax Ct. 1992); IC 6-2.5-1-1; IC 6-2.5-1-2; IC 6-2.5-2-1; IC 6-2.5-4-1; IC 26-1-2-401(2)

Taxpayer protests the assessment on delivery charges arguing that such delivery service does not qualify as part of a unitary retail transaction.

**III. State Gross Retail Tax – Manufacturing Exemption**

**Authority:** IC 6-8.1-5-1; 45 IAC 2.2-5-9(g)

Taxpayer protests assessments of Indiana sales tax on its use of a front-end loader, maintaining that this item qualifies for the manufacturing exemption.

**IV. Tax Administration – Abatement of Penalty**

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

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is an Indiana corporation which operates a stone quarry and sells sand and stone from its inventory. As part of its business, taxpayer uses its trucks to deliver sand and stone sold to its customers. The sales tax assessed against transactions for which taxpayer failed to collect sales tax and was unable to provide exemption certificates has been resolved. Taxpayer now protests the Audit Division's proposed assessments of sales tax on taxpayer's retail unitary transactions, as well as assessments of use tax on taxpayer's use of front-end loaders. Additional facts are discussed below.

**I. State Gross Retail Tax – Exemption Certificates**

**DISCUSSION**

During taxpayer's audit, the auditor disallowed several sales, that taxpayer maintains are tax-exempt sales, because taxpayer failed to provide tax exemption certificates.

Subsequent to the audit, the taxpayer produced exemption certificates applicable to the transactions upon which the auditor assessed sales tax. Because valid exemption certificates existed for these transactions, taxpayer is not liable for sales tax on such transactions.

**FINDING**

Taxpayer's protest is sustained, subject to verification by the Audit Division.

**II. State Gross Retail Tax – Unitary Transactions**

**DISCUSSION**

As part of its quarry business, taxpayer uses its trucks to deliver the sand and stone it sells to its customers, and to deliver sand and stone sold to its customers by other vendors. Because the delivery drivers are not able to calculate the sales tax due on a particular order, taxpayer computes sales tax at taxpayer's office and includes said tax in the price quoted to the customer. Taxpayer then generates a billing ticket for its records that includes the sales tax calculated on the cost of the materials, but does not separate the delivery charge from the cost of the sand and stone. The actual invoice taxpayer sends to its customers, however, does separate the delivery charge from the charges for the cost of the sand or stone and the sales tax thereon. Upon customer's payment of an invoice, taxpayer remits sales tax to the Department on the cost of the sand and/or stone sold.

At the conclusion of the audit, the auditor assessed sales tax on the entire amount invoiced to taxpayer's customers on the basis that the proceeds were received in a retail unitary transaction. Taxpayer protests the assessment on the delivery charges based upon taxpayer's contention that the charges for delivery services, in fact, were separated from the sale of the sand and stone.

An excise tax, known as the state gross retail tax (sales tax), is imposed on retail transactions made in Indiana. IC 6-2.5-2-1. A taxable retail transaction is "a transaction of a retail merchant that constitutes selling at retail as described in IC 6-2.5-4." IC 6-2.5-1-2(a). Selling at retail requires a transfer of tangible personal property. IC 6-2.5-4-1(b)(2). Since a service does not constitute tangible personal property, the sale of services usually fall outside the scope of the gross retail tax. However, there are two instances

when an otherwise non-taxable sale of a service is subject to sales tax. The first is when the services are performed with respect to tangible personal property being transferred in a retail transaction and the services take place prior to the transfer of the tangible personal property. IC 6-2.5-4-1(e). The second is when the services are part of a retail unitary transaction. IC 6-2.5-1-2.

A unitary transaction is defined as a transaction that includes the transfer of tangible personal property and the provision of services for a single charge pursuant to a single agreement or order. IC 6-2.5-1-1. A retail unitary transaction is a unitary transaction that is also a retail transaction. Under IC 6-2.5-1-1, taxpayer's sale of sand and stone and delivery service does not constitute a retail unitary transaction. While the sale of the materials and the service are furnished under a single order, the additional documentation that taxpayer submitted at its protest hearing clearly establishes that taxpayer does not calculate a combined charge for the materials and services but charges them separately.

In the *Explanation of Adjustments*, the auditor states that sales tax was due on the entire amount invoiced to customers because taxpayer provided its customers with "lump-sum" invoices. However, case law does not lend support to the auditor's broad interpretation of the regulation. The legislature did not intend for non-taxable services to be subject to tax merely because performance occurred in a unitary transaction. *Cowden & Sons Trucking, Inc. v. Indiana Dept. of State Revenue*, 575 N.E.2d 718, 723 (Ind. Tax Ct. 1991). As the court in *Cowden* observed, "generally, services [are taxable] only when the transfer of property and the rendition of services in a retail unitary transaction are inextricable and indivisible..." *Cowden*, 575 N.E.2d at 722.

Consequently, the divisibility of a transaction is indicated by the temporal relationship between the provision of the services and the transfer of the property, that is, services performed prior to a transfer of property indicate an inextricable transaction wholly subject to sales tax, IC 6-2.5-4-1(e)(2), and services performed after a transfer of property indicate a divisible transaction in which the sale is taxed but the services are not.

*Id.* In *Cowden*, the court found that the provision of hauling services was provided concurrently with the transfer of stone. After making this determination, the court applied a multi-factor test and found that the service and sale of property were not subject to sales tax because the transactions were not inextricable and indivisible. In reaching its finding, the court looked to *Cowden*'s records, the overall nature of its business, and the nature of the unitary transactions. It is important to note that the court in *Cowden*, adopted the multi-factor test only after it had determined that the delivery of the goods at issue occurred not before or after but concurrently with the transfer of goods. *Id.* at 722. The multi-factor test will only be applied where the time of delivery of the service is inconclusive.

Applying the reasoning of *Cowden*, we now look to whether taxpayer's delivery services occurred before or after the transfer of the sand or stone from the taxpayer to its customers. If legal transfer occurs at the point of sale, then the delivery is non-taxable. If legal transfer does not occur until taxpayer actually delivers the sand or stone to the customer, then that service is taxable.

Indiana courts refer to the law of sales for interpreting tax laws that relate to the sale of goods. *Monarch Beverage v. Indiana Dept. of State Revenue*, 589 N.E.2d 1209, 1212 (Ind. Tax Ct. 1992). Under Indiana's Uniform Commercial Code:

Unless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods...

(a) if the contract requires or authorizes the seller to send the goods to the buyer but does not require him to deliver them at destination, title passes to the buyer at the time and place of shipment; but

(b) if the contract requires delivery at destination, title passes on tender there.

IC 26-1-2-401(2).

Subsection (a) above recognizes the situation where a buyer contracts to have the seller send purchased goods, but the buyer does not require the seller to deliver the goods to their destination. Under this scenario, the legislature determined that title passes when the goods have indeed been shipped. Subsection (b) illustrates the situation where a buyer contracts to have the seller send purchased goods and requires seller to deliver the goods to their destination. We find the facts of the instant case to be more closely aligned with the situation set forth in subsection (b) above.

Taxpayer is in the business of selling sand and stone. Sand and stone are heavy, bulky products that must be delivered by trucks equipped to handle excess weight. As such, the majority of taxpayer's customers purchase both sand and stone and delivery services, while a smaller percentage of customers receive only delivery services. When taxpayer agrees to make a sale of sand or stone to its customers, the customers (in the instance where the sale is for both materials and services) contract for materials and delivery, plus any applicable sales tax due. Although taxpayer's final invoice printed and delivered to taxpayer's customers separately lists the material costs from the labor costs from the sales tax, we do not believe that the contract is completed until taxpayer delivers the materials to the customer's destination.

Here we find that legal transfer of the sand and stone sold occurs after taxpayer has delivered the materials to its customers' destinations. As such, taxpayer's delivery charges are taxable under IC 6-2.5-4-1(e) because such delivery is performed prior to legal transfer.

**FINDING**

Taxpayer's protest is respectfully denied.

**III. State Gross Retail Tax – Manufacturing Exemption**

**DISCUSSION**

Taxpayer protests the assessment of use tax upon 20% of taxpayer's use of its front-end loaders. Taxpayer's front-end loaders

are used to transport the stone and sand from a crusher to a wash plant, to transport the stone and sand from the wash plant to a stockpile to allow moisture to drain and evaporate from the washed stone, and to load its trucks for delivery of the stone and sand to taxpayer's customers. Taxpayer asserts that the use of the loaders to load trucks for the delivery of stone and sand to taxpayer's customers is approximately 2% of the total loader usage. However, the auditor determined, after comparing loader usage of taxpayers operating similar businesses, that taxpayer's taxable use of the loaders was 20%.

There is no issue that the use of the loaders to feed the wash plant and to stockpile the stone and sand are exempt from sales tax, and the use of the loaders to load the stone and sand onto trucks for the delivery of the stone and sand to customers is taxable. See 45 IAC 2.2-5-9(g), Examples (1), (2) and (3). The issue before us is simply whether the auditor overestimated the taxable use of the loaders used to load stone and sand from the stockpiles onto taxpayer-owned trucks for delivery to taxpayer's customers.

IC 6-8.1-5-1 provides in pertinent part that:

If 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 to the department.... The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

At the time of the audit, no information was available to the Department's auditor to determine the taxable usage of the front-end loaders. According to the auditor, taxpayer performed no studies to document the taxable percentage of use. See *Explanation of Adjustments*, pg. 8. The auditor, therefore, looked to taxable usage of front-end loaders used to load delivery trucks at other similarly operated businesses to determine taxpayer's taxable use. The auditor determined taxpayer's taxable use of its front-end loaders to be 20%.

Taxpayer protested the auditor's taxable use determination and assessment but did not offer any substantive evidence that the determination and assessment was invalid. As such, the taxpayer failed to meet the burden imposed by IC 6-8.1-5-1.

**FINDING**

Taxpayer's protest is denied.

**IV. Tax Administration – Abatement of Penalty**

**DISCUSSION**

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...." 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id.*

Here, taxpayer maintains that its failure to remit sales tax was due to personnel's lack of knowledge as to the sales tax due on retail unitary transactions, and what percentage of the use of taxpayer's loaders is subject to the Indiana sales tax. The Department determined that imposition of the negligence penalty was appropriate because taxpayer made no attempts to understand regulations governing sales tax due on retail unitary transactions, and failed to perform a formal study to determine actual taxable use of its manufacturing equipment.

In the instant case, we find that taxpayer has failed to demonstrate that, regarding the issues of unitary transactions and the manufacturing exemption, it exercised the degree of reasonable care required to justify waiving the ten percent negligence penalty. Taxpayer may not assert its own naivete as a basis for an abatement of penalty. 45 IAC 15-11-2(b) states that "[i]gnorance of the listed tax laws, rules and/or regulations is treated as negligence. Waiver of the penalty is inappropriate.

**FINDING**

Taxpayer's protest is respectfully denied.

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**DEPARTMENT OF STATE REVENUE**

02980675.LOF

**LETTER OF FINDINGS NUMBER: 98-0675 IT**

**Gross Income Tax**

**For Tax Periods: 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. Gross Income Tax – Telecommunications Services**

**Authority:** IC 6-22.1-2-2; 45 IAC 1-1-121; 45 IAC 1-1-124

Taxpayer protests the assessment of Indiana gross income tax on its interstate telecommunication services.

**STATEMENT OF FACTS**

Taxpayer provides private line transmission services to (primarily) long distance telecommunications carriers. In the provision of these services, Taxpayer operates microwave transmission equipment on a regional basis. These regional circuits overlap creating a national telecommunications transmission network. Taxpayer has terminals and equipment at three (3) Indiana locations.

In computing its Indiana gross income, Taxpayer included only the receipts derived from its transport of "intrastate" communications. That is, Taxpayer limited its gross income to those receipts derived from the transport of communications over circuits that both originate and terminate in Indiana.

Audit, however, contends Taxpayer is not a "communications carrier" and cannot adopt the relatively narrow definition of "intrastate" afforded to "communications carriers." Rather, Audit characterized Taxpayer's activities as the provision of private line transmission services to *communications carriers*. And as with any service provider, Taxpayer must, according to Audit, include in its Indiana gross income all receipts attributable to its Indiana activities. Since Taxpayer failed to do so, Audit proposed additional assessments of gross income tax.

**I. Gross Income Tax – Telecommunications Services**

**DISCUSSION**

Taxpayer operates a nationwide private line telecommunications network. Specifically, Taxpayer supplies long-distance communications carriers with private line point-to-point transmission access. Long-distance carriers often require, for a variety of reasons, additional private line access in order to complete transmissions of voice and data communications. Taxpayer (among others) provides this additional private line access via its regional circuits. During the audit period, Taxpayer had private line contracts with over two hundred (200) long-distance carriers.

A private line is an unswitched telecommunications transmission circuit used to transport "traffic" between LATAs (local access and transport areas). Taxpayer markets its private line capacity to both facilities based and non-facilities based carriers. Taxpayer explains:

During the audit period, taxpayer's income came from "private line" revenue. A private line is an unswitched telecommunications circuit used by customers to transport their data between LATA's (Local Access and Transport Areas). Calls being transmitted over a private line circuit for a customer are generally routed by the customer through a switch to a receiving terminal in taxpayer's network. Taxpayer then transmits the signals over a private line to the terminal where the signal exits the taxpayer's network. The signals are then generally routed by the customer through another switch and to the call recipient through a[n] LEC (local exchange carrier).

According to Audit, Taxpayer typically bills its customers (the long-distance carriers) a fixed monthly rate based on the capacity or length of the circuit—regardless of the amount of "traffic" actually transported over the circuit.

Initially, Taxpayer arrived at its gross income from Indiana sources by employing a "route/mile" formula. Taxpayer apportioned income to various states based on the circuit distance in each applicable state. Using this methodology, Taxpayer included in its Indiana apportionment formula (1) income from circuits with origin and destination within Indiana, (2) income from circuits with origin or destination within Indiana, and (3) income from circuits across Indiana with origin and destination outside Indiana.

Subsequently, amended returns were filed. Taxpayer reduced its Indiana gross income by limiting inclusion to only that income derived from telecommunications circuits both originating and terminating in Indiana. Income previously included in Taxpayer's Indiana gross income was now characterized as exempt interstate income.

Taxpayer relies on 45 IAC 1-1-124(b), which instructs:

Income from wire communications including telephone and telegraph lines, is taxable if derived from carrying communications between two (2) points in Indiana. It is not taxable if derived from carrying communications between a point outside Indiana and a point in Indiana, or from a point outside Indiana into and across the State to a point outside Indiana.

*(Note: 45 IAC 1 was repealed effective January 1, 1999, and replaced by 45 IAC 1.1.)*

Audit contends Taxpayer's activities are different from those addressed in 45 IAC 1-1-124(b). Specifically, Audit determined Taxpayer did not "carry" communications. Rather, Taxpayer offered a service that allowed its customers (i.e., the long-distance carriers) to use capacity on its transmission network.

Implicit in the taxing scheme described in 45 IAC 1-1-124(b) is the requirement that a telecommunications carrier derive income from "carrying communications" originating and terminating at identifiable locations. The paradigm associated with the taxation of income derived from "carrying communications" presumes transmission of voice or data from an originating source to a terminating destination. Otherwise, it would be impossible, under the regulation, to distinguish exempt "interstate" transmissions from non-exempt "intrastate" ones.

Furthermore, the computation of a carrier's Indiana gross income from "carrying communications" can only be determined on a transactional basis. The relevant transaction is represented by the transmission of communications by the carrier from the source to its intended destination. Consequently, one must pinpoint the origination and terminus of each transmission in order to determine the taxability of the income derived from such transmissions. For example, if a particular transmission originates in Batesville, Indiana, and terminates in Bicknell, Indiana, the receipts derived from "carrying" this intrastate communication must be included in the carrier's Indiana gross income. Conversely, if the transmission either originates or terminates in Rockford, Illinois (or any location outside Indiana), the interstate nature of the transaction would serve to exclude such receipts from the carrier's Indiana gross income.

Unlike its customers (i.e., the long distance carriers), taxpayer provides a more intermediate data transmission service. Taxpayer provides interexchange access to facilitate completion of long-distance data communications transmissions by long-distance carriers. Nevertheless, taxpayer is not "carrying communications" as that term is used in 45 IAC 1-1-124(b). Rather, taxpayer offers a service that allows its communication carrier customers to use—for a predetermined contracted amount—capacity on taxpayer's transmission network. Taxpayer, as a provider of services within Indiana, must include in its Indiana gross income all income derived from such services. That is, taxpayer must include all income derived from customer data transmissions that utilize taxpayer's Indiana data transmission network.

A final caveat: a determination of the taxability of receipts derived from Taxpayer's private-line service activities does not depend on the nature of the underlying communications transmissions performed by Taxpayer's customers (i.e., the long-distance carriers); rather, such determination is a function of the utility of Taxpayer's Indiana private line circuits in the context of its customers' transmissions.

#### **FINDING**

Taxpayer's protest is denied.

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#### **DEPARTMENT OF STATE REVENUE**

02990029.LOF

#### **LETTER OF FINDINGS NUMBER: 99-0029**

#### **Gross Income Tax For Tax Year 1997**

**NOTICE:** Under Ind. Code § 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. Gross Income Tax – Low Rate versus High Rate Classification of Income Received from Sale/Leaseback of Production Equipment**

**Authority:** IC § 6-2.1-2-1; 45 IAC 1-1-11; IC § 6-8.1-5-1; 45 IAC 1-1-13; IC § 6-2.1-1-12; 45 IAC 1-1-14; IC § 6-2.1-2-4(4); 45 IAC 1-1-17; IC § 6-2.1-2-3; 45 IAC 1-1-21; IC § 6-2.1-2-5(8); 45 IAC 1-1-22; IC § 6-2.1-1-9; 45 IAC 1-1-85; IC § 6-2.1-2-5(9); 45 IAC 1-1-86; IC § 6-2.1-2-7; 45 IAC 1-1-88; 45 IAC 1-1-107

Taxpayer protests the reclassification of income received on a sale and leaseback transaction from the low rate to the high rate of taxation.

#### **STATEMENT OF FACTS**

Taxpayer is an Indiana corporation, 98% of which is owned by a Japanese corporation. Taxpayer manufactures and wholesales piston parts for large tractor and truck engines. The Department audited taxpayer for tax year 1997, finding that all taxable revenue was reported but not correctly classified between the high and low rates of taxation for gross income tax purposes. The Department reclassified some low rate income to that of high rate. This reclassification led to proposed assessments of Indiana gross income tax. Taxpayer timely protested these assessments. The Department requested that taxpayer provide additional information. Taxpayer has done so. Further facts will be supplied as required.

**I. Gross Income Tax – Low Rate versus High Rate of Classification of Income Received from Sale/Leaseback of Production Equipment**

**DISCUSSION**

Taxpayer protests the reclassification of income received on the sale/leaseback of production equipment from the low rate pursuant to IC § 6-2.1-2-4 to the high rate of taxation pursuant to IC § 6-2.1-2-5. *See also*, 45 IAC 1-1-22 and 45 IAC 1-1-107. The Department’s audit of taxpayer revealed that taxpayer sold certain production equipment—two lathes and a sawing machine—to a leasing company who then leased the equipment back to taxpayer. Taxpayer classified the sale as wholesale sales and included the sales proceeds as low rate income for gross income tax reporting purposes. Taxpayer had originally purchased the equipment from the parent corporation and sold it 6 months later to the equipment leasing company. The auditor reclassified the proceeds as receipts from a sale of capital assets pursuant to 45 IAC 1-1-21 because of how taxpayer treated the transaction in its own corporate records.

Taxpayer did not treat the transaction as a sale at wholesale on its internal financial statements and federal income tax return. The transaction was not characterized as a sale at wholesale within their accounting system. Rather, for federal income tax purposes, taxpayer characterized the proceeds from the sale/leaseback transaction as a \$283,652 short-term capital gain. Taxpayer had purchased the equipment for \$1,893,652 and sold it for \$2,177,080. The information from taxpayer’s federal tax return clearly contradicts taxpayer’s assertion that there was no mark up on the sale of the equipment to the leasing company.

Within its own internal financial statements and accounting system, taxpayer treated the proceeds from the transaction as a “deferred gain on sale leaseback of equipment;” the transaction itself is listed in a section of taxpayer’s internal documents entitled “Assets, Property and Equipment.” (emphasis added). Taxpayer’s “Unaudited Statement of Cash Flows” treats the proceeds from the transaction as “investing activities.” Further, taxpayer’s “Notes to Financial Statements,” under “Leases,” show the transaction as a “sale and leaseback... resulting in a gain... to be recognized ratably over the life of the lease.” Finally, under “Income Taxes,” the proceeds were treated as “gain on sale and leaseback.”

Taxpayer argues in its Letter of Protest that it purchased the production equipment with the intent to resell it in the same form that it was purchased, holding it primarily for sale to a customer in the regular course of business. *See*, IC § 6-2.1-2-1. Taxpayer claims that whenever it has purchased equipment, it has always sold the equipment in a sale and leaseback transaction. Taxpayer claims the property was never used before its sale and the price was not marked up. In the alternative, taxpayer argues that the transaction was a sale at retail, thus qualifying for the low rate of taxation pursuant to IC § 6-2.1-2-1(b)(1). Taxpayer states it was acting as a retail merchant who, in the ordinary course of its business, transferred production equipment with the intention of reselling it.

Under IC § 6-8.1-5-1(b), a “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.” Therefore, taxpayer has the burden of proof in showing that the Department’s classification of the income received from the transaction at issue is incorrect. Generally speaking, “gross income means all the gross receipts a taxpayer receives from (1) trades, businesses, or commerce; (3) from the sale, transfer, or exchange of property, real or personal, tangible or intangible; (10) from any other source not specifically described in this subsection.” IC § 6-2.1-1-2. *See also*, 45 IAC 1-1-17. The less complex issue raised by taxpayer’s protest concerns taxpayer’s argument in the alternative, i.e., is taxpayer a retail merchant and thus is the income received from the transaction at issue subject to the low rate of taxation?

For gross income tax purposes, a retail merchant means “a taxpayer who is regularly and occupationally engaged in the business of purchasing tangible personal property and providing the tangible property to his customers at a fixed and established place of business.” IC § 6-2.1-1-12. Taxpayer is not a retail merchant. *See also*, IC § 6-2.1-2-1(b)(1), 45 IAC 1-1-11, 45 IAC 1-1-13, and 45 IAC 1-1-14. A retail sale is a transaction in which the tangible personal property is transferred for consideration “**in the ordinary course of the seller’s regularly conducted business.**” (45 IAC 1-1-13(3); emphasis added). Taxpayer’s “ordinary course” of “regularly conducted business” is the manufacture of piston parts for sale at wholesale; taxpayer’s “fixed and established place of business” is a manufacturing plant, not a retail store. Therefore, IC § 6-2.1-2-4(4) does not apply. The proceeds from the transaction at issue cannot be subject to the low rate of taxation under taxpayer’s theory that the sale of the production equipment was a retail sale. *See also*, 45 IAC 1-1-88, the regulation providing for the low rate of tax for retail sales. Therefore, taxpayer’s argument in the alternative must fail.

The more complex issue concerns taxpayer’s primary argument, that the income received from the transactions at issue falls under IC § 6-2.1-2-4(1); that is, the income qualifies for low rate treatment as a wholesale sale. First, IC § 6-2.1-2-3 sets forth 2 separate rates of tax for different classes of transactions:

- (a) The receipt of gross income from transactions described in section 4 of this chapter is subject to a tax rate of three-tenths of one percent (0.3%).
- (b) The receipt of gross income from transactions described in section 5 of this chapter is subject to a tax rate of one and two-tenths percent (1.2).

The low rate of taxation applies to, among other transactions, retail and wholesale sales. IC § 6-2.1-2-4. The high rate of



taxation applies to, among other things, activities described in other Indiana tax statutes. *See*, IC § 6-2.1-2-5(8). The other Indiana statutes applicable to taxpayer's transactions are IC § 6-2.1-1-9 and IC § 6-2.1-2-5(9).

IC § 6-2.1-2-4 states that the "receipt of gross income from the following is subject to" the low rate of taxation: "(1) wholesale sales" and (4) selling at retail." Subsection 4 does not apply because taxpayer is not a retail merchant under IC § 6-2.1-1-12 or under 45 IAC 1-1-11 (a retail merchant is a taxpayer who is regularly and occupationally engaged in the business of purchasing and reselling or renting tangible personal property). *See* discussion, *supra*. Therefore, the income received from the transaction at issue does not constitute gross income received by selling tangible personal property at retail. Subsection 1 applies if taxpayer's transaction falls within the ambit of IC § 6-2.1-2-1(c)(1) definition of wholesale sales:

(c)(1) "Wholesale sales" means any sale described in this subsection in which the purchaser is not a division, subdivision, agency, instrumentality, unit, or department of government:

(A) Sales of tangible personal property (except capital assets or depreciable assets of the seller) for resale in the form in which it was purchased.

(B) Sales of tangible personal property which is to be directly consumed in direct production by a purchaser in the business of producing tangible personal property by manufacturing, processing, refining, repairing, mining, agriculture, or horticulture.

(C) Sales of tangible personal property to be incorporated as a material or integral part of tangible personal property produced by a purchaser in the business of manufacturing, assembling, constructing, refining, or processing.

*See also*, 45 IAC 1-1-88, which sets forth the low rate of taxation for retail sales.

An equipment leasing company purchased the equipment, not a consumer for its own personal use or a vendor for resale purposes. Subsection (B) of IC § 6-2.1-2-1(c)(1) does not apply, as the purchaser is an equipment leasing company, not a purchaser who produces tangible personal property by any of the means set forth in subsection (B). Subsection (C) does not apply because the purchaser, an equipment leasing company, is not a purchaser who incorporates tangible personal property as a "material or integral part of tangible personal property" in manufacturing, etc.

At first blush, subsection (A) seems to apply; taxpayer argues in its Letter of Protest that it purchased the equipment from its parent corporation for "resale in the form in which it was purchased." However, the parenthetical statement in subsection A excludes "capital assets or depreciable assets of the seller." Capital assets include "all assets except stock-in-trade of a retail merchant held primarily for sale to a customer in the regular course of a trade or business. Receipts from the sale of capital assets are taxed at the higher rate...." 45 IAC 1-1-21.

The Department finds that for Indiana gross income tax purposes, the income should be taxed at the higher rate pursuant to IC §§ 6-2.1-2-5(8), 6-2.1-2-5(9), and 6-2.1-1-9. This finding is consistent with taxpayer's own characterization of the proceeds received from the transaction at issue for federal income tax purposes and for its own bookkeeping records. Taxpayer's transaction falls squarely within the ambit of 45 IAC 1-1-22: "The gross income received from a complete sale and transfer of ownership of... capital assets... is subject to gross income tax and is taxable at the higher rate."

**FINDING**

Taxpayer's protest concerning the reclassification, from the low rate to the high rate of taxation, of gross income received on the sale and leaseback of production equipment, is denied.

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**DEPARTMENT OF STATE REVENUE**

15990119.LOF

**LETTER OF FINDINGS NUMBER: 99-0119**

**International Fuel Tax Agreement (IFTA)**

**For the Tax Periods of 1995, 1996, and 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. IFTA – Sufficiency of Documentation**

**Authority:** IFTA, Article XII, R1210.300; IFTA, P510, IFTA P520.100; IFTA, P530.100; IFTA, R1210; IC 6-8.1-10-9

The Taxpayer protests the IFTA audit assessment resulting from Taxpayer's lack of fuel tax documentation.

**II. IRP – Sufficiency of Documentation**

**Authority:** IRP Article XVII, 1702; IC 6-8.1-5-1; IC 9-28-4-6

The Taxpayer protests the IRP audit assessment resulting from Taxpayer's lack of mileage records.

**FACTS**

Taxpayer was assessed tax as a result of an IFTA audit covering the periods of 1995 through 1997 and an IRP audit, for registration year 1997. The assessments resulted after the auditor determined that Taxpayer did not maintain records or documents

with regards to fuel purchased or mileage for the periods in question. A hearing date was set after several attempts to set such date with Taxpayer. Taxpayer failed to appear for the hearing. More facts provided as necessary.

**DISCUSSION**

The department, representing a member jurisdiction of IFTA, requested taxpayer records pursuant to IFTA, P510:

The licensee is required to preserve the records upon which the quarterly tax return is based for four years from the return due date or filing date, whichever is later, plus any time period included as a result of waivers or jeopardy assessments

IFTA P520.100 states: "Records shall be made available upon request by any member jurisdiction and shall be available for audit during normal business hours." Also, pursuant to IFTA, P530.100:

Failure to maintain records upon which the licensee's true liability may be determined or to make records available upon proper request may result in an assessment as stated in IFTA Articles of Agreement Section R1200.

In the event the licensee fails to make records available or fails to maintained the base jurisdiction may determine the tax liability of the licensee on the basis of the best information available to it. IFTA, R1210.

Taxpayer suggested in his initial letter requesting a hearing that the Paper Reduction Act mandates that small businesses should be exempt from audits. Taxpayer's assertions are baseless. The Paper Reduction Act pertains to the Federal Government.

IFTA, Article XII, R1210.300 states in relevant part:

The assessment made by a base jurisdiction pursuant to this procedure shall be presumed to be correct, and in any case where the validity of the assessment is drawn in question, the burden shall be on the licensee to establish by a fair preponderance of evidence that the assessment is erroneous or excessive.

Taxpayer provides no evidence that assessments are in error.

Taxpayer also denied that the assessments are valid because the corporation has been dissolved. Again, Taxpayer's claim is groundless. The assessments were due and owing before the dissolution of the company. The officers and directors of a corporation effecting dissolution or liquidation shall make all tax payments due to the department and failure to do so does not foreclose the option to pursue collection of the assessments. IC 6-8.1-10-9.

**FINDING**

The Taxpayer's protest is denied.

**II. IRP – Sufficiency of Documentation**

**DISCUSSION**

IC 9-28-4-6 states:

(a) The department of state revenue, on behalf of the state, may enter into reciprocal agreements providing for the registration of vehicles on an apportionment or allocation basis with the proper authority of any state, any commonwealth, the District of Columbia, a state or province of a foreign country, or a territory or possession of either the United States or of a foreign country.

(b) To implement this chapter, the state may enter into and become a member of the International Registration Plan or other designation that may be given to a reciprocity plan developed by the American Association of Motor Vehicle Administrators.

(c) The department of state revenue may adopt rules under IC 4-22-2 to carry out and enforce the provisions of the International Registration Plan or any other agreement entered into under this chapter.

(d) If the state enters into the International Registration Plan or into any other agreement under this chapter, and if the provisions set forth in the plan or other agreements are different from provisions prescribed by law, then the agreement provisions prevail.

(e) This chapter constitutes complete authority for the registration of vehicles, including the registration of fleet vehicles, upon an apportionment or allocation basis without reference to or application of any other Indiana law.

Additionally, IRP Article XVII, 1702 states:

Assessments based on audit, interest on assessments, refunds, or credits or any other amounts including auditor's per diem and travel shall be made in accordance with the statute of each jurisdiction involved with the audit of a registrant.

Accordingly, the department, representing a member jurisdiction of IRP, requested taxpayer records pursuant to IC 6-8.1-5-4 requirements:

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records.

Applying the Indiana statute per IRP Article XVII, 1702; IC 6-8.1-5-1 states in relevant part: "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Taxpayer does not provide any indication that the assessment is in error.

**FINDING**

The Taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

02990351.LOF

**LETTER OF FINDINGS NUMBER: 99-0351**

**Indiana Gross Income Tax**

**For the 1991 through 1997 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. Gross Income Tax – Assessment Against Nonresident Taxpayer's Receipts Acquired Under a Contract for Work to Be Performed in Indiana**

**Authority:** U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV; IC 6-2.1-1-2(a); IC 6-2.1-2-2; IC 6-2.1-2-2(a)(2); Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue, 107 S.Ct. 2810 (1987); Bethlehem Steel v. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue, 598 N.E.2d 647 (Ind. Tax Ct. 1992); 45 IAC 1-1-49; 45 IAC 1-1-120

Taxpayer protests the audit's assessment of Indiana's gross income tax on receipts derived from a contract for work to be performed in Indiana. Taxpayer argues that it does not have nexus with Indiana and that, as a consequence, the assessed gross income tax is inappropriate.

**II. Request for Abatement of the Ten Percent Negligence Penalty**

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

Taxpayer requests that the Department exercise its discretionary authority to abate the ten percent negligence penalty associated with the imposition of taxpayer's state's gross income tax liabilities.

**III. Request for Abatement of Interest**

**Authority:** IC 6-8.1-10

Taxpayer has requested that the interest, which has accumulated against its gross income tax liabilities, be abated.

**STATEMENT OF FACTS**

Taxpayer is a Delaware corporation with its principal place of business located in Virginia. Taxpayer is in the business of providing specialized computer and information processing services. Taxpayer entered into a multi-year contract with the federal government. The contract called for the design and implementation of a logistic system to support the receipt, segregation, storage, and issuance of supplies. The contract negotiations took place in Washington, D.C. Taxpayer's representatives did not enter into Indiana in order to negotiate the contract. Taxpayer has no property, employees, or activities in Indiana other than holding the contract for services to be provided in Indiana. Under the terms of the contract, the work began in 1990 and continued until 2000. The contract was to be performed at various government installations throughout the United States including Indiana. In order to fulfill the terms of the contract, work was performed – through taxpayer's subsidiaries – at three Indiana locations. Under the terms of the contract, taxpayer agreed to provide "Automatic Data Processing Support Services" at one specific Indiana location. According to the taxpayer, the work performed in Indiana was completed by two of its wholly owned subsidiaries. These two subsidiaries filed Indiana corporation income tax returns for the years at issue. In those returns, the two subsidiaries reported the income derived from the contract entered into between taxpayer and the federal government. The proposed assessment – subject of the taxpayer's protest – purportedly calls for the identical gross income attributable to taxpayer, as the parent company, to be taxed again at the parent company level.

**DISCUSSION**

**I. Gross Income Tax Assessment Against Nonresident Taxpayer's Receipts Acquired Under a Contract for Work to Be Performed in Indiana**

Taxpayer protests the gross income tax assessment on the grounds that it does not have nexus with the state of Indiana and that imposition of the tax offends the provisions of the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, and the Due Process Clause, U.S. Const. amend. XIV, § 1. More specifically, and as a basis for its assertions, taxpayer maintains that it does not have employees or property within the state. Taxpayer maintains that it did not perform any of the work attributable to its contract with the Department of Defense. Taxpayer argues that it contracts out all of the work performed under the contract, and that the actual contract work is performed by certain subcontractors including its own wholly owned subsidiaries.

Taxpayer sets out a second, general equitable argument in which it asserts that imposition of the tax is inappropriate because its two subsidiaries – the entities actually performing the work in Indiana – have filed Indiana corporate income tax returns and have already paid tax upon receipts derived from performance of the contract.

Under the provisions of IC 6-2.1-2-2, the Indiana gross income tax is imposed on the receipt of "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of

Indiana.” IC 6-2.1-2-2(a)(2).

The Indiana tax court has set forth a three-part test to determine whether a non-resident taxpayer is subject to imposition of the gross income tax. The taxability of a non-resident taxpayer is dependent on determining whether (1) the taxpayer’s receipts constitute “gross income,” (2) whether the “gross income” is derived from “sources within Indiana,” and (3) whether the “gross income,” derived from those sources within Indiana, is “taxable gross income.” Bethlehem Steel v. Dept. of State Revenue, 597 N.E.2d 1327, 1330 (Ind. Tax Ct. 1992), *aff’d* 639 N.E.2d 264 (Ind. 1994); *See also* Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue, 598 N.E.2d 647, 661 (Ind. Tax Ct. 1992).

As a preliminary question, it must be determined that the receipt of income from the performance of the contract represents Indiana gross income. IC 6-2.1-1-2(a) provides that “[e]xcept as expressly provided in this article, ‘gross income’ means all the gross receipts a taxpayer receives... from the performance of contracts.” Taxpayer entered into a contract to perform certain, particularized computer services for the Defense Department. Subsequently, taxpayer received payment for the performance of those services. Under IC 6-2.1-1-2(a), those receipts constitute “gross income” for the purpose of determining the applicability of the state’s gross income.

It is the second provision of the Bethlehem Steel test which is central to taxpayer’s protest. In order for the Department to establish that taxpayer’s income is subject to the state’s gross income tax, the Department must find that the taxpayer’s income is derived from a source within Indiana. Specifically, “[i]f the activities giving rise to the income sought to be taxed do not occur within Indiana, then the tax may not be levied – not because to do so is forbidden by the United State Constitution (although it may well be) – but rather because under those facts the levy is forbidden by the statute.” Bethlehem Steel, 597 N.E.2d at 1330. 45 IAC 1-1-120 instructs in part that “[a]s a general rule, income derived from sales made by nonresident sellers to Indiana buyers is not subject to gross income tax unless the seller was engaged in business activity within the State [i.e., business situs] and such activity was connected with or facilitated the sales [i.e., tax situs].” The court in Indiana-Kentucky explained, stating that “the regulations teach that a nonresident is subject to taxation if the ‘source’ of the gross income is an Indiana *tax situs*, i.e., an Indiana *business situs* at which business activities are performed that are connected with or facilitate the transaction... giving rise to the gross income.” Indiana-Kentucky, 598 N.E.2d at 662 (Emphasis added).

As the audit determined, taxpayer has an Indiana business situs as represented by the taxpayer’s execution of a contract to provide service within the state of Indiana. Specifically, the regulation provides that “[f]or purposes of these regulations... a taxpayer may establish a ‘business situs’ in ways including but not limited to... [the] Performance of services.” 45 IAC 1-1-49.

However, to determine tax situs, it must be determined whether the transaction giving rise to taxpayer’s gross income are related to taxpayer’s Indiana activities. In addition, it must be determined that the related Indiana activities are “more than minimal, and not remote or incidental to the total transaction...” Indiana-Kentucky, 598 N.E.2d at 663.

Taxpayer entered into a long-term contract for the provision of computer services. The parties’ contract specified that computer services were to be performed at an Indiana location. Taxpayer’s gross income was clearly related to its Indiana activities because performance of the Indiana activities were inherently necessary to the fulfillment of the contract. Because the income was derived from the performance of its contractual obligations within Indiana, taxpayer’s Indiana activities rose to a level which was neither minimal nor incidental to the relevant transactions.

Taxpayer argues that it does not have sufficient nexus with the state because the actual contract is being performed by two of its wholly owned subsidiaries. However the Supreme Court rejected a similar argument in Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue, 107 S.Ct. 2810 (1987).

Tyler argues that its business does not have a sufficient nexus with the State of Washington to justify the collection of a gross receipts tax on its sales.... Tyler maintains no office, owns no property, and has no employees residing in the State of Washington. Its solicitation of business in Washington is directed by executives who maintain their offices out-of-state and by an independent contractor located in Seattle. Id. at 2821 (Internal emphasis omitted).

The Supreme Court explicitly rejected Tyler’s argument agreeing with the state court’s decision that Tyler, by virtue of its representatives’ activities, had sufficient nexus with Washington state.

As the Washington Supreme Court determined, “the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer’s ability to establish and maintain a market in this state for the sales.” The court found this standard was satisfied because Tyler’s “sales representatives perform any local activities necessary for maintenance of Tyler Pipe’s market and protection of its interest...” Id. (Internal citations omitted).

The Supreme Court concluded that Tyler could not defeat a nexus determination by insulating itself from the taxing state by virtue of the intervening activities of an independent contractor. “[A] showing of a sufficient nexus could not be defeated by the argument that the taxpayer’s representative was properly characterized as an independent contractor instead of as an agent.” Id.

Taxpayer entered into a contract the terms and performance of which establish both a business and tax situs for purposes of the state’s gross income tax. The fact that taxpayer’s subsidiaries are engaged for the purpose of performing the terms of the contract, is an irrelevancy.

Additionally, taxpayer challenges imposition of the gross income tax on constitutional grounds. Taxpayer argues that imposition of the tax against an out-of-state taxpayer is offensive to the Commerce Clause and the Due Process Clause. To the extent

that taxpayer challenges the constitutionality of the Indiana's gross income tax scheme, taxpayer raises issues which are beyond the purview of this administrative review. Taxpayer's wholesale constitutional challenge will not be addressed here.

Similarly, taxpayer's generalized equitable argument must also fail. The Department is without authority to grant taxpayer an equitable adjustment to a tax assessment properly levied under Indiana's statutes and regulations.

**FINDING**

Taxpayer's protest is respectfully denied.

**II. Request for Abatement of the Ten – Percent Negligence Penalty**

Taxpayer has requested that the ten percent negligence penalty, imposed under authority of IC 6-8.1-10-2.1(a), be abated. The penalty was assessed against taxpayer's cumulative gross income tax liabilities determined for the tax years 1991 through 1997.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2.1(a), can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer." Negligence results from a "taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." Id.

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax due was due to "reasonable cause." 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...." Id. In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

Regardless of the Department's determination concerning taxpayer's gross income tax liability, under IC 6-8.1-10-2.1(d), taxpayer – as an out-of-state entity having no substantive assets located within the state – has established that its failure to file Indiana corporate income tax returns during the relevant tax years was due to "reasonable cause and not due to willful neglect...." However erroneous its failure to file Indiana corporate tax returns may have been, taxpayer, by its interpretation and application of the relevant statutes and regulations, has demonstrated that it exercised "ordinary business care" in determining that it did not have sufficient nexus with the state and that it was not subject to the state's gross income tax scheme.

**FINDING**

Taxpayer's protest is sustained.

**III. Request for Abatement of Interest**

Taxpayer protest the imposition of interest against the assessed taxes and requests that the interest which has accumulated on those taxes be abated. Under IC 6-8.1-10-1(a), if a person incurs a deficiency upon a determination by the Department, "the person *is* subject to interest on the nonpayment." (Emphasis added).

The Department has no discretion regarding the imposition of interest. Under IC 6-8.1-10-1, the accumulated interest may not be abated for any reason and the Department must decline taxpayer's invitation to do so.

**FINDING**

Taxpayer's protest and request for abatement is respectfully denied.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 99-0651**

**Sales Tax**

**For Years 1991-1998**

**NOTICE:** Under Ind. Code 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 Tax – Imposition of Gross Retail Tax on Sales of Software**

**Authority:** IC § 6-2.5-1-2(a); 45 IAC 2.2-1-1(c); IC § 6-2.5-1-8; 45 IAC 2.2-2-1; IC § 6-2.5-2-1; 45 IAC 2.2-2-2; IC § 6-2.5-4-1; 45 IAC 2.2-4-1; IC § 6-2.5-4-2; 45 IAC 2.2-4-4; IC § 6-2.5-5-4; 45 IAC 2.2-4-27; IC § 6-2.5-5-8; Sales Tax Information; Bulletin #8

Taxpayer protests the imposition of gross retail tax on sales of "canned" software made to one specific customer.

**II. Tax Administration – Penalty**

**Authority:** IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of the 10% negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is a corporation registered in the state of North Carolina as a retail merchant. Taxpayer sells, among other items, software packages to various businesses which engage in charitable financial planning, e.g., setting up trusts, annuities, and the like. As a registered retail merchant in North Carolina, taxpayer pays gross retail tax in that state only. The Department audited taxpayer after auditing one of taxpayer's customers, an Indiana corporation (hereinafter "customer"). Customer's audit resulted in the imposition of gross retail tax liability for tax years 1991-1994, and customer successfully protested the audit. The Department, based on a letter submitted by taxpayer outlining an agency relationship, found that customer was acting as an agent of taxpayer in order to sell software to end customers. The Department therefore found that customer was not ultimately liable for the gross retail tax that should have been collected and remitted on the purchasing transactions.

Thereafter, the Department audited taxpayer and determined that taxpayer was liable for the Indiana gross retail taxes for tax years 1991-1998. The Department also imposed the 10% negligence penalty. Taxpayer timely protested the results of the audit and a hearing was held on March 28, 2001 by telephone conference. Further information will be added as necessary.

**I. Sales Tax – Imposition of State Gross Retail Tax on Computer Software**

**DISCUSSION**

Taxpayer protests the imposition of Indiana's gross retail (sales) tax on its retail sales of computer software packages to Indiana customers. Taxpayer contends these computer software packages were not transferred in retail transactions; but rather the packages were sold to an Indiana retailer (customer) which subsequently resold them. Taxpayer argues that its customer, the retailer, is liable for the sales tax liabilities—not taxpayer, the customer's wholesale supplier.

At the hearing, taxpayer (a software retailer and developer), stated that two of customer's executives flew to North Carolina with a business proposition for taxpayer: since customer was good at business administration and taxpayer was good at developing software, customer and taxpayer should do business together. Customer wanted to use taxpayer's existing proprietary software, but also wanted special programming added for annuities and other complex charitable financial planning transactions. Customer gave taxpayer specifications and taxpayer created a computer software package.

Taxpayer also stated at the hearing that customer held training seminars lasting up to 4 days, charging each attendee up to \$5,000. According to taxpayer, customer purchased the software packages from taxpayer for \$595 each, resold them to attendees for \$695 each, remitting the purchase price to taxpayer and keeping the difference.

Simply stated, the issue in this protest concerns the nature of the business relationship between taxpayer and customer. Is taxpayer supplying software packages to customer for resale, or is taxpayer itself engaged in retail transactions?

Generally speaking, the retail transactions of retail merchants are subject to Indiana's gross retail tax as set forth in IC §§ 6-2.5-1-1, 6-2.5-1-2(a), 6-2.5-1-8, 6-2.5-1-1(a), (b)(1)(2) and (d), 6-2.5-4-1 and 4-2(a)(b)(1). Exemptions from the gross retail tax can be found at 6-2.5-5-4 and 5-8. *See also*, 45 IAC 2.2-1-1(a), 45 IAC 2.2-2-2-1, 45 IAC 2.2-2-2, 45 IAC 2.2-4-1 and 4-4. In the normal course of business, a computer software design firm creates a package, licenses it for "sale," and provides maintenance agreements for software upgrades. The Department has issued Information Bulletins concerning software packages.

Sales Tax Information Bulletin #8, revised and published in 1990, discusses the application of the gross retail tax to the sale, lease, and use of computers and computer related equipment. With respect to transactions involving computer software, Bulletin #8 provides in pertinent part:

As a general rule, transactions involving computer software are not subject to Indiana Sales or Use Tax provided the software is in the form of a custom program specifically designed for the purchaser.

Pre-written programs, not specifically designed for one purchaser, developed by the seller for sale or lease on the general market in the form of tangible personal property and sold or leased in the form of tangible personal property are subject to tax irrespective of the fact that the program may require some modification for a purchaser's particular computer. Pre-written or canned computer programs are taxable because the intellectual property contained in the canned program is no different than the intellectual property in videotape or a textbook. (emphasis added)

In summary, transactions involving "canned" software are taxable; those involving "custom" software are not. The evidence now presented by taxpayer—testimony, purchase orders and invoices—suggests that taxpayer was a supplier of software that its customer subsequently sold. However, this same issue (i.e., the relationship between who sells the software to ultimate users) was addressed in the prior Letter of Findings 4 years ago. At that time, the customer presented a letter from this taxpayer indicating that customer was acting as an agent for taxpayer in its transfer of software to ultimate users, the seminar attendees. In the absence of facts supporting a change in their relationship, taxpayer cannot now come forward and claim customer is no longer its agent.

**FINDING**

Taxpayer's protest concerning the imposition of sales tax on sales of computer software is denied.

## **II. Tax Administration – Penalty**

The taxpayer protests the Department's imposition of the 10% negligence penalty.

Indiana Code 6-8.1-10-2.1(a)(3) authorizes the Department to impose a penalty on a taxpayer if he "incurs, upon examination by the department, a deficiency that is due to negligence." Subsection (d) provides in pertinent part:

If a person subject to the penalty imposed under this section can show that the failure to...pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department **shall** waive the penalty.

(Emphasis added)

Indiana Administrative Code, Title 45, Article 15, Rule 11-2(b) provides in pertinent part:

"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.

In determining whether or not to assess the 10% penalty, the Department looks for indicia of negligence as well as indicia of due diligence. Taxpayer did not present any evidence, arguments, or documents, which would show due diligence on taxpayer's part to discover its tax liabilities for doing business in Indiana. Since ignorance of Indiana's tax laws is treated as negligence, the penalty stands.

### **FINDING**

The taxpayer's protest concerning the imposition of the 10 % negligence penalty is denied.

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## **DEPARTMENT OF STATE REVENUE**

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### **LETTER OF FINDINGS NUMBER: 00-0075 PUF**

#### **Fuel Tax For Year 2000**

**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. Fuel Tax – Assessment**

**Authority:** Illinois Title 86 Section 500.285; IC § 6-6-2.5-62; IC § 6-8.1-5-1

Taxpayer protests that state's assessment of penalty for use of red dye fuel was prohibited due to taxpayer's initial out-of-state purchase and use of red dye fuel.

### **FACTS**

In November of 1999 taxpayer operated a truck in Indiana and a fuel analysis by the Department, consisting of a sample drawn from the vehicle's tank, found a Red Dye Concentration by VIS Spectroscopy. The Department issued an assessment for the violation. Taxpayer protested, arguing that the Indiana exemption for dyed fuel from an exempt jurisdiction applies, inasmuch as the truck in question filled its tank in Illinois, which taxpayer alleges did not regulate the use of dyed fuel in commercial vehicles at the time of the infraction.

### **DISCUSSION**

#### **I. Fuel Tax – Assessment**

Taxpayer presents three arguments in support of its position. 1) Taxpayer argues that 26 U.S.C.A. 4081 (with supporting court citations) imposes the federal excise tax on manufacturers and retailers of gasoline and diesel fuel and not on the sale at the pump. Taxpayer further alleges that Federal law does not impose any liability on the consumer or any duty on the consumer to make sure the supplier has paid excise tax prior to the consumer pulling away from the pump and that the taxpayer was not violating federal law. 2) A finding of a violation would render the exception of IC § 6-6-2.5-62(c) meaningless, inasmuch as taxpayer was not violating Illinois law and if federal law prohibited the introduction of dyed fuel, no jurisdiction would qualify for the exception. 3) The local prosecutor dismissed the criminal charge against taxpayer for the same violation.

IC § 6-6-2.5-62 states in relevant part:

(c) No person shall operate or maintain a motor vehicle on any public highway in Indiana with special fuel contained in the fuel supply tank for the motor vehicle that contains dye or a marker, or both, as provided under section 31 of this chapter. This

provision does not apply to persons operating motor vehicles that have *received fuel into their fuel tanks outside of Indiana in a jurisdiction that permits introduction of dyed or marked, or both, special fuel of that color and type into the motor fuel tank of highway vehicles or to a person that qualifies for the federal fuel tax exemption under Section 4082 of the Internal Revenue Code and that is registered with the department as a dyed fuel user.* A person who knowingly:

- (1) violates; or
- (2) aids and abets another person in violating;

this subsection commits a Class A infraction. However, the violation is a Class A misdemeanor if the person has committed one (1) prior unrelated violation of this subsection, and a Class D felony if the person has committed more than one (1) prior unrelated violation of this subsection. (*Emphasis added*)

As Indiana law specifically provides at IC § 6-8.1-5-1, notice of a proposed assessment is *prima facie* evidence that the Department's claim for the unpaid tax is valid. IC § 6-8.1-5-1 states in relevant part:

The notice of proposed assessment is *prima facie* evidence that the department's claim for the 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.

Taxpayer presents two forms of evidence: fuel receipts for an Illinois fuel purchase and an Illinois Informational Bulletin from September of 1999 announcing that as of January 1<sup>st</sup>, 2000 "Illinois is implementing a dyed diesel fuel program." Taxpayer argues that this announcement of a prospective implementation of a law for a date after taxpayer's citation constitutes proof that dyed fuel was allowed in Illinois at the time of the citation.

Taxpayer does not address the circumstances existing in Illinois at the time of the violation. 26 U.S.C.A. § 4082 establishes a Federal requirement that nontaxable fuel be dyed. At the time of this violation, Illinois did permit the use of nontaxable fuel on its highways. By way of illustration, Illinois Title 86 Section 500.285(in force as of 1995) states:

a) A distributor of motor fuel or a supplier of special fuel may make tax-free sales thereof to a privately-owned public utility which owns and operates 2 axle vehicles designed and used for transporting more than 7 passengers, which vehicles are used as common carriers in general transportation of passengers, are not devoted to any specialized purpose and are operated entirely within the territorial limits of a single municipality or of any group of contiguous municipalities, or in a close radius thereof, and the operations of which are subject to the regulations of the Illinois Commerce Commission, provided that the distributor or supplier obtains an official Certificate of Exemption in lieu of the tax.

b) Such Certificate of Exemption shall accompany the distributor's or supplier's monthly Motor Fuel Tax return to the Department to support his claim to exemption from the tax. [*Note: the Taxpayer has not claimed that this exemption applies and this cite is strictly for illustration of the Department's position.*]

Taxpayer's argument can be summarized as follows: since it is sometimes permissible in an outside jurisdiction for a taxpayer to use dyed fuel on its highways, Indiana must permit any taxpayer using dyed fuel purchased outside of Indiana to do so. Taxpayer argues that absent evidence of wrongdoing in Illinois, Indiana is prohibited from assessing tax against taxpayer and has presented the Department with the task of proving a violation in a jurisdiction outside of Indiana prior to proving an Indiana violation.

The Department notes that at the time of the violation the Federal government, the state of Illinois, and the state of Indiana regulated the use of dyed fuel. At the time of the assessment the Indiana statute permitted the use of dyed fuel on Indiana highways if the taxpayer held an exemption "under Section 4082 of the Internal Revenue Code and that [exemption] is registered with the department as a dyed fuel user," (IC § 6-6-2.5-62(c)) the Department also recognized an exemption for surrounding states for taxpayers "operating motor vehicles that have received fuel into their fuel tanks outside of Indiana in a jurisdiction that permits introduction of dyed or marked, or both, special fuel of that color and type into the motor fuel tank of highway vehicles." (IC § 6-6-2.5-62(c)) The regulation cited from Illinois states that a taxpayer, under the circumstances outlined in that regulation, may use dyed fuel if the taxpayer "obtains an official Certificate of Exemption in lieu of the tax." (Illinois Title 86 Section 500.285) Taxpayer's argument that there must have been a circumstance where the statutory exemption for the use of dyed fuel from outside jurisdictions was permitted on Indiana's highways is answered by the Indiana statute's provisions for both Federal dyed fuel use and by the indication that Illinois did have a means of regulating the use of dyed fuel on its highways with corresponding documentation required.

Absent proof by the taxpayer that the taxpayer's use of dyed fuel on Illinois highways was permitted by Illinois law, either by providing the above cited Certificate of Exemption or citing to an Illinois statute or regulation permitting this taxpayer to operate in said fashion, or demonstrating that taxpayer meets the Internal Revenue Code 4082 requirements, taxpayer has failed to meet the requirements of IC § 6-8.1-5-1. IC § 6-8.1-5-1 establishes the assessment as "prima facie evidence that the department's claim for the 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." The Department will not indulge in searching for proof of violations of Illinois or Federal laws to disprove taxpayer's blanket assertion that taxpayer's actions were legal in these jurisdictions. Taxpayer was using dyed fuel on an Indiana highway, in violation of Indiana statutes, and taxpayer- not the Department- must establish the existence of a valid Illinois or Federal exemption to this statute.



Taxpayer's argument that the local prosecutor's decision to drop the charges related to this violation establish grounds for sustaining taxpayer's protest is not sustainable. The decision by a local prosecutor to proceed or defer on any case has no bearing on the validity of an Indiana Dept. of Revenue assessment.

**FINDINGS**

Taxpayer protest denied.

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**DEPARTMENT OF STATE REVENUE**

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**LETTER OF FINDINGS NUMBER: 00-0127**

**Gross Income Tax**

**For Tax Years 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. Gross Income Tax – Advertising Income**

**Authority:** IC 6-2.1-2-2; IC 6-2.1-2-2(a); IC 6-2.1-2-3; IC 6-2.1-2-4(2); IC 6-2.1-2-5; 45 IAC 1-1-87

Taxpayer protests the assessment of Indiana gross income tax at the high rate on the income taxpayer received for providing advertising.

**II. Tax Administration – Abatement of Penalty**

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

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is a subsidiary of a large retail bookstore, and an operator of retail bookstores located primarily in shopping malls. In addition to the income generated from the sale of books, taxpayer receives income from book publishers under co-op advertising contracts. For a fee, taxpayer will advertise publishers' books and their authors in taxpayer's print, radio or television advertisements, in catalogs, on customer receipts, or on in-store displays.

After a routine audit for the years in question, the Department of Revenue issued a notice of proposed assessments. In determining the assessment, the Department's auditor apportioned the income taxpayer received from advertising and included said amount as gross income to be taxed at the high rate. Taxpayer protests the portion of the proposed assessment which characterizes the advertising income as high rate gross income rather than low rate gross income.

**I. Gross Income Tax – Advertising Income**

**DISCUSSION**

Taxpayer argues that the revenue generated from its sale of advertising to book publishers is considered display advertising, and is taxable at the low rate for gross income tax purposes. Indiana's Gross Income Tax encompasses most receipts of income. Pursuant to IC 6-2.1-2-2(a), "[a]n income tax, known as the gross income tax, is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana..." Gross income tax is imposed at one of two rates. IC 6-2.1-2-3. These rates are generally referred to as the high and low rate. In determining which of the two rates is to be applied, we look to the type of transaction from which the taxable gross income is received. IC 6-2.1-2-2.

Income received from display advertising is taxable at the lower rate. Income from display advertising includes the gross receipts derived from advertising in newspapers, magazines, periodicals, other similar advertising media, outdoor posters and painted displays, and sales of time to local or national advertisers by radio and television stations. 45 IAC 1-1-87; IC 6-2.1-2-4(2). Display advertising does not include the sale or rental of tangible property or any personal professional service rendered in connection with such advertising. *Id.* The high gross income tax rate, however, applies to gross income received from (among other things): "... (9) any activity which is not described in section 4 of this chapter including the provision of services of any character, sales of real estate, rentals (except rentals described in section 4(6) of this chapter), the performance of contracts, and the investment of capital." IC 6-2.1-2-5 (emphasis added).

Subsequent to the protest hearing, taxpayer submitted copies of co-op advertising contracts that it entered into with various publishers. According to taxpayer, the process of entering the contracts is as follows. Taxpayer's marketing department decides to run a promotion. Taxpayer's marketing department then contacts publishers to determine whether or not publisher would like its books to be included in the promotion. If the publisher agrees to participate in the promotion, a verbal agreement is reached and taxpayer's marketing department sends a contract to the publisher stating the cost of participating in the promotion. The publisher's

payment for participating in the promotion is made via chargeback (*i.e.*, an offset to the amount taxpayer owes for the cost of publisher's books).

In their format, we find that taxpayer's co-op advertising contracts are agreements on the part of publishers to make payments to taxpayer for taxpayer's services for providing advertising and otherwise promoting the sales of the books. The services provided are the inclusion of publishers' books in taxpayer's newspaper, radio, and television advertisements, and the featuring of the books in taxpayer's store displays, receipts, and catalogs. Although taxpayer states that the total income received from publishers for the promotions is nearly equal to the cost of running the promotions, the contracts belie the statement. The contracts show that the specified rates are merely measures for determining the value preceding or accruing from the service. No contracts submitted provided that the payments be in the exact amounts of expenses incurred in the performance of services.

Careful review of the information of file and all of the documentation provided by taxpayer leads us to the conclusion that the income that taxpayer receives from publishers is not display income, but instead constitutes income generated from taxpayer's provision of services. We, therefore, find that the income in question is taxable at the high rate for gross income tax purposes.

**FINDING**

Taxpayer's protest is denied.

**II. Tax Administration – Abatement of Penalty**

**DISCUSSION**

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed..." 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id.*

In this case, the Audit Division imposed the penalty because it found that taxpayer failed to report revenue agent report changes, and failed to include the income generated from the promotion services as income subject to gross income tax. Taxpayer contends that it did, in fact, make reasonable efforts in filing tax returns and making timely payments. Taxpayer also maintains that it had every intention of paying its proper tax liability.

While taxpayer has attempted to offer an explanation for its tax discrepancies, taxpayer has not shown reasonable cause under 45 IAC 15-11-2.

**FINDING**

Taxpayer's protest is respectfully denied.

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**DEPARTMENT OF STATE REVENUE**

0420000139.LOF

**LETTER OF FINDINGS NUMBER: 00-0139**

**Use Tax**

**Calendar Years 1996, 1997, and 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. Use Tax – Utilities**

**Authority:** IC 6-2.5-5-5.1

Taxpayer protests the denial of a portion of its electrical exemption.

**II. Use Tax – Diesel Fuel**

**Authority:** IC 6-2.5-3-2

Taxpayer protests use tax on diesel fuel.

**III. Use Tax – Batteries, Repair and Replacement Parts**

**Authority:** IC 6-2.5-3-2

Taxpayer protests use tax for batteries and replacement parts for a forklift.

**IV. Use Tax – GRP & LVR Purchases**

**Authority:** IC 6-2.5-3-2

**V. Use Tax – Gun and Ammunition**

**Authority:** IC 6-2.5-2-1, IC 6-2.5-3-2

**VI. Use Tax – Sales Tax Paid at Point of Purchase**

**Authority:** IC 6-2.5-2-1

Taxpayer protests the inclusion of purchases upon which sales tax was paid at point of purchase.

**STATEMENT OF FACTS**

Taxpayer failed to show for a hearing scheduled for Wednesday, August 8, 2001. The determination is made based upon information contained in the audit file and taxpayer's protest letter dated January 20, 2000. The audit file was previously sent to the auditor in order to resolve the issues contained in taxpayer's letter. Taxpayer failed to respond to auditor's numerous attempts at resolution.

Taxpayer is a small manufacturer and rebuilder of custom pallets and produces small runs on a job shop basis. Sales are wholesale to other manufacturers. The taxpayer remitted a minimal amount of use tax in 1996 and 1997 and no use tax in 1998.

**I. Use Tax – Electrical Exemption**

**DISCUSSION**

Taxpayer has not provided a "Utility Sales Tax Exemption Application" (Form ST-200) nor proof that its electricity is exempt. The auditor had previously made numerous attempts to obtain the necessary information. No documentation has been provided.

**FINDING**

Taxpayer's protest is denied.

**II. Use Tax – Diesel Fuel**

**DISCUSSION**

Taxpayer's letter states that it uses a forklift to transport the product between two buildings during the manufacturing process and requests eighty percent (80%) exemption for diesel fuel used in the fork lift truck.

The auditor had previously requested additional information, which has not been supplied to date. In a letter dated April 23, 2001, the auditor explained its reasons for disallowing the exemption that was also discussed with the taxpayer personally.

**FINDING**

Taxpayer's protest is denied.

**III. Use Tax – Batteries and Repairs to Fork Lift Truck**

**DISCUSSION**

Taxpayer's letter states the auditor assessed use tax for batteries and repairs on equipment to move work in process between machines. The auditor has agreed to remove fifty percent (50%) of the assessment for items and repairs for equipment to move work in process.

**FINDING**

Taxpayer's protest is sustained for fifty percent (50%) of the assessment for batteries and repair part for the fork lift truck.

**IV. Use Tax – GRP & LVR Purchases**

**DISCUSSION**

Taxpayer protests the assessment of use tax on personal purchases where sales tax was paid at point of purchase. The taxpayer has provided copies of invoices that indicate sales tax was paid.

**FINDING**

Taxpayer's protest is sustained.

**V. Use Tax – Gun and Ammunition**

**DISCUSSION**

Taxpayer protests the tax on a firearm and states it was a casual transaction between individuals. Taxpayer further states the seller was not in the business of selling firearms and no sales tax should be due on this casual transaction.

The auditor found that two different documents offering this firearm and ammo indicate that the seller is a manager for law enforcement product sales. The sale does not seem to be casual and the seller was in the business of selling Remington products that include firearms and ammunition. No evidence indicates payment of sales tax on the original purchase of these items.

Taxpayer has not provided proof to allow negation of the assessment.

**FINDING**

Taxpayer's protest is denied.

**VI. Use Tax – Sales Tax Paid at Point of Purchase**

**DISCUSSION**

Taxpayer paid sales tax on a portion of its purchases of lumber used in the production of pallets. Credit is due for sales tax already paid. Taxpayer has provided copies of sales receipts.

**FINDING**

Taxpayer's protest is sustained for purchases of lumber that have been documented with sales tax paid at point of purchase.

**CONCLUSION**

Taxpayer's protest is denied for issues I, II, and V, sustained for issues IV and VI, and partially sustained for issue III.

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**DEPARTMENT OF STATE REVENUE**

0220000440.LOF

**LETTER OF FINDINGS NUMBER: 00-0440**

**Income Tax**

**For Tax Years 1996 through 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.

**ISSUES**

**I. Gross Income Tax – Taxation of Reimbursements**

**Authority:** *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 609 N.E.2d 48; (Ind. Tax Ct. 1993) (*UGL I*); *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 642 N.E.2d 553 (Ind. Tax Ct. 1994) (*UGL III*); IC 6-2.1-2-2(a); IC 23-4-1-9(1); 45 IAC 1-1-54

Taxpayer protests the assessment of Indiana gross income tax on the amounts taxpayer received as reimbursements for accounting and payroll services taxpayer provided on behalf of the employees of the Partnership.

**II. Gross Income Tax – Intangible Interest Income**

**Authority:** *Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue*, 598 N.E.2d 647 (Ind. Tax Ct. 1992); 45 IAC 1-1-17; 45 IAC 1-1-49; 45 IAC 1-1-51

Taxpayer protests the assessment of Indiana gross income tax on interest income received by taxpayer for financing veal farmers' purchases of veal calves, feed, and veterinary supplies.

**III. Adjusted Gross Income Tax – Business/Nonbusiness Income**

**Authority:** *Standard Oil Co*, 342 U.S. 382, 384-85, 72 S.Ct. 309, 310 (1952); *Hunt Corp. v. Indiana Dept. of State Revenue*, 709 N.E.2d 766; (Ind. Tax Ct. 1999)

Taxpayer protests the Audit Division's determination that the interest income received by taxpayer for financing veal farmers' purchases of veal calves, feed, and veterinary supplies was business income subject to apportionment.

**IV. Tax Administration – Abatement of Penalty**

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

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is an Indiana corporation that is in the business of producing and selling liquid milk replacement veal feed. An Indiana general partnership which, *inter alia*, owns, manages, and operates veal barns (hereinafter, "Partnership"), owns 97% of taxpayer's stock. Pursuant to an oral agreement entered into in 1988, and reduced to writing in 1998, taxpayer, in addition to operating its business, provides accounting and payroll services to Partnership. Pursuant to a written agreement executed in 1996, taxpayer agreed to provide accounting and payroll services to a Partnership-controlled entity, *i.e.*, a Wisconsin based limited liability company (hereinafter, "LLC"), which LLC produces dry veal feed. For providing these services, taxpayer is reimbursed by both Partnership and LLC for costs incurred. To further promote taxpayer's veal feed business, taxpayer extends credit to veal farmers under feeder finance agreements. Taxpayer receives interest income from these agreements.

The Department of Revenue conducted an audit for the years in question, and issued a notice of proposed assessments for gross income tax and interest on the amounts received by taxpayer as reimbursements for providing the accounting and payroll services to Partnership. The Department also issued a notice of proposed assessments for gross income tax on interest income taxpayer received for extending credit to veal farmers under finance agreements. Taxpayer excluded the reimbursements and the interest income from its taxable gross income. Additional facts will be supplied as necessary.

**I. Gross Income Tax – Taxation of Reimbursements**

**DISCUSSION**

In dispute is taxpayer’s exclusion of the Partnership reimbursements from its taxable gross income. We do not look to the reimbursements taxpayer received from the LLC, as the Audit Division found that those reimbursements were not subject to gross income tax because they were reimbursements for work performed outside of the State of Indiana.

Indiana’s Gross Income Tax encompasses most receipts of income. Pursuant to IC 6-2.1-2-2(a), “[a]n income tax, known as the gross income tax, is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana...” Except as expressly provided in IC 6-2.1 et. seq., gross income means all of the gross receipts a taxpayer receives. However, some exceptions do exist.

Taxpayers are not subject to Indiana’s gross income tax on the income they receive in an agency capacity. 45 IAC 1-1-54. However, before a taxpayer may deduct such income in computing its taxable gross receipts, it 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 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....

...  
Characteristic of agency is the principal’s right to control 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.

45 IAC 1-1-54.

Taxpayer maintains that the reimbursements it receives for its accounting and payroll services are exempt from the gross income tax because an agency relationship exists between itself, as agent, and Partnership, as principal; there is no overlap or duplication of employees between taxpayer and Partnership; and, the reimbursements merely place taxpayer in the position that it would have been in had it not provided the services. Taxpayer contends that its position is best supported by an unpublished Indiana Tax Court opinion. Ind. Tax Ct. Rule 16(E) states in pertinent part: “Unless specifically designated “For Publication”, such written memorandum decisions shall not be published and shall not be regarded as precedent nor cited before any court except for the purpose of establishing the defense of res judicata, collateral estoppel or the law of the case.” (emphasis added). Although we are not a court, we, nevertheless, decline to view this case as persuasive authority as it is of no precedential value.

In determining that the reimbursements taxpayer received for accounting and payroll services were subject to gross income tax, the Department’s auditor appears to rely upon *Universal Group Ltd. v. Indiana Dept. of State Revenue*, and the fact that Partnership employees are designated in the respective management agreements with taxpayer as taxpayer employees, and are deemed to be under taxpayer’s control. In *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 609 N.E.2d 48 (Ind. Tax Ct. 1993) (hereinafter, “UGL I”), and the subsequent case *Universal Group Ltd. v. Indiana Dept. of State Revenue*, 642 N.E.2d 553 (Ind. Tax Ct. 1994) (hereinafter, “UGL III”), the court dealt with an affiliated group of corporations which decided to centralize some of its operations by designating one or more of the corporations to act on the behalf of the other corporations on a non-profit basis. The expenses for the operations were allocated among the corporations by formulas; and, the corporations performing the centralized operations were reimbursed for their expenses by the other corporations.

The taxpayers in UGL I and III maintained that the reimbursements did not constitute gross income. The Indiana Tax Court reached the opposite conclusion. The court explained that “reimbursements of a taxpayer’s own expenses are receipts of gross income to the taxpayer... [while] [c]onversely, reimbursements to an agent for amounts advanced or paid to third parties substantively represent ‘pass throughs’ of income and [therefore] are not taxable to the agent.” UGL I, 609 N.E.2d at 54. However, the court in UGL found that, “[t]he reimbursements to the corporations that performed the administrative tasks were reimbursements for those corporations’ own expenses, such as paying their employees’ wages, not for monies advanced to third parties.” UGL III, 642 N.E.2d At 558. The court’s finding was supported by the following facts: the employees performed work for the particular taxpayer as well as for the entire affiliated group, which allowed said taxpayer to benefit from its own employees’ labor; the reimbursements defrayed expenses that the taxpayers receiving reimbursements otherwise would have incurred; and, but for the agreement to centralize functions, the taxpayers receiving reimbursements from the other affiliated corporations under the agreement would have had to incur the full cost of paying their employees.

We find that the facts of the instant case can be distinguished from those of the UGL cases. Partnership owns 97% of the stock of taxpayer. The Partnership has absolute voting control of taxpayer and controls taxpayer’s board of directors. The written management agreement between Partnership and taxpayer sets forth that taxpayer will continue to provide all accounting and payroll services to Partnership, and that Partnership will reimburse taxpayer on a monthly basis for such services. Taxpayer did not receive a management fee from Partnership. Instead, taxpayer was reimbursed monthly on a dollar-for-dollar basis for the amounts it

extended on behalf of Partnership. The reimbursements have never been for a predetermined amount. The amount of the reimbursements received by taxpayer vary according to the amount taxpayer expends on Partnership's behalf.

From these facts we conclude that an agency relationship exists between taxpayer and Partnership. We now turn to the question of whether taxpayer, as agent, is merely a conduit through which the payroll and accounting reimbursements pass, or a beneficiary of funds which defray expenses that taxpayer otherwise would have incurred.

Taxpayer and Partnership do not engage in the same business operations. Taxpayer produces and sells liquid milk replacement feed. Partnership operates veal barns. As stated above, the management agreement designates the Partnership employees as employees of taxpayer. And, taxpayer has complete responsibility with respect to hiring, training, supervising and discharging all employees. However, the Partnership employees work exclusively for the Partnership and perform duties for the Partnership only, just as the LLC employees work exclusively for the LLC and perform duties for the LLC only. Taxpayer is merely reimbursed by Partnership in amounts equal to what taxpayer expends in accounting and payroll services directly connected to the operation and management of Partnership's business. Partnership reimburses taxpayer on a monthly basis. Taxpayer has no right, title or interest in the payroll and accounting funds that it transfers on Partnership's behalf. Taxpayer is merely a conduit through which the funds pass.

The facts of this case lead to the conclusion that taxpayer, as agent for Partnership, is merely making payments to third parties for which taxpayer is reimbursed. As a result, the reimbursements do not constitute gross income.

**FINDING**

Taxpayer's protest is sustained.

**II. Gross Income Tax – Intangible Interest Income**

**DISCUSSION**

Taxpayer also protests the Audit Division's proposed assessment of gross income tax on the interest income taxpayer received for financing veal farmers' purchases of veal calves, feed, and veterinary supplies. Taxpayer's primary business is the production and sale of liquid milk replacement veal feed. In an effort to promote additional feed sales, taxpayer began extending credit to veal farmers under feeder finance agreements (hereinafter, "Agreements"). Once an Agreement is entered into, the veal farmer is provided with a veal calf, supplied with feed for the calf, and, if necessary, is reimbursed for any other expenses incurred in the raising, or "grow out", of the veal calf. While the farmer does not own the veal calf, all decisions regarding the grow out process are made by the farmer. Once the veal calf has matured (generally at the end of an eighteen-week grow out cycle), the veal calf is marketed by the farmer. Upon the sale of the veal calves, the meat packer issues a check as payment for the calves. The farmer then settles his account with taxpayer.

Out of the proceeds of the sale of the veal calf, the taxpayer retains the cost of the calf, the ordinary sale price of the feed, any other funds extended on behalf of the farmer, and interest charged at a fixed amount per calf. Any amount received upon the sale of the calf over the sum of the initial costs is returned to the farmer as his profit. If the sale of the veal calf does not cover the amount due the taxpayer, the taxpayer becomes a creditor of the farmer for the difference.

Taxpayer maintains that the interest income it receives from the Agreements is out-of-state business income because title to all items financed by the taxpayer (excluding the dry feed, which title passes to the producer, and calves, which title never passes to farmer) pass at the location of the farmer's farm, and all items financed by taxpayer are utilized by the farmer at the farmer's farm. As such, Taxpayer contends that any and all interest income generated from Agreements with farmers located outside of Indiana should not be subject to Indiana gross income tax, but instead should be apportioned to the state in which the respective veal farmers have business situs. In short, taxpayer argues that the intangible interest income lacks Indiana situs for gross income tax purposes.

45 IAC 1-1-17 provides in pertinent part that: "'gross income' and 'gross receipts' mean the entire amount of gross income received by a taxpayer. This includes all income actually or constructively received." Here, the income in question is the interest income received by the taxpayer for financing veal farmers' purchases of veal calves, feed, and veterinary supplies. Interest income is considered an intangible for gross income tax purposes. *See* 45 IAC 1-1-51. Intangible means a personal property right, which exists only in connection to something else. *Id.* In general, receipts derived from an intangible are included in gross income. *Id.* However, determining the taxability of income from intangibles is a two part test. *Id.* (Emphasis added).

The first test, the "business situs" test, provides that if the taxpayer has established a business situs in Indiana, and "the intangible forms an integral part of a business regularly conducted at [that] situs," then the intangible has an Indiana situs for tax purposes. *Id.* The second test, termed the "commercial domicile" test, holds that if the taxpayer has established its commercial domicile in Indiana, "all of the income from intangibles will be taxed... except that income which may be directly related to an integral part of a business regularly conducted at a 'business situs' outside Indiana." *Id.* If the taxpayer has established its commercial domicile in another state, then "no income from intangibles will be taxed... unless the taxpayer has also established a business situs in Indiana and the intangible income derived therefrom forms an integral part of that Indiana activity." *Id.*

Pursuant to 45 IAC 1-1-49, 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 taxpayer's affairs are carried on;

(2) Performance of services;

...

(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);...

45 IAC 1-1-49.

Taxpayer is an Indiana, for-profit, domestic corporation. Taxpayer derives income from services that are performed in Indiana, and taxpayer owns income-producing property within the State (*i.e.*, the milk replacement veal feed operations). According to the requirements set out in 45 IAC 1-1-49, taxpayer has established a business situs in Indiana.

The Department looks to the following types of activities and the location of such activities of a taxpayer to determine the commercial domicile of the taxpayer:

... (1) location of management and administrative activities connected with each location...;

(2) location of board of directors' meetings;

(3) residence of executives and their offices;

(4) location of books and records;

(5) location of payment on income from intangibles of the taxpayer; and

(6) information from annual and quarterly reports of the taxpayer...

45 IAC 1-1-51. It is clear from the information contained in the file and taxpayer's protest letter that taxpayer has its commercial domicile in Indiana.

Although taxpayer has a business situs and is commercially domiciled in Indiana, it must be determined whether taxpayer's business situs is also the "tax situs" or "source" of its interest income. *See Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue*, 598 N.E.2d 647, 662 (Ind. Tax 1992) (finding that Ohio corporation was not subject to imposition of gross income tax for sales of electricity to Indiana customers, where Ohio corporation had no tax situs within Indiana). We do this by examining whether the transactions giving rise to the intangible interest income taxpayer receives from the Agreements are an integral part of taxpayer's Indiana business activities.

For purposes of this assessment, taxpayer is involved in two types of transactions. Taxpayer's business is the production and sale of liquid milk replacement veal feed. The principal focus of the business is the sale of veal feed. To enhance its veal feed sales, taxpayer extends credit to veal farmers under feeder finance Agreements. Taxpayer's sole objective in entering into the Agreements was to increase taxpayer's feed sales. Although the actual grow out of the veal calves takes place at the respective farmers' business sites and farmers may interact with local sales and service representatives employed by taxpayer and located in the farmers' states if the farmers so choose, we believe that the facts of this case lead to the conclusion that the taxpayer's offering of the feeder finance Agreements, and the interest income that flows therefrom, are an integral part of taxpayer's Indiana business activities.

If a farmer needs additional feed for its veal calf, the farmer may contact his local representative or order additional feed directly from the LLC (seller of dry feed) or taxpayer (seller of liquid milk feed). If the farmer requests additional dry feed from the local representative, the local representative contacts the LLC and requests that the dry feed be sent directly to the farmer. Regardless of how the farmers order additional feed, taxpayer must be made aware of the additional purchases so that taxpayer can add the sale price of the feed to the farmers' accounts. Likewise, if a farmer needs medication from a veterinarian for its calves, the farmer makes arrangements with the local representative to have the cost of such medication invoiced directly to taxpayer. Upon receipt of the invoice from the veterinarian, taxpayer pays the veterinarian and adds said cost to the farmer's account. At the time of the audit, taxpayer also assisted farmers in obtaining veal calves if such assistance was requested. As part of this service, taxpayer would locate the calves, obtain the terms of their purchase from the veal producer, and forward this information to the farmer. If the farmer decided to purchase the calves, the taxpayer would arrange for the delivery of the calves from the producer directly to the farmer. Once delivery was made, the purchase price of the calves would be invoiced directly to taxpayer and added to the farmer's account. All taxpayer activities associated with the management of these Agreements occur in Indiana.

It is clear from the description of the aforementioned transactions that said transactions giving rise to the interest income taxpayer receives from its extension of credit to veal farmers are an integral part of its primary business of selling veal feed. The majority of taxpayer's sales of veal feed was generated from the Agreements. Taxpayer's extension of credit to veal farmers through the Agreements was not a one-time occurrence, rather, it was an ongoing business practice which stemmed from and promoted taxpayer's primary business goal, *i.e.*, to increase its veal feed sales. Taxpayer is the financier and sole record keeper of all of the transactions associated with the Agreements. All decisions regarding the financial aspects of the Agreements are made ultimately by taxpayer. In essence, these Agreements are negotiated, implemented, and managed by taxpayer. Furthermore, taxpayer has a business situs and is commercially domiciled in Indiana. The evidence of file clearly establishes that the transactions giving rise to

the interest income derived from the Agreements are an integral part of taxpayer's Indiana business activities, *i.e.*, selling veal feed. The auditor did not err in determining that the intangible interest income has an Indiana situs for gross income tax purposes.

**FINDING**

The taxpayer's protest is denied.

**III. Adjusted Gross Income Tax – Business/Nonbusiness Income**

**DISCUSSION**

During its protest hearing, taxpayer expanded its argument that the interest income it receives from the Agreements is out-of-state income not subject to Indiana gross income tax by asserting that the interest income earned by taxpayer from the finance Agreements is not allocable to Indiana, but instead is subject to apportionment. According to taxpayer, this tax, as assessed, is not fairly apportioned because it attempts to tax receipts that are derived from business transactions taking place outside of Indiana, *i.e.*, in the states in which the respective veal farmers have business situs. In support of its position, taxpayer relies upon *Hunt Corp. v. Indiana Dept. of State Revenue*, 709 N.E.2d 766 (Ind. Tax Ct. 1999), for the proposition that the interest income constitutes business income subject to apportionment, rather than non-business interest income taxable entirely by Indiana.

After an extensive review of the auditor's tax computations, we find that the only adjustment the auditor made to taxpayer's adjusted gross income (hereinafter, "AGI") was to exclude from AGI taxpayer's distributive share of income from the Wisconsin based LLC. No further adjustments to AGI were made, as the auditor determined that the apportionment reported by taxpayer (which included the interest income from the finance Agreements) was substantially correct. *See Explanation of Adjustments*, pg. 7. No error occurred here.

**FINDING**

Taxpayer's protest is denied.

**IV. Tax Administration – Abatement of Penalty**

**DISCUSSION**

Taxpayer protests the imposition of a ten percent (10%) negligence penalty. Taxpayer argues that it had reasonable cause for its failure to pay the appropriate amount of tax due because said underpayment of tax was based solely upon taxpayer's interpretation of relevant statutes and regulations.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed..." 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id.*

Taxpayer has failed to set forth a basis for establishing that it exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Although some of the questions raised by taxpayer involve technical issues of interpretation and applicability, given the totality of the circumstances, waiver of the penalty is inappropriate in this instance.

**FINDING**

Taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

0220000449P.LOF

**LETTER OF FINDINGS NUMBER: 00-0449P**

**Income Tax Penalty  
Calendar Year 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 6-8.1-10-2.1(d); 45 IAC 15-11-2

Taxpayer protests the penalty assessed.

**II. Tax Administration – Interest**

**Authority:** IC 6-8.1-10-1

Taxpayer protests the interest assessed.

**STATEMENT OF FACTS**

Taxpayer's representative, in letters dated November 15, 2000 and April 16, 2001 protested the penalty and interest assessed for 1998.

**I. Tax Administration – Penalty**

**DISCUSSION**

Taxpayer was assessed a penalty for failure to timely pay its entire tax liability by the due date of the return.

Taxpayer, in a letter dated April 16, 2001, set forth several reasons for its failure to remit the entire amount of tax due by the due date. In summary, it did not fully pay its AGIT liability for the tax year at the time it submitted its extension request because it was not in possession of all of the financial information necessary to calculate a true and correct extension payment. Specifically, it was not in possession of final financial information from various partnerships at the time it filed the subject extension request. The partnerships were granted extensions of time for filing required information reports. As a result of the additional time granted to the subject partnerships to file the subject information returns, taxpayer was not able to accurately calculate its final consolidated AGIT liability at the time it submitted its extension request.

Taxpayer states that the failure was due to several factors which include the selling of its stock to an unrelated party on July 17, 1998. In April 1999, the taxpayer calculated an estimated net operating loss and anticipated that it would be required to remit Gross Income Tax, but not Adjusted Gross Income Tax or Supplemental Net Income Tax. Accordingly, it remitted Gross Income Tax with its timely filed extension request based on its anticipated net operating loss for the Tax Year. Taxpayer states that the full balance due was timely remitted with the return filed for the Tax Year and it remitted to the Department, on or before the original due date, at least ninety percent of the Indiana tax that is reasonably expected to be due. Taxpayer requests the penalty be considered for abatement.

Taxpayer remitted eighty-two percent (82%) of its tax due by the due date; i.e. April 15, 1999. Taxpayer paid the balance on October 20, 1999.

IC 6-8.1-6-1 clearly states that at least ninety percent (90%) of the tax that is reasonably expected to be due must be paid by the due date.

The department finds that a negligence penalty is proper.

**FINDING**

Taxpayer's protest is denied.

**II. Tax Administration – Interest**

**DISCUSSION**

Taxpayer requests the abatement of interest for the same reasons as stated in item I.

The department has no authority to waive interest under IC 6-8.1-10-1(e).

**FINDING**

Taxpayer's protest is denied.

**CONCLUSION**

Taxpayer's protest is denied for issues I and II.

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**DEPARTMENT OF STATE REVENUE**

0120010080.LOF

**LETTER OF FINDINGS NUMBER: 01-0080**  
**Indiana Individual Income Tax**  
**For the 1999 Tax Year**

**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. Definition of “Income” as Applied to Individual Indiana Residents for the Purpose of Imposing the State’s Individual Income Tax**

**Authority:** Ind. Const. art. X, § 8; IC 6-3-1-3.5 et seq.; New York v. Graves, 300 U.S. 308 (1937); Doyle v. Mitchell, 247 U.S. 179 (1918); Southern Pacific Co. v. Lowe, 247 U.S. 330 (1918); Stratton’s Independence v. Hobert, 231 U.S. 399 (1913); United States v. Connor, 898 F2d 942 (3<sup>rd</sup> Cir. 1990); Wilcox v. Commissioner of Internal Revenue, 848 F2d 1007 (9<sup>th</sup> Cir. 1988); Coleman v. Commissioner of Internal Revenue, 791 F2d 68 (7<sup>th</sup> Cir. 1986); United States v. Koliboski, 732 F2d 1328 (7<sup>th</sup> Cir. 1984); United States v. Romero, 640 F2d 1014 (9<sup>th</sup> Cir. 1981); Snyder v. Indiana Dept. of State Revenue, 723 N.E.2d 487 (Ind. Tax Ct. 2000); Thomas v. Indiana Dept. of State Revenue, 675 N.E.2d 362 (Ind. Tax. Ct. 1997); Richey v. Indiana Dept. of State Revenue, 634 N.E.2d 1375 (Ind. Tax Ct. 1994)

Taxpayers are of the opinion that the private “monetary gain” experienced by an individual Indiana resident does not constitute “income” for purposes of the state’s individual income tax.

**II. Definition of “Taxpayer” for the Purpose of Assessing the State’s Individual Income Tax**

**Authority:** IC 6-2.1-1-16; IC 6-3-1 et seq.; IC 6-3-1-3.5(a); IC 6-3-1-9; IC 6-3.1-1-12

Taxpayers argue that, for purposes of assessing the state’s individual income tax, they are not statutorily defined “taxpayers” subject to imposition of the tax.

**STATEMENT OF FACTS**

Taxpayers filed an individual income tax return for 1999. On that return, taxpayers reported a federal adjusted gross income of “0.” Attached to the return was a statement indicating that the return was not filed or signed voluntarily but out of a concern that by failing to file the return, taxpayers would subject themselves to illegal prosecution. Attached elsewhere to the 1999 return was a statement outlining the substance of taxpayers’ protest. Essentially, taxpayers disagreed with the necessity of filing the return stating that a return containing “zeros” was sufficient to comply with the requirements for filing an income tax return. Elsewhere in taxpayers’ statement, taxpayers argued that only corporate gain was subject to imposition of federal and state income taxes. For the taxing authorities to determine otherwise, according to taxpayers, would be to ignore the court references, statutes, and regulations cited by the taxpayers. Subsequently, the Department issued a notice of “proposed assessment.” Taxpayers averred, repeating the essence of their earlier arguments. Taxpayers requested and were granted the opportunity to present their arguments at an administrative hearing. This Letter of Findings follows as a consequence of that hearing.

**DISCUSSION****I. Definition of “Income” as Applied to Individual Indiana Residents for the Purpose of Imposing the State’s Individual Income Tax**

Taxpayers maintain that for the purpose of determining income tax liability, “income” can only be a derivative of corporate activity. Accordingly, individual Indiana residents – who by definition do not receive “corporate” income – are not subject to income tax liability.

Taxpayers rely upon various court cases to support this assertion. Among those cases is Doyle v. Mitchell, 247 U.S. 179 (1918) in which the Court stated that, “Whatever difficulty there may be about a precise and scientific definition of ‘income,’ it imports... the idea of gain or increase arising from corporate activities.” *Id.* at 185. Taxpayers read this and its companion cases for the generalized proposition that income tax can only be levied against corporate gain. *See also Stratton’s Independence v. Hobert*, 231 U.S. 399 (1913); Southern Pacific Co. v. Lowe, 247 U.S. 330 (1918). According to taxpayers, the cited cases lead to the conclusion that the “income” – as commonly referred to within the state and federal tax statutes – is exclusively limited to that definition established under the Civil War Income Tax Act of 1867; the Corporation Excise Act of 1909; and the Income Tax Acts of 1913, 1916, and 1917.

Leaving aside questions concerning the accuracy of taxpayers’ legal analysis, the conclusions fairly attributable to the cited cases simply do not get taxpayers where they want to go. Taxpayers have cited cases in which the federal courts were asked to decide what constituted corporate income under the various corporate income and excise taxes in effect at the time the courts reached their decisions. If one chooses those cases in which questions of corporate income are placed before the courts, one will get answers related to corporate income tax and not – despite taxpayers’ circular reasoning – related to the questions concerning the applicability and legitimacy of the state’s individual income tax.

The question of what constitutes individual taxable “income” has been answered by the courts. Although not binding upon the state’s decision to tax the wages of its own citizens, the United States Supreme Court has definitively ruled on the question of whether a citizen’s individual income may be subjected to an adjusted gross income tax. In New York v. Graves, 300 U.S. 308, 312-13 (1937), Justice Stone stated as follows:

That the receipt of income by a resident of the territory of a taxing sovereignty is a taxable event is universally recognized. Domicile itself affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right to invoke the protect of its laws are inseparable from the responsibility for sharing the costs of government.... A tax measured by the net income of residents is an equitable method of distributing the burdens of government among those who are

privileged to enjoy its benefits. The tax, which is apportioned to the ability of the taxpayer to pay it, is founded upon the protection afforded by the state to the recipient of the income in his person, in his right to receive the income and in his enjoyment of it when received. These are rights and privileges which attach to domicile within the state. To them and to the equitable distribution of the tax burden, the economic advantage realized by the receipt of income and represented by the power to control it, bears a direct relationship. Neither the privilege nor the burden is affected by the character of the source from which the income is derived.

Since that 1937 decision, the federal courts have consistently, repeatedly, and without exception determined that individual wages – no matter in what form the taxpayers have attempted to characterize, define, or label those wages – are income subject to taxation. United States v. Connor, 898 F2d 942, 943 (3<sup>rd</sup> Cir. 1990) (“Every court which has ever considered the issue has unequivocally rejected the argument that wages are not income”); Wilcox v. Commissioner of Internal Revenue, 848 F2d 1007, 1008 (9<sup>th</sup> Cir. 1988) (“First, wages are income.”); Coleman v. Commissioner of Internal Revenue, 791 F2d 68, 70 (7<sup>th</sup> Cir. 1986) (“Wages are income, and the tax on wages is constitutional.”); United States v. Koliboski, 732 F2d 1328, 1329 n. 1 (7<sup>th</sup> Cir. 1984) (“Let us now put [the question] to rest: WAGES ARE INCOME. Any reading of tax cases by would-be tax protesters now should preclude a claim of good-faith belief that wages – or salaries – are not taxable”) (Emphasis in original); United States v. Romero, 640 F2d 1014, 1016 (9<sup>th</sup> Cir. 1981) (“Compensation for labor or services, paid in the form of wages or salary, has been universally held by the courts of this republic to be income, subject to the income tax laws currently applicable.... [Taxpayers] seems to have been inspired by various tax protesting groups across the land who postulate weird and illogical theories of tax avoidance all to the detriment of the common weal [sic] and of themselves.”).

In addressing the identical question, the Indiana Tax Court has held that, “Common definition, an overwhelming body of case law by the United States Supreme Court and federal circuit courts, and this Court’s opinion... all support the conclusion that wages are income for purposes of Indiana’s adjusted gross income tax.” Snyder v. Indiana Dept. of State Revenue, 723 N.E.2d 487, 491 (Ind. Tax Ct. 2000). See also Thomas v. Indiana Dept. of State Revenue, 675 N.E.2d 362 (Ind. Tax Ct. 1997); Richey v. Indiana Dept. of State Revenue, 634 N.E.2d 1375 (Ind. Tax Ct. 1994).

Taxpayers’ hypertechnical linguistic distinctions aside, taxpayers’ “monetary gain” is subject to Indiana’s adjusted gross income tax as defined by the General Assembly under IC 6-3-1-3.5 et seq. and as authorized by the Indiana Constitution. Ind. Const. art X, § 8.

**FINDING**

Taxpayers’ protest is respectfully denied.

**II. Definition of “Taxpayer” for the Purpose of Assessing the State’s Individual Income Tax**

Taxpayers do not believe that, for purposes of the state’s individual income tax, they fall within the statutory definition of “taxpayer.” Taxpayers cite to IC 6-2.1-1-16 in support of this proposition. IC 6-2.1-1-16 defines “taxpayers” as, inter alia, various business and commercial organizations such as partnerships, banks, clubs, institutions, and municipalities. Taxpayers are correct in their basic assertion that they do not come within the definition of “taxpayer” as set out in IC 6-2.1-1-16. However, that distinction is ultimately irrelevant to taxpayers’ argument because IC 6-2.1-1-16 is a provision of the state’s gross income tax, IC 6-2.1 et seq., and because taxpayers can be reasonably assured that they will not be subjected to that particular tax.

Taxpayers’ are more properly concerned with the applicability of the state’s individual *adjusted* gross income tax found at IC 6-3-1 et seq. IC 6-3-1-3.5(a) imposes the state’s adjusted gross income tax on “individuals.” IC 6-3-1-9 defines the term stating that “[t]he term ‘individual’ means a natural person, whether married or unmarried, adult or minor.”

Given that taxpayers are undoubtedly “natural person[s]” receiving taxable income, and were residents of Indiana for the year at issue (IC 6-3-1-12), it can be safely concluded that taxpayers fall squarely under the authority of the state’s individual income tax provisions.

**FINDING**

Taxpayers’ protest is respectfully denied.

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**DEPARTMENT OF STATE REVENUE**

2920010104.LOF

**LETTER OF FINDINGS NUMBER: 01-0104 CG**  
**State of Indiana Charity Gaming**  
**Denial of Charity Gaming License Application**

**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. Charity Gaming – Qualified Organization**

**Authority:** IC 4-32-6-20; IC 4-32-9-4; IC 6-8.1-5-1; Portland Summer Festival v. Department of Revenue, 624 N.E.2d 45 (Ind.App. 5 Dist. 1993)

The Petitioner, S.A.F.E. (Save Adolescence Future Efforts) Youth Program, protests the Department's denial of its Indiana Charity Gaming License Application.

**STATEMENT OF FACTS**

The Petitioner protests the Department's denial of its Indiana Charity Gaming License Application. An investigation by the Department's Criminal Investigation Division could not verify the existence of Petitioner's parent organization Followers of Christ Church (FOCC). Petitioner protested the Department's denial of its Indiana Charity Gaming License in a letter dated May 9, 2001. The Petitioner's protest was filed in a timely manner. A hearing on Petitioner's protest was held on July 19, 2001 pursuant to IC § 4-32-8-1.

**I. Charity Gaming – Qualified Organization**

**DISCUSSION**

The Indiana Department of Revenue has the primary responsibility to administer, investigate, and enforce IC § 4-32, and has the sole authority to license entities under that article. To be approved for a license, the entity must comply with the definition of a qualified organization under IC § 4-32-6-20. An entity, which complies with the definition and has supplied other required information along with a license fee, may conduct various charity gaming events once a license is obtained. IC 4-32-6-20 states, "(a) 'Qualified organization' means: (1) a bona fide religious... organization operating in Indiana that: (A) operates without profit to the organization's members; (B) is exempt from taxation under Section 501 of the Internal Revenue Code; and (C) has been continuously in existence in Indiana for at least five (5) years or is *affiliated with a parent organization that has been in existence in Indiana for at least five (5) years*;..."<sup>1</sup>

The Petitioner's CG-1 states that it was formed on April 12, 1994. The organization's bylaws were dated April 12, 1994 but they were not signed. (See Department's Exhibit A). Along with the Petitioner's application were documents supporting the five years existence for Followers of Christ Church c/o FOCCUS Co. Inc. of Indiana (FOCC) and not the Petitioner. The Petitioner chose to rely upon its parent organization FOCC for meeting the five years of existence requirement found in IC 4-32-6-20. The documentation supplied by the Petitioner substantiates the fact that the § 501(c) organization FOCC was leasing automobiles, had a bank account, procured automobile insurance, and paid utility bills, etc. None of the documents supplied by the Petitioner substantiated the main purpose of FOCC as a not-for-profit organization.

According to the Indiana Department of State Revenue's Criminal Investigation Division, an investigation into the Petitioner's parent organization determined that the FOCC did not exist at the address supplied by Petitioner on its Indiana Charity Gaming Qualification Application (CG-1). The Department's first witness testified under oath that he observed a home (purported to be the location of FOCC) on two separate occasions. The first time was on December 9, 2000 from 8:55 am to approximately 9:45 am and then again on February 24, 2001 from 11:05 am to 11:45 am. (Record at 7-8). On each occasion, the Department's investigator was asked to observe if indeed there were church services being held by FOCC (this instruction by the Department was irrelevant in determining FOCC's existence). On both occasions, according to the Department's witness, there were no signs of worship being held at that location. On direct examination, the witness commented that the house under surveillance was yellow in color, and had blinds covering the windows. (Record at 7-8). The Department's second witness testified that he observed several locations ranging from homes to businesses looking for FOCC. The witness admitted that these addresses were not on Petitioner's application because the businesses have been closed. (Record at 31). As for his visits to these locations, the witness could only remember vague dates, times, and locations. The witness could not remember any addresses, or the names of individuals he spoke with. The Department's witness stated that he went to the address of FOCC on several occasions during the week and also on Sunday. (Record at 33). The witness also testified that the residence in question did have a garage but that the garage did not have any windows. (Record at 32).

Pursuant to IC 6-8.1-5-1, the Department's findings are prima facie evidence that the Department's claim that the entity does not qualify for a license is valid. The burden of proving that the findings are wrong rests with the person against whom the findings are made. See Portland Summer Festival v. Department of Revenue, 624 N.E.2d 45 (Ind.App. 5 Dist. 1993). However, the Department must have a good faith basis for their actions.

IC 4-32-9-4 provides in pertinent part, "(a) Each organization applying for a bingo license... must submit to the department a written application on a form prescribed by the department. (b) The application must include the information that the department requires, including the following: ... (6) Sufficient facts relating to the organization or the organization's incorporation or founding to enable the department to determine whether the organization is a qualified organization... (9) Any other information considered necessary by the department...."

Certain characteristics are generally attributed to churches. These attributes have been developed by the IRS and by court decision. They include:

- a) A distinct legal existence
- b) A recognized creed and form of worship
- c) A definite and distinct ecclesiastical government
- d) A formal code of doctrine and discipline
- e) A distinct religious history
- f) A membership not associated with any other church or denomination
- g) An organization of ordained ministers
- h) Ordained ministers selected after completing prescribed courses of study
- i) A literature of its own
- j) Established places of worship
- k) Regular congregations
- l) Regular religious services
- m) "Sunday schools" for the religious instruction of the young
- n) Schools for the preparation of its ministers.

Although the list is not all-inclusive, and not all the attributes must be present in every case, these characteristics, together with other facts and circumstances, are generally used to determine whether an organization constitutes a church for federal tax purposes.

According to the Petitioner, FOCC currently holds church services in Indianapolis at a Michigan Street address. Prior to using this location FOCC had a Post Road address until November 2000. From November 2000 to June of 2000 FOCC held its services at the Carmel address in question. At hearing, the Petitioner supplied church bulletins for services held on both December 9, 2000 and February 24, 2001. (Petitioner's Exhibit No. 1 & 2). According to the Petitioner's witness (Pastor of FOCC), the Sabbath school begins at 9:30 am, and the church service begins at 11:00 am and ends at approximately 1:00 pm. (Record at 35). The witness also stated under oath that the number of members present for services ranges anywhere from five (5), to as many as thirty (30) members. (Record at 38). The witness was also asked to describe the home which was according to the witness not yellow but gray, and that the garage had windows as well as sheer draperies on the windows, and not blinds. (Record at 40, 57-58). Petitioner's testimony and exhibits presented at hearing raises the presumption that the Department observed the wrong house on several occasions.

The Petitioner's argument supported by clear and convincing evidence has overcome the burden of proof established in Portland Summer Festival v. Department of Revenue, 624 N.E.2d 45 (Ind.App. 5 Dist. 1993). The evidence supplied by the Petitioner suggests that its parent FOCC was operating at the location provided on the CG-1, and carrying out its intended purpose.

**FINDING**

The Petitioner's protest is sustained.

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<sup>1</sup>The Court of Appeals of Indiana Fifth District questioned the constitutionality of the Department's interpretation of the definition of a "qualified organization" more specifically the phrase "*in Indiana*" in Dept. of Revenue v. There to Care, Inc., 638 N.E.2d 871, at 873 (Ind. App. 5 Dist 1994). The amended version of IC 4-32-6-20(a)(1)(C) was not before the court and they did not address its constitutionality.

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**DEPARTMENT OF STATE REVENUE**

2820010125.LOF

**LETTER OF FINDINGS NUMBER: 01-0125 CSET  
Controlled Substance Excise Tax  
For Tax Periods: 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**

**1. Controlled Substance Excise Tax – Imposition**

**Authority:** IC 6-7-3-5. IC 6-8.1-5-1 (b), Hurst v. Department of Revenue, 720 N.E.2d 370 (Ind. Tax. 1999), Hall v. Department of Revenue, 720 N.E.2d 1287 (Ind. Tax 1999)

The taxpayer protests the imposition of the Controlled Substance Excise Tax.

**STATEMENT OF FACTS**

On October 2, 1998, the taxpayer was arrested for the possession of marijuana. The County Prosecutor of the appropriate county on December 27, 2000 sent the Indiana Department of Revenue written notification that there would be no prosecution for the charge of the possession of the marijuana. On April 6, 2001, the Indiana Department of Revenue issued a Record of Jeopardy

Finding, Jeopardy Assessment Notice and Demand in a base tax amount of \$340.62. A telephone hearing was held on August 8, 2001. Further facts will be provided as necessary.

**1. Controlled Substance Excise Tax – Imposition**

**DISCUSSION**

IC 6-7-3-5 imposes the Controlled Substance Excise Tax on the possession of marijuana in the State of Indiana. 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). Possession of the controlled substance can be either actual or constructive. Hurst v. Department of Revenue, 720 N.E.2d 370 (Ind. Tax. 1999), Hall v. Department of Revenue, 720 N.E.2d 1287 (Ind. Tax 1999). Although both direct and circumstantial evidence may prove constructive possession, proof of presence in the vicinity of drugs, presence on property where drugs are located, or mere association with the possessor is not sufficient. Hurst at 374-375. To prove constructive possession, there must be a showing that Taxpayer had not only the requisite intent but also the capability to maintain dominion and control over the substance. Hurst at 374.

The issue to be determined in this case is whether or not the taxpayer had constructive possession of the marijuana. State Police officers observed marijuana growing on the taxpayer's real estate during a helicopter flyover. Officers later located marijuana growing in several areas of the real estate. Paths led between the various groupings of marijuana plants and ended near the taxpayer's residence. The plants appeared to be cultivated since they were held over by vines and manure was at the base of the plants. This evidence supports the finding that the taxpayer intended to grow the marijuana and had the capability to maintain dominion and control over the marijuana. Therefore, the taxpayer had constructive possession of the marijuana.

**FINDING**

The taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

2820010126.LOF

**LETTER OF FINDINGS NUMBER: 01-0126 CSET**

**Controlled Substance Excise Tax**

**For Tax Periods: 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**

**1. Controlled Substance Excise Tax – Imposition**

**Authority:** IC 6-7-3-5. IC 6-8.1-5-1 (b), Hurst v. Department of Revenue, 720 N.E.2d 370 (Ind. Tax. 1999), Hall v. Department of Revenue, 720 N.E.2d 1287 (Ind. Tax 1999)

Taxpayer protests the imposition of the Controlled Substance Excise Tax.

**STATEMENT OF FACTS**

On October 2, 1998, the taxpayer was arrested for the possession of amphetamine. The County Prosecutor of the appropriate county on December 27, 2000 sent the Indiana Department of Revenue written notification that there would be no prosecution for the charge of the possession of the amphetamine. On April 6, 2001, the Indiana Department of Revenue issued a Record of Jeopardy Finding, Jeopardy Assessment Notice and Demand in a base tax amount of \$18.80. A telephone hearing was held on August 8, 2001. Further facts will be provided as necessary.

**1. Controlled Substance Excise Tax – Imposition**

**DISCUSSION**

IC 6-7-3-5 imposes the Controlled Substance Excise Tax on the possession of amphetamine in the State of Indiana. 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). Possession of the controlled substance can be either actual or constructive. Hurst v. Department of Revenue, 720 N.E.2d 370 (Ind. Tax. 1999), Hall v. Department of Revenue, 720 N.E.2d 1287 (Ind. Tax 1999). Although both direct and circumstantial evidence may prove constructive possession, proof of presence in the vicinity of drugs, presence on property where drugs are located, or mere association with the possessor is not sufficient. Hurst at 374-375. To prove constructive possession, there must be a showing that Taxpayer had not only the requisite intent but also the capability to maintain dominion and control over the substance. Hurst at 374.

In the Hall case, the Indiana Department of Revenue assessed Controlled Substance Excise Tax on a husband and wife. The couple owned and lived together in a residence. The marijuana was grown in a basement room with a locked door. Only the husband

had a key to the room. Although the wife co-owned the house, lived in the house, did laundry in the room adjacent to the room which housed the marijuana, and the smell of marijuana permeated the house; the Court found that the wife did not have the capability to maintain dominion and control over the marijuana. Therefore she did not constructively possess the marijuana and the Controlled Substance Excise Tax was improperly imposed against the wife.

The issue to be determined in this case is whether or not Taxpayer had constructive possession of the amphetamine. After receiving permission from the taxpayer to search the premises, the police found the amphetamine in a Winnebago registered to her husband. Evidence indicated that the taxpayer regularly drove a car registered in her name. The evidence in this case does not support a finding that the taxpayer had the intent and capability to maintain dominion and control over the amphetamine found in her husband's motor vehicle.

**FINDING**

The taxpayer's protest is sustained.

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**DEPARTMENT OF STATE REVENUE**

0420010164P.LOF

**LETTER OF FINDINGS NUMBER: 01-0164P**

**Use Tax**

**Calendar Years 1998 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 – Penalty**

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

Taxpayer protests the penalty assessed.

**STATEMENT OF FACTS**

Taxpayer is a limited partnership owned by an international specialty retailer with stores in the United States, Canada, the United Kingdom, France, Germany, and Japan. Taxpayer has two stores in Indiana. At audit, it was determined that the taxpayer failed to self assess use tax in 1998 and paid a minimal amount in 1999.

**I. Tax Administration – Penalty**

**DISCUSSION**

Taxpayer's audit report revealed that it failed to remit use tax on clearly taxable purchases and fixed assets.

Taxpayer states that it had an inability to accrue tax properly on fixed assets and store expenditures. In June 1999, it implemented a model which accrues tax on these types of purchases. Taxpayer requests a penalty waiver based upon the above statement along with its excellent filing history.

A review of the audit indicates the taxpayer had no use tax accrual system in place for 1998 and remitted a minimal amount in 1999 although it was registered with the Department. Taxpayer did not provide reasonable cause to allow a waiver of the penalty.

**FINDING**

Taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

0220010168P.LOF

**LETTER OF FINDINGS NUMBER: 01-0168P**

**Gross and Adjusted Gross Income Tax**

**Calendar Years 12/31/90, 12/31/91, 12/31/92, 12/31/93, 12/31/94, 12/31/95, 12/31/96, and**

**Fiscal Years 09/30/97, 09/30/98, 09/30/99**

**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, incorporated under the laws of New York, was audited for calendar years 1990 through 1996 and fiscal years ending 09/30/97, 09/30/98, and 09/30/99. Upon audit it was discovered that the taxpayer failed to file Indiana income tax returns although it was filing sales tax returns. Taxpayer began filing returns for 9/30/98 and forward in 1999.

Taxpayer requests that the department waive the negligence penalty.

**I. Tax Administration – Penalty**

**DISCUSSION**

Taxpayer was assessed a negligence penalty for all years of the audit because it failed to file returns for all years with the exception of 1998 and 1999.

Taxpayer, in a letter dated June 25, 2001, protested penalties assessed and states it was its understanding that the penalty was assessed in cases of negligence or a failure to remit trust taxes. Taxpayer further states that neither of those was the case in its situation, and prior to the filing of its 1998 return, income taxes were handled by its former parent. Taxpayer further states there was a miscommunication between the companies as to where nexus existed.

A review of the audit indicates that the taxpayer filed sales tax returns and should have been aware that income tax returns should also be filed. Taxpayer filed returns for 1998 and 1999 but failed to review its prior years' filings.

Taxpayer did not provide reasonable cause.

**FINDING**

Taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

0220010176P.LOF

**LETTER OF FINDINGS NUMBER: 01-0176P**

**Gross and Adjusted Gross Income Tax**

**Fiscal Years Ended 01/28/96, 02/02/97, and 02/01/98**

**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(d); 45 IAC 15-11-2

Taxpayer protests the penalty assessed.

**STATEMENT OF FACTS**

Taxpayer is incorporated in Georgia and has four Indiana business locations. Upon audit it was discovered that the taxpayer made various errors in preparing its income tax returns such as the failure to report income at the correct rate of gross income tax, failure to report sales of Indiana real estate, to correctly apportion sales, property and payroll factors, and failing to addback real and personal property tax for the year of 1/28/96 as is required by 45 IAC 3.1-1-8. Although estimated payments were made for fiscal year 1997, taxpayer failed to file an income tax return. Other errors are also noted.

Taxpayer protests the penalty and states that it had retained the services of an outside accounting firm to prepare the company's tax returns prior to the 1999 filing. Taxpayer further states that the company is still new to the issues that were handled by the outside accounting firm in prior years. Taxpayer requests that all penalties associated with the taxes due be waived or abated.

**I. Tax Administration – Penalty**

**DISCUSSION**

Taxpayer was assessed a negligence penalty for failure to correctly report receipts in gross income, various errors in the apportionment factor, failure to addback property taxes, and failure to file an income tax return for the period 02/02/97.

Taxpayer, in a letter dated June 25, 2001, protested penalties assessed because it had retained the services of an outside accounting firm to prepare the company's tax returns and, in the more recent years, the company had people dedicated to the filing responsibilities of state taxes. Taxpayer further states that it is still new to the issues that were handled by the outside accounting firm in prior years.

Taxpayer had an outside accounting firm that made errors in various areas of its tax return that should have been verified before



filing. Taxpayer has not provided reasonable cause to allow the department to waive the negligence penalty.

**FINDING**

Taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

0420010202P.LOF

**LETTER OF FINDINGS NUMBER: 01-0202P**

**Use Tax**

**Calendar Years Ended 12/31/97 and 12/31/98**

**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 6-3-4-4.1

Taxpayer protests the penalty assessed.

**STATEMENT OF FACTS**

Taxpayer was assessed a negligence penalty for failure to assess tax on numerous fixed assets and general purchases in calendar year 1998. Taxpayer incurred a tax credit in 1997. A prior audit was dated May 19, 1995 that contained similar issues.

**I. Tax Administration – Penalty**

**DISCUSSION**

Taxpayer protests the penalty assessed because it overpaid tax in 1997 that affirmatively establishes that it attempts to provide reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Further it protests the ten percent (10%) penalty to all of 1998 without any considerations give to the 1997 over-assessment. Taxpayer further states that many of the issues addressed in the audit relate to gray areas in the tax law that it is accepting without protest.

The penalty was assessed in this instance because the Taxpayer did not self-assess tax on numerous fixed assets and general purchases, issues that were in a prior audit. In addition, 24.4% of the use tax due was not remitted in 1998.

Taxpayer overpaid in 1997 and believes the department should take this into consideration when applying penalty to all of 1998. Each year stands on its own at audit. Taxpayer's overpayment in 1997 does not negate or reduce the assessment for 1998.

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

**FINDING**

Taxpayer's protest is denied.

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**DEPARTMENT OF STATE REVENUE**

04970028.SLF

**SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 97-0028 SLF**

**State Gross Retail Tax**

**For Years 1992, 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**

**I. State Gross Retail Tax – Prescription Safety Glasses**

**Authority:** 45 IAC 2.2-5-28; IC § 6-2.5-5-18

Taxpayer protests the assessment of tax on prescription safety glasses purchased for employees.

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## Nonrule Policy Documents

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### II. State Gross Retail Tax – Statute of Limitations

**Authority:** IC § 6-2.5-3-2; IC § 6-2.5-4-1

Taxpayer protests the assessment of tax on transaction alleged to be outside statute of limitations.

#### STATEMENT OF FACTS

Taxpayer is a specialty chemical manufacturer. Taxpayer's large-scale production facilities are located outside of Indiana. Products that are manufactured which do not require a full plant quantity production run are produced at Taxpayer's Indiana pilot plant. These small production runs are for marketed products and research and product development projects. After an initial hearing, Letter of Finding 04970028.LOF was issued, Rehearing was granted on two issues. The following discussion supplements the First Letter of Findings.

### I. State Gross Retail Tax – Prescription Safety Glasses

#### DISCUSSION

Taxpayer protests assessment of tax based on its purchase of prescription safety glasses for employees. Taxpayer cites IC § 6-2.5-5-18, which states in relevant part:

(a) Sales of artificial limbs, orthopedic devices, dental prosthetic devices, eyeglasses, contact lenses, and other medical equipment, supplies, and devices are exempt from the state gross retail tax, if the sales are prescribed by a person licensed to issue the prescription.

Taxpayer provides additional documentation, and has demonstrated that the eyeglasses are exempt under this statute by demonstrating proof that these sales were the result of a prescription by a person licensed to issue a prescription.

#### FINDINGS

Taxpayer's protest is sustained.

### II. State Gross Retail Tax – Statute of Limitations

#### DISCUSSION

Taxpayer is protesting the assessment on purchases made by its sister corporation and then transferred to Taxpayer. The purchases of non-exempt specialty equipment made by the sister corporation were during the calendar year of 1991, the transfer to Taxpayer's corporation did not occur until April of 1992. Taxpayer argues that the transfer between the two corporations was not a retail transfer, but a casual sale exempted from tax.

The transfer between the corporations can constitute a taxable event for Taxpayer; the tax is imposed under IC § 6-2.5-3-2, which requires:

(a) An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana, if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Indiana Code § 6-2.5-4-1, defines selling at retail as:

(b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:

- (1) Acquires tangible personal property for the purpose of resale; and
- (2) Transfers that property to another person for consideration.

The April 1992 purchase was a sale of tangible personal property, but was not part of the regularly conducted trade or business of the corporation selling the property and was thus a casual sale exempted from tax by Taxpayer. Consequently the tax does not apply.

#### FINDINGS

Taxpayer's protest is sustained.

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## DEPARTMENT OF STATE REVENUE

02980242.SLOF

### SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 98-0242

#### Indiana Corporation Income Tax

#### For the Tax Years 1992, 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

### I. Apportionment of Taxpayer's 1992 Indiana Source Income

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

Taxpayer protests the audit's determination that a casualty loss, experienced at taxpayer's Indiana business location, should be included within the standard apportionment formula. Taxpayer argues that the circumstances under which taxpayer experienced the casualty loss, along with the purported distortion of the taxpayer's 1992 adjusted gross income, warrants an alternative method of apportioning the taxpayer's Indiana source income.

**II. Abatement of the Ten Percent Negligence Penalty.**

**Authority:** 45 IAC 3.1-1-62; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c); IC 6-3-1-3.5(b); IC 6-3-2-2.6; IC 6-8.1-10-2.1(a); IC 6-8.1-10-2.1(d)

Taxpayer requests that the Department exercise its discretionary authority to abate the ten percent negligence penalty. A certain portion of the penalty is based upon the taxpayer's original method of apportioning its 1992 income and the taxpayer's decision to carry forward a portion of the loss attributable to 1992 into subsequent years. Taxpayer maintains that its original decision to carry forward the 1992 losses was a reasonable and that abatement of the penalty is warranted.

**STATEMENT OF FACTS**

Taxpayer is in the hotel and lodging business. Taxpayer operates hotels in various states including a single hotel located in the state of Indiana. The taxpayer's headquarters is located in Missouri. Taxpayer originally protested the audit's determination that losses incurred at its Indiana business site should be included in the apportionment factor for determining taxpayer's adjusted gross income. The original Letter of Findings agreed with audit's determination. The taxpayer was granted the opportunity for a rehearing. This Supplemental Letter of Findings revisits the issue.

**DISCUSSION**

**I. Apportionment of Taxpayer's 1992 Indiana Source Income**

In February of 1992, the taxpayer's Indiana business location was the site of a military airplane accident. The airplane accident resulted in substantial damage to the taxpayer's property. As a result, the taxpayer stopped receiving Indiana source income from that site. After the taxpayer completed the reconstruction of its business property and after the taxpayer recovered all related insurance proceeds, the taxpayer sustained a casualty loss of \$491,177.

The original Letter of Findings determined that the casualty loss was properly classified as ordinary business casualty loss and not – as taxpayer originally maintained – a “non-business” casualty loss otherwise attributable entirely to the state of Indiana. Taxpayer does not dispute the original determination that the 1992 \$491,177 casualty loss was “business” in nature. What the taxpayer does contest is the Department's proposed apportionment of Indiana income for the tax year ending December of 1992.

Taxpayer receives business income from sources within the state of Indiana and outside the state. Accordingly, in calculating its adjusted gross income, taxpayer falls within the provisions of IC 6-3-2-2(b), which states that:

[I]f 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 (3).

In effect, the taxpayer does not want the 1992 \$491,177 casualty loss, experienced at its Indiana business site, subjected to the apportionment provisions of IC 6-3-2-2(b) but wants the loss to “stay” exclusively within Indiana. Taxpayer believes that it falls within the provisions of 45 IAC 3.1-1-62 – promulgated pursuant to IC 6-3-2-2(l) – which allows a taxpayer to depart from the standard allocation and apportionment provisions under certain unique circumstances. That regulation states that such a departure is warranted when the standard apportionment provisions “do not result in a division of income which fairly represents the taxpayer's income from Indiana sources.” *Id.*

The standard established for allowing the taxpayer to claim the regulatory exception is high. 45 IAC 3.1-1-62 directs that “the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.”

Taxpayer has set forth a compelling argument that the 1992 aircraft accident brings it within the purview of 45 IAC 3.1-1-62. Indeed, it can be fairly argued that an Air National Guard C-130 crashing into and destroying taxpayer's Indiana business location does create a scenario which “will arise only in limited and unusual circumstances.” 45 IAC 3.1-1-62. However, the precise circumstances under which taxpayer experienced the business loss – no matter how tragic or unique those circumstances may be – are not determinative of the issue. In the analytical language of the tax code, taxpayer experienced a casualty loss. Divorced from the singular circumstances under which the particular loss was sustained, taxpayer's business loss is indistinguishable from the loss occasioned by a fire, a flood, a highway relocation, or simply a particularly bad business cycle.

**FINDING**

Taxpayer's protest is respectfully denied.

**II. Abatement of the Ten Percent Negligence Penalty**

Taxpayer has requested that the ten percent negligence penalty, imposed under the authority of IC 6-8.1-10-2.1(a), be abated

for the taxpayer's additional income tax liabilities assessed during the tax years 1992, 1993, 1994, and 1995. Taxpayer maintains that any mistakes it made, with regard to its income tax liabilities, were made in good faith and were not the result of taxpayer's negligence.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2.1(a), can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer." Negligence results from a "taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." *Id.*

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax due was due to "reasonable cause." 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed..." *Id.* In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. *Id.*

After taxpayer originally determined that it had incurred a business loss during 1992, it carried a portion of that loss forward to taxpayer's 1993 and 1994 tax returns. The audit determined that this decision was inappropriate and disallowed the carryforward of the 1992 loss. Taxpayer maintains that it based its initial decision to carry forward the losses on IC 6-3-2-2.6. According to taxpayer, IC 6-3-2-2.6 permits taxpayer, as a nonresident corporation, a deduction and a carryforward for net operating losses pursuant to I.R.C. § 172. In addition, taxpayer predicated its decision to carry forward the 1992 losses under the provisions of IC 6-3-1-3.5(b) which instructs corporations to begin computing their Indiana income based upon the definition of "taxable income" as contained within I.R.C. § 63.

Taxpayer's analysis of the Indiana and Internal Revenue Code remains obscure, and the Department believes that taxpayer's specific application of the cited provisions is entirely unwarranted. However, regardless of the Department's ultimate treatment of the taxpayer's 1992 casualty loss, under IC 6-8.1-10-2.1(d), taxpayer has established that its initial decision to allocate its 1992 business loss to Indiana under the provisions of 45 IAC 3.1-1-62 and to carry forward that 1992 loss to its 1993 and 1994 tax returns was due to "reasonable cause and not due to willful neglect..." However erroneous those decisions may have been, taxpayer, by its interpretation and application of the relevant statutes and regulations, has demonstrated that it exercised "ordinary business care" in determining that it could allocate and carry forward the 1992 loss. 45 IAC 15-11-2(c). Accordingly, to the extent that taxpayer was subjected to the ten percent negligence based upon the errors it made in its 1993 and 1994 returns, the Department is obligated to abate that penalty under IC 6-8.1-10-2.1(d). However, because the penalty attributable to 1992 was only partially based upon taxpayer's decision to allocate its business loss to Indiana, the Department does not have a sufficient basis upon which to justify abating the 1992 negligence penalty.

The audit determined that taxpayer had underreported its 1995 income. Taxpayer maintains that it believed that, under IC 6-3-1-3.5(b), it had properly reported its 1995 taxable income as defined under § I.R.C. 63. However, unlike the facts surrounding the preparations of its 1993 and 1994 returns, taxpayer has presented no substantive evidence demonstrating that it exercised the requisite "reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b). The Department may not abate the negligence penalty based upon the taxpayer's bare assertion that it believed it was correctly reporting its 1995 taxable income.

#### **FINDING**

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

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**INDIANA DEPARTMENT OF STATE REVENUE**  
**Revenue Ruling #2001-09 IT**  
**September 11, 2001**

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#### **ISSUES**

**Gross Income Tax, Adjusted Gross Income Tax, Supplemental Net Income Tax, Sales/Use Tax, and Payroll Taxes – Proposed Business Restructurings**

**Authority:** IC 6-2.1-3-25; Rule 45 IAC 1.1-1-3; Rule 45 IAC 1.1-2-13; IC 6-2.1-16; Tax Policy Directive # 2; IC 6-3-1-11; IC 6-2.5-2-1; IC 6-2.5-3-2; IC 6-2.5-4-1; IC 6-3-4-8

The taxpayer requests the Department to rule on various issues pertaining to two proposed business restructurings. The specific issues will be listed and addressed in the "Discussion and Rulings" portion of this ruling.

#### **STATEMENT OF FACTS**

The taxpayer is commercially domiciled in Indiana with one current wholly owned subsidiary and a partial interest in two existing limited liability companies. The taxpayer is an agricultural cooperative and is a major supplier of farm inputs. The taxpayer is, also, a major supplier of motor fuels, heating fuels and motor oils to both commercial and residential customers.

The taxpayer is contemplating a business restructuring with two possible plans, i.e., proposal #1 and proposal #2. Under either proposal the taxpayer's subsidiary, sometime prior to the execution of the proposed restructuring, will be liquidated, tax-free into itself under IRC Section 332.

Under restructuring proposal #1 the taxpayer would contribute a 99% undivided interest in a substantial portion of assets and liabilities to SMLLC #1, a newly created single member LLC, in exchange for a 100% membership interest in SMLLC #1. The taxpayer would also contribute a 1% undivided interest in the identical assets and liabilities to SMLLC #2 in exchange for a 100% membership interest in SMLLC #2. As both SMLLC #1 and #2 are single member LLCs, disregarded as an entity separate from its owner under Federal Regulation 301.7701-3(b)(ii), the transfer would be affected in a tax-free manner. For federal income tax purposes the transfer is treated as a transfer from one division of a company to another. No gain or loss is recognized and the assets will have a carryover basis.

SMLLC #1 and #2 will then both contribute their respective undivided interests in the taxpayer's assets and liabilities to a limited partnership (LP). SMLLC #1 will receive a 99% limited or general partnership interest and SMLLC #2 will receive a 1% general or limited partnership interest in exchange for the assets contributed.

For federal income tax purposes income or loss earned by the LP will be treated as if the taxpayer earned it. This is the case because both SMLLCs are disregarded entities for federal income tax purposes, e.g., they are treated as branches of the taxpayer. For federal income tax purposes, the LP would, therefore, be treated as if it were solely owned by the taxpayer and also disregarded as an entity separate from its owner under Regulation 301.7701-3(b)(ii). Thus, for federal income tax purposes the income or loss of the LP would be included as a part of the taxpayer's federal taxable income.

Under restructuring proposal #2 the taxpayer would contribute a 99% undivided interest in a substantial portion of assets and liabilities to SMLLC #1, a newly created single member LLC, in exchange for a 100% membership interest in SMLLC #1. As SMLLC #1 is single member LLC and is disregarded as an entity separate from its owner under Federal Regulation 301.7701-3(b)(ii), the transfer would be affected in a tax-free manner. For federal income tax purposes the transfer is treated as a transfer from one division of a company to another. No gain or loss is recognized and the assets will have a carryover basis.

SMLLC #1 will then contribute its 99% undivided interest in the taxpayer's assets and liabilities to a newly formed Limited Partnership (LP) in exchange for a 99% limited or general partnership interest. The taxpayer will then contribute the remaining 1% undivided interest in the identical assets directly to the LP in exchange for a 1% general or limited partnership interest. Under the provisions of Federal Regulation 301.7701-3(b)(ii), the LP will then become an entity with a single owner, and will be disregarded as an entity separate from its owner. Thus, for federal income tax purposes income or loss earned by the LP will be treated as if the taxpayer earned it.

#### **DISCUSSION AND RULINGS**

##### **ISSUES:**

1. Will IDOR recognize the existence of the LP as a partnership for Gross Income Tax (GIT) purposes for both proposed Restructurings #1 and #2, described above?

The Department recognizes the existence of the LP for gross income tax purposes for both proposal #1 and proposal #2 to the extent the partnership is created pursuant to all Indiana applicable statutes.

2. Will the LP be subject to GIT in either of the proposed restructurings?

The Department rules that the LP will not be subject to gross income tax in either of the proposals to the extent the LP is not a publicly traded partnership that is treated as a corporation for federal income tax purposes under Section 7704 of the Internal Revenue Code as provided by IC 6-2.1-3-25.

3. If the LP is treated as a partnership for GIT for both proposed restructurings, will the net income earned by the LP be treated as a dividend from the limited partnership and as an apportioned, using the equally weighted three-factor formula, partnership distribution from the general partner, respectively, to the taxpayer and be subject to GIT at the taxpayer level at the 1.2% GIT rate?

The Department rules that, pursuant to Rule 45 IAC 1.1-1-3, distributions from the limited partner are taxed 100% to the taxpayer at the rate of 1.2%. Pursuant to Rule 45 IAC 1.1-2-13, distributions from the general partner are apportioned, if applicable, and taxed at the rate of 1.2% at the taxpayer's level.

4. As presented in Issue #2, will the two SMLLCs in proposed restructuring #1 and the one SMLLC in proposed restructuring #2, be treated as disregarded entities, non-taxpayers or pass through entities not subject to GIT?

Pursuant to IC 6-2.1-1-16, limited liability companies that have a single member and are disregarded as entities for federal income tax purposes are not defined as gross income tax "taxpayers". Further, Departmental Tax Policy Directive #2 provides that

for Indiana income tax purposes LLCs are treated the same as they are for federal income tax purposes. The Department rules, therefore, that the SMLLCs are both, not defined as gross income taxpayers and are disregarded entities for gross income tax, hence, are not subject to gross income tax.

5. If the LP was not treated as a partnership for GIT purposes, how will it be treated and what are the GIT consequences for both proposed restructurings?

The Department rules that, as discussed in issue #1, the LP will be treated as such for gross income tax purposes.

6. For Indiana Adjusted Gross Income Tax (AGIT) and Supplemental Net Income Tax (SNIT) will the existence of the SMLLCs and the LP follow federal income tax treatment and be disregarded? The result being that for AGIT and SNIT the taxpayer's taxable income will include all the income or loss, subject to apportionment, of all the entities described in the two proposed restructurings, e.g., the entire respective group of entities in both proposed restructuring scenarios would be treated as single entities?

Pursuant to IC 6-3-1-3.5, the departure point for calculation of the Indiana adjusted gross income tax and the supplemental net income tax for corporations is IRC Section 63 "taxable income". This being the case the Department rules that, to the extent the SMLLCs and the LP are treated as disregarded entities for federal income tax purposes, the taxpayer's adjusted gross income tax and supplemental net income tax "taxable income" will include all income or loss, subject to apportionment, of all entities described in proposal #1 and proposal #2, e.g., each respective group of entities in proposal #1 and proposal #2 will be treated as single entities.

7. As the taxpayer is an agricultural cooperative, eligible to deduct patronage dividends under Subchapter T of the Internal Revenue Code (IRC), would any of the scenarios described above inhibit in any way the taxpayer's ability to take a full patronage dividend deduction for AGIT and SNIT purposes?

The Department rules that, to the extent the taxpayer is eligible to deduct patronage dividends for federal income tax purposes, the creation of the SMLLCs and LP would not inhibit the taxpayer's ability to take a full patronage dividend deduction for Indiana adjusted gross income tax and supplemental net income tax purposes as provided by IC 6-3-1-11.

8. Does the fact that the taxpayer is an agricultural cooperative for federal income tax purposes affect the answer to questions 1 through 6 above in any way?

The Department rules that the fact the taxpayer is an agricultural cooperative for federal income tax purposes does not affect the answers to the above issues #1 through #6 as Indiana uses the IRC Section 63 "taxable income" as the starting point for the calculation of Indiana corporate adjusted gross income tax and supplemental net income tax.

9. Are there any sales or use taxes due on the transfer of vehicles and other assets from the taxpayer to the SMLLCs or the LP in either of the proposed restructurings?

IC 6-2.5-2-1 and IC 6-2.5-3-2 impose sales/use tax on retail transactions made in Indiana and on tangible personal property stored, used or consumed in Indiana that was acquired in a retail transaction. IC 6-2.5-4-1 provides that a "retail transaction" is defined as the transfer of tangible personal property for consideration. The Department rules then, that to the extent that the transfer of vehicles and other assets from the taxpayer to the SMLLCs and the LP is not a taxable event for federal income tax purposes there is no consideration involved in the transfer, therefore, no retail transaction is executed and no sales/use tax is due on the transfer of vehicles and other assets in proposal #1 or proposal #2.

10. For Indiana individual income tax withholding purposes will the taxpayer or the LP be treated as the employer following the restructuring? If the taxpayer is not treated as the employer, will the taxpayer and the LP have to file separate W-2s and W-3s and other related payroll tax reports?

IC 6-3-4-8 states that every employer making payments of wages subject to tax under IC 6-3 who is required under the provisions of the Internal Revenue Code to withhold, collect and pay over income tax on wages paid by such employer to such employee, shall, at the time of payment of such wages, deduct and retain therefrom the amount prescribed in the withholding instructions issued by the Department. It is clear then, every employer who is required under the provisions of the Internal Revenue Code to withhold, collect and pay over federal income tax on wages paid by the employer is required, also, to withhold Indiana state and county tax (if applicable) on these wages. The Department rules, therefore, that to the extent the taxpayer and/or the LP are required to withhold federal income tax on wages paid, the taxpayer and/or the LP are required to, also, withhold Indiana state and county tax (if applicable) on these wages.

#### **CAVEAT**

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, changes in statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

**INDIANA DEPARTMENT OF STATE REVENUE**

**Revenue Ruling #2001-09 ST**

**September 11, 2001**

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**ISSUE**

**Sales/Use Tax – Sale of Club Memberships**

**Authority:** IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-1-1; IC 6-2.5-1-2

The taxpayer requests the Department to determine the proper taxation of the sale of club memberships for sales/use tax.

**STATEMENT OF FACTS**

The taxpayer is located in Illinois and is engaged in the wholesale sale of collectibles and giftware. The taxpayer sells several lines of figurine collectibles. Most of the figurines are sold at retail shops and stores. Due to the popularity of the figurines and propensity of its end customers to collect the figurines, the taxpayer (initially through an affiliate that no longer exists) formed collector’s clubs for three of its product lines (Club #1, Club #2 and Club #3).

A prospective club member generally picks up a membership application at a local retail shop and mails it, with his or her remittance, to the taxpayer in Illinois. The company also mails applications to potential club members from lists that are either developed internally or purchased. The individual may purchase a one or two year membership, payable in advance.

Membership confers a number of benefits. Club members become eligible to purchase exclusive members-only figurines. They receive a quarterly newsletter, and they are invited to attend special shows, to attend members only events at collectors’ conventions, and to go on collectors’ cruises. The conventions feature seminars on crafts, interactive games, cross-stitching sessions, a paint your own collectible session, a seminar on new products, dinners and a dance. The offerings at particular conventions vary from time to time.

When an individual purchases a membership, he or she receives a “Club Kit.” If a two-year membership is purchased, a second Club Kit is sent on the first day of the following club year. The Club Kit generally includes a “symbol of membership” figure (which is smaller and considerably less expensive to produce than the figurines sold in retail stores), decorative packaging and other ancillary items. The figurines and kits are manufactured and assembled in the Far East.

The membership fees charged, and approximate cost of the Club Kits, for 2001 are set forth below. In each case, the cost of the free membership pieces is approximately 25% of the total cost of the club kits. The other costs consist of the decorative box, a few ancillary items such as pens and paper, and various forms that are sent to the collectors.

	<u>Membership Fee</u>	<u>Cost of Club Kits</u>
Club #1	\$28.00	\$8.20
Club #2	20.00	6.35
Club #3	22.50	9.09

**DISCUSSION**

IC 6-2.5-2-1 imposes sales tax on retail transactions made in Indiana. IC 6-2.5-4-1 defines a retail transaction as the transfer of tangible personal property for consideration. IC 6-2.5-1-1 provides that a “unitary transaction” includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated. IC 6-2.5-1-2 states that a “retail unitary transaction” means a unitary transaction that is, also, a retail transaction, hence, the transaction is subject to sales tax.

It is clear then, the taxpayer’s sale of club memberships is statutorily defined as a “retail unitary transaction” [sale of tangible personal property and services (intangible rights)], therefore, the membership fees are subject to sales tax to be collected by the taxpayer.

**RULING**

The Department rules that the sale of club memberships is subject to sales tax to be collected by the taxpayer.

**CAVEAT**

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer’s facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, changes in statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

**DEPARTMENT OF STATE REVENUE  
REVENUE RULING #2001-10 ST  
September 19, 2001**

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**ISSUE**

**Sales/Use Tax – Taxability and Reporting Requirements Concerning a Federal “Like-Kind Exchange” Transaction**

**Authority:** IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-9-3; Rule 45 IAC 2.2-3-5; IC 6-2.5-5-8

The Taxpayer requests the Department to rule on the application of, and reporting requirements for, sales/use tax on three scenarios concerning a federal “like-kind exchange” transaction.

**STATEMENT OF FACTS**

Taxpayer is a lessor of tangible personal property (i.e., motor vehicles). The transaction at issue involves the typical purchase, lease, and sale of motor vehicles as modified to qualify under Internal Revenue Code (“IRC”) Section 1031. The Internal Revenue Service has ruled that exchanges of property (including rental property) by a corporation through an intermediary can qualify under IRC Section 1031 as tax-free like-kind exchanges for federal income tax purposes. The Taxpayer has entered into an agreement with an “Intermediary” that qualifies for the federal tax-free like-kind exchange treatment.

During the course of a leasing transaction, events can be divided into the following three segments or categories: (a) the acquisition of the property by the lessor; (b) the term of the lease; and (c) the disposition of the property by the lessor at the conclusion of the lease term. Simply stated, the lease is born, it lives for a period of time, and it terminates. The complexities of IRC Section 1031 only impact the lease transaction(s) at issue when the motor vehicle is (a) sold at the conclusion of the lease, and (b) when a new or replacement vehicle is acquired.

The IRC Section 1031 transaction does not impact the relationship between the lessor and lessee during the term of the lease. The lessee will continue to remit all payments during the term of the lease to the lessor. The lease payments will continue as they currently exist, and the lessor will continue to issue invoices to the lessee. The only change in business operation for the proposed IRC Section 1031 transaction is upon (1) the sale of the motor vehicle at the conclusion of the lease, and (2) the purchase of a newly-leased motor vehicle by the lessor.

On termination of the lease, Taxpayer disposes of (i.e., sells) the vehicles in one of several ways: (1) the Taxpayer directly sells the motor vehicle to the lessee through the purchase option of the lease; (2) the Taxpayer sells the motor vehicle to the dealer for resale to the lessee, who exercises the purchase option; (3) the Taxpayer sells the motor vehicle directly to the dealer for resale to someone other than the lessee; or (4) the Taxpayer sells the motor vehicle at auction to a dealer for purposes of resale. Under any of these described scenarios, the Taxpayer will dispose of the vehicles (“Relinquished Property”) at the termination of the lease through the Intermediary. The Intermediary has been assigned the Taxpayer's rights (but not its obligations) with respect to the sale of the Relinquished Property at the termination of the lease. The property is sold in accordance with the Taxpayer's directions and instructions either to (a) the lessee, or (b) the dealer for resale. In the first instance, the transaction would be assumed taxable for sales and use tax purposes (e.g., sale to consumer). In the second instance, the transaction would be generally assumed not taxable for sales and use tax purposes (e.g., exempt for resale). The Taxpayer controls the disposition of the relinquished property, and the title to the property is transferred directly from the Taxpayer to the purchaser. The proceeds from the sale are received in a Taxpayer and Intermediary joint bank account (“Account”) which restricts the Taxpayer's right to receive or otherwise obtain the immediate benefit of the proceeds. The Intermediary merely serves as a qualified Intermediary for federal Like-kind Exchange purposes, but does not change the basic character of the transaction. For this service, the Intermediary receives a fee.

The Taxpayer also acquires “Replacement Property” using the services of the Intermediary. As with the Relinquished Property, the Intermediary has been assigned the Taxpayer's rights (but not its obligations) with respect to the acquisition of newly leased vehicles (“Replacement Property”). At the Taxpayer's direction, the Intermediary pays for the Replacement Property out of the Account with funds from the sale of Relinquished Property. If there is a shortfall (the funds in the Account are less than the purchase price of Replacement Property), the Taxpayer will pay the difference. Replacement Property relinquished in a particular exchange is identified within 45 days of the sale of the Relinquished Property. If an exchange does not occur within the shorter of (a) 180 days or (b) the due date, including extensions, of the Taxpayer's federal income tax return, the Taxpayer will recognize gain on the exchange for federal income tax purposes. Again, as in the sale of Relinquished Property, the role of the Intermediary in the purchase of the Replacement Property is merely to provide a service to the Taxpayer. The title for the motor vehicle is transferred directly from the dealer to the Taxpayer and never rests with the Intermediary.

Scenarios at Issue for Sales and Use Tax Purposes

1. Sale of Motor Vehicle to a Taxable Individual or Other Taxable Entity

An individual purchaser (which for the purposes of the ruling is defined as any person or other legal entity) may exercise an



option to purchase the leased vehicle at the conclusion of the lease term. By way of comparison, in a typical taxable scenario (not an IRC Section 1031 transaction), the Taxpayer (i.e., lessor) (a) sells a motor vehicle, (b) collects the payment (e.g., purchase price plus tax), and (c) remits the appropriate sales and use tax on the transaction, in exchange for (d) the title to the motor vehicle. However, the individual purchaser will be directed to (b) remit their payment for the vehicle to the Account. For sales and use tax purposes, the Taxpayer will continue to document, report, and remit all taxes due on the transaction. The reporting of the transaction will continue to follow the flow of the documentation (i.e., title) at the Department of Revenue. It should be noted that the Taxpayer does not typically sell the leased vehicle directly to the lessee at the conclusion of the lease. With some exceptions, the Taxpayer usually sells the leased vehicle to the dealer who resells such vehicle.

2. Sale of Motor Vehicle to a Nontaxable Dealer

The lessor, at the conclusion of the lease sells the used motor vehicle to a dealer or another nontaxable reseller. The dealer may subsequently sell the vehicle to the lessee or to another third party. By way of comparison, in a typical nontaxable scenario (not an IRC Section 1031 transaction) the Taxpayer (i.e., lessor) (a) sells a motor vehicle, (b) receives payment (e.g., purchase price without tax) and a resale exemption, and (c) does not remit sales and use tax on the transaction, in exchange for (d) the title to the motor vehicle. In a qualified IRC Section 1031 transaction, the Taxpayer will continue to (a) sell a motor vehicle, (b) receive a resale certificate, and (c) not remit sales and use tax, in exchange for (d) the title to the motor vehicle. However, as noted above, the dealer will be directed to remit their payment for the vehicle to the Account. For sales and use tax purposes, the Taxpayer will continue to document and report the non-taxability of the transaction. The reporting of the transaction will continue to follow the flow of the documentation (i.e., title) at the Department of Revenue.

3. Purchase of a Motor Vehicle for Purposes of Leasing

In a situation where the lessor purchases tangible personal property (i.e., motor vehicles) and the lessee pays tax based upon the rental costs, typically the lessor acquires the property without being subject to sales or use tax (i.e., resale). Typically the Taxpayer (i.e., lessor) (a) purchases the vehicle from the seller, (b) supplies a written statement that the merchandise is being purchased for resale, and (c) receives title for the motor vehicle. In an IRC Section 1031 transaction, the Taxpayer will direct the Intermediary to make payment from the Account to the seller. The Taxpayer will continue to (b) supply a valid sale for resale exemption to the seller and (c) receive title. The related lease of the motor vehicle will remain unchanged, and the lessor will continue to remit all rental taxes due upon the lease payments.

#### **DISCUSSION**

IC 6-2.5-2-1 imposes sales tax on retail transactions made in Indiana. A “retail merchant” is a person who makes retail transactions by engaging in selling at retail. A person is “engaged in selling at retail” when, in the ordinary course of regularly conducted trade or business, the person acquires tangible personal property for the purpose of resale and transfers that property to another person for consideration (IC 6-2.5-4-1). The purchaser is liable for the tax on the transaction and shall pay the tax to the retail merchant as a separate added amount to the consideration of the transaction. The retail merchant must collect and remit the tax as an agent of the Department (IC 6-2.5-2-1 and IC 6-2.5-9-3).

The sale of any vehicle required to be licensed by Indiana for highway use in the state shall constitute selling at retail and is subject to sales/use tax unless the purchaser is entitled to an exemption (Rule 45 IAC 2.2-3-5). Transactions involving tangible personal property are exempt from sales/use tax if the person acquiring the property acquires it for resale, rental or leasing in the ordinary course of business without changing the form of the property (IC 6-2.5-5-8).

It is clear then, the three scenarios at issue fall within the ambit of the above statutes and regulation. The Taxpayer has correctly interpreted and applied the statutes and regulation to the three scenarios. The introduction of the Intermediary into the three scenarios has no effect on the responsibilities of the Taxpayer for sales/use tax collection and reporting.

#### **RULING**

The Department rules that:

1. The sale of a motor vehicle at the conclusion of the lease (e.g., sale to the lessee) is a taxable transaction for sales and use tax purposes between the Taxpayer and the customer. The Taxpayer would be the party responsible for remittance of the appropriate sales or use tax to the State of Indiana. The required IRC Section 1031 payment to the Account, managed by an Intermediary, does not change the filing and payment process of the Taxpayer;
2. The sale of a motor vehicle at the conclusion of the lease (e.g., sale to a dealer) is a nontaxable transaction for sales and use tax purposes between the Taxpayer and the dealer, provided that the proper exemption certificates are issued. The required IRC Section 1031 payment to the Account, managed by an Intermediary, does not alter the reporting process of the Taxpayer; and
3. The purchase of a new motor vehicle (i.e., Replacement Property) for leasing operations is a nontaxable transaction, for sale and use tax purposes, between the Taxpayer and the dealer, pursuant to the proper completion of the resale exemption certificate. The required IRC Section 1031 payment from the Account, managed by an Intermediary, does not alter the reporting process of the seller.

#### **CAVEAT**

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer’s facts and circumstances, as stated herein, are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling

may not rely on it. Other taxpayers with substantially identical factual situations, however, may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in a statute, a regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

**DEPARTMENT OF STATE REVENUE  
TAX POLICY DIRECTIVE #12**

**Charity Gaming  
September 2001**

**PURPOSE.** Tax policy directives are intended to provide the general public with information concerning the Department's official position with regard to specific issues. These directives may be relied upon by taxpayers until superseded by:

- (1) another policy directive,
- (2) a change in statute or regulation, or,
- (3) a court decision that has the effect of voiding the policy directive.

**SUBJECT: INTERPRETATION AND APPLICATION OF CHARITY GAMING AMENDMENTS CONTAINED IN P. L.129-2001, SECTION 1**

**REFERENCES:** IC 4-32-9; 45 IAC 18

**BACKGROUND.** The 2001 General Assembly adopted House Enrolled Act 1578, which among other things, will make changes to IC 4-32-9-21. The Department's ultimate intention is to adopt an administrative rule to formally spell out how these changes will be interpreted and applied. However, since these statutory changes have already taken effect (July 21, 2001), this directive is intended to bridge the gap until an administrative rule can be put into place.

**I. DEFINITION OF "NATIONALLY RECOGNIZED CHARITABLE ORGANIZATION".** The Department defines such an organization as one which:

- (1) possesses a determination letter or a ruling from the Internal Revenue Service stating that the organization is currently exempt from taxation under 26 U. S. C. 501, or is listed in Internal Revenue Service Publication 78 (Cumulative List of Organizations),
- (2) is organized primarily for charitable purposes,
- (3) is incorporated (or legally authorized to do business) in at least three states including Indiana; and
- (4) has a national membership of at least 5,000 people.

**II. DEFINITION OF "SERVES A MAJORITY OF COUNTIES IN INDIANA".** The Department defines this phrase to mean that a "nationally recognized charitable organization" must do the following:

- (1) maintain an office with a mailing address which is open for business during posted business hours; and
- (2) directly assist selected individuals or conducts other charitable activity.

Both services must be continuously available and ongoing in at least 47 Indiana counties.

**III. DEFINITION OF "IN EXISTENCE FOR AT LEAST 25 YEARS...".** The Department defines this phrase to mean that the "nationally recognized charitable organization" must have been continuously incorporated (or legally authorized to do business) for at least 25 years as a charitable organization, in each of at least three states (including Indiana).

**IV. EFFECTS OF 2001 CHANGES ON EXISTING LAW.** (1) Prior to the 2001 legislative amendments, an Indiana "qualified organization" was allowed to conduct charitable gaming events in only one county (the location of its principal business office; see IC 4-32-9-21.). The principal effect of the 2001 changes is to allow certain "qualified organizations" to hold events in counties other than those containing their principal offices.

(2) The Department will continue to enforce the daily and annual event limits contained in IC 4-32-9-18 and elsewhere in IC 4-32-9. The 2001 changes do not affect these limits.

(3) Also, current law only allows for one license per day for each allowable event conducted by a qualified organization. Even if a qualified organization is licensed to operate an event in more than one county, the Department will still issue only one license per day for each allowable event to each qualified organization.

(4) IC 4-32-9-5(b) states that an officer of a qualified organization who signs an application for a bingo license must live in the county in which the proposed bingo events will be held. Presumably, this provision would limit the number of counties in which such events could be held, to the maximum number of officers of a "qualified organization"; e.g., five officers, thus five counties). If this interpretation were sustained, the 2001 changes would be essentially moot. Therefore, in order to give effect to the 2001 changes, the Department interprets those changes as having the effect of overriding IC 4-32-9-5(b).

A copy of the 2001 amendments to IC 4-32-9-21 is attached for reference.  
Kenneth L. Miller, Commissioner  
Indiana Department of State Revenue  
Attachment (SECTION 1 of P. L. 129-2001)

**ATTACHMENT (SECTION 1, P. L. 129-2001)**

SECTION 1. IC 4-32-9-21 IS AMENDED TO READ AS FOLLOWS [EFFECTIVE JULY 21, 2001]: Sec. 21. Except where a qualified organization or its affiliate is having a convention or other annual meeting of its membership, a qualified organization may only conduct an allowable event in the county where the principal office of the qualified organization is located. The principal office of a qualified organization shall be determined as follows:

- (1) Except as provided in subdivision (3) **or subdivision (4)**, if a qualified organization is a corporation, the principal office shall be determined by the street address of the corporation's registered office on file with the secretary of state.
- (2) If a qualified organization is not a corporation, the principal office shall be determined by the street address of the organization on file with the Internal Revenue Service, the department, or county property tax assessment board of appeals for tax exempt purposes.
- (3) If a qualified organization is affiliated with a parent organization that:
  - (A) is organized in Indiana; and
  - (B) has been in existence for at least five (5) years; the principal office shall be determined by the principal place of business of the qualified organization.
- (4) If a qualified organization is affiliated with a parent organization that:**
  - (A) is a nationally recognized charitable organization;**
  - (B) serves a majority of counties in Indiana; and**
  - (C) has been in existence for at least twenty-five (25) years;**

**the principal office shall be deemed to be present in every county served by the organization.**

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