DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBERS: 97-0296 and 97-0297
Indiana Sales/Use Tax
For Tax Years 1992 through 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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales/Use Tax – Equipment and Materials Directly Used or Consumed in Direct Production, Manufacturing, Processing, and Refining

Authority: IC 6-2.5-2-1, IC 6-2.5-3-2, IC 6-2.5-3-4, IC 6-2.5-5-3; IC 6-2.5-5-5.1, IC 6-2.5-5-5.1, IC 6-2.5-5-30; 45 IAC 2.2-5-8(k), 45 IAC 2.2-5-10(k); White River Environmental v. Department of State Revenue, 694 N.E.2d 1248 (Ind.Tax 1998); Mechanics Laundry & Supply, Inc. v. Department of State Revenue, 650 N.E.2d 1223 (Ind.Tax 1995); Indianapolis Fruit Co. v. Department of State Revenue, 691 N.E.2d 1379, (Ind.Tax 1998); Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983); Rotation Products v. Department of State Revenue, 690 N.E.2d 795 (Ind.Tax 1998); Faris Mailing v. Dept. of State Revenue, 512 N.E.2d 480 (Ind.Tax 1987); General Motors v. Department of State Revenue, 578 N.E.2d 399, 404 (Ind.Tax 1991)

Taxpayer protests assessments of use tax on various purchases of equipment and materials.

II. Tax Administration – Negligence Penalty

Authority: IC 6-8-10-2.1; 45 IAC 15-11-2

Taxpayer protests assessment of the negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a waste management facility in Indiana. Taxpayer's primary business activities involve the collection (removal and site cleanup), transport, treatment, and disposal of hazardous and non-hazardous industrial waste materials. Taxpayer analyzes incoming waste materials to determine the optimal method for treatment and disposal. Treated waste may be recycled as scrap, disposed of in landfills, or transferred to permitted facilities where such waste can be used (consumed) as recycled fuel. Taxpayer also provides site restoration and environmental remediation services.

For the years subject to audit (1992 – 1995), taxpayer failed to self-assess and remit use tax on its taxable purchases. Audit, after reviewing taxpayer records to identify items acquired by taxpayer in retail transactions, proposed assessments of use tax.

Taxpayer now takes exception to Audit's determinations and ensuing use tax assessments. Specifically, taxpayer claims the proposed assessments are excessive because Audit, in its use tax calculus, failed to exclude purchases exempt from sales/use tax pursuant to IC 6-2.5-5-3 (the equipment exemption), IC 6-2.5-5-5.1 (the consumption exemption), and IC 6-2.5-5-30 (the environmental quality compliance exemption).

DISCUSSION

I. Sales/Use Tax – Equipment and Materials Used or Consumed in Production

Audit disagreed with and dismissed taxpayer's exemption claims. Audit rejected taxpayer's conclusions regarding both the impact and relevance of the cited exemptions. "Only taxpayers engaged in the production of tangible personal property," says Audit, "will qualify for the equipment, consumption, and environmental quality compliance exemptions." Audit previously had characterized taxpayer's business activities—conducted primarily at a full service waste treatment, storage, and disposal facility—as those of a *service* provider. And service providers, according to Audit, generally, are not engaged in production activities. Audit reasoned that since this taxpayer *did not produce products for resale*, it could not claim the exemptions.

Taxpayer countered by arguing that it qualified for the exemptions because it was, in fact, engaged in production activities—specifically that of processing and refining. Taxpayer describes its business activities in the following manner:

Taxpayer is engaged in the business of processing and refining hazardous and nonhazardous waste into alternative fuels and metallic by-products. This process involves obtaining certain types of hazardous and nonhazardous waste, removing scrap metal by-products, and converting the waste into an alternative fuel.

....

The Taxpayer's operations involve the conversion of waste materials into useable products including the [f]uel, which is used by cement producers in their kilns, and metallic by-products, which are sold to scrap metal dealers.

To summarize, taxpayer contends that is engaged in "production" because it "wrests usable fuels out of useless liquid and solid waste materials" and "creates value from waste products by extracting and processing usable metallic materials from the waste products."

Authorities

Indiana imposes a gross retail tax (sales tax) on retail transactions made in Indiana. IC 6-2.5-2-1. Indiana also imposes a use tax on the "storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction." IC 6-2.5-3-2. Use tax, however, will not be imposed on property stored, used, or consumed in Indiana if sales tax has been paid on the property acquired, or if the property acquired is exempt, pursuant to IC 6-25-5, from Indiana sales tax. IC 6-2.5-3-4(a).

There exist within IC 6-2.5-5 a number of sales/use tax exemptions. Manufacturing machinery, tools, and equipment acquired "for the direct use in the direct *production, manufacture, … processing, refining, or finishing* of other tangible personal property" are exempt from Indiana sales/use tax. See IC 6-2.5-3(b), the "equipment" exemption. Additionally, property acquired "for direct consumption as a material to be consumed in the direct *production* of other tangible personal property in the person's business of *manufacturing, processing, refining…*" is exempt from Indiana sales/use tax. See IC 6-2.5-5-5.1, the "consumption" exemption. And property constituting, incorporated into, or consumed in the operation of "a device, facility, or structure predominantly used and acquired for the purpose of complying with any…environmental quality statutes, regulations, or standards" is also exempt from Indiana sales/use tax. See IC 6-2.5-5-30(1), the "environmental quality compliance" exemption. But note: the entity acquiring property for the purpose of complying with environmental quality statutes, regulations, or standards must be "engaged in the business of *manufacturing, processing, refining, mining, or agriculture*." IC 6-2.5-5-30(2). Emphases added.

These exemption provisions require the taxpayer claiming such exemptions to have been engaged in production activities. "The terms listed in the exemption provisions, i.e., processing, manufacturing, etc., 'have meaning only to the extent that there is production.'" (The Indiana Tax Court in White River Environmental v. Department of State Revenue, 694 N.E.2d 1248,1250 (Ind.Tax 1998) quoting from Mechanics Laundry & Supply, Inc. v. Department of State Revenue, 650 N.E.2d 1223, 1228 (Ind.Tax 1995).) "If there is no production of goods, the exemption provisions do not apply." Id. "There is one ironclad rule: without production there can be no exemption." Indianapolis Fruit Co. v. Department of State Revenue, 691 N.E.2d 1379, 1384 (Ind.Tax 1998). Taxpayer's entitlement to the cited sales and use tax exemptions depends, therefore, not on whether its activities may be characterized as processing or refining, but on whether taxpayer is engaged in the production of goods or other tangible personal property. (Also see White River Environmental at 1251.)

Regulation 45 IAC 2.2-5-8(k) sheds light on this concept of "production":

"Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property" is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product have a distinctive name, character, and use.

Regulation 45 IAC 2.2-5-10(k) provides the following definition of " processing and refining."

Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. … A processed or refined end product…must be substantially different from the component materials used.

Indiana common law has contributed to the definition of "production"—at least in the context of the sales/use tax exemptions. Indiana courts have identified certain situations in which specific activities will (or will not, as the case may be) constitute production.

For example, the Indiana Supreme Court, in Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520, 525 (Ind. 1983), found that production had occurred where crude stone, blasted from a quarry, was crushed into aggregate stone. The Indiana Tax Court characterized the exposure of bananas to ethylene gas as "production". "Although the ripened bananas are still bananas, they have been placed in a 'form, composition, or character substantially different from that in which [they] were acquired.' They [the bananas] have been transformed both physically and chemically, and this transformation [ripening] makes a marketable banana from an unmarketable one." Indianapolis Fruit at 1385. Likewise, the Indiana Tax Court found that the remanufacture of roller bearings constituted production within the meaning of the equipment and consumption exemptions. "[T]his Court finds that RPC [taxpayer] substantially transforms the unusable roller bearings when it remanufactures them and thereby produces other tangible personal property. In other words, a scarce economic good has been created." Rotation Products v. Department of State Revenue, 690 N.E.2d 795, 804 (Ind.Tax 1998).

On the other hand, the Indiana Tax Court determined that a taxpayer in the business of hauling waste was not engaged in production. "[Taxpayer] simply transports garbage. That it compresses the garbage is irrelevant: to have a colorable claim for the equipment exemption, it would have to compress the garbage as part of its own process to produce other tangible personal property, not as part of an alleged process of another taxpayer." Indiana Waste Systems of Indiana at 363. And in Faris Mailing v. Dept. of State Revenue, 512 N.E.2d 480 (Ind.Tax 1987), the Indiana Tax Court determined that taxpayer's assembling of packaging materials on behalf of customers did not constitute "production." "Regardless of what Petitioner chooses to call his business, 'production of other tangible personal property' is required. … The items used in [taxpayer's] process cannot reasonably be assumed to transform the customer's package into a new product." Id. at 483. The Indiana Tax Court also found that the laundering of soiled textiles does not represent production within the meaning of the equipment, consumption, and environmental compliance exemptions. "The supreme court's expansive definition of 'production' [referring to the Indiana Supreme Court's Cave Stone opinion], however, in no way negates the requirement that the overall production process, whether it be termed 'processing' or otherwise, must result in the production of goods or other tangible personal property. Thus, despite Mechanics Laundry's [taxpayer's] attempt to explain its operation in a manner that conforms to the supreme court's definition of 'production,' the laundering of soiled textiles does not constitute 'production.'" Mechanics Laundry & Supply at 1229.

Issue

At issue, then, is whether taxpayer's activities constitute the production of goods or other tangible personal property. Specifically, whether the *extraction* of scrap metal by-products and the *conversion* of waste materials into alternative fuel represent exempt production activities.

Taxpayer receives hazardous and non-hazardous waste from manufacturers and service providers (i.e., taxpayer's customers). These customers pay taxpayer a fee for accepting their waste. The incoming waste will be analyzed by taxpayer to determine proper treatment and disposal methods. Taxpayer will then treat (if necessary) and dispose of the waste accordingly. Disposal methods vary. Some waste will be buried in landfills; some waste will be segregated and sold (e.g., the scrap metal); and some waste will be treated and transferred, for a price, to others who use the treated waste as fuel for kilns. That is, taxpayer will *pay* others (in this instance, qualified cement manufacturers) to dispose of taxpayer's waste materials.

Conversion of waste into fuel

Taxpayer claims the equipment, consumption, and environmental quality compliance exemptions based upon activities in which taxpayer converts industrial waste into usable fuel. Taxpayer explains:

> Taxpayer's various processes clearly are of the type that involve the production of 'other tangible personal property.' The [f]uel results from the transformation of hazardous waste products into a new form that has a valuable use to the Taxpayer's Customers.

With regard to taxpayer's fuel conversion activities, the Department need not parse taxpayer's processes in order to identify indicia of production. The Department need not determine whether taxpayer's activities transform hazardous waste into usable fuel. The Department need not perform such analyses because taxpayer does not *sell* usable fuel. Rather, taxpayer *pays* others to accept and dispose of such fuel. Absent the creation of a marketable product, taxpayer cannot have been engaged in production. The "marketable" moniker, of course, is a function of sales; if the fruits of taxpayer's labors are not sold, a marketable product cannot have been produced. Case law supports this commonsense conclusion.

The Indiana Tax Court indicated the close relationship between sales and the concept of "marketability" in its Indianapolis Fruit opinion when it stated:

> Most of these fruits and vegetables require little in the way of *processing before resale* because they are in a *marketable* condition when Indianapolis Fruit [the taxpayer] receives them. That is not the case with bananas and tomatoes; when Indianapolis Fruit [taxpayer] receives them, they are not marketable, and they require additional processing to put them into that condition. Emphasis added. Id. at 1381.

The Indiana Tax Court in White River Environmental, after stating the maxim that production "is defined broadly and focuses on the creation of a marketable product," wrote:

> Despite the possibility that the clean water, ash, and sludge created by WREP's [taxpayer's] waste treatment process may be sold in the future, the fact remains that those byproducts are not sold in the present. Accordingly, they remain the byproducts of a useful service, not goods for the marketplace. See Indiana Dep't of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524 (1983) (production encompasses all activity directed to increasing the number of scarce economic goods, i.e., *goods to be sold in the marketplace*). Emphasis added.

So, regardless of the endeavor taxpayer professes to be engaged in, it cannot be characterized as "production." Even though taxpayer's treatment of industrial waste permits taxpayer to *dispose* of its waste in a more economical manner, such effects, for purposes of the claimed exemptions, will not serve to transform "treatment" into "production."

Recapture of metallic by-products

Taxpayer contends "extraction" of metallic by-products from industrial waste and the subsequent sale (as scrap) of such by-products represent, collectively, production for purposes of the equipment, consumption, and environmental quality compliance exemptions. Taxpayer states "[these] exemption[s] appl[y] to all equipment used and materials consumed as 'an essential and integral part of an integrated production process' which produces metallic by-products."

Taxpayer, in this instance, *sells* tangible personal property. Taxpayer *sells* the collected metallic by-products for scrap. Taxpayer, however, does not create a *processed* or *refined* end product. Taxpayer does not place "tangible personal property in a form, composition, or character different from that in which it was acquired." 45 IAC 2.2-5-10(k). Rather, the metallic by-products are *recovered* from industrial waste materials. Such activity does not represent, as taxpayer claims, the selling of byproducts *produced* in the course of taxpayer's business. Taxpayer's labors result in neither a "different product" nor a "refined end product…substantially different from the component materials used." 45 IAC 2.2-5-10(k) and 45 IAC 2.2-5-8(k). Consequently, taxpayer's recovery and collection of metallic by-products from industrial waste cannot, regardless of the label used by taxpayer (e.g., manufacturing, processing, or refining), represent production.

Conclusion

The legislature intended the exemptions at issue to be available only to those engaged in the production of goods or other tangible personal property. See General Motors v. Department of State Revenue, 578 N.E.2d 399, 404 (Ind.Tax 1991) and Mechanics Laundry at 1230. Taxpayer, however, is not engaged in production. Taxpayer produces neither goods nor other tangible personal property. Rather, taxpayer transports, treats, and disposes of hazardous and non-hazardous industrial waste materials. Pursuant to statute, regulation, and relevant case law, taxpayer will not qualify for and may not claim the equipment, consumption, and environmental quality compliance exemptions.

FINDING

Taxpayer's protest is denied.

II. Tax Administration – Negligence Penalty

The Department may impose, in certain situations, a ten percent (10%) negligence penalty. IC 6-8-10-2.1 and 45 IAC 15-11-2. Taxpayer's failure to report and remit use tax generally will result in penalty assessment. IC 6-8.1-10-2.1(a)(1). The Department, however, will waive this penalty if taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "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*. Taxpayer has failed to make such a showing.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER: 97-0298
Indiana Gross and Adjusted Gross Income Tax
For Tax Years 1992 through 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Gross Income Tax – Enterprise Zone Exemption

Authority: IC 4-4-6.1-2.5, IC 6-2.1-3-32; CNB Banchares, Inc. v. Department of State Revenue, 700 N.E.2d 616 (Ind.Tax 1999); St. Mary's Medical Center v. State Bd. of Tax Comm'rs, 534 N.E.2d 277 (Ind.Tax 1989); Caylor-Nickel Clinic v. Dept. of State Revenue, 569 N.E.2d 765 (Ind.Tax 1991)

Taxpayer protests the Department's disallowance of an enterprise zone gross income exemption.

II. Gross, Adjusted Gross, and Supplemental Net Income Tax – Methods Used to Compute Tax Liabilities

Authority: IC 6-8.1-5-1, IC 6-8.1-9-1; 45 IAC 15-9-29(d), 45 IAC 15-11-3

Taxpayer protests the Department's calculation of taxpayer's Indiana income tax liabilities.

III. Tax Administration – Negligence Penalty

Authority: IC 6-8-10-2.1; 45 IAC 15-11-2

Taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a waste management facility in Indiana. Taxpayer's primary business activities involve the collection (removal and site cleanup), transport, treatment, recycling, and disposal of hazardous and non-hazardous waste materials. Taxpayer analyzes incoming waste materials to determine the optimal method for treatment and disposal. Treated waste may be recycled as scrap, disposed of in landfills, or transferred to permitted facilities where such waste can be used as recycled fuel. Taxpayer also provides restoration and remediation services.

For the years subject to audit (1992 – 1994), taxpayer failed to file Indiana income tax returns. To determine taxpayer's Indiana income tax liabilities, Audit inspected relevant taxpayer documents and directed inquiries to appropriate taxpayer personnel. Audit's research resulted in proposed assessments of Indiana income tax. Taxpayer has protested these assessments.

DISCUSSION

I. Gross Income Tax – Enterprise Zone Exemption

In computing taxpayer's Indiana gross income tax liabilities, Audit, according to taxpayer, failed to exclude from taxpayer's Indiana gross receipts certain income derived from sources within an enterprise zone. Taxpayer contends Audit's decision was driven by taxpayer's failure to notify the appropriate enterprise zone board of its intent to claim the exemption.

All qualified increased enterprise zone gross income is exempt from the Indiana gross income tax. IC 6-2.1-3-32. Generally, taxpayers eligible to claim zone business incentives (including the qualified increased enterprise zone gross income exemption) "shall, by letter postmarked before June 1 of each year: (1) submit to the board and to the zone urban enterprise association…a verified summary concerning the amount of tax credits and exemptions claimed by the business in the preceding year; [and] (2) pay the amount specified in section 2(4) of this chapter to the board." IC 4-4-6.1-2.5(a). Failure to comply with these requirements may result in penalties, denial of incentives, or disqualification from further participation in the enterprise zone program. IC 4-4-6.1-2.5(d) and (e). Entitlement to the "increased enterprise zone gross income" exemption of IC 6-2.1-3-32, however, contains no such notification requirement. It is sufficient, for purposes of claiming the exemption, to show the income represented "qualified increased enterprise zone gross income." The statute requires nothing more. (Also see CNB Banchares, Inc. v. Department of State Revenue, 700 N.E.2d 616 (Ind.Tax 1999).

The taxpayer claiming an exemption, however, "has the burden of showing the terms of the exemption statute are met." St. Mary's Medical Center v. State Bd. of Tax Comm'rs, 534 N.E.2d 277, 281 (Ind.Tax 1989). Taxpayer, therefore, must show that it has, in fact, received "qualified increased enterprise zone income" as defined in IC 6-2.1-3-32. Taxpayer, though, has failed to do so.

In Caylor-Nickel Clinic v. Dept. of State Revenue, 569 N.E.2d 765 (Ind.Tax 1991), the Indiana Tax Court found that the timely filing of Form IT-20SC under IC 6-2.1-3-24.5(d) *was not* a condition precedent to obtaining the small business corporation gross income tax exemption provided for in IC 6-2.1-3-24.5(b). Along with its findings, however, the Court offered the following cautionary language:

> Finding IC 6-2.1-3-24.5(d) [timely filing of Form IT-20SC] is not a condition precedent to obtaining the exemption provided in IC 6-2.1-3-24.5(b) [the small business corporation gross income tax exemption], however, does not render the filing requirement meaningless and is consistent with the rule that exemption statutes are construed in favor of imposing tax. IC 6-2.1-3-24.5(d) does impose upon the taxpayer claiming exemption the burden of showing the terms of the exemption statute are met. Consequently, a taxpayer failing to meet this burden, not qualifying for exemption, is subject to assessment.

Id. at 770.

Such logic applies to this controversy as well.

FINDING

Taxpayer's protest is denied.

II. Gross, Adjusted Gross, and Supplemental Net Income Tax – Methods Used to Compute Tax Liabilities

To determine taxpayer's gross receipts for *Indiana gross income* tax purposes, Audit, pursuant to a signed projection agreement (dated 11/25/96), tallied taxpayer invoices for a three-month period. Audit segregated taxpayer's invoiced revenue for the period into revenue earned both from within and without Indiana. The percentage of Indiana sales to total sales for the three-month period was then computed. Taxpayer's annual invoice-generated revenue for each year was multiplied by this ratio to arrive at taxpayer's Indiana gross receipts.

Audit, in order to compute taxpayer's *Indiana adjusted gross income* tax liabilities for the tax period, started with taxpayer's federal income as reported on Federal Form 1120 and then made the appropriate Indiana adjustments pursuant to 45 IAC 3.1-1-5.

Taxpayer has disagreed with these results. Taxpayer explains:

> The Taxpayer did not timely file Indiana tax returns for the years at issue [1992 – 1994]. The Department of Revenue made their adjustments based upon estimates and approximations. The Taxpayer has since filed Indiana returns based upon actual information the Taxpayer has available. The Taxpayer's returns do not agree with the Department's adjustments, and the Taxpayer is therefore requesting an opportunity to reconcile the differences.

When the Department believes a taxpayer has failed to report the proper amount of tax due, pursuant to IC 6-8.1-5-1(a), "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…."

Returns filed by taxpayer *after* the Department has completed its income tax audit and after the Department has sent notices of deficiency to taxpayer will not serve as proxy for timely filed original returns. Taxpayer's delinquent returns, depending on context, may (if respective statutory requirements are met) represent a protest of proposed assessments under IC 6-8.1-5-1(c) or a claim for refund under IC 6-8.1-9-1(a).

To succeed as a *protest of a proposed assessment*, taxpayer's submissions must overcome the *rebuttable presumption* that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." IC 6-8.1-5-1(b). To succeed as a legally cognizable *refund claim*, the claim "must set forth the amount of the refund to which the person is entitled and the *reasons* that the person is entitled to the refund." IC 6-8.1-9-1(a). That is, a valid refund claim must include (1) the amount of refund claimed; (2) a sufficiently detailed explanation of the basis of the claim such that the department may determine its correctness; (3) the tax period for which the overpayment is claimed; and (4) the year and date the overpayment was made. 45 IAC 15-9-29(d).

Taxpayer's request "to reconcile the differences" between the audit assessments resulting in deficiency notices and taxpayer's tax liabilities as represented on its delinquent returns is incomplete. Neither taxpayer's request nor subsequently filed returns provides the Department with the information necessary to determine the basis of taxpayer's protest or refund claim. Because taxpayer's submissions do not rebut the presumption that the assessments were valid, or collectively rise to the level of a refund claim, taxpayer's request to "reconcile the differences" must be denied.

FINDING

Taxpayer's protest is denied.

III. Tax Administration – Negligence Penalty

The Department may impose, in certain situations, a ten percent (10%) negligence penalty. IC 6-8-10-2.1 and 45 IAC 15-11-2. Taxpayer's failure to timely file income tax returns, generally, will result in penalty assessment. IC 6-8.1-10-2.1(a)(1). The Department, however, may waive the penalty if taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "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*. Taxpayer has failed to make such a showing.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS NUMBER 98-007SFT
Special Fuel Tax for the Period
January 1, 1994 – May 31, 1997

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

ISSUES

I. Special Fuel Tax – Imposition –Taxable Event

Special Fuel Tax –Imposition – Imports – Parties Liable

Tax Administration – Special Fuel Supplier's Duties to Collect/Remit Tax

Authority: I.R.C. (26 U.S.C.) §§ 4081-4083 (1994); IC §§ 6-6-2.5-57(b) and -8.1-5-4(a) (1993); IC §§ 6-6-2.5-20, -35 and -40(f) (1993 and Supps. 1994-97); IC § 6-8.1-5-1(b) (1998); Treas. Reg. (26 C.F.R.) §§ 48.4081-1(b) and -2(c)(1) (1996-2002); Treas. Reg. (26 C.F.R.) § 48.4081-1(m) and Temp. Treas. Reg. (26 C.F.R.) § 48.4081-11T(b)(1) (1994-95)

The taxpayer alleges that it is not liable for special fuel tax on fuel sold from five out-of-state terminals in which it maintained inventory positions to several of its customers that have operations in Indiana. The taxpayer argues that information provided by those customers, and its own records, show that the majority of the special fuel was delivered in the respective states of origin, i.e. the states in which the respective terminals from which the taxpayer removed it are located.

II. Tax Administration – Special Fuel Supplier's Duties to Collect/Remit Tax

Special Fuel Tax – Imposition – Imports – Payment of Fuel Tax to State of Export

Authority: IC § 6-6-2.5-30(a)(1) (1993 and Supps. 1994-97)

In the alternative to its argument that most of the assessed fuel remained in its respective states of origin, the taxpayer contends that tax was paid on the fuel to those states.

III. Special Fuel Tax – Imposition – Status of Taxed Substance as Special Fuel

Authority: IC § 6-6-2.5-22 (1993 and Supps. 1994-97); IC § 6-8.1-5-1(b) (1998)

The taxpayer contends that some of the imports of one of its customers were not special fuel, but kerosene, and as such not subject to imposition of special fuel tax.

SUMMARY OF FINDINGS

The taxpayer's protest is sustained in part and denied in part as to Issue I, and denied as to Issues II and III, as discussed below.

STATEMENT OF FACTS

A. Introduction – The Taxpayer/Supplier, Its Customers and the Terminals

1. The Taxpayer/Supplier

Between January 1, 1994 and May 31, 1997 (hereinafter "the audit period") the taxpayer, an out-of-state general partnership formed by two corporations, refined and distributed petroleum products. It engaged in distribution both through its own chain of retail outlets and to customers that had their own chain-outlet retail operations. The taxpayer did business in Indiana during the audit period, maintaining inventory positions in several terminals in the state. For that reason it held an Indiana special fuel supplier's license from January 1, 1994 to April 30, 1997, when the Department cancelled the license at the taxpayer's request incident to the dissolution of the partnership. (The partnership used the supplier's license of one of its corporate partners to wind up the partnership's affairs.) By virtue of its status as a licensed supplier the Department will also refer to the taxpayer in this letter as "the supplier."

2. The Taxpayer's Customers and Terminals

In addition to its supplier's license, on June 30, 1994 the taxpayer executed and submitted to the Department a Tax Precollection Agreement Application (Form SF-10A). It checked Option 1 on that form, which states that an electing supplier or permissive supplier "agree[s] to treat all out-of-state terminal removals of undyed special fuel for export into Indiana, as if they were received in Indiana, and will collect the Indiana special fuel tax from every purchaser." *Id.*

The audit adjustment in issue in this protest assessed the taxpayer's receipt of unreported gallons of special fuel that formed the subjects of certain transactions between it and eight of its customers. However, the supplier submitted documents to the auditor, or documents or argument in support of its protest, as to only seven of these customers, to which the Department will hereinafter refer as Customers A through G. Each special fuel transaction occurred at one of five terminals, located in one of three states adjoining Indiana, in which the taxpayer maintained fuel inventory positions during the audit period.

B. The Supplier's and Customers' Course of Dealing

There is nothing in the record indicating that these customers were agents of the taxpayer, or that the transactions in question were anything other than arms-length sales of special fuel to these customers. All sales were F.O.B. point of origin. All seven customers picked up their purchases with trucks that they owned or hired.

The supplier issued one or more numbered terminal cards to each driver picking up a load of fuel for one of the taxpayer's customers. The driver was to use the card/s to withdraw fuel from the terminal in question. Each card number was linked to a business location of the purchasing customer and also to the destination state for that location. Drivers picking up fuel for customers with multiple locations (e.g., chain-outlet retailers, including several of the customers whose transactions are in issue in this protest) were issued multiple terminal cards. A driver making a pickup would use the card for the customer and (if the customer in question had multiple locations) the location in question, to access the terminal. In addition to the terminal scanner reading the location/destination number on the inserted card, the driver would also manually enter the destination, as well as the product type. The terminal would then dispense fuel into the cargo tank of the driver's truck and create an invoice, and a bill of lading or fuel receipt (hereinafter also referred to as "the shipping paper") for the transaction.

The shipping paper was supposed to indicate the state of destination with a two-letter abbreviation corresponding to those used by the United States Postal Service. However, some shipping papers nevertheless did not clearly indicate a destination state. In the case of Customer A the bill of lading or fuel receipt indicated a destination state of "XX," i.e. did not indicate a destination state. Shipping papers issued to Customers B and C indicated two destination states, one being the state in which the terminal from which they got the fuel was located and the other being shown as "IN" for Indiana. The shipping paper for the single assessed transaction the taxpayer had with Customer E, and all of the shipping papers the auditor examined for transactions between the supplier and Customer F, indicated a destination state of "XX" with "IN" penciled in.

C. The Taxpayer's Sales Records

When the supplier processed the invoice, its computer system would assign a terminal number, a state code for the customer's location and a number for the fuel's destination. From this data the taxpayer would prepare reports indicating, by customer, the locations of the points of origin and destination for each shipment. The supplier used these reports to prepare its special fuel tax returns. However, the former corporate partner that assumed responsibility for the taxpayer's outstanding audits at the time of dissolution did not retain hard copies of these reports, keeping only a data file copy or copies. The contact person for the audit in issue in this protest, the excise tax manager of that former partner, could not access the data file/s, and there was no programmer available to do so. In addition, by the time of the audit, all of the supplier's former tax compliance personnel had taken positions with other businesses.

D. The Audit and Proposed Assessment on the Additional Imports

The auditor compared the special fuel sales schedules supporting the returns the taxpayer filed for the states where the terminals were located with its Indiana Schedules 2x (Gallons Received from Distributor on Exchange) and Schedules 3 (Gallons Imported Via Truck, Barge or Rail, Tax Unpaid) for the audit period. The adjoining states' schedules indicated sales to customers with multiple customer numbers, but the numbers of themselves did not indicate the respective destination states of the various shipments. As noted above, there was neither a remaining hard copy of a master list indicating the respective destination states of each customer's special fuel shipments, nor any compliance personnel of the supplier available with whom to discuss the matter. The auditor therefore was unable to reconcile the adjoining states' special fuel sales schedules with the Indiana Schedules 2x and 3 and inferred that additional untaxed special fuel might have been imported into Indiana.

Accordingly, the auditor asked for and reviewed bills of lading for Customers A, B, D, E, F and G. After having done so, at what was to have been the final audit conference with the taxpayer's contact person, the auditor advised that the Department would be assessing the supplier tax on transactions with these customers. The reasons she gave were the deficient identification of the destination state on the reviewed bills of lading issued to Customers A, B, D and F, and that gallons imported by Customer G had been underreported on Indiana Schedule 3. The auditor instructed the taxpayer's contact person to locate any source documents that would show an exact destination for sales made to Customers A, B and D, the three customers whose fuel purchases formed the bulk of the import adjustment. The auditor at that time also scheduled an additional week of fieldwork to review additional source documents. During that week the supplier's contact person submitted to the auditor printouts of invoices the taxpayer had issued to Customers A, B, D, E and G, all of which purported to show that the respective fuel shipments in question had been shipped to states other than Indiana. At the second final conference the auditor rejected the invoices issued to Customers A, B and D as proof because they suffered from the same deficiencies as the respective bills of lading issued to these customers, and the invoice issued to Customer G showed an Indiana destination. The taxpayer's contact person did not, and as of the date this letter was issued the supplier still had not, submitted source documents to the Department showing clear destination states for the fuel shipments in question.

Based on the auditor's findings, the Department proposed an adjustment that would assess the supplier for special fuel tax on all shipments having bills of lading that indicated a destination state of "XX." In addition, the adjustment included special fuel tax on all shipments of such fuel for which the bill of lading showed an Indiana destination, either alone, by the taxpayer having changed a machine-printed "XX" destination on a bill of lading to Indiana by interlineation, or in combination with a destination in another state. Lastly, the assessment included fuel the taxpayer had sold to Customer G but had failed to report on its Indiana Schedule 3. The proposed assessment also included a separate adjustment assessing special fuel tax on certain other underreported gallons of special fuel not in issue here. One of the supplier's former corporate partners timely protested the additional taxable gallons adjustment on its behalf, and the Department held a telephone conference on the protest.

E. Documents Submitted During the Protest

In support of its original protest letter, the taxpayer submitted photocopies of pages from printouts of sales to in-state customers that purportedly supported one fuel tax return the supplier filed during the audit period with each of the three adjoining states. Each such printout page itemized the supplier's sales by customer name. They each included one of the customers for whose fuel purchases the Department had proposed to assess special fuel tax, and identified each such customer as having a fuel tax license issued by the adjoining state in question. The taxpayer highlighted one or two transactions on each such printout page and included copies of the respective bills of lading for those transactions. One of those bills of lading was for a sale to Customer C and gave a dual destination of Indiana and the adjoining state in which the terminal from which Customer C got the fuel was located. The other bills of lading all gave the destination state as being "XX."

After the Department conducted the telephonic conference on this protest, the supplier submitted a post-conference letter summarizing its position. Along with that letter the taxpayer submitted copies of statements purporting to be from Customers A, B, D, F and G. The statements did not appear to be copies of any source business records, or any other authenticated writings, of these respective customers. The Department therefore presumes that these documents were prepared for purposes of this protest. Although an officer of each customer purportedly signed the statement in question, none of the statements was under oath. Each statement purported to summarize transactions the customer in question had had with the supplier for sample months of the audit period. All of the purported statements used sample months that were after the taxpayer had submitted its Form SF-10A and made its election to precollect special fuel tax, except for the purported statement of Customer F, which covered both the first quarter of 1994 (pre-election) and August 1994 (post-election).

With one exception, the statements purporting to come from Customers A, B, D and F represented that the respective fuel shipments appearing on those statements had been delivered to destinations outside Indiana. That exception again appears on the purported statement of Customer F, which represents that one shipment in March 1994 had an Indiana destination and was reported on its special fuel tax return for that month. The statement purporting to be from Customer G shows that the deliveries listed were made to Indiana, but that a substantial fraction of those shipments allegedly consisted of nontaxable kerosene. The Department will provide additional facts below in the Discussions of the respective issues if and as needed.

I. Special Fuel Tax – Imposition – Taxable Event

Special Fuel Tax – Imposition – Imports – Parties Liable

Tax Administration – Special Fuel Supplier's Duties to Collect/Remit Tax

DISCUSSION

As noted in the Statement of Facts, on June 30, 1994 the supplier executed and submitted to the Department a Tax Precollection Agreement Application (Form SF-10A). It checked Option 1 on that form and thereby "agree[d] to treat all out-of-state terminal removals of undyed special fuel for export into Indiana, as if they were received in Indiana, and [to] collect the Indiana special fuel tax from every purchaser." *Id.* Option 1 tracks, and by electing Option 1 the taxpayer chose to subject itself to, a portion of IC §6-6-2.5-35(j) (1993 and Supps. 1994-97). The General Assembly added subsection (j) to IC § 6-6-2.5-35 in P.L. 18-1994, § 27, 1994 Ind. Acts 423, 440, 443, which took effect July 1, 1994, *id.* at 440. (The General Assembly made no substantive change to IC §6-6-2.5-35(j) during the audit period, although it did make one technical correction to a phrase in this subsection that refers to other sections of IC chapter 6-6-2.5. P.L. 61-1996, § 2, 1996 Ind. Acts 1539, 1542.)

As it read when it took effect, and for the majority of the audit period, IC § 6-6-2.5-35(j) stated in relevant part that:

[A]ny licensed supplier or permissive supplier may make an election with the department to treat all out-of-state terminal removals with an Indiana destination as shown on the terminal-issued shipping paper *as if the removals were received by the supplier in Indiana pursuant to sections 28 and 35(a) of this chapter, for all purposes.*

Id (emphasis added). The definition of "received" in IC § 6-6-2.5-20 (1993 and Supps. 1994-97) states that "[t]he tax imposed under section 28 of this chapter with respect to special fuel removed from terminals within Indiana …, shall be imposed at the same time and in the same manner as the tax imposed by Sections 4081 to 4083 of the Internal Revenue Code [26 U.S.C. §§ 4081-4083 (1994)]." *Id.* The primary taxable event under the current Special Fuel Tax Law, P.L. 277-1993(ss), § 44, 1993 Ind. Acts 4555, 4734-4757, codified as amended at IC chapter 6-6-2.5 (1993 and Supps. 1994-97), therefore occurs when special fuel is "received" as IC § 6-6-2.5-20 defines that word. Removal of special fuel from an Indiana terminal for consumption, use, sale or warehousing, is one of the acts falling within the definition of "received." *Id. Cf.* I.R.C. § 4081(a)(1)(A)(ii) (imposing the federal fuel manufacturer's excise tax on removal of a taxable fuel from any terminal).

Thus, when the present supplier elected Option 1 on Form SF-10A, it chose from that date forward to treat special fuel removed from an out-of-state terminal that had issued a shipping paper showing an Indiana destination *as if it had originally removed that fuel from an Indiana terminal.* The taxpayer thereby also consented to be ultimately liable, as the licensed supplier, for the tax on all special fuel with a shipping paper that showed an Indiana destination and was removed from any out-of-state terminal in which it maintained an inventory position. As quoted above, IC § 6-6-2.5-35(j) treated all of the taxpayer's removals of such fuel (hereinafter "subject special fuel") as being made "pursuant to sections 28 and 35(a) of this chapter, for all purposes." *Id.* IC § 6-6-2.5-28(a) imposes the tax and states that "[t]he tax shall be paid at those times, in the manner, and by those persons specified in this section and section 35 of this chapter." *Id.* IC § 6-6-2.5-28(c) states that "the tax imposed on special fuel by [IC § 6-6-2.5-28](a) …shall generally be determined in the same manner as the tax imposed by Section 4081 of the Internal Revenue Code and Code of Federal Regulations." *Id.* In turn, Temp. Treas. Reg. (26 C.F.R.) § 48.4081-11T(b) (1994-95) stated concerning diesel fuel, and Treas. Reg. (26 C.F.R.) § 48.4081-2(c)(1) (1996-2002) states concerning all taxable fuel, that in general "[t]he position holder with respect to the [, respectively, diesel or taxable] fuel is liable for the [, respectively, diesel or federal fuel manufacturers' excise] tax imposed …." Treas. Reg. § 48.4081-1(m) (1994-95) (current version at Treas. Reg. § 48.4081-1(b) (1996-2002)) defines "position holder" as "the person that holds the inventory position in the taxable fuel, as reflected on the records of the terminal operator." *Id. Accord, see* IC § 6-6-2.5-23 (1993 and Supps. 1994-97) (defining "supplier" in part as being "a person …that owns special fuel in the pipeline and terminal distribution system in Indiana," *id.*). Thus, by electing Option 1 on Form SF-10A, the taxpayer agreed that the Department could treat it as an in-state owner and supplier as to each post-election removal of subject special fuel. It also thereby agreed to be liable for the tax on any such removals.

However, by making its election, the supplier in addition consented to other duties by which it could have shifted, and thereby mitigated, its personal liability for that tax. Specifically, the taxpayer consented to the duties to precollect special fuel tax from its purchasers, and to remit the precollected tax to the Department, that IC §§ 6-6-2.5-28 and -35(a) specify upon a receipt of such fuel. IC § 6-6-2.5-35(a) states that "[t]he tax on special fuel received by a licensed supplier in Indiana that is imposed by section 28 of this chapter shall be collected and remitted to the state *by the supplier who receives taxable gallons*…." *Id* (emphasis added). The first sentence of IC § 6-6-2.5-35(c) elaborates on a supplier's duty to collect, stating that "[a] supplier who sells special fuel shall collect *from the purchaser* the special fuel tax imposed under section 28 of this chapter." *Id* (emphasis added). Finally, IC § 6-6-2.5-28(c) states that "the tax imposed on special fuel by [IC § 6-6-2.5-28](a) shall be measured by invoiced gallons of nonexempt special fuel received by a licensed supplier in Indiana for sale or resale in Indiana …." *Id.* Thus the taxpayer, a licensed supplier, consented by making its election under IC § 6-6-2.5-35(j) that from that date on it would precollect special fuel tax, and remit to the Department the tax precollected, from each purchaser of subject special fuel, measured by the gallons invoiced to that purchaser.

The taxpayer argues that the majority of the additional taxable gallons remained in their respective states of origin, thereby implying that liability for Indiana special fuel tax never attached as to those gallons. The supplier has submitted the unauthenticated statements purporting to be from Customers A, B, D and F in support of its argument. However, that circumstance, even if true, and the purported evidence, even if it were authentic, are irrelevant to the previously discussed subjects of the taxpayer's liability for, and its duties to precollect from its customers and remit to the Department, the special fuel tax. The only questions, and the only evidence, bearing on those subjects on this record, are whether the supplier made a valid, binding election of Option 1 on Form SF-10A pursuant to IC § 6-6-2.5-35(j), and whether the taxpayer left any such election in effect. It has not disputed or offered evidence on either of these points. Since the answer to both questions is therefore "yes," then on these facts the supplier's liability for the tax on each removal of subject special fuel, and its duties to precollect and remit that tax on every such removal, became absolute as a matter of law once the election took effect.

The location of the ultimate destination of each shipment is thus simply irrelevant to the existence of that liability and those duties, which as a matter of simple chronology if nothing else plainly attached as to each shipment at the time of its origin, not of its arrival at its destination. Moreover, the taxpayer had no control over the ultimate destination of the fuel in any case, since there is no evidence in the record that any of the customers were acting as the supplier's agents or that the transactions in question were anything other than straightforward sales of fuel to those customers. Any entitlements to abatements of special fuel tax due to diversions of shipments from Indiana or failures to print proper destination information on the terminal-issued shipping papers would have arisen only if the customers had paid the taxpayer the special fuel tax on their respective shipments. *See* IC § 6-6-2.5-40(f) (providing a right to claim a refund of special fuel tax in cases where the fuel was diverted or the terminal operator printed improper information on the shipping paper). More importantly, since it was the customers who would have paid the taxes, while the supplier would have merely remitted the taxes it precollected, any rights to claim refunds under such circumstances therefore would have been those of the respective customers, not the taxpayer. *See id* (so implying).

The supplier's argument thus is one that it lacks standing to make, and also relies on later actions of other parties to determine whether the taxpayer's ultimate liability for, and its duties to precollect and remit, tax on the subject special fuel existed in the first place. The Department will not interpret a listed tax statute in such a way as to render it a nullity. Relying on 20/20 hindsight to decide whether the liability, precollection and remittance provisions of IC §§ 6-6-2.5-28 and -35 apply would have exactly that effect on those statutes. Given the consequences of adopting the supplier's position, the Department views it as an attempt by the taxpayer to avoid that liability and those duties that were the consequences of its own election and that it thereby freely chose to assume. The Department must therefore reject the supplier's argument.

Even if the Department were to accept the taxpayer's argument on its own terms, however, the documents it has submitted, and its failure to submit other documents, would cause that argument to fail. As previously noted, the statements purporting to be from Customers A, B, D and F are not regularly maintained business records of those customers, were prepared for the specific purpose of use in this protest and are not under oath or otherwise authenticated. Those circumstances alone render them suspect. In addition, however, the supplier has failed to point to any of its own source records that would persuade the Department that the contents of the purported statements of Customers A, B, D and F were true. Nor is it likely that it can do so, since as of the date of this letter it has still failed to produce source records showing exact destinations for the subject special fuel, as the auditor originally had requested during the fieldwork as to Customers A, B and D. The printouts of invoices issued to Customers A, B, D, E and G that the taxpayer did produce during the third week of fieldwork were insufficient evidence of destination, and therefore did not comply with the auditor's request. They were not "terminal-issued shipping paper[s]" as the Special Fuel Tax Law uses that term, i.e. they were not bills of lading, fuel receipts or equivalent documents. The shipping papers of Customers A, B, D, E and F that the auditor was able to review were deficient; they indicated either that Indiana was the destination or a possible destination, or failed to indicate another state as the sole destination, of the fuel they respectively covered. The bills of lading the supplier submitted in support of its original protest letter suffered from the same deficiencies.

IC § 6-8.1-5-4(a) (1993) states:

> (a) 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. The records referred to in this subsection include all source documents necessary to determine the tax, ….

Id. In addition, IC § 6-6-2.5-57(b) (1993) states that "[f]or purposes of reporting and determining tax liability under this chapter, every licensee shall maintain inventory records as required by the department." *Id.* The taxpayer failed in both of these duties, and as a result did not have the records available with which it could have supported its argument. Thus, even if that argument were relevant, the supplier has failed to sustain its burden of proving it. *See* IC § 6-8.1-5-1(b) (1998) (stating that "[t]he burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.").

However, the taxpayer's liability for the tax on the subject special fuel does not cover the entire audit period. As noted at the beginning of this Discussion, IC § 6-6-2.5-35(j) did not take effect until July 1, 1994, i.e. the beginning of the third quarter of 1994. Since the statute was not in effect for the first two quarters of 1994, the supplier could not have made an election to assume any liability for, or duties to precollect and remit, tax on any special fuel removed from the out-of-state terminals during those quarters. Accordingly, the Department sustains the taxpayer's protest as to this issue to that extent, but only to that extent.

FINDINGS

The taxpayer's protest is sustained in part and denied in part as to this issue. The taxpayer's protest is sustained as to all special fuel tax assessed on fuel removed from the out-of-state terminals and sold to the taxpayer's customers during the first two quarters of 1994, and is denied as to the rest of the audit period.

II. Tax Administration – Special Fuel Supplier's Duties to Collect/Remit Tax

Special Fuel Tax – Imposition – Imports – Payment of Fuel Tax to State of Export

DISCUSSION

In the alternative to its argument that most of the assessed fuel remained in its respective states of origin, the supplier contends that tax was paid on the fuel to those states. However, the taxpayer has not been consistent in contending who paid those taxes. In its original protest letter it implied that its various customers had paid the taxes, offering the copies of printout pages it filed in support of its fuel tax returns with the adjoining states. During the telephonic conference with the hearing officer on this protest, however, the supplier stated that it had paid the taxes to the exporting states. Finally, the unauthenticated statement purporting to be from Customer F states that it paid the tax on one shipment of special fuel on its March 1994 special fuel tax return.

Who, if anyone, paid taxes on the subject special fuel to the states of export, is irrelevant to whether the taxpayer is liable for Indiana tax on the subject special fuel. The Special Fuel Tax Law contains no provisions for granting an exemption from, or credit against, that tax for fuel tax paid to another state on the same fuel. The only provision in that law that even comes close is IC § 6-6-2.5-30(a)(1) (1993 and Supps. 1994-97), which exempts special fuel on which special fuel tax has been paid to another state if that fuel is destined for export to that state, not import into Indiana. Even if the Special Fuel Tax Law did provide for abatement of tax for fuel tax paid to another state, the taxpayer presumably would not have standing to claim such relief if its customers, entities unrelated to the supplier, were the ones who had actually paid such taxes. (The Department notes in this connection that the purported transaction involving Customer F occurred in March 1994, i.e. before IC § 6-6-2.5-35(j) took effect. The taxpayer therefore could not then have been primarily liable for, and could not then have had duties to precollect and remit, tax incurred in connection with any transactions with Customer F in any case.) Nor, presumably, would the supplier have standing to file claims for refund for those taxes in the states of export. The copies of the printouts the supplier submitted in support of its fuel tax returns to the adjoining states are therefore not relevant evidence that the taxpayer is not liable for Indiana special fuel tax.

Accordingly, if the supplier (not its customers) paid fuel taxes on the subject special fuel to the states of export, it would have to claim refunds from those states, not seek an abatement of assessed, unpaid special fuel tax in this state.

FINDING

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

III. Special Fuel Tax – Imposition – Status of Taxed Substance as Special Fuel

DISCUSSION

The supplier had reported all of the gallons of fuel sold to Customer G on the taxpayer's schedules of fuel sold to licensed customers filed with the exporting state. However, it reported a lower number of gallons for some of those transactions on its Indiana Schedules 3, and the auditor assessed tax on the difference between the two figures as unreported gallons. The taxpayer now contends that some of the imports of Customer G were not special fuel, but kerosene, and as such not subject to special fuel tax. In support of its argument, it offers the purported statement of that customer.

The definition of "special fuel" in IC § 6-6-2.5-22 (1993 and Supps. 1994-97) does exclude kerosene. *Id.* However, the purported statement from Customer G suffers from the same evidentiary deficiencies described generally under Subsection E of the Statement of Facts and as to Customers A, B, D and F in particular in the Discussion of Issue I above. The Department incorporates those remarks by reference as if fully set out here. In addition, there are no copies of source records in the auditor's workpapers, nor has the supplier submitted any source records, that would corroborate its assertion. Accordingly, the taxpayer has failed to sustain its burden of proof that the unreported gallons it sold to Customer G were nontaxable kerosene. *See* IC § 6-8.1-5-1(b) (1998) (stating that "[t]he burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.").

FINDING

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

DEPARTMENT OF STATE REVENUE

04990350.LOF

LETTER OF FINDINGS NUMBER: 99-0350
Retail Sales Tax, Withholding Tax
For the Tax Periods: 1995 through 1997

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

ISSUE

I. Retail Sales Tax, Withholding Tax – Responsible Officer Liability

Authority: IC 6-2.5-9-3, IC 6-3-4-8, IC 6-8.1-5-1, IC 6-2.5-2-2, *Department of Revenue v. Safayan*, 654 N.E.2d 270, 273 (Ind. 1995), 11 U.S.C. §507(a)(7)

The Taxpayer disputes the determination that he had a duty to remit the corporation's sales tax and withholding tax.

II. Retail Sales Tax, Withholding Tax – Returned Check

Authority: IC 6-8.1-8-1, IC 6-2.5-9-3, IC 6-8.1-10-5

The Taxpayer disputes the 100% penalty for a returned check.

STATEMENT OF FACTS

Taxpayer was assessed for retail sales and withholding taxes as a responsible officer. Taxpayer was listed as the President of the corporation at the Secretary of State's Office. The Department's records indicate the corporation closed in 1998. Taxpayer subsequently petitioned for Bankruptcy under Chapter 7. More facts will be provided as necessary.

I. Retail Sales Tax, Withholding Tax – Responsible Officer

DISCUSSION

A gross retail (sales) tax is imposed on retail transactions made in Indiana. IC 6-2.5-2-1. While this sales tax is levied on the purchaser of retail goods, it is the retail merchant who must "collect the tax as agent for the state." IC 6-2.5-2-2. Individuals may be held personally responsible for failing to remit any sales tax. Pursuant to IC 6-2.5-9-3:

An individual who:

(1) is an individual retail merchant or is an employee, officer, or member of a corporate or partnership retail merchant; and

(2) has a duty to remit state gross retail or use taxes to the department; holds those taxes in trust for the state and is personally liable for the payment of those taxes, plus any penalties and interest attributable to those taxes, to the state.

In addition, withholding taxes were assessed against the Taxpayer pursuant to IC 6-3-4-8(f), which provides that " [i]n the case of a corporate or partnership employer, every officer, employee, or member of such employer, who, as such officer, employee, or member is under a duty to deduct and remit such taxes shall be personally liable for such taxes, penalties, and interest."

IC 6-8.1-5-1 specifically provides that notice of a proposed assessment is *prima facie* evidence that the Department's claim for the unpaid tax is valid. It is the burden of the taxpayer to prove that the proposed assessment is wrong.

Taxpayer concedes he was President of the corporation, but states that he is not responsible for the tax liabilities. Taxpayer provided the Department with copies of letters and invoices sent to the Secretary of the company and argues that the Secretary is solely responsible. The documents sent contain notes allegedly made by the Secretary and purport to demonstrate that he handled the bills. Taxpayer stated that the Secretary embezzled from the company although no evidence of criminal or civil action against the Secretary was provided. Taxpayer also provided a copy of a Master Demand Business Loan Note for the corporation signed by the Secretary. However, the note also requires Taxpayer to provide an annual personal financial statement.

Pursuant to *Indiana Department of Revenue v. Safayan*, 654 N.E.2d 270, 273 (Ind. 1995): " The statutory duty to remit trust taxes falls on any officer or employee who has the authority to see that they are paid". Also, the court stated, "where the individual was a high ranking officer, we presume that he or she had sufficient control over the company's finances to give rise to a duty to remit the trust taxes." *Id.* Here, the Taxpayer held the title of president.

From these facts, the Department must conclude that Taxpayer was properly named a responsible officer. As President, Taxpayer had control and authority over the company's finances to ensure that the trust taxes were paid. Therefore, pursuant to IC 6-2.5-9-3 and IC 6-3-4-8, Taxpayer had a duty to remit the sales and withholding taxes to the State of Indiana.

Taxpayer also provided a copy of Taxpayer's Chapter 7 Bankruptcy. However, the Department has an unsecured priority claim pursuant to 11 U.S.C. §507(a)(7), thus, this does not relieve Taxpayer of his obligation to the State of Indiana.

FINDING

The Taxpayer's protest is denied.

II. Retail Sales Tax, Withholding Tax – Returned Check

Taxpayer protests the assessment for a returned check dated May 7, 1998 made by the corporation. Taxpayer sent in a money order postmarked October 4, 1998 and did not include the 100% penalty. Taxpayer was assessed as a responsible officer for the difference. The liability was paid in March 2000.

Pursuant to IC 6-8.1-8-1, if a person pays a tax liability by check, bank draft, cashier's check, or money order, "the liability is not discharged and the person has not paid the tax until the draft, check, or money order has been honored by the institution on which it is drawn." An individual who is considered a responsible officer is liable to remit sales tax. IC 6-2.5-9-3.

Also, IC 6-8.1-10-5 states:

(a) If a person makes a tax payment with a check and the department is unable to obtain payment on the check for its full face amount when the check is presented for payment through normal banking channels, a penalty of ten percent (10%) of the unpaid tax or the face value of the check, whichever is smaller, is imposed.

(b) When a penalty is imposed under subsection (a), the department shall notify the person by mail that the check was not honored and that the person has ten (10) days after the date the notice is mailed to pay the tax and the penalty either in cash, by certified check, or other guaranteed payment. If the person fails to make the payment with the ten (10) day period, the penalty is increased to one hundred percent (100%) multiplied by the face value of the check or the unpaid tax, whichever is smaller….

Taxpayer missed the 10 day deadline to pay the liability before the liability increased to include the 100% penalty. Thus, when Taxpayer sent in the money order for the original assessment, there remained an outstanding balance created by the addition of the penalty. Consequently, the assessment was valid.

FINDING

The Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04990406
04990540.LOF

LETTER OF FINDINGS NUMBERS: 99-0406; 99-0540
Indiana Gross Retail Tax
For the Tax Years 1987 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Sales Tax Assessments

Authority: IC 6-2.5-2-1; IC 6-2.5-2-1(b); IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 2.2-4-8; 45 IAC 2.2-4-8(a); 45 IAC 2.2-4-8(b)

Taxpayers argue that the audit erred in assessing their sales tax liability. Taxpayers maintain that the audit either overstated the amount of tax due or that the audit misunderstood that extent and nature of their business transactions.

STATEMENT OF FACTS

Taxpayers, as husband and wife, are in the business of selling certain items to tourists at various festivals. One of these festivals is located within the state. Taxpayer wife sold wood craft items. The audit found that taxpayer husband sold "golf carts and gaming equipment." In addition, taxpayers owned land on which numerous transient vendors also sold tourist items. Taxpayers rented the individual parcels of land – including small display booths – to these other vendors.

Taxpayers have operated their various businesses – to a greater or lesser degree – for the last ten years. During those years, taxpayers failed to file Indiana income tax returns. Except on one occasion, taxpayer's failed to pay sales tax owed to the state. It is uncertain if the taxpayers ever filed federal income tax returns.

The audit conducted an investigation of taxpayers' available business records and assessed the taxpayers for unpaid income and sales taxes. Taxpayers submitted a protest challenging both the extent and the amount of the assessments. An administrative hearing was held, and this Letter of Findings – addressing only the sales tax issues – followed.

DISCUSSION

I. Sales Tax Assessments

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 otherwise applicable. The statute requires that, "The retail merchant shall collect the tax as agent for the state." IC 6-2.5-2-1(b). In addition, 45 IAC 2.2-4-8(a) imposes sales tax on income derived from the "renting or furnishing for periods of less than thirty (30) days any accommodation including booths [or] display spaces...."

A. Sales of Craft Items

Taxpayer wife sold craft items to festival tourists. In the absence of other available information, the audit assessed sales tax based on the amount of taxpayer wife's gross income as set out in the taxpayers' pro forma federal returns. The tax was assessed for nine years; 1988, 1989, 1990, 1991, 1992, 1993, 1995, 1996, and 1997. No sales tax was assessed for 1994 because taxpayers made a single payment of sales tax that year.

The taxpayers do not challenge the amount of gross income attributed to taxpayer wife and received during the nine years. Taxpayers do maintain that a certain amount of that gross income was derived from sales which occurred outside the state.

Taxpayers have provided financial information differentiating the amount of income taxpayers received in Indiana from the amount of income received in various other states. The gross income amounts set out in the supplementary information comports with the original information contained in the pro forma federal returns.

The audit report's original conclusions are presumed correct. IC 6-8.1-5-1(b) states in part that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." Faced with the audit report's original conclusions, "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Id.

Taxpayers have met their burden of demonstrating that a portion of their yearly gross income received from craft sales was earned in states other than Indiana. The sales tax assessment related to taxpayer wife's craft sales should be adjusted to reflect the amount of sales income derived within the state.

B. Sale of Golf Carts and Gaming Machines

The audit determined that taxpayer husband was engaged in selling golf carts and gaming devices (pinball machines) during the Indiana tourist festival. The audit reported that the taxpayers were unable to provide information sufficient to calculate taxpayer husband's income from these sales. Therefore, the audit estimated the amount of sales income and assessed sales tax accordingly. The audit did so under the provisions of IC 6-8.1-5-1(a) which states, "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." As stated above, this "proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid." IC 6-8.1-5-1(b).

Taxpayer husband disagrees with the audit's conclusions and denies that he ever received income from the sale of golf carts and gaming devices. Taxpayers maintain that the golf carts were acquired pursuant to an unsuccessful plan to rent the golf carts to tourists. After the initial plan failed, taxpayer husband states that – with one exception – the golf carts were given away.

In regards to the gaming machines, taxpayers maintain that the devices were actually sold by a third-person. Taxpayers provided evidence purporting to establish that this third-person was in the business of selling the gaming machines. Taxpayers offer the theory that the audit incorrectly assumed taxpayers were selling these items because, on occasion, taxpayers would provide assistance to the third-person.

The audit report – completed in 1999 – stated that between eight and ten auditors worked at the Indiana festival beginning in 1994 and that each of the auditors witnessed taxpayer husband selling golf carts and gaming machines. In addition, the report indicated that all of the auditors from the district office witnessed taxpayer husband selling golf carts and gaming machines each day of ten-day festival. One of the auditors indicated that taxpayer husband offered to sell that particular auditor a golf cart. Finally, the records indicate that the third-person – cited by taxpayers as the individual responsible for actually selling the gaming machines – has never paid Indiana sales tax.

Taxpayers have failed to rebut the presumption of correctness afforded the assessment at issue. The sales tax assessment related to the sale of golf carts and gaming machines will not be abated.

C. Lease Income

Taxpayers own real property at the Indiana tourist festival site. Taxpayers rent small parcels of this land to transient vendors. In 1987, taxpayer owned and rented 11 of these individual parcels. By 1997, taxpayers' holdings had substantially increased, and taxpayer owned more than 100 parcels. Taxpayers reported none of these revenues for income tax or sales tax purposes.

Beginning in 1999, taxpayers were asked to supply copies of the lease agreements with the various vendors. At that time, taxpayers were either unwilling or unable to comply with the repeated requests for copies of the lease agreements. Accordingly, in the absence of contrary information, the audit used taxpayers' pro forma federal returns to determine the taxpayer husband's rental income for 1987 through 1997. On the ground that the parcels were rented for less than 30 days, the audit assessed sales tax on the rental income reported on the federal pro forma returns. The audit assessed sales tax under 45 IAC 2.2-4-8 which states, in relevant part, as follows:

> For the purpose of the state gross retail tax and use tax: Every person engaged in the business of renting or furnishing for periods of less than thirty (30) days any accommodation including booths, display spaces and banquet facilities, in any place where accommodations are regularly furnished for a consideration is a retail merchant making retail transactions in respect thereto and the gross income received therefrom shall constitute retail income from retail unitary transactions. 45 IAC 2.2-4-8(a).

Taxpayers argues that, under 45 IAC 2.2-4-8(b), they are not liable for the sales tax assessment because individual parcels were rented for an entire year. The rule states that, "In general, the gross receipts from renting or furnishing accommodations are taxable. An accommodation which is rented for a period of thirty (30) days or more is not subject to the gross retail tax." Taxpayers maintain that the vendors who rent one of the parcels have access to the site during the entire year. According to taxpayers, the use of the parcels is not confined to a single annual festival but that a number of festivals are held at the same site throughout the year.

Subsequent to the hearing, taxpayers provided copies of lease agreement receipts. Taxpayers provided information attributable to 18 separate agreements, involving six different lessees, spanning the years from 1989 to 1996. The lease receipts state that the agreement term was to run from "November 1 to October 31." The rate schedule specifically refers to a single, 10-day tourist festival but also states that the individual lessee should "let us [the lessors] know if you need electricity for any of the other festivals."

The information provided by taxpayers indicates that the general purpose of the lease agreement was to provide the lessee with a vendor space for the particular 10-day tourist festival. However, the information would also indicate that the lease agreement was for a one-year term and that each lessee was paying for the privilege of using the vendor space for one year. Therefore, under IC 6-8.1-5-1(b), the taxpayers have met their burden of proof necessary to demonstrate that the lease agreements – here at issue – spanned a one-year term. Under 45 IAC 2.2-4-8(b), the income attributable to these agreements was not subject to the gross retail tax. Accordingly, the sales tax assessment should be adjusted to reflect that determination.

FINDING

The taxpayers' protest is sustained in part and denied in part.

DEPARTMENT OF STATE REVENUE

02990553.LOF

LETTER OF FINDINGS NUMBER: 99-0553
Indiana Corporation Income Tax
For Years 1994 to 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana

Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Property Taxes Attributable to Leased Office Equipment – Gross Income Tax

Authority: IC 6-8.1-5-1(b); 45 IAC 1-1-10; 45 IAC 1-1-28

Taxpayer argues that, in calculating its gross income liability, the audit erred in including amounts attributable to the payment of property taxes.

II. Income Derived from Sales of Used Office Equipment – Gross Income Tax

Authority: 45 IAC 1-1-8; 45 IAC 1-1-107

Taxpayer argues that, in determining its gross income tax liability, the audit erred in including amounts attributable to sales of used office equipment.

STATEMENT OF FACTS

Taxpayer is in an out-of-state entity in the business of leasing office equipment such as copiers, computers, printers, and other similar items. Taxpayer purchases this equipment from its parent company, stores the equipment at various warehouses, and operates sales and service offices throughout the United States including an office located in Indiana. The Department conducted an audit of taxpayer's business records resulting in the assessment of additional corporate income tax. Taxpayer disagreed with the audit results and submitted a protest. The Department conducted an administrative hearing, and this Letter of Finding results.

DISCUSSION

I. Property Taxes Attributable to Leased Office Equipment – Gross Income Tax

In reviewing taxpayer's records, the audit concluded that amounts for "the payment of personal property taxes on the leased equipment" should have been included in the calculation of taxpayer's gross income tax liability. Accordingly, the audit made an adjustment to include "personal property taxes."

Taxpayer protested that adjustment arguing that, "In all rental contracts [taxpayer] includes personal property tax as a factor in determining the cost to the customer." Taxpayer believes that the audit incorrectly "added back" the property tax amounts to its rental income and that the audit is "double counting this number." In response, the audit requested that taxpayer substantiate its claim and – to that end – requested a copy of taxpayer's lease agreement. Taxpayer apparently declined to provide the requested document.

At the time of its protest, taxpayer provided a document purporting to establish that taxpayer considers "prop taxes" in calculating lease payments. Taxpayer refers to this document as its "model."

Specifically relevant to taxpayer's own income is 45 IAC 1-1-28 which states that "Rental income is any payment, in cash or other form, for the possession or use of real or tangible personal property for a limited period time. The gross receipts, without any deductions, derived from the lease or rental of real or tangible personal property, whether actually or *constructively received* are taxable at the higher rate...." (*Emphasis added*).

45 IAC 1-1-10 defines "constructive receipts" stating such receipts "are those items of gross income which are not actually received by the taxpayer but which are credited to him, available for his withdrawal, paid to another for his benefit, or represent income to which he is entitled."

It is not disputed that taxpayer retains ownership of the equipment it leases to its customers. It is not disputed that taxpayer is responsible for the payment of any property taxes attributable to the ownership of that equipment. However, it is unclear as to the manner in which taxpayer accounts for the payment of the property tax. Taxpayer's "model" suggests that the cost of the property tax on each item of leased equipment is simply passed along as an undifferentiated portion of the lease charge. For example, taxpayer charges customers $1,200 a year in lease payments, $100 of that amount is designated for property taxes, customer pays taxpayer $1,200 each year, and taxpayer forwards the designated $100 to the taxing jurisdiction. If such is the case, the amount designated as property tax – $100 in the example – is one portion of the taxpayer's rental income under 45 IAC 1-1-28 and is properly included as part of taxpayer's gross income.

However, taxpayer also intimates that the cost of the property tax is "not directly billed to the customer." This suggests that responsibility for payment of property taxes is, by means of the lease agreement, assigned to each individual lessee and that the lessee pays the amount of property tax directly to the local taxing authority. If such is the case, taxpayer may also not be heard to complain because that amount is one portion of the taxpayer's "constructive receipts" as defined under 45 IAC 1-1-10. In such circumstances, the individual lessee pays the property tax assessment for the benefit of the taxpayer.

However, taxpayer raises a third basis for its protest. Taxpayer suggests that the audit "double counted" property taxes by including the property tax when it was included in its gross rental receipts and then counting the same amounts a second time when the property taxes were listed separately in taxpayer's records. Taxpayer has presented nothing which would lead to the conclusion that the audit made such a procedural or factual error. Taxpayer's bare assertion that the audit added an amount of property taxes twice over does not meet its burden of demonstrating the proposed assessment is incorrect. Under IC 6-8.1-5-1(b), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

FINDING

Taxpayer's protest is respectfully denied.

II. Income Derived from Sales of Used Office Equipment – Gross Income Tax

The audit included, as one portion of the taxpayer's gross income, amounts attributable to the sale of used office equipment. Taxpayer challenged this determination arguing that the audit was "double counting this number." Taxpayer provided the audit with a one-page workpaper purporting to establish "How [Taxpayer] Does It." The workpaper suggests that amounts attributable to the disposal of used equipment are listed once as "cash" and once as "sales." This particular workpaper was also provided at the time taxpayer submitted its protest.

The audit concluded that "taxpayer claims that there was no valid sale of the lease equipment but only a book transaction for the disposition of the lease equipment." The audit rejected taxpayer's initial claim that the amounts were "not to be considered as proceeds subject to gross income tax."

45 IAC 1-1-107 provides in part as follows:

> Taxpayers engaged in leasing tangible personal property hold such property as a capital or depreciable asset during the time it is leased. If such assets are sold upon their return to the lessor, or because of the lessee's exercise of an option to purchase, receipts from the sale are taxable at the higher rate. However, if such assets are sold in the regular course of the taxpayer's business, the property has character as inventory and the receipts from the sale are taxable at the lower rate.

By whatever means taxpayer arranges for the sale of the used equipment, under 45 IAC 1-1-107, the audit correctly concluded that those amounts – regardless of "loss on disposal" or "accumulated depreciation" – were one portion of the taxpayer's receipts under 45 IAC 1-1-8.

Again, taxpayer's suggestion that the audit counted the receipts twice is unsupported. There is no indication that the audit counted the receipts found on one page of the taxpayer's records and added that amount to a duplicate record of those same receipts found at another location.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

01990560.LOF

LETTER OF FINDINGS NUMBER: 99-0560
Individual Income Tax
For the Tax Period: 1997

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

ISSUE

I. Individual Income Tax – Notification

Authority: IC 6-8.1-5-1, IC 6-8.1-5-2

Taxpayer protests the timeliness of the assessment.

II. Individual Income Tax – Military Service Deduction

Authority: *Davis v. Michigan Department of the Treasury*, 489 U.S. 803, (1989), IC 6-3-2-4, IC 6-8.1-5-1

Taxpayer protests the adjustment to his Military Service Deduction.

III. Individual Income Tax – Residency

Authority: IC 6-3-1-12, IC 6-8.1-5-1

Taxpayer protests being considered an Indiana resident.

STATEMENT OF FACTS

Taxpayer was assessed income tax on his 1997 IT-40 (Indiana full-Year Resident Tax Return) after Taxpayer's Military Service Deduction was adjusted. Taxpayer failed to appear at the hearing. The Letter of Findings is based on information contained in the file. More facts will be provided as necessary.

I. Individual Income Tax – Notification

DISCUSSION

Taxpayer protests the timeliness of the assessment. Taxpayer received the proposed assessment for his 1997 individual income tax return in April 1999.

IC 6-8.1-5-1 states: "[i]f the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department." Also, IC 6-8.1-5-2(a) states the Department may not issue, unless otherwise provided, a proposed assessment more than three (3) years after the latest of either the date the return was filed or the due date of the return. In either case, the Department was within the period allowed by law to make the assessment.

FINDING

The Taxpayer's protest is denied.

II. Individual Income Tax – Military Service Deduction

DISCUSSION

Taxpayer's return exceeded the two-thousand dollar ($2,000) deduction allowed for the Military Service Deduction. Taxpayer claims that his military retirement is not taxable. Taxpayer has not demonstrated that he is sixty (60) years of age.

Taxpayer argues that his military retirement income is not taxable pursuant to *Davis v. Michigan Department of the Treasury*, 489 U.S. 803, (1989). In *Davis*, the Supreme Court held that states cannot tax federal pensions while exempting state employee pensions under principles of intergovernmental tax immunities. *Id*. at 817. However, this argument is irrelevant because Indiana does not exempt state employee pensions from taxation.

However, Indiana does offer a deduction for military retirement income. IC 6-3-2-4 states:

> Each taxable year, an individual, or the individual's surviving spouse, is entitled to an adjusted gross income tax deduction for the first two thousand dollars ($2,000) of income, including retirement or survivor's benefits, received during the taxable year by the individual, or the individual's surviving spouse, for the individual's service in an active or reserve component of the armed forces of the United States, including the army, navy, air force, coast guard, marine corps, merchant marine, Indiana army national guard, or Indiana air national guard. However, a person who is less than sixty (60) years of age on the last day of the person's taxable year, is not, for that taxable year, entitled to a deduction under this section for retirement or survivor's benefits.

"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 not demonstrated that he has met the age requirement and regardless of his age, has exceeded the $2,000 limit for the deduction.

FINDING

Taxpayer's protest is denied.

III. Individual Income Tax – Residency

DISCUSSION

Taxpayer states that he was not a resident of Indiana during the period in question because he was serving in the military. Taxpayer filed a Full Year Resident return (IT-40) for 1997. IC 6-3-1-12 defines a resident to include "(a) any individual who was domiciled in this state during the taxable year, or (b) any individual who maintains a permanent place of residence in this state and spends more than one hundred eighty-three (183) days of the taxable year within this state..." "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 signed and sent in a 1997 IT-40. Taxpayer has conceded to being an Indiana resident and has not provided any evidence to overturn his assertion.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02990654.LOF

LETTER OF FINDINGS NUMBER: 99-0654
Adjusted Gross Income Tax – Unitary Filing Status
Fiscal Years 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. Adjusted Gross Income Tax – Unitary Filing Status

Authority: *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct.

3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983); IC 6-3-2-2(l); IC 6-3-2-2(p); IC 6-3-2-2(q); 35 ILCS 5/1501(a)(27); Tenn.Code Ann. § 67-4-2004(25)(B)

Taxpayer protests the Audit Division's subsequent disallowance of unitary combined filing status, for purposes of the taxpayer's combined adjusted income tax return for fiscal years 1996 and 1997, on the basis that the combined return inaccurately reported taxpayer's Indiana source income.

II. Adjusted Gross Income Tax – Unitary Filing Status – Retroactive Withdrawal of Permission to File Unitary

Authority: IC 6-3-2-2

Taxpayer claims that if the Department finds that it does not qualify to file on a unitary basis with its parent corporation and the members of the recreational vehicle group for Indiana tax purposes, then alternatively taxpayer and the original members of the recreational vehicle group that filed Indiana tax returns for the tax years in question should have been allowed to file on a consolidated basis with the parent corporation. As such, taxpayer protests the Audit Division's retroactive withdrawal of its grant of permission to allow taxpayer and the original members of the recreational group that filed Indiana tax returns to file unitary combined returns.

III. Adjusted Gross Income Tax – Consolidated Returns

Authority: None

Taxpayer claims that the Department erred in requiring taxpayer and the five additional members of the recreational vehicle group that filed Indiana tax returns to file separate tax returns.

IV. Adjusted Gross Income Tax – Throwback Sales

Authority: *Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 112 S.Ct. 2447 (1992); *Indiana Dept. of State Revenue v. Continental Steel Corp.*, 399 N.E.2d 754 (Ind. Ct. App. 1980); IC 6-3-2-2; IC 6-8.1-5-1; 45 IAC 3.1-1-64; Public Law 86-272 (15 U.S.C.A. §381-385)

Taxpayer raises for the first time at hearing the following issue: whether taxpayer and the original members of the recreational group that filed Indiana tax returns erred in classifying sales to states other than Indiana as throwback sales.

STATEMENT OF FACTS

Taxpayer's parent corporation (hereinafter, "Parent") is a holding company for various companies located in the United States and Canada which manufacture recreational vehicles. By a letter dated August 25, 1995, Parent petitioned the Department of Revenue for permission to file a combined return with all fourteen of its recreational vehicle subsidiaries (hereinafter referred to collectively as the "RV Subsidiaries") based upon the premise that they formed a unitary group. In its petition, Parent maintained that the RV Subsidiaries were one hundred percent (100%) owned by Parent; that the entities are all engaged in the same line of business; that the entities share common directors and common management; and, that filing separate company returns would not fairly reflect Indiana income.

In a letter dated October 10, 1995, and based upon the information submitted by Parent, the Indiana Department of Revenue granted Parent's petition to file unitary combined returns as a unitary group with five of the fourteen RV Subsidiaries for fiscal year 1995 forward. Specifically, the Department found that Parent and the five members of the RV Subsidiary that filed Indiana income tax returns met the unity requirements through their unity of ownership, centralized management, and centralized financial, administrative and operational services. (*See Department of Revenue-Tax Policy Division Letter* dated October 10, 1995, page 2). The Department further found that Parent and the five subsidiaries met the "best method for reporting adjusted gross income" test through their shared industry impact on Indiana adjusted gross income and their non-arms length transactions. *Id*. The Department determined that the remaining nine subsidiaries could not be included in the unitary group or taxed by Indiana because they did not have sufficient contacts with the state of Indiana. Although the Department granted Parent's request, in part, to file unitary, it nevertheless, reserved the right to revoke its grant of permission for unitary combined filing in the event that, *inter alia*, the facts subsequently established by the Department disclosed material error or misrepresentation of the facts set forth in Parent's original petition. (*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 3).

In a letter dated March 2, 1996, Parent re-petitioned the Department for permission to file combined returns with all of the RV Subsidiaries. In its letter dated March 20, 1996, the Department denied Parent's second petition, and reiterated that permission was granted for only five of the fourteen subsidiaries. Thereafter, Parent filed unitary combined returns including the five subsidiaries beginning in the fiscal year ending July 31, 1995.

In 1998, Parent amended its 1995 and 1996 Indiana tax returns to expand its combined filings to include all fourteen of its RV Subsidiaries. Parent based its amended returns on its position that the Department had erroneously failed to grant it permission to file combined Indiana income tax returns with the RV Subsidiaries.

<u>The "taxpayer" in the instant case is an Indiana subsidiary of Parent and one of the five RV subsidiaries originally permitted to be included in the combined filings</u>. The audit of taxpayer stems from an audit that was performed on the combined filings of Parent and its RV Subsidiaries for fiscal years 1995 through 1997 (which included the 1995 and 1996 amended returns). The disallowance of Parent's combined filings resulted in separate filing reports being generated for the subsidiaries that were originally granted permission to be included in the combined filing. The audit of taxpayer is of one such separate filing.

Pursuant to the audit performed on taxpayer, the auditor found that the expenses incurred by Parent on behalf of its subsidiary were properly reflected in the books of the subsidiary. As such, the Department determined that the Indiana income of taxpayer was more fairly reflected by filing separate company returns.

I. Adjusted Gross Income Tax – Unitary Filing Status

DISCUSSION

The taxpayer (*i.e.*, one of the RV Subsidiaries that filed Indiana income tax returns and was originally permitted to be included in the combined filings) protests the Department's determination that it may not file unitary combined returns for the fiscal years in question. Taxpayer argues that the combined reporting is the only filing method that fairly represents the flow of value from functional integration, centralized management, and economies of scale, present between taxpayer, Parent, and the remaining RV Subsidiaries.

In addressing this question, we examine: (1) whether a unitary relationship actually existed between Parent, taxpayer, and the remaining RV Subsidiaries; and (2) whether filing a combined return would more fairly represent the Parent's, taxpayer's, and remaining RV Subsidiaries' Indiana income. Hereinafter, the remaining RV Subsidiaries will be collectively referred to as the "RV Group".

The Supreme Court over the years has developed a three-part test in determining whether a unitary relationship exists: common ownership, common management, and common use or operation. *See, e.g.*, *Mobil Oil Corporation v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin,* 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992). The first item to be considered under this three-part test is common ownership. As a general rule, at least fifty percent (50%) of a corporation's stock must be commonly owned (either directly or indirectly) in order for a corporation to be considered part of a unitary business. *See*, *e.g.*, 35 ILCS 5/1501(a)(27) and Tenn.Code Ann. § 67-4-2004(25)(B). The information in taxpayer's file shows that during the audit period Parent owned one hundred percent (100%) of the stock of taxpayer and the members of the RV Group. The evidence of file is sufficient to establish common ownership.

The second criteria to be considered is common management. Common management is shown when the parent corporation provides a management role that is grounded in the parent's own operation expertise and overall operational strategy. *See, e.g.*, *Container Corp. V. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983).

Here, the taxpayer has supplied evidence which shows that Parent exercised control and influence over it and the RV Group. Parent's upper management consisted of a CEO, a Chairman and Treasurer, and a Vice President of Finance and Chief Administrative Officer. These three individuals were responsible operationally for taxpayer and the entire RV Group. Taxpayer and each one of the entities in the RV Group were required to submit to Parent's upper management for review and comment daily sales reports, monthly and annual financial reports, and operating and budget plans and goals. The CEO of Parent approved all capital expenditures in excess of one thousand dollars ($1000.00). Common management existed between Parent, taxpayer, and the RV Group.

The third test is that of common operation or use. Evidence of a common operation exists where certain functions are performed for the group by the parent (such as purchasing, financing, advertising, marketing, research, tax compliance, insurance, and pension plan management) which independent companies would perform for themselves.

In the taxpayer's case, information was supplied which shows that many of the administrative, management, and financing functions for taxpayer and the RV Group were centralized. Parent's upper management employed a purchasing agent who was responsible for negotiating national supply contracts for the RV Group. Upper management selected the independent accountants, legal counsel, and insurance carriers that provided accounting, legal and insurance services to the RV Group. Parent's upper management also coordinated the administration of the employee benefits plan for the RV Group. Upper management purchased advertising space in various recreational vehicle trade magazines for the RV Group, and the entities of the RV Group often participated in joint presentations.

On the basis of these facts, it appears that taxpayer enjoyed a unitary relationship with Parent and the RV Group. There exists the elements of common ownership and management, and a modicum flow of value between the members of the business group. Using Parent's upper management to provide services for the RV Group that the taxpayer and the RV Group could have provided for themselves, resulted in common operation.

We now turn to the next point of analysis and the question of whether requiring taxpayer and the RV Group to use a standard apportionment or separate company filing method, instead of combined return filing, would result in a distortion of the income Parent reported as Indiana source income. Ultimately, this question requires us to determine whether, under all of the circumstances of the unitary relationship between Parent, taxpayer, and the RV Group, standard apportionment fulfills the statutory purpose of avoiding distortion of and realistically portraying Indiana source income. *See* IC 6-3-2-2(p).

Although IC 6-3-2-2(q) allows a parent corporation to petition the Department to file a combined return, it also incorporates by reference the restrictions imposed on alternative methods of reporting adjusted gross income by subsection (l) of that same section. Subsection (l) states in pertinent part:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

...

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is clear from the language in subsection (l) that the standard apportionment and the separate accounting filing methods are the preferred methods of representing a taxpayer's income derived from Indiana sources. Other methods of income allocation and apportionment (including the combined reporting method) should only be allowed when those provided for by IC 6-3-2-2 do not fairly reflect a taxpayer's Indiana income. As stated in a more concise manner, if the Indiana source income in the instant case can be fairly represented on the basis of standard apportionment or separate accounting, then such filing methods should be used.

Despite the finding of a unitary relationship between Parent, taxpayer, and the RV Group, and despite the relationship between the business operations of the entities, it does not appear that the operations of the businesses were so integrated to the point where the filing of separate returns would lead to a distortion of income. The evidence on file establishes that inter-company accounts existed for inter-company transactions between Parent, taxpayer, and the RV Group. Interest was paid and received by Parent on these accounts. The balance of the amounts contained in the inter-company accounts consisted of the earnings and profits of taxpayer and the members of the RV Group. Taxpayer and the members of the RV Group were required to remit to Parent at the end of each fiscal year any and all earnings and profits. If taxpayer or a member of the RV Group was unable to remit its profits for the year, Parent charged the entity interest on the unpaid amount. The delinquent entity paid an interest rate of prime plus one percent (1%).

Additionally, the evidence on file substantiates the finding that Parent was compensated for the services that it performed for taxpayer and the members of the RV Group. The expenses incurred by Parent were allocated to the appropriate entity receiving the benefit. As such, the expenses were properly reflected on each subsidiary's financial statements.

The extensive documentation presented by taxpayer does not demonstrate that the business operations of Parent, taxpayer, and the members of the RV Group were so interconnected that it becomes impossible to accurately determine the Indiana source income attributable to the respective entities.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax – Unitary Filing Status – Retroactive Withdrawal of Permission to File Unitary

DISCUSSION

Taxpayer next argues that it and the original members of the recreational vehicle group that filed Indiana tax returns for the tax years in question should have been allowed to file on a unitary basis with the parent corporation. As such, taxpayer protests the Audit Division's retroactive withdrawal of its grant of permission to allow taxpayer and the original members of the recreational group that filed Indiana tax returns to file unitary combined returns without a finding of some material misstatement of fact.

In a letter dated October 10, 1995, the Department of Revenue granted Parent's petition to file unitary combined returns as a unitary group with five of the fourteen RV Subsidiaries for fiscal year 1995 forward. However, pursuant to an audit of Parent that resulted in the disallowance of Parent's filing on a combined basis with its subsidiaries, Parent was required to generate separate taxed returns for all of its subsidiaries, including the taxpayer and the subsidiaries with which Parent was originally granted permission to file on a unitary basis.

The statute applicable to the permission issue is found in IC 6-3-2-2 which states in pertinent part that:

IC 6-3-2-2 Corporations and nonresidents; "adjusted gross income derived from sources in state" defined...

(l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana...

(q)... taxpayers may petition the department... for permission to file a combined income tax return for a taxable year. The petition to file a combined income tax return must be completed and filed with the department not more than thirty (30) days after the end of the taxpayer's taxable year.

(*See Department of Revenue-Tax Policy Division Letter* dated October 10, 1995, page 1).

The Department's grant of permission to file combined returns was a determination, based upon the facts available to the Department at the time, upon which taxpayer's parent corporation could rely. However, the Department did reserve the right to revoke the grant of permission if, *inter alia*, "the facts subsequently established by the Department disclose material error or misrepresentation to the facts set forth in this petition." (*See Department of Revenue-Tax Policy Division Letter* dated October 10, 1995, page 3). This right of revocation was clearly set forth in the letter to Parent. And, the language of the letter clearly warned Parent that should a subsequent audit reveal a misrepresentation of the facts set forth originally, permission to file combined returns would be revoked.

The evidence on file evinces that the Department granted permission to Parent to include certain subsidiaries in a combined filing based upon an assertion made by Parent in its original petition letter dated August 25, 1995. In this letter, Parent stated that, "Management fees are not paid by the subsidiaries to [Parent]. [Parent] is not a profit center; therefore, no income is recognized by

[Parent] from services provided to its subsidiaries." (*See Parent's Original Petition Letter* dated August 25, 1995, page 4). Upon examination of the facts purported by Parent in its petition, and pursuant to the audit, the auditor discovered inter-company transactions (including management services) that were provided by Parent to its subsidiaries at arm's length.

Notwithstanding the foregoing, we do not believe that the Audit Division's subsequent reversal of the Department's determination that taxpayer could file combined tax returns was due to a material error or misrepresentation. The original approval letter specifically stated that combined filing status would be revoked if a material error or misrepresentation was discovered. However, through its examination of the books, records, and property of taxpayer, and its determination that separate filing best represented the taxpayer's Indiana income, Audit did not discover any material error or misrepresentation on the part of taxpayer.

Upon review of the instant case, the Department concludes that the original approval letter granting taxpayer permission to file combined tax returns is in error, but was not the result of a material error or misrepresentation on the part of taxpayer in the application process. Therefore, the appropriate remedy is for taxpayer's combined filings with the five RV subsidiaries originally permitted to be included in the combined returns for the years in question to be allowed.

FINDING

Taxpayer's protest is sustained. Taxpayer's combined returns with the five RV subsidiaries originally permitted to be included in the combined returns for the tax years in question will be allowed. However, taxpayer's permission to file combined tax returns with the five RV subsidiaries originally permitted to be included in the combined returns is revoked for tax years beginning after the date of the audit report.

III. Adjusted Gross Income Tax – Consolidated Returns

DISCUSSION

Taxpayer next protests the Audit Division's determination that taxpayer and the members of the recreational vehicle group that filed Indiana tax returns were required to file separate filing reports for fiscal year ends 1995 through 1997. Taxpayer maintains that it should have been allowed to file consolidated returns with the members of the recreational vehicle group that filed Indiana tax returns for fiscal year ends 1995 through 1997, and with Parent for fiscal year ends 1996 and 1997. According to taxpayer, the filing of consolidated returns is the only way to fairly reflect taxpayer's and the subsidiaries' Indiana source income.

As we have already granted taxpayer permission to file combined tax returns with the five RV subsidiaries originally permitted to be included in the combined returns for the tax years encompassed by the audit, this question is moot.

FINDING

Taxpayer's protest is denied.

IV. Adjusted Gross Income Tax – Throwback Sales

DISCUSSION

During the audit period, taxpayer and the subsidiaries that filed Indiana tax returns classified sales of recreational vehicles and parts to customers outside of Indiana (*i.e.*, recreational vehicle dealers and other subsidiaries) as throwback sales. According to taxpayer, it and the subsidiaries were under the mistaken belief that they were not subject to income tax in states other than Indiana, Ohio, and Michigan. Taxpayer believes that because it and the subsidiaries clearly had nexus activity in all the states where the recreational vehicles dealers are located (hereinafter, the "Dealers"), sales destined to those particular states should not have been classified as throwback sales.

Sales made by Indiana corporations to out-of-state purchasers must be apportioned as income to Indiana if the state in which the purchaser resides is without legal authority to claim such income as its own. *See* IC 6-3-2-2(e) and 45 IAC 3.1-1-64. Specifically, if interstate sales are "taxable in another state" - *i.e.*, the state of the purchaser - the sales are not includible in the numerator of the Indiana sales factor. Such sales are defined as throwback sales.

According to IC 6-3-2-2(n):

For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:

(1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

(2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Indiana's regulatory language further defines "taxable in another state." 45 IAC 3.1-1-64 states in part:

A corporation is "taxable in another state" under the Act when such state has jurisdiction to subject it [the corporation] to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. §381-385.

The taxpayer bears the burden to prove that an assessment by the Department is invalid. IC 6-8.1-5-1.

In *Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 112 S.Ct. 2447 (1992), the United States Supreme Court interpreted the term "solicitation" for purposes of P.L. 86-272, the federal law that generally exempts a corporation from state income tax if the company's only activity in the state is solicitation of sales of tangible personal property. Wrigley also established that a *de minimis* amount of nonsolicitation activity will not cause a corporation to lose its exemption from state taxation under P.L. 86-272. In *Wrigley*, the Court found that activities ancillary to the solicitation of orders would not result in a loss of immunity to taxation. Additionally, the Court held that as long as an activity, or activities, did not establish a nontrivial, additional connection with the taxing state it is sufficiently *de minimis* to avoid taxation. (*See also*, *Indiana Dept. of State Revenue v. Continental Steel Corp.*, 399 N.E.2d 754, 759 (Ind. Ct. App. 1980), where the court set out examples of activity which exceeded "mere solicitation" including "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, collecting deposits and advances on orders within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property... and associated local business activity for purposes not related to soliciting orders within the taxing state.")

The records and evidence presented to the Department lead to the conclusion that taxpayer and the Indiana subsidiaries contracted with Dealers outside of Indiana to perform warranty repair services. Periodic visits made by the employees of taxpayer and the Indiana subsidiaries to other states were to brief Dealers' on the products and the distinguishing features of the products in comparison with competitor's products, and to generate new business and to insure future sales of the products. These activities are all protected as ancillary to solicitation and would not subject taxpayer or any of the Indiana subsidiaries to taxation in other states. The few visits made by employees to brief Dealers on the products could be construed as *de minimis*. The Department concludes that taxpayer has not proven that it is subject to taxation in other states, and that the throwback of sales shipped to the other states were properly added into the numerator of the sales factor.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220000373.LOF

LETTER OF FINDINGS NUMBER: 00-0373
Indiana Corporate Income Tax
For the Tax 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Telephone Cooperative's Addback of Taxes Attributable to Patronage Income – Adjusted Gross Income

Authority: 45 IAC 3.1-1-8; 45 IAC 3.1-1-8(3)(a), (b); I.R.C. § 164; I.R.C. § 277

Taxpayer argues that income and property taxes, attributable to income received from its own patrons, should not be added back in calculating its Indiana adjusted gross income.

II. Abatement of the Ten percent Negligence Penalty

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c); 45 IAC 15-11-2(c)(1), (4)

Taxpayer maintains that – based upon the particular nature of taxpayer's business and the tax questions unique to that business – it is entitled to an abatement of the ten percent negligence penalty assessed at the time of the original audit.

STATEMENT OF FACTS

Taxpayer is a telephone cooperative in the business of providing telephone service to several Indiana communities. Taxpayer receives income from "patrons" and from "non-patrons." Until 1993, taxpayer was classified as a tax-exempt entity under I.R.C. § 501(c)(12). However, beginning in 1994, taxpayer no longer qualified as a tax-exempt entity because it no longer received 85 percent of its income from patrons. Thereafter, taxpayer filed as a "non-exempt cooperative" differentiating between income received from patrons and income received from non-patrons.

The Department of Revenue (Department) conducted an audit of taxpayer's 1996, 1997, and 1998 financial records and tax returns. In calculating the taxpayer's adjusted gross income tax, the audit added back income and property taxes attributable to obtaining its patronage income. As a result, the Department determined that taxpayer owed additional state income tax. The taxpayer disagreed with the audit's methodology arguing that only those income and property taxes associated with non-patronage income should be added back; the income and property taxes associated with the patronage income should not have been added back. Taxpayer submitted a protest challenging the audit's methods and the consequent additional tax assessments. An administrative hearing was held, and this Letter of Findings results.

DISCUSSION

I. Telephone Cooperative's Addback of Taxes Attributable to Patronage Income – Adjusted Gross Income

Taxpayer failed to qualify as a tax exempt organization under I.R.C. § 501 because it no longer received 85 percent of its income from its patron members. Thereafter – pursuant to I.R.C. § 277 – in reporting its income for federal income tax purposes, taxpayer differentiated between income and expenses attributable to its patrons and the income and expenses attributable to its non-patrons. The bottom-line effect of this distinction is that taxpayer paid federal income tax on that portion of its income received from its non-patrons and did not pay taxes on income received from its patrons.

In a substantially simplified manner – and as far as relevant to the issue raised by the taxpayer – taxpayer calculates its federal adjusted gross income tax in the following manner.

In the first step – and for the purposes of this illustration – assume that taxpayer received $5,000 in gross receipt income from its patrons but also paid $1,000 in gross income and property taxes attributable to the acquisition of the $5,000. On its federal return, taxpayer would be entitled to deduct the $1,000 from the $5,000 yielding $4,000 in patronage "taxable income."

In the second step, assume also that taxpayer also received $2,500 in non-patronage income and paid $300 in gross income and property taxes attributable to acquisition of that particular non-patronage income. On its federal return, taxpayer would again be entitled to deduct the $300 yielding $2,200 in "taxable income" from its non-patronage members.

In the third step, taxpayer returns to the original gross receipts – the $5,000 and the $2,500 – to arrive at "total income" of $7,500. However, in arriving at its final "taxable income," taxpayer is entitled to deduct the $4,000 in patronage "taxable income" from the "total income." The consequence is that taxpayer has $3,500 in bottom line, federal taxable income. In summary, after deducting the associated property and gross income taxes, taxpayer does not pay federal adjusted gross income tax on the remaining patronage income – the $4,000 noted above.

As illustrated previously, the Department does not challenge the taxpayer's federal methods or calculations. The dispute arises when taxpayer adapts those same calculations in arriving at its Indiana adjusted gross income tax.

In calculating taxpayer's Indiana adjusted gross income, taxpayer begins with the federal adjusted gross income (the $3,500 cited in the example above) and then makes certain adjusted adjustments. Specifically, 45 IAC 3.1-1-8 states as follows:

> "Adjusted Gross Income" with respect to corporate taxpayers is "taxable income" as defined in Internal Revenue Code section 63 with three adjustments.
>
> (1) Subtract income exempt from tax under the Constitution and Statutes of the United States.
> (2) Add back deductions taken pursuant to Internal Revenue Code section 170 (Charitable contributions);
> (3) Add back deductions taken pursuant to Internal Revenue Code section 63 for:
> (a) Taxes based on or measured by income levied at the state level
> ...
> (b) Property taxes levied by a political subdivision of any state; and
> (c) Indiana motor vehicle excise taxes, except for that portion of the tax not considered an ad valorem tax.

The dispute arises from the Indiana provision which requires the state taxpayer to add back "property taxes" and "taxes based on or measured by income." 45 IAC 3.1-1-8(3)(a), (b).

Taxpayer argues that it is required to add back only those property and gross income taxes associated with the non-patronage income. In the example above, taxpayer maintains that it would begin with $3,500 and add back the $300. As a result, taxpayer would have $3,800 in Indiana adjusted gross income.

The audit maintained that taxpayer is required to add back those property and gross income taxes associated with the non-patronage income *and* the property and gross income taxes associated with the patronage income. In the example above and employing the audit's proposed method, the taxpayer would start with the $3,500, add back the $300, and *also* add back the $1,000. As a result of the two additions, taxpayer would have $4,800 in Indiana adjusted gross income.

In support of its argument, taxpayer maintains that the starting point for determining the states adjusted gross income is non-patronage taxable income; in effect, the patronage sourced gross income tax and the property tax were never a component of the federal taxable income. According to taxpayer, "It simply is not logical to add back expenses that were never deducted in the first place. To do so creates phantom income."

Taxpayer is not required to pay federal income tax on income received from its patrons. I.R.C. § 277 states, in relevant part, as follows:

> In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year *from members or transactions with members*." (*Emphasis added*).

As a "membership organization" which functions to provide its patrons with telephone services, taxpayer is clearly permitted to "deduct" the income received from those patrons. Equally clear is that 45 IAC 3.1-1-8 does not require taxpayer to add back the total patron income in determining its Indiana adjusted gross income.

In addition, taxpayer – along with every other taxpayer – is entitled to deduct state and local real or personal property taxes and state and local income taxes. I.R.C. § 164 states in part that:

> Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.
(2) State and local personal property taxes.
(3) State and local, and foreign, income, war profits, and excess profits taxes...

In addition, there shall be allowed as a deduction State and local, and foreign taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business....

Therefore, under I.R.C. § 164, taxpayer is entitled to deduct those property and local income taxes which are paid in association with patronage and non-patronage income. There is nothing discernible which restricts or limits the taxpayer from deducting those particular expenses from both sources of taxpayer's income. This conclusion is reinforced by the particular federal form employed by taxpayer in distinguishing its forms of income. Form 8817, entitled "Allocation of Patronage and Nonpatronage Income and Deductions," provides in lines 12 through 29 specific provisions whereby taxpayer is permitted to specify and then deduct its local income and property taxes from both its "Patronage" (column a) and from its "Nonpatronage" (column b) "taxable income."

Under I.R.C. § 164, taxpayer was plainly entitled to "deduct" local gross income and property taxes from both its patronage and non-patronage income. The additional fact that, under I.R.C. § 277, taxpayer was also entitled to deduct the sum of its patronage income does not nullify the effect of the deduction permitted under I.R.C. § 164. The obligation placed on taxpayer under 45 IAC 3.1-1-8(3)(a), (b) requires that taxpayer add back the local gross income and property taxes deducted; there is simply no reasonable reading of the regulation which permits the taxpayer to add back *some* income and property taxes but ignore the parallel deduction it made of other income and property taxes. Taxpayer is correct that the federal tax is assessed against its non-patronage income. Nonetheless, in arriving at its federal adjusted gross income – however intricate that calculation may have been – it deducted gross income and property taxes from *both* its patronage and non-patronage income. Those taxes must be added back.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten Percent Negligence Penalty

Taxpayers ask the Department to exercise its discretionary authority and abate the ten percent negligence penalty assessed at the time the audit report was concluded. IC 6-8.1-10-2.1 requires that a ten percent penalty be imposed if a tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) permits the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed..."

The factors which "may be considered in determining reasonable cause" include the "nature of the tax involved" and the "published department instructions, information bulletins, letters of findings, rulings, [and] letters of advice." 45 IAC 15-11-2(c)(1), (4).

Given the nature of taxpayer's business and the tax laws implicated by that particular business, it cannot be said that the taxpayer failed to exercise "ordinary business" care in arriving at the decisions it did. The Department finds that abatement of the ten percent negligence penalty is warranted.

FINDING

Taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420010057.LOF

LETTER OF FINDINGS NUMBER: 01-0057
Sales and Use Tax
For Tax Periods: 1997-1999

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.

ISSUES

1. Sales and Use Tax – Delivery Charges

Authority: IC 6-8.1-5-1 (b), IC 6-2.5-2-1, IC 6-2.5-4-1(b), IC 6-2.5-4-1 (e) (2), IC 26-1-2-401(2), 45 IAC 2.2-4-3 (a), 45 IAC 2.2-4-3(b)(3)

The taxpayer protests the assessment of tax on delivery charges.

2. Sales and Use Tax – Scotchguard Fees

Authority: IC 6-2.5-4-1(e)(2), Sales Tax Information Bulletin #2, May, 2002

The taxpayer protests the assessment on scotchguard fees.

3. Tax Administration – Penalty
Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2, 45 IAC 15-11-2

The taxpayer protests the imposition of the ten percent (10%) penalty.

STATEMENT OF FACTS

The taxpayer is a retail furniture store. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional sales and use tax, interest and penalty. The taxpayer protested and a hearing was held on the issues of tax assessed on delivery charges, tax assessed on scotchguard applications, and the penalty.

1. Sales and Use Tax – Delivery Charges

DISCUSSION

The taxpayer delivers furniture with its own employees on its own trucks. The taxpayer's invoices include a separately stated delivery fee that covers the transportation services. The department assessed sales tax on the delivery fees. The taxpayer contends that the delivery fees are nontaxable services.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC 6-8.1-5-1 (b).

Retail transactions made in Indiana are subject to sales tax. IC 6-2.5-2-1. A retail transaction is defined generally as the acquiring and subsequent selling of tangible personal property. IC 6-2.5-4-1(b). Except for certain enumerated services, sales of services are generally not retail transactions and are not subject to sales tax. Delivery prior to the transfer of title to the purchaser is, however, one of the enumerated services that is specifically subjected to sales tax. IC 6-2.5-4-1(e)(2).

The taxpayer maintains that separately stated delivery charges where no F.O.B. has been established are non taxable. The taxpayer bases this conclusion upon 45 IAC 2.2-4-3(b)(3) which states, "[d]elivery charge[s] separately stated where no F.O. B. has been established [are] non taxable." The taxpayer's reliance on F.O.B. designations in this case is misplaced. The Regulation's reference to F.O.B. designations are applicable only when public transportation companies deliver the product.

There are two prerequisites for separately stated delivery charges to be subject to sales tax. The Regulations state these prerequisites as "[s]eparately stated delivery charges are considered part of selling at retail and subject to sales and use tax if the delivery is made by or on behalf of the seller of property not owned by the buyer." 45 IAC 2.2-4-3(a). In this instance, the first prerequisite for assessing sales tax is met because the delivery of the furniture is made by the taxpayer.

Whether or not sales tax applies to these delivery charges, then, depends upon when title to the goods transferred to the buyer. The Indiana law concerning the passing of title of goods to the buyer states that, "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... " IC 26-1-2-401(2). The taxpayer offered no evidence indicating that title to the goods passed to the buyer at any point prior to delivery of the goods. The taxpayer's fact situation, then, meets the requirements of 45 IAC 2.2-4-3(a) with the delivery service taking place prior to the transfer of title to the buyer. The delivery charges are subject to Indiana sales tax.

FINDING

The taxpayer's protest is denied.

2. Sales and Use Tax – Scotchguard Fees

DISCUSSION

The taxpayer offers purchasers the option of purchasing scotchguard application and related warranty. The department assessed additional sales tax on the application of the scotchguard prior to delivery of the product to the consumer pursuant to IC 6-2.5-4-1(e)(2) that provides that services provided prior to delivery are subject to the sales tax.

The taxpayer contends that the fee charged is actually for the exempt purchase of an optional warranty and not for the application of the scotchguard prior to delivery. The department's definition of an optional extended warranty is found in Sales Tax Information Bulletin #2, May, 2002 as follows:

> Optional extended warranties and maintenance agreements may either be purchased alone, or purchased as an option with the sale of the covered product. Typically, the terms of these agreements provide assurances that any required service and parts will be provided in the event of a break down or malfunction of the covered product.

The taxpayer's evidence consists of an invoice from the company providing the chemical and the warranty to the taxpayer. The invoice shows no charge for this chemical to the taxpayer. The taxpayer's evidence and argument misses the point. There is no evidence that the taxpayer sells the warranty without applying the chemical. Therefore, the sale of the warranty is inextricable from the application of the chemical.

FINDING

The taxpayer's protest is denied.

3. Tax Administration – Penalty

DISCUSSION

The taxpayer also protests the imposition of the ten percent (10%) negligence penalty pursuant to IC 6-8.1-10-2.1. Negligence is defined at 45 IAC 15-11-2(b) as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2 (c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed... "

The taxpayer provided sufficient evidence that it was not willfully negligent in its failure to collect and remit sales tax on the delivery charges.

FINDING

The taxpayer's protest to the imposition of the penalty is sustained.

DEPARTMENT OF STATE REVENUE

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0220010112.LOF

LETTER OF FINDINGS NUMBERS: 01-0111; 01-0112
Indiana Corporate Income Tax
For the Tax 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Service Income Received from Out-of-State Customers – Gross Income Tax

Authority: IC 6-2.1-2-2(a); IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 1-1-121; 45 IAC 1-1-121(a)

Taxpayers argue that the audit erred in determining that their income, derived from the out-of-state provision of services to Indiana customers, was subject to the state's gross income tax.

II. Payroll Adjustment – Adjusted Gross Income Tax

Authority: 45 IAC 3.1-1-3; I.R.C. § 62

Taxpayers argue that the audit, in calculating the taxpayers' Indiana adjusted gross income tax, erred in disallowing a portion of payroll expenses – purportedly attributable to the second taxpayer – reported on the first taxpayer's federal return.

III. Abatement of the Ten Percent Negligence Penalty

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

Taxpayers request that the Department of Revenue exercise its discretion to abate the ten percent negligence imposed against both taxpayers at the time of the original audit reports.

STATEMENT OF FACTS

Both taxpayers are out-of-state companies and are both affiliate members of a larger group of related companies. Both taxpayers are incorporated in Ohio and conduct business from an Ohio business location. Both taxpayers provide their clients with bill collection services. Their clients include retailers, financial institutions, credit card companies, and telecommunications companies. Taxpayers and clients enter into agreements in which taxpayers agree to obtain payment for unpaid bills owed the clients. The taxpayers pursue the collection of the unpaid bills by sending dunning letters and making phone calls to the debtors. According to taxpayers, these letter-writing and phone activities are conducted in Ohio.

During 1996, 1997, and 1998 the taxpayers took various and inconsistent views with regard to their Indiana gross income tax liability. For example, in 1996 taxpayers reported all collections related to Indiana customers as subject to gross income tax. In 1997, taxpayers reconsidered their position and determined that none of the Indiana service revenues were subject to Indiana gross income tax.

The Department of Revenue (Department) conducted successive audits (Hereinafter simply referred to as "audit.") of taxpayers' business records for the tax years 1996, 1997, and 1998. The audit concluded that taxpayers had "substantial nexus' with Indiana and that their Indiana activities subjected taxpayers' Indiana collection service receipts to gross income tax. The audit only considered receipts received from Indiana customers in calculating the taxpayers' gross income tax liability.

The audit was initially permitted to examine taxpayers' federal and state income tax returns. Certain correspondence was exchanged between taxpayers and the audit personnel in which the Department requested additional information. However, the audit concluded that – despite the information provided within the resulting correspondence – there "[was] insufficient information to accurately determine the source and activities of [taxpayers'] collection service income." Therefore, the audit reached its conclusions based upon the "best information available."

Taxpayers' disagreed with the audit's conclusions. Thereafter, taxpayers' representatives submitted a protest setting out numerous challenges to the audit's conclusions and to the amount of taxes assessed as a result of those conclusions.

An administrative hearing was conducted during which taxpayers' protest was discussed. It was agreed that three issues required resolution at the administrative level. This Letter of Findings addresses those three issues.

DISCUSSION

I. Service Income Received from Out-of-State Customers – Gross Income Tax

Indiana imposes a gross income tax on income received by Indiana residents and by certain out-of-state residents. IC 6-2.1-2-2(a) states as follows:

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

Both taxpayers are registered to do business in Indiana; taxpayers admit, that in rendering their collection services, they are protected by Indiana law and "have the ability to file suits in Indiana." In addition, taxpayers agree with the audit that they have "substantial nexus" with Indiana.

It is evident from the audit report that the Department was less than satisfied with the adequacy of the information received from the taxpayers during the audit investigation. The audit report noted that there was "insufficient information to accurately determine the source and activities of [taxpayers'] service income." Taxpayers disagree maintaining that they provided the Department with access to not only their state and federal returns but also the original work papers used in preparing those returns. Furthermore, taxpayers maintain that, on two separate occasions, taxpayers provided written answers to questions submitted to them by the Department.

Setting aside the issue of whether taxpayers fully cooperated with the Department or were wholly forthcoming in responding to the Department's request for additional information, it is apparent that the precise nature of taxpayers' business activities, taxpayers' relationship to the parent company, and the extent and nature of taxpayers' in-state activities remain to some extent unclear.

45 IAC 1-1-121 provides that "Gross income derived from the performance of a contract or service within Indiana is subject to gross income tax." The regulation points out that "Income from a contract for the performance of services within the State is subject to gross income tax. However if the contract calls for the performance of services both within and without the State by a nonresident with no in-state business situs and the non-resident's performance within the State is minimal or incidental in comparison to his performance out-of-state, no service income will be taxed." 45 IAC 1-1-121(a).

The regulation instructs that the income received by an out-of-state business for the performance of services is not subject to the state's gross income tax unless the business's activities within the state are more than "minimal or incidental" compared to those activities performed within the foreign state. To that end, the Department has set a benchmark figure for determining whether a business's in-state activities exceed the "minimal or incidental" threshold. The regulation states that, "If five percent (5%) or less of the total hours or total fee under the contract in any tax year is attributable to services performed in Indiana, the entire proceeds of the contract received in that year are exempt from gross income tax. If the five percent (5%) figure is exceeded, the entire proceeds of the contract are taxable." 45 IAC 1-1-121(a).

Taxpayer maintains that all of its phone calls are made from outside of the state and that all of its collection letters are prepared and then sent from outside the state. What has not been established are the nature and extent of the taxpayers' activities performed within the state. The audit report indicated that taxpayers were "vague in the answers and information provided" and that the "no general ledgers, no service billings, no notes or contracts, no detail of customers" were available for examination. After reviewing the information taxpayers provided during various stages of the audit investigations, it is reasonable to conclude that taxpayers' responses to the Department's questions outlining their Indiana activities are somewhat obtuse. For example, in response to a question of whether taxpayers' pursued collection activities against recalcitrant debtors within the state, taxpayers' representative stated that "Presumably, if either entity is registered to do business in Indiana, they have the ability to file suits in Indiana." (Both entities are registered with the Indiana Secretary of State to do business within the state.)

It is apparent from the available information that taxpayers engaged in certain activities within the state. However, whether those in-state activities constituted one percent, five percent, or 20 percent of the activities related to the acquisition of the Indiana source income, is an issue which cannot be resolved with any mathematical certainty from the information the taxpayers provided at the time of the audit, from the information contained within the original audit report, or from the information contained within taxpayers' initial protest letter. Accordingly, the audit did not overstep its authority under 6-8.1-5-1(a) in determining that taxpayers' Indiana source income was subject to the state's gross income tax. The statute plainly states 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." IC 6-8.1-5-1(a).

IC 6-8.1-5-1(b) provides that the assessment of gross income taxes is "prima facie evidence that the department's claim for the unpaid tax is valid." It is taxpayers' burden to demonstrate that the proposed assessment is wrong. Id. Taxpayers have failed to do so, and the Department is left with no alternative but to deny their protest.

FINDING

Taxpayers' protest is respectfully denied.

II. Payroll Adjustment – Adjusted Gross Income Tax

In calculating its adjusted gross income tax, taxpayer one deducted an amount of payroll expenses which it had paid on behalf of taxpayer two. The audit disallowed the portion of the payroll paid on behalf of taxpayer two. Taxpayer one argues that it was entitled to the entire deduction because it had entered into an agreement with taxpayer two to serve as both companies' "common payroll master."

Pursuant to this agreement, taxpayer one made the payroll payments for taxpayer two. In return, taxpayer two forwarded a "service fee charge" to taxpayer one. Taxpayer one now argues that "there is no reasonable basis for [the] disallowance."

In support of its argument taxpayer one cites to 45 IAC 3.1-1-3 which states as follows; "The following deductions contained in Internal Revenue Code Section 62 are allowed in determining Indiana adjusted gross Income: (1) Trade and business deductions."

In turn, the federal code allows the taxpayer – calculating its adjusted gross income – to subtract from its gross income certain expenses "attributable to a trade or business carried on by the taxpayer...." I.R.C. § 62.

In calculating its adjusted gross income, taxpayer one is plainly entitled to deduct from its gross income the amount of money it pays to its employees. The sum of money it pays to those employees may be deducted because, under I.R.C. § 62, that sum represents a cost attributable to conducting its own collection business. However, there is no discernible authority under either 45 IAC 3.1-1-3 or I.R.C. § 62 which permits taxpayer one to deduct the amount of payroll paid on behalf of a second entity. Taxpayer one's secondary payroll costs are not one of the expenses incurred as a result of taxpayer one's collection business; these secondary payroll expenses – incurred as a result of its agreement with taxpayer two – are peripheral to the conduct of taxpayer one's business affairs.

FINDING

Taxpayers' protest is respectfully denied.

III. Abatement of the Ten Percent Negligence Penalty

Taxpayers ask the Department to exercise its authority and abate the ten percent negligence penalties assessed at the time the audit report was concluded. IC 6-8.1-10-2.1 requires that a ten percent penalty be imposed if a tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) permits the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Taxpayers' inconsistent stance regarding their Indiana tax liabilities and their circumspect provision of requested information does not exhibit the "ordinary business care and prudence" warranting abatement of the negligence penalty.

FINDING

Taxpayers' protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0220010263.LOF

LETTER OF FINDINGS NUMBER: 01-0263
Income Tax
For Tax Period: 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 specific issues.

ISSUE

Adjusted Gross Income Tax – Throwback Sales

Authority: 15 U.S.C.S. 381; IC 6-3-1-25; IC 6-8.1-5-1(b); 45 IAC 3.1-1-64; Indiana Department of State Revenue v. Continental Steel Corporation, 399 N.E.2d 754 (Ind. Ct. App. 1980); Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992)

The taxpayer protests the imposition of tax pursuant to the throw-back rule.

STATEMENT OF FACTS

The taxpayer designs, manufactures, and markets liquid electrostatic paint application equipment. The taxpayer has employees who represent it in various locations. It also contracts for a manufacturer's representative who is employed by a French concern to represent it in Europe and a manufacturer's representative who is employed by a Thai concern to represent it in Asia. In an audit, the Indiana Department of Revenue, hereinafter the "department," assessed adjusted gross income tax on the receipts from sales that originated in Indiana and were delivered to several foreign countries where the taxpayer has no nexus requiring the filing of income tax returns. The taxpayer protested this assessment and a hearing was held.

DISCUSSION

15 U.S.C.S.381 (Public Law 86-272) prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales. 15 U.S.C.S. 381 (a), (c). The effect of the throw-back rule is to revert sales receipts back to the state from where the goods were shipped in those situations where 15 U.S.C.S. 381 deprives the purchaser's own state of the power to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. 381 permits Indiana to tax out-of-state business, without violating the Commerce Clause and without the possibility of subjecting taxpayers to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every sales transaction, at least one state has the authority to tax income derived from the sale of the tangible personal property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. 381, then the income is "thrown-back" to the originating state.

For the purposes of determining whether a taxpayer is subject to the taxing jurisdiction of another state pursuant to 45 IAC 3.1-1-64, "the term 'state' means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof." IC 6-3-1-25. Accordingly, the jurisdictions at issue fall within the definition of a "state" and are properly considered as potentially subject to the throw back rule. *See also* IC 6-3-1-25.

The department must determine whether the taxpayer's employees' activities within the foreign jurisdictions exceed the 15 U.S.C.S. 381 benchmark of "mere solicitation." Indiana Department of State Revenue v. Continental Steel Corporation, 399 N.E.2d 754 (Ind. Ct. App. 1980), defines those activities which do and do not exceed the "mere solicitation," standard. In that case, the court held that, "solicitation should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders not those which follow as a natural result of the transaction, such as collections, servicing complaints, technical assistance and training..." Id. at 759. Further, "solicitation must be limited to those acts which lead to the placing of orders and does not include those acts which follow as a result of the transaction." Id. The court set out examples of activity which exceeded "mere solicitation" including "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property and associated local business activity for purposes not related to soliciting orders within the taxing state." Id.

In Continental, the court held that the taxpayer's employees' activities within the foreign state exceeded solicitation because the taxpayer's employees' activities "[did] not lead to the placing of orders but follow[ed] as a natural result of transaction." Id. Those activities included the taxpayer's "salesmen making adjustment on complaints, [and] salesmen giving customers technical assistance... "Id.

The "mere solicitation" by a corporation's employees standard was refined by the Supreme Court in Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992). The Court concluded, "although solicitation covered more than what was strictly essential to making requests for purchases, the fact that an activity is performed by salespersons does not automatically convert that activity into solicitation." Id. at 2456-57.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC 6-8.1-5-1 (b). The taxpayer submitted a significant amount of material concerning the activities of its employees in the foreign countries. This material substantiated that the taxpayer's employees had significant activities past mere solicitation and established nexus in Canada and Mexico. Therefore, Indiana is precluded from imposing corporate income tax on the income from Indiana sales to those jurisdictions.

The taxpayer was unable to sustain its burden of proving that its employees had significant activities past mere solicitation and established nexus in the other foreign jurisdictions. Receipts from Indiana sales to these other foreign jurisdictions were properly thrown-back and subjected to Indiana adjusted gross income tax.

FINDING

The taxpayer's protest to the tax assessed on income from sales to Canada, and Mexico is sustained. The remainder of the protest is denied.

DEPARTMENT OF STATE REVENUE

0220010312.LOF

LETTER OF FINDINGS NUMBER: 01-0312
Adjusted Gross Income Tax – Unitary (Combined) Filing Status
Fiscal 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

Adjusted Gross Income Tax – Nexus

Authority: *Rural Elec. Mem. v. Indiana Dept. of State Revenue*, 733 N.E.2d 44 (Ind.Tax 2000); IC 6-8.1-9-1(a); *Black's Law Dictionary* (7th Ed. 1999)

Taxpayer protests the Department's determination that taxpayer should have filed unitary combined tax returns with its holding company, on the basis that taxpayer does not have the requisite nexus with Indiana to subject taxpayer to the Indiana adjusted gross income tax.

STATEMENT OF FACTS

Taxpayer is a manufacturer and distributor of pharmaceutical products. Although taxpayer has no business location within Indiana and maintains headquarters outside of the state of Indiana, taxpayer does have a resident sales force in Indiana. Taxpayer's resident salespersons generally work from home offices. The salespersons do not give away samples; and, no orders are accepted or approved within Indiana.

In 1990, taxpayer formed a wholly owned Delaware holding company (hereinafter, "Holding Company"). At that time, taxpayer transferred marketing rights to the Holding Company pursuant to an Internal Revenue Code § 351 tax-free exchange for one hundred percent (100%) of the Holding Company's stock. Three thousand (3000) shares of common stock with a par value of one dollar ($1.00) per share were issued. Taxpayer and the Holding Company simultaneously executed a royalty agreement whereby the Holding Company granted an exclusive, irrevocable license of the marketing rights and other intellectual property to the taxpayer in exchange for royalty payments.

The royalty fee was computed based upon a percentage of sales of licensed products sold by the taxpayer. The Holding Company then loaned royalty proceeds at a market rate of interest to taxpayer and other members of the taxpayer's family of companies. Royalty proceeds not loaned to members of taxpayer's family of companies were returned to taxpayer in 1998 in the form of an inter-company dividend that was one hundred percent (100%) eliminated from taxable income.

After review of the audit results, the Department's position was that the business activities of the Holding Company and the taxpayer constituted a unitary business. In addition to finding that taxpayer and the Holding Company enjoyed unity of ownership, operation, and use, the Department further found that the net effect of the inter-company business arrangement was that the large amounts of royalty income reported by the Holding Company, and the corresponding large royalty expense reported by taxpayer reduced the taxable income apportioned to all states in which taxpayer conducted business. Due to this distortion of income, the Department determined that the only way to realistically portray taxpayer's true Indiana income was to require taxpayer to file a unitary combined return with the Holding Company.

Taxpayer disagrees with the Department's determination. According to taxpayer, a review of taxpayer's activities in Indiana renders the Department's unitary determination moot, as the review demonstrates that taxpayer does not have the requisite nexus within the state to subject taxpayer to the Indiana adjusted gross income tax.

Adjusted Gross Income Tax – Nexus

DISCUSSION

In the instant case, the Department determined that taxpayer should have filed unitary combined tax returns with its holding company in order to accurately report taxpayer's Indiana income. Taxpayer asserts that the Department's determination is moot because taxpayer lacks sufficient nexus with the state to subject taxpayer to Indiana's adjusted gross income tax.

Taxpayer raises the nexus argument for the first time in its protest letter dated October 26, 2001. As such, the original audit report does not address this argument. Based upon the circumstances of this case (*i.e.*, taxpayer's raising an argument not addressed in the audit report), it must be determined whether or not taxpayer's protest is ripe for determination.

"Ripeness relates to the degree to which the defined issues in the case are based on actual facts rather than on abstract possibilities, and are capable of being adjudicated on an adequately developed record." *Rural Elec. Mem. v. Indiana Dept. of State Revenue*, 733 N.E.2d 44, 47 (Ind.Tax 2000). According to Black's Law Dictionary, p. 1328 (7th Ed. 1999), ripeness is the "circumstance existing when a case has reached, but has not passed, the point when the facts have developed sufficiently to permit an intelligent and useful decision to be made."

In the instant case, the nexus issue is not ripe for determination. Taxpayer raised the nexus issue after the audit report was completed. Although the audit report provides ample findings regarding whether or not taxpayer should have been required to file unitary tax returns with the Holding Company, the report does not (because it could not) provide any findings regarding taxpayer's nexus argument. Because of the unique circumstances of this case, the Hearing Officer received a file wherein the facts were insufficient to allow an intelligent decision to be made.

Notwithstanding the above, taxpayer may still preserve its nexus issue. In order to do so, however, taxpayer must pay the current assessment in full and file a claim for refund. By paying the current assessment and filing a claim for refund, taxpayer's claim for refund avoids the bar of statute of limitations. (*See*, IC 6-8.1-9-1(a) which states in relevant part: "If a person has paid more tax than he determines is legally due for a particular taxable period, he may file a claim for refund with the department. In order to obtain the refund, the person must file the claim with the department within three (3) years after the latter of the following:...; (2) the date of payment;...")

Once taxpayer pays the assessment and files its claim for refund, the Audit Division will review the claim for refund and make its determination based upon the facts of the case. If taxpayer is not satisfied with the Audit Division's decision regarding taxpayer's claim for refund, taxpayer may file a protest requesting a hearing before a Hearing Officer for the Department.

FINDING

Taxpayer's protest is denied. However, if taxpayer would like to preserve its nexus argument, taxpayer should, in accordance with this Letter of Findings, pay the assessment in full and file a claim for refund..

DEPARTMENT OF STATE REVENUE

0420010313.LOF

LETTER OF FINDINGS NUMBER: 01-0313
Sales and Use Tax
For Tax Years 1998 through 2001

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 and Use Tax – Post Mix and CO2 Equipment

Authority: General Motors Corporation v. Indiana Department of State Revenue, 578 N.E.2d 399 (Indiana Tax Court 1991); 45 IAC 2.2-5-8

Taxpayer protests imposition of use tax on post mix and CO2 equipment.

II. Sales and Use Tax – Shipping Pallets

Authority: IC 6-2.2-4-2; 45 IAC 2.2-5-16

Taxpayer protests imposition of use tax on shipping pallets.

STATEMENT OF FACTS

Taxpayer produces and sells soft drinks. Taxpayer sells syrup and provides fountain-style mixing equipment to its customers, who dispense the soft drinks on a glass-by-glass basis. The Indiana Department of Revenue ("Department") issued proposed use tax assessments on the equipment used to mix the drinks and on shipping pallets used by taxpayer to ship goods to a related company. Taxpayer protests these assessments. Further facts will be provided as necessary.

I. Sales and Use Tax – Post Mix and CO2 Equipment

DISCUSSION

Taxpayer protests the Department's proposed assessment of use tax on 73.11% of taxpayer's purchase of fountain-style soft drink mixing equipment. The equipment is located at the various restaurants where taxpayer's customers fill soft drink orders by the glass. The mixing equipment is essentially an elaborate swizzle stick. The Department issued assessments on the equipment on the basis that 73.11% of the equipment is capitalized by taxpayer and is supplied to taxpayer's customers at no charge.

The Department based its assessment on 45 IAC 2.2-5-8(a), which states:

> In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. *[45 IAC 2.2]* extends only to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. It does not apply to material consumed in production or to materials incorporated into tangible personal property produced.

The Department determined that the equipment was not used directly by the purchaser (taxpayer) in the direct production of tangible personal property. Therefore, the exemption afforded by 45 IAC 2.2-5-8 did not apply.

Taxpayer protests that the equipment is used in its continuous production process, and should be exempt from sales tax as described in 45 IAC 2.2-5-8. Taxpayer refers to General Motors Corporation v. Indiana Department of State Revenue, 578 N.E.2d 399 (Indiana Tax Court 1991). In General Motors, the court explains:

> Finally, a determination that an integrated production process ends upon the completion of the actual end product marketed (the most marketable product) is wholly consistent with the legislative purposes of the exemption statutes to encourage industrial growth and to avoid tax pyramiding.

Id. at 405

Taxpayer believes that its most marketable product is the individual glass of soft drink, and that its production process ends with the mixing of ingredients through the mixing equipment at issue. Since, according to taxpayer, the most marketable product is made with the mixing equipment, the production process does not end until the mixing equipment is used, thereby making the equipment part of the production process and exempt as provided in 45 IAC 2.2-5-8.

Taxpayer's position is flawed. Taxpayer's customer is not the ultimate consumer of the soft drink. Rather, taxpayer's customer is the restaurant. The restaurant buys syrup from taxpayer. The customer's employees then use the equipment to mix the syrup with chilled water and CO2. Taxpayer's actual end product marketed to its restaurant customers is the syrup, not the completed soft drink. Therefore, the production process ends when taxpayer sells the syrup to the restaurant.

Taxpayer also asserts that to tax the mixing equipment would result in tax pyramiding. The court in General Motors explained:

> When equipment or materials used in the direct manufacturing process are taxed, the tax is generally passed on as part of the cost of the product being produced.

General Motors at 405.

As previously established, the equipment is not used in the direct manufacturing process by taxpayer. Any processing utilizing the mixing equipment is performed after taxpayer has sold its product (syrup) to its customer. The purchase of the mixing equipment is not part of the manufacturing process of the syrup, which taxpayer sells to its customers.

While taxpayer is correct that the final consumers of soft drinks want a pre-mixed drink, taxpayer does not charge by the glass, but rather charges for the syrup. The mixing equipment is not part of taxpayer's production process. Therefore, the mixing equipment is not directly used by the purchaser in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property, and is not eligible for the exemption provided in 45 IAC 2.2-5-8. The equipment is not used by taxpayer, and does not play any role in the manufacture of syrup. It is the syrup which is taxpayer's actual end product marketed to its restaurant customers, so no tax pyramiding occurs.

FINDING

Taxpayer's protest is denied.

II. Sales and Use Tax – Shipping Pallets

DISCUSSION

Taxpayer protests the imposition of use tax on shipping containers used to ship goods to an out of state sister division. The Department assessed taxpayer's purchase of the containers. The Department referred to 45 IAC 2.2-5-16, which states in part:

> (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

Taxpayer protests that the containers are used for selling finished goods to its sister division, which does not return the pallets to taxpayer, thus constituting a retail transaction.

Also of relevance is IC 6-2.2-4-2, which states in pertinent part:

> (a) A person is a retail merchant making a retail transaction when he is making wholesale sales.
> (b) For purposes of this section, a person is making wholesale sales when he:
>> (1) sells tangible personal property, other than capital assets or depreciable property, to a person who purchases the property for the purpose of reselling it without changing its form;

Taxpayer has provided sufficient documentation to establish that the containers are nonreturnable and are used by the purchaser as a container for selling contents to be added. In this case the finished goods are added to the containers and then the finished goods are sold in a retail transaction without return of the pallets. Also, while taxpayer does purchase and capitalize some pallets used in its business, the pallets resold to the sister corporation are expensed rather than capitalized. Therefore, taxpayer is making a retail transaction under IC 6-2.2-4-2 and so satisfies the exemption requirements of 45 IAC 2.2-5-16.

FINDING

Taxpayer's protest is sustained. The pallets and containers expensed and used by taxpayer to ship goods to its out of state sister division are exempt.

DEPARTMENT OF STATE REVENUE

0120020084.LOF

LETTER OF FINDINGS NUMBER: 02-0084
Individual Income Tax
For the Tax Periods: 1997 through 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

I. Individual Income Tax – Indiana Source Income

Authority: IC 6-3-2-1; IC 6-8.1-5-1; IC 6-3-1-12; 45 IAC 3.1-1-22; Fla. Stat. § 199.052; Fla Stat. §222.17

The Taxpayer protests the Department's adjustment to include dividends and interest in his adjusted gross income.

II. Individual Income Tax – Entertainment Expenses

Authority: IC 6-3-1-3.5; IRC § 212; IRC § 274; Treas. Reg §1.274-2; Treas. Reg §1.274-5A

The Taxpayer protests the Department's adjustment disallowing an entertainment expense.

III. Tax Administration – Penalty

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

The Taxpayer protests the Department's assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer and spouse filed joint Indiana individual income tax returns for the 1997, 1998, and 1999 calendar years. Taxpayer has filed form IT-40 PNR with the wife filing as an Indiana resident and the husband filing as a Florida resident. Taxpayer has excluded all income except in 1999 as being attributable to Florida. Taxpayer was audited for periods 1997 through 1999 and the auditor determined that all of husband's income was derived from Indiana sources. Taxpayer (husband) provided evidence of a Florida driver's license, voter registration, checking account and was selected for jury duty in Florida. Indiana BMV records indicate that husband's Indiana driver's license expired in August 1999. Taxpayers' residence is owned by a trust controlled by the wife and she claims the Indiana Homestead Credit on the Indiana property. Taxpayers indicated on their 1997 through 1999 Indiana tax returns that two vehicles were registered in Indiana. Taxpayers used their Indiana address on their federal income tax return. A business building burned in 1998, destroying records for business and personal operations. More facts supplied as necessary.

I. Individual Income Tax – Indiana Source Income

DISCUSSION

Taxpayer was audited for Income tax for the periods of 1997 through 1999. Taxpayer has filed form IT-40 PNR with the wife filing as an Indiana resident and husband filing as a Florida resident. Taxpayer has excluded all income except in 1999 as being attributable to Florida. The auditor determined that all of husband's income was derived from Indiana sources.

Taxpayer claims that since he is a resident of Florida his interest and dividend income should not be subject to tax in Indiana. IC 6-3-2-1 states in part: "[e]ach taxable year, a tax at the rate of three and four-tenths percent (3.4%) of adjusted gross income is imposed upon the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every non-resident person." In order to determine whether all of Taxpayer's income or just the income derived from Indiana sources is subject to Indiana adjusted gross income tax, Taxpayer must show that he was not an Indiana resident. "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.

A resident is defined as any individual who is domiciled in Indiana during the taxable year or any individual who maintains a permanent place of residence and spends more then one hundred eighty-three (183) days within the state. IC 6-3-1-12.

45 IAC 3.1-1-22 defines domicile as follows:

> For the purposes of this Act, a person has only one domicile at a given time even though that person maintains more than one residence at that time. Once a domicile has been established, it remains until the conditions necessary for a change of domicile occur.
>
> In order to establish a new domicile, the person must be physically present at a place, and must have the simultaneous intent of establishing a home at that place. It is not necessary that the person intend to remain there until death; however, if the person, at the time of moving to the new location, has definite plans to leave that new location, then no new domicile has been established.
>
> The determination of a person's intent in relocating is necessarily a subjective determination. There is no one set of standards that will accurately indicate the person's intent in every relocation. The determination must be made on the facts present in each individual case. Relevant facts in determining whether a new domicile has been established include, but are not limited to:
>
> (1) Purchasing or renting residential property
> (2) Registering to vote
> (3) Seeking elective office
> (4) Filing a resident state income tax return or complying with the homestead laws of a state
> (5) Receiving public assistance
> (6) Titling and registering a motor vehicle
> (7) Preparing a new last will and testament which includes the state of domicile.

Taxpayer/husband has provided documentation showing that he is registered to vote and has been summoned to jury duty in Florida. Taxpayer also maintains a Florida driver's license and maintained a checking account in Florida. The husband canceled his Indiana voter's registration in 1996. Taxpayers own several acres of farm ground in Indiana and own several Indiana businesses.

Taxpayers' residence is owned by a trust controlled by the wife and she claims the Indiana Homestead Credit on the Indiana property. However, Taxpayers indicated on their 1997 through 1999 Indiana tax returns that two vehicles were registered in Indiana. Also, according to records maintained by the Indiana Bureau of Motor Vehicles, the husband also maintained a valid Indiana driver's license that expired in August 1999 and registered a vehicle in Indiana in 2000. Taxpayers used their Indiana address on their federal income tax return.

While Taxpayer does not contend that the wife is a Florida resident, they claim that the husband is and that the couple spends much of their time in Florida. However, no documentation has been provided to show how much of each year is spent in Florida. Taxpayer conceded that a Florida Intangible Personal Property Tax Return was not filed as required by Fla. Stat. § 199.052. In addition. there is no evidence that husband filed a Declaration of Domicile in Florida pursuant to Fla Stat. §222.17.

Based on all the facts before the Department, Taxpayer has not demonstrated either a lack of an Indiana domicile or that he does not spend more then 183 days within the state of Indiana. Thus, all of Taxpayer's income should have been reported to Indiana.

FINDING

The Taxpayer's protest is respectfully denied.

II. Individual Income Tax – Entertainment Expenses

DISCUSSION

During the audit, the auditor made adjustments to Taxpayer's Sub-Chapter "S" distributions for disallowed advertising expenses. The expenses included Brickyard 400 and Indy Grand Prix race tickets.

The computation of Indiana Adjusted Gross Income for individuals begins with the definition provided in Section 62 of the Internal Revenue Code. IC 6-3-1-3.5. Taxpayer claims the expenses should be allowed pursuant to IRC § 212 which states in part: "[i]n the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year- (1) for the production or collection of income…."

However, Taxpayer does not consider IRC § 274(d) which states:

Substantiation Required. – No deduction or credit shall be allowed-

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,

(3) for any expense for gifts, or

(4) with respect to any listed property (as defined in section 280F(d)(4)),

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or the other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. …

This is clarified in Treas. Reg §1.274-2 (1) which states in relevant part:

Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Code shall be allowed for any expenditure with respect to entertainment unless the taxpayer establishes-

(i) That the expenditure was directly related to the active conduct of the taxpayer's trade or business, or

(ii) In the case of an expenditure directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the expenditure was associated with the active conduct of the taxpayer's trade or business….

Also Treas. Reg §1.274-2(c)(7) states:

Expenditures generally considered not directly related. Expenditures for entertainment, even if connected with the taxpayer's trade or business, will generally be considered not directly related to the active conduct of the taxpayer's trade or business, if the entertainment occurred under circumstances where there was little or no possibility of engaging in the active conduct of trade or business. The following circumstances will generally be considered circumstances where there was little or no possibility of engaging in the active conduct of a trade or business:

(i) The taxpayer was not present;

(ii) The distractions were substantial, such as-

(a) A meeting or discussion at night clubs, theaters, and sporting events, (*emphasis added*) or during essentially social gatherings such as cocktail parties….

Taxpayer has provided a list of the individuals who received the tickets. Yet, Taxpayer has not provided any documentation of what business took place either at or directly proceeding or following the races. Treas. Reg §1.274-5A(b)(1) states in part that:

Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;
(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift:
(iii) Business purpose; and
(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

Treas. Reg. §1.274-5A(c)(2) states:

To meet the "adequate records" requirements of section 274(d), a taxpayer shall maintain an account book, diary, statement of expense or similar records provided in subdivision (ii) of this subparagraph) which, in combination, are sufficient to establish each element of an expenditure specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, statement of expense or similar record which duplicates information reflected on a receipt so long as such account book and receipt complement each other in an orderly manner.

Consequently, the auditor was correct in disallowing the expenditures. Taxpayer has not shown that any business took place.

FINDING

Taxpayer's request is respectfully denied.

III. Tax Administration – Penalty

Taxpayer protests the ten percent negligence penalty. The Department may impose a ten percent (10%) negligence penalty on the amount of deficiency as determined by the Department. IC 6-8.1-10-2.1. Also, 45 IAC 15-11-2 states in part:

…

(a) "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.

(b) 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 causes is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has not provided any reasonable caused to show that the penalty should be waived. Taxpayer's protest is respectfully denied.

FINDING

The Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0120020118.LOF

LETTER OF FINDINGS NUMBER: 02-0118
Individual Income Tax
Calendar Years 1999 and 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.

ISSUE

I. Tax Administration – Penalty

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

Taxpayer protests the penalties assessed.

STATEMENT OF FACTS

The taxpayers' 1997 Indiana individual income tax return reflected a refund due in the amount of $9,544. According to the taxpayer's representative, the entire refund amount was to be applied to the taxpayer's 1998 estimated income tax account. However, someone altered the return by entering the figures $2,500 as the amount to be applied to the 1998 estimated account and $7,044 as an amount to be refunded to the taxpayer.

The $7,044 was refunded to the taxpayer. However, in preparing their 1998 and subsequent Indiana individual income tax returns, the taxpayers assumed that this amount had been applied to their estimated account and claimed credit for estimated tax payments accordingly. Naturally, the actual balance in the taxpayer's estimated account was consistently $7,044 less than what the taxpayers believed the balance to be. For tax years 1999 and 2000, the Department assessed penalties for the underpayment of estimated tax and the failure to remit the proper amount of tax due by the due date.

In a letter dated January 24, 2002, the taxpayer's representative requested that these penalties be waived based, in part, upon the following statement: "As soon as the refund (of $7,044) was identified as an estimated payment, the taxpayers paid the additional tax, interest and penalty…" This remittance was processed by the Department on November 27, 2000. The taxpayer's representative further asserts that the Department was in error in making the refund.

I. Tax Administration – Penalty

DISCUSSION

Administrative Rule 45 IAC 15-11-2 (b) states the following:

> "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 identity of the person who altered the 1997 return is unknown. However, lacking any evidence to the contrary, the Department must conclude that this alteration was made by the taxpayers. The refund of $7,044 for tax year 1997 is deemed to be due to the taxpayers' error and not to any error on the part of the Department. Therefore, the imposition of penalty is proper. The taxpayers have not established that their failure to timely pay the full amount of tax due was due to reasonable cause and not due to negligence.

FINDING

The taxpayers' protest is denied.

DEPARTMENT OF STATE REVENUE

0220020246.LOF

LETTER OF FINDINGS NUMBER: 02-0246
Unrelated Business Income Tax
For the Years Ending 1996 through 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. Adjusted Gross and Supplemental Net Income Tax – Unrelated Business Income

Authority: IC 35-45-5-3; IC 6-2.5-5-25; IC 6-2.1-3-23; IC 6-3-2-3.1(a); IC 6-3-1-17(a); IC 6-8.1-5-1; 45 IAC 3.1-1-68

The taxpayer protests the classification of proceeds from illegal gambling machines as unrelated business income.

II. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

The taxpayer protests the Department's imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

As a result of an Indiana Excise Police investigations and citations dated August 12, 1995 and June 29, 2000, the Taxpayer was cited for professional gambling under IC 35-45-5-3 and promotion of professional gambling under IC 35-45-5-4 respectively. The Department conducted an income tax audit based upon the Taxpayer's possession of five (5) illegal gambling machines discovered at its location.

The Taxpayer's representative admitted that the operation of the gaming machines was illegal for state law purposes. The taxpayer also received 60% of the proceeds from the machines for allowing and operating the machines at their facility.

I. Adjusted Gross and SNIT – Unrelated Business Income

DISCUSSION

Under Indiana Code section 35-45-5-3 the machines operated in taxpayer's establishment constitute illegal gambling. Proceeds from illegal gambling are considered unrelated business income and subject to Indiana gross or adjusted gross and supplemental net income tax.

IC 35-45-5-3 provides in pertinent part:

A person who knowingly or intentionally: … (3) maintains, in a place accessible to the public slot machines, one-ball machines or variants thereof… commits professional gambling, a Class D felony.

The Department and the Internal Revenue Service have held that illegal gambling is always unrelated to a tax exempt organization's exempt purpose. Exemption from tax for exempt organizations is tied to the gross income tax provisions with respect to exempt organizations. IC 6-2.5-5-25. As provided under IC 6-2.1-3-23, exempt organizations are not entitled to exemption from gross income received by a taxpayer that is derived from an unrelated trade or business, as defined in Section 513 of the Internal Revenue Code. Thus, the Department's determination was guided by I.R.C. § 513, which provides, in part, the following:

…The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Pursuant to IC 6-3-2-3.1(a) and IC 6-3-1-17(a), the Indiana General Assembly has expressly adopted the Code's tax treatment, with respect to Code section 501(c) organizations, for purposes of the Indiana adjusted gross and supplemental income tax analysis. Moreover, the Department's rule 45 IAC 3.1-1-68 defines an unrelated trade or business under the same guidelines as IRC section 513, and the rule also subjects any unrelated business income to the Indiana taxes. Additionally, the rule cites taxpayers to Code sections 511 through 515 for guidance in determining whether income is subject to the taxes.

Pursuant to IC 6-8.1-5-1 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 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.

The taxpayer's representative argues that only their members are allowed to use the gambling machines and that all of the money should have been classified as related business income. The taxpayer contends that it is a fraternal organization organized for social purposes and that the machines are played for social purposes and are a vital part of its receipts used to operate its facility. The taxpayer's representative contends that they had an audit by the Internal Revenue Service in which the federal auditor told the organization that gambling proceeds from its machines is related business income. The Department doubts the validity of IRS auditor's alleged statement. If the taxpayer was established to overtly conduct illegal activities then the income could be classified as related. The use of illegal gambling machines is also grounds for the IRS and State of Indiana to revoke taxpayer's not-for-profit status.

FINDING

The taxpayer's protest is denied.

II. Tax Administration – Liability for 10% Negligence Penalty

DISCUSSION

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent. 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

In this instance, the taxpayer has shown reasonable cause. The taxpayer has provided to the Department's satisfaction, sufficient justification for why the negligence penalty should be waived.

FINDING

The taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420020284.LOF

LETTER OF FINDINGS NUMBER: 02-0284 ST
Sales And Use Tax
For Tax Periods: 1998 through 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 specific issues.

ISSUE

Sales and Use Tax – Public Transportation Exemption

Authority: IC 6-2.5-3-2, IC 6-2.5-5-27, 45 IAC 2.2-5-61(b), National Serv-All, Inc. v. Indiana Department of State Revenue, 644 N.E. 2d 960 (Ind. Tax 1994), Indiana Waste Systems of Indiana, Inc. v. Indiana Department of State Revenue, 644 N.E. 2d 960 (Ind. Tax 1994), Panhandle Eastern Pipeline Company and Trunkline Gas Company v. Indiana Department of State Revenue, 741 N.E.2d 816 (Ind. Tax 2001)

The taxpayer protests the assessment of tax on a boom for a wrecker, trucks, and truck repair parts.

STATEMENTS OF FACTS

The taxpayer is an Indiana corporation that operates a body shop primarily making repairs to customer owned trucks. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional sales and use tax. The taxpayer protests the assessment of use tax on certain items that it contends were used in public transportation.

Sales and Use Tax – Public Transportation Exemption

DISCUSSION

IC 6-2.5-3-2 imposes the use tax on "the storage, use, or consumption of tangible personal property in Indiana." The department assessed use tax on several items used in the taxpayer's business. The taxpayer contends that the boom for a wrecker, certain trucks, and truck repair parts qualify for the public transportation exemption from the use tax pursuant to the following provisions of IC 6-2.5-5-27:

> Transactions involving tangible personal property and services are exempt from the state gross retail tax, if the person acquiring the property or service directly uses or consumes it in providing public transportation for persons or property.

The taxpayer supports this contention by citing the definition of public transportation found at 45 IAC 2.2-5-61 (b) as follows:

> Public transportation shall mean and include the movement, transportation, or carrying of persons and/or property for consideration by a common carrier, contract carrier, household goods carrier, carriers of exempt commodities, and other specialized carriers performing public transportation service for compensation by highway, rail, air or water, which carriers operate under authority issued by, or are specifically exempt by statute or regulation from economic regulation of, the public service commission of Indiana, the Interstate Commerce Commission, the aeronautics commission of Indiana, the U.S. Civil Aeronautics Board, the U.S. Department of Transportation, or the Federal Maritime Commissioner; however, the fact that a company possesses a permit or authority issued by the P.S.C.I., I.C.C., etc., does not of itself mean that such a company is engaged in public transportation unless it is in fact engaged in the transportation of persons or property for consideration as defined above.

The issue to be determined in this case is how the public transportation exemption from the use tax applies to the taxpayer's boom for a wrecker, trucks, and truck repair parts.

The Indiana Tax Court has addressed the issue of public transportation in several cases. The first two cases involved contract hauling of garbage. In National Serv-All, Inc. v. Indiana Department of State Revenue, 644 N.E. 2d 954 (Ind. Tax 1994), the Court stated that although National Serv-All "engaged in 'public transportation' when it hauled Contract garbage," nonetheless National Serv-All did not prove "that its hauling of Contract garbage was the *predominant share* of its use of the items at issue." Id. At 959. (Emphasis in the original). The Court concluded: "Although National engaged in the public transportation of property within the meaning of IC 6-2.5-5-27 when it hauled Contract garbage, it did not prove it predominantly engaged in public transportation." Id. at 960.

The Court faced a similar issue concerning the applicability of the public transportation exemption to the contract hauling of garbage in Indiana Waste Systems of Indiana, Inc. v. Indiana Department of State Revenue, 644 N.E. 2d 960 (Ind. Tax 1994). In that case the Court held as follows:

> Waste Management's maximum annual revenue from public transportation was 17.7 percent of its total revenue, and therefore, the remaining 80 percent of its revenue came from non-public transportation. The predominant use of Waste Management's trucks and other items, therefore, is not exempt...

Id. at 962.

The third case dealing with this issue is Panhandle Eastern Pipeline Company and Trunkline Gas Company v. Indiana

Department of State Revenue, 741 N.E.2d 816 (Ind. Tax 2001). The petitioners were pipeline companies that transported natural gas belonging to third parties and natural gas belonging to the petitioners. In each case, the predominate use of the pipelines was to transport natural gas belonging to others. The Court, after noting the relevance of its two previous cases on public transportation, stated the following.

> If a taxpayer acquires tangible personal property for predominate use in providing public transportation for third parties, then it is entitled to the exemption. If a taxpayer is not predominately engaged in transporting the property of another, it is not entitled to the exemption.

Id. at 819.

The Indiana Tax Court has set out a two-pronged test to determine if a particular business qualifies for the public transportation exemption from sales and use tax. First the taxpayer must be predominately engaged in public transportation of the property of another. Secondly, the taxpayer's property must be predominately used for providing public transportation.

The first prong looks at the taxpayer itself. A determination must be made whether or not the taxpayer is engaged in public transportation. The second prong looks at the individual units to determine how they are used. Both prongs must be satisfied for the taxpayer to qualify for the public transportation exemption.

In this situation, the taxpayer is primarily engaged in the repair of customer owned motor vehicles. It is not predominately engaged in public transportation. Therefore, having failed the first prong of the test, the taxpayer does not qualify for the public transportation exemption from the sales and use tax for any of the years of the audit. The department does not need to determine whether the taxpayer's use of the one re-supply truck qualifies that truck for the public transportation exemption.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220020311.LOF

LETTER OF FINDINGS NUMBER: 02-0311
Indiana Corporate Income Tax
For the 1998, 1999, and 2000 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.

ISSUES

I. Inclusion of Capitation Payments in Taxpayer's Reserve Exclusion – Gross Income Tax

Authority: 45 IAC 1-1-68; 45 IAC 1.1-1-14; 45 IAC 1.1-1-14(a); 45 IAC 1.1-1-14(j); Tax Policy Directive #9, July 1995; Black's Law Dictionary (7th ed. 1999)

Taxpayer maintains that, for purposes of computing its gross income tax liability, it is entitled to include capitation payments in its reserve exclusion.

II. Credit for Payments Made to the Indiana Comprehensive Health Insurance Association

Authority: IC 6-8.1-5-1(b); IC 27-8-10-2.1(a); IC 27-8-10-2.1(f); IC 27-8-10-2.1(g); IC 27-8-10-2.1(n)(1); IC 27-8-10-2.1(n)(2)

Taxpayer argues that the audit erred when it disallowed an income tax credit which taxpayer had claimed for payments made to the Indiana Comprehensive Health Insurance Association (ICHIA).

STATEMENT OF FACTS

The taxpayer is an Indiana Health Maintenance Organization (HMO) currently undergoing liquidation. As part of the liquidation proceedings, the taxpayer's income tax returns for 1998, 1999, and 2000 were reviewed. The audit made two adjustments to the returns which resulted in an assessment of additional corporate income taxes. Taxpayer protested the audit's conclusions, an administrative hearing was conducted, and this Letter of Findings followed.

DISCUSSION

I. Inclusion of Capitation Payments in Taxpayer's Reserve Exclusion – Gross Income Tax

Before undergoing liquidation, the taxpayer was a health maintenance organization (HMO). As such, it provided health care services to a defined, enrolled population of insureds. Individual insureds were each charged an annual premium which was not directly related to the services the insureds received during a particular time period.

The taxpayer contracted with independent third-party physicians to provide the insureds the necessary health care services. The insureds were free to choose one of these participating physicians as the individual insured's primary health care provider. The taxpayer compensated the participating physicians on a capitation basis; for each insured who had chosen a particular physician, that physician would receive a designated amount each month. The amount of capitation payments each physician received was unrelated to the number of times the individual insureds obtained medical services.

In 1985, taxpayer – together with a number of similarly situated insurance companies – sought and received a Revenue Ruling from the Department of Revenue. The petitioners sought and received a determination that, under 45 IAC 1-1-68, in reporting their taxable receipts, the petitioners as HMOs were entitled to deduct from their gross income an amount equal to the HMO's gross premiums, multiplied by the ratio of claims incurred, to premiums earned during the taxable year. For simplicity's sake, this amount will be hereinafter referred to as the "reserve exclusion." Specifically the Department ruled as follows:

> [I]t is apparent to the Department that HMOs should be treated analogously to traditional health insurance carriers. Accordingly, under the authority of Regulation 45 IAC 1-1-68, [petitioners] shall be permitted, in computing their gross income tax liability, to exclude from gross enrollment fees (i.e., premium income) a corresponding amount computed by multiplying their gross fee premium income by the ratio of medical and hospital care payments made by the HMO to premiums earned by the HMO on an annual basis.

However, following an audit of taxpayer's income tax returns, the audit determined that taxpayer erred in calculating its reserve exclusion. The audit found that "capitation payments were erroneously included." The audit stated that the capitation payments should not have been included because the "capitation payments were a fixed prepayment to doctors, hospitals, etc. to cover members' medical needs regardless of the actual number of services provided to each person." Essentially, because the capitation payments were not an amount "at risk," the audit concluded that the capitation payments should not have been included in the reserve account.

The 1985 Revenue Ruling was issued on January 16, 1985. Pursuant to Tax Policy Directive #9, July 1995, the 1985 ruling was "declared null and void and of no effect for tax years beginning after December 31, 1996." Nonetheless, it is reasonable to assume that the 1985 Revenue Ruling correctly interpreted the pertinent gross income tax regulations in effect at the time the original ruling was first issued.

The 1985 Revenue Ruling interpreted 45 IAC 1-1-68, "Explanation of Lines 1 through 5: Underwriting Income" under that portion of the regulation related to "Accident and Health Insurance." In pertinent part, that section reads as follows:

> 3. For classes of business on which reserves comparable to life insurance reserves are maintained – use company records of net premiums for such business... with respect to such classes of business as noncancellable accident and health insurance.
> 4. For other accident and health business or hospitalization multiply the gross premiums for such business included in line 1, Column 1, by the ratio of claims incurred... to premiums earned... for such other accident and health insurance, e.g., groups, and other short-term cancelable accident and health policies.

The 1985 Revenue Ruling interpreted the 45 IAC 1-1-68 to mean that traditional health insurers were entitled to exclude from their gross income a reserve amount sufficient to pay its insureds' anticipated health care costs. For example, if an individual insured paid $2,000 for one year's coverage, the $2,000 would constitute the insurer's "gross premiums." Thereafter, the traditional insurer was entitled – based upon its past claims experience – to exclude from its gross income an amount necessary to pay the insured's anticipated medical costs for the covered year. For purposes of this example, the insured might determine that $1,500 was necessary to pay those anticipated costs. The amount of its "reserve exclusion" would, of course, be based upon the insurer's claim experience over a very large number of its insureds. Based upon that larger pool of insureds, the $1,500 individual reserve – multiplied by the total number of similar insureds – would be expected to cover the total medical expenses for the entire pool.

For reasons not relevant here, HMO's operate differently. Assuming that one of taxpayer's own insureds paid taxpayer $2,000 for one years worth of individual health care coverage, the taxpayer would thereafter make capitation payments to the health care provider selected by that particular insured. The taxpayer might make $100 monthly capitation payments to the physician; in this example, the physician would receive $1,200 over the course of that year. The amount of capitation payments would be based upon on the anticipated health care costs for that single insured. However, the physician would receive the $1,200 regardless of the number of times the insured sought and received services from the provider.

The language contained within the 1985 Revenue Ruling is straightforward. The ruling states that, "HMOs should be treated analogously to traditional health insurance carriers." The reserve amount, maintained by traditional health insurers, is analogous to the capitation payments paid by HMOs to their physicians. Although the amount of the reserve might be considered an amount "at risk," in reality, the difference between the reserve amount and the capitation payments is simply one of semantics and is not reflected in practical reality. Both the reserve amount and the capitation payments reflect the insurers' determination – based upon past claims experience – of the cost of providing medical services for a particular pool of insureds. Regardless of the appropriateness of providing such an exclusion, 45 IAC 1-1-68, as interpreted by the 1985 Revenue Ruling, permits both traditional health insurers and HMOs to treat, for gross income tax purposes the amount paid to health care providers, as "pass through" income having no gross income tax effect for the traditional health insurer *or* the HMO.

However, the taxpayer lodges its protest based upon gross income tax assessments for 1998, 1999, and 2000. The determination above applies only to the 1998 assessment made against the taxpayer because, on January 1, 1998, the regulations governing the gross income tax law were revised. Thereafter, 45 IAC 1.1-1-14 governs the issues raised by taxpayer concerning the capitation payments.

The regulation states, in relevant part, as follows:

Except as otherwise provided in this section, "gross income of an insurance carrier" means the total amount of premiums, interest, dividends, commissions, rents, and other earnings with respect to conducting the business of an insurance. The term does not include the following: (1) The amount of gross earnings which becomes or is used to maintain a policy reserve or other policy liability, to the extent that the insurance carrier is required to maintain the policy reserve or other policy liability by the department of insurance. 45 IAC 1.1-1-14(a).

Also relevant to taxpayer's argument is the 45 IAC 1-1-14(j) which states that "[f]or purposes of this section and 45 1.1-6-11, a health maintenance organization licensed under IC 27-13 shall be treated the same as an insurance carrier selling accident and health insurance on all income from providing prepaid health care."

Because the 1985 Revenue Ruling expired in 1995 and, because 45 IAC 1-1-68 was replaced in 1999, 45 IAC 1.1-1-14(a), (j) governs taxpayer's 1999 and 2000 claims. 45 IAC 1.1-1-14(a) permits an insurer to exclude from its gross income an amount sufficient "to maintain a policy reserve." A "policy reserve" is defined as "[a]n insurance company's reserve that represents the difference between net premiums and expected claims for a given year." Black's Law Dictionary 1308 (7th ed. 1999). More generally, a "reserve" is defined as "a fund of money set aside by a bank or an insurance company to cover future liabilities." Id.

Resorting again to the example first cited above – in which the insured paid a yearly premium of $2,000 and the HMO insurer made capitation payments of $1,200 – the amount of "net payment" is $2,000 and the amount of "expected claims" is $1,200. The difference between the two figures is, of course, $800. The $800 represents the insurance company's cost of operations, profits, and those medical costs which are not covered by the capitation payments.

It is apparent that taxpayer's capitation payments do not come within the designation of a "policy reserve" as defined under 45 IAC 1.1-1-14(a) because those particular payments are not "set aside by... an insurance company to cover future liabilities." As set out in the prior example, the HMO insurer would be entitled to set aside a portion of the $800 to pay for those medical expenses not covered by the capitation payments. It is this amount – not the capitation payments – which may be included within the reserve exclusion allowed under 45 IAC 1.1-1-14(a). The 1999 and 2000 capitation payments are within the definition of "gross income of an insurance carrier" and are properly subject to the gross income tax.

Therefore, based upon the 1985 Revenue Ruling and its interpretation of 45 IAC 1-1-68, taxpayer's capitation payments may be included in its 1998 gross income tax reserve exclusion. However, based upon the fact that the 1985 Revenue Ruling expired in 1996 and that 45 IAC 1.1-1-14 replaced the prior regulation, taxpayer is not entitled to include the capitation payments in its 1999 or 2000 gross income tax reserve exclusion.

FINDING

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

II. Credit for Payments Made to the Indiana Comprehensive Health Insurance Association

Taxpayer was a member of the Indiana Comprehensive Health Insurance Association. (*Hereinafter* "ICHIA"). ICHIA is a non-profit legal entity that provides health insurance to Indiana residents who cannot obtain private insurance. IC 27-8-10-2.1(a). All Indiana health insurance carriers, such as taxpayer, which provide health insurance or health care services within the state are required to be members of ICHIA. Id. Because ICHIA is required to charge rates which "may not be unreasonable in relation to the benefits provided..." (IC 27-8-10-2.1(f)), ICHIA usually generates losses rather than profits. ICHIA recovers those losses by making assessments to its members in proportion to the amount of health insurance premiums that the members earn during each year. IC 27-8-10-2.1(g). However, each member is thereafter permitted to take a credit against its state income tax liability up to the amount of the assessment paid to ICHIA. IC 27-8-10-2.1(n)(1). Alternatively, the member is entitled to recoup the assessment by passing along the cost to its own insureds. IC 27-8-10-2.1(n)(2). However, the members may not do both; the insurer may either take the credit against their income tax *or* pass the ICHIA assessment along to its own insureds in the form of increased premium costs.

The audit determined that taxpayer had claimed the credit in calculating its gross income. Although taxpayer was able to provide documentation that the amounts claimed were actually paid to ICHIA, it was unable to provide verification that the amounts had not also been included in its premium base. Specifically, taxpayer was asked to provide a statement from the head of its actuarial department attesting that the ICHIA payments were not included in the premium base. However, taxpayer's representatives were unable to do so because, according to the representatives, taxpayer's former officers were unwilling to supply the requested information.

Taxpayer argues that the ICHIA payments could not have been included in the premium base because taxpayer did not charge premium rates sufficient to recoup its expenses. According to taxpayer, this is evidenced by the fact that taxpayer accumulated a substantial retained deficit at the time it entered into liquidation.

The fact that the taxpayer sustained substantial losses is not alone sufficient to warrant a finding that the assessment was incorrect. It is entirely possible that taxpayer, despite indications that it incurred substantial financial losses, erroneously claimed the ICHIA payments as a credit on its income tax and erroneously included the payments in its premium base.

Under IC 6-8.1-5-1(b), the taxpayer bears the burden of demonstrating that the proposed assessment is incorrect. The statute establishes that "[t]his 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 submitted affidavits purporting to establish that it did not recoup the ICHIA payments in its premium rate amounts and that it was legitimately entitled to claim credit against its income tax in accordance with IC 27-8-10-2.1(n)(1). Taxpayer included an affidavit from the Commissioner of the Indiana Department of Insurance. The Commissioner somewhat circumspectly stated that the "[Commissioner was] in no manner acknowledging the validity of the [taxpayer's] claim...." However, the Commissioner also noted that taxpayer's contention, that it was unable to recoup the ICHIA payment via increases to its premium rates, was consistent with taxpayer's earlier assertions set out in an action brought by taxpayer – together with two other HMOs licensed in the state of Indiana – against ICHIA and the Commissioner.

Taxpayer submitted an affidavit prepared by the taxpayer's former vice-president and general manager. The affiant's former responsibilities included "overall development of the operating budget and strategic plan for the company." In addition, the affiant stated that she was "privy to and participated in the process whereby [taxpayer] developed its premium rates...." Further, the affiant stated that, "it was not economically feasible for [taxpayer] to increase premiums to recover ICHIA assessments above its annual tax credits" and that "[t]o increase premiums to recover the excess amount of accrued ICHIA assessments would have put [taxpayer] at a competitive disadvantage in a highly competitive market...." The affiant further stated that "there was never a line item added during the development of [taxpayer's] premium rates, or during the filing of such rates with the Indiana Department of Insurance, to recoup ICHIA Assessments pursuant to Ind. Code § 27-8-10-2.1(n)(2)."

Taxpayer submitted an affidavit prepared by a consulting actuarial. The actuarial was employed by the Indiana Department of Insurance. During that time, the actuarial was required to review rate filings submitted by various HMOs including taxpayer's own rate filings. The actuarial reviewed the taxpayer's rate filings which would have been effective in 1998, 1999, and 2001. The actuarial indicated that there was no reference in the rate filings "indicating or otherwise suggesting that [taxpayer], in accordance with the terms of I.C. § 27-8-10-2.1(n), included in its premium rate calculations amounts sufficient to recoup the... ICHIA assessments, or any portions thereof."

Under IC 6-8.1-5-1(b), the taxpayer has met its burden of demonstrating that the proposed assessment is incorrect.

FINDING

Taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0120020426.LOF

LETTER OF FINDINGS NUMBER: 02-0426
Indiana Individual Income Tax
For the Tax Year 2001

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. Individual Income Tax – Imposition

Authority: Rockland R. Snyder v. Indiana Department of Revenue, 723 N.E.2d 487 (Ind. Tax 2000); IC 6-3-1-3.5; IC 6-8.1-4-2; 45 IAC 3.1-1-1; 45 IAC 3.1-1-2; Black's Law Dictionary, 6th Ed., 1579 (West Publishing, 1990)

Taxpayer protests imposition of Indiana Individual Income tax.

STATEMENT OF FACTS

Taxpayer filed a 2001 Indiana individual income tax return on which he reported that his Federal adjusted gross income was "0" (zero). The Indiana Department of Revenue ("Department") issued a proposed assessment for 2001 individual income taxes. Taxpayer protests this assessment. Further facts will be provided as necessary.

DISCUSSION

Taxpayer protests the Department's proposed assessment of 2001 individual adjusted gross income tax. Taxpayer filed a 2001 Indiana individual income tax return with Federal adjusted gross income reported as "0" (zero). The Department reviewed the documentation available to it and, after determining that taxpayer received pension payments during the tax period, issued a proposed assessment for 2001. Taxpayer protests that, since he reported "0" on his Federal tax return, he was compelled to report his income as "0" on his Indiana tax return or commit perjury. Taxpayer presented several Federal cases, which he believes support his position that pension payments are not income.

Taxpayer presents arguments that have been made before. The Indiana Tax Court dealt with an identical argument in Rockland R. Snyder v. Indiana Department of Revenue, 723 N.E.2d 487 (Ind. Tax 2000). In that case, the Court wrote:

Indiana relies upon the Internal Revenue Code's definitions for gross and adjusted gross income. Even so, in ascertaining whether Snyder is liable for his unpaid state adjusted gross income taxes, this Court is not obligated to adopt the federal courts' interpretations of income under I.R.C. § 61(a). However, their interpretations are certainly persuasive in this matter. Common definition, an overwhelming body of case law by the United States Supreme Court and federal circuit courts, and this Court's opinion in *Thomas* all support the conclusion that wages are income for purposes of Indiana's adjusted gross income tax. Snyder, at 491.

The word "Wages" is defined as, "A compensation given to a hired person for his or her services. Compensation for employees based on time worked or output of production." Black's Law Dictionary, 6th Ed., 1579 (West Publishing, 1990). The word "Pension" is defined as, "Retirement benefit paid regularly (normally, monthly), with the amount of such benefit based generally on length of employment and amount of wages or salary of pensioner. *Deferred compensation for services rendered.*" Black's 6th ed, at 1134, (emphasis added). Therefore, pensions are simply deferred wages.

The Department refers to 45 IAC 3.1-1-1, which states:

Adjusted Gross Income for Individuals Defined. For individuals, "Adjusted Gross Income" as defined in Internal Revenue Code § 62 modified as follows:

(1) Begin with gross income as defined in section 61 of the Internal Revenue Code.
(2) Subtract any deductions allowed by section 62 of the Internal Revenue Code.
(3) Make all modifications required by IC 6-3-1-3.5(a).

Also, IC 6-3-1-3.5 states in relevant part:

When used in IC 6-3, the term "adjusted gross income" shall mean the following:

(a) In the case of all individuals, "adjusted gross income" (as defined in Section 62 of the Internal Revenue Code), modified as follows:

….

The statute then lists Indiana's modifications to Federal adjusted gross income. The instructions on the tax form are there to show taxpayers where to put numbers. IC 6-3 and its accompanying statutes and regulations inform taxpayers what numbers to put on the form. The wording on the form does not relieve a taxpayer of the duty to accurately report income as defined in the Internal Revenue Code.

Next, the Department refers to 45 IAC 3.1-1-2, which states in relevant part:

Indiana residents must report all income as defined by § 61of the Internal Revenue Code. Sources of income include, but are not limited to:

…

(11) Pensions

As part of the written protest, taxpayer stated that the Department needed to show where in the Indiana statutes it gives anyone the right to change his tax return. The Department refers to IC 6-8.1-4-2, which states:

(a) The division of audit may:

(1) have full prompt access to all local and state official records;
(2) have access, through the data processing offices of the various state agencies, to information from government and private sources that is useful in performing its functions;
(3) inspect any books, records, or property of any taxpayer which is relevant to the determination of the taxpayer's tax liabilities;
(4) detect and correct mathematical errors on taxpayer returns;
(5) detect and correct tax evasion;
(6) employ the use of such devices and techniques as may be necessary to improve audit practices.

(emphasis added)

This statute gives the Department the right to change a taxpayer's tax return.

At the administrative hearing, taxpayer provided several federal tax cases as support for his protest. These cases dealt with federal taxation of corporations (primarily on capital gains), rather than state taxation of an individual's adjusted gross income. As these cases are not relevant to Indiana adjusted gross income tax for individuals, the Department will not discuss them further.

In conclusion, the Department determined that taxpayer received pension payments during 2001, and has the right under IC 6-8.1-4-2(a) to change taxpayer's tax return. Pensions are deferred wages and the Indiana Tax Court has already determined that wages are income for purposes of Indiana's adjusted gross income tax, as explained in Snyder. 45 IAC 3.1-1-2 explicitly states that pensions are to be reported as income. Taxpayer was required to report on his Indiana form income as defined in section 61 of the Internal Revenue Code.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120020427.LOF

LETTER OF FINDINGS NUMBER: 02-0427
Indiana Individual Income Tax
For the Tax 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Imposition of State's Individual Income Tax by Reference to Taxpayer's Federal Adjusted Gross Income

Authority: Ind. Const. art. I, § 25; Ind. Const. art. IV, § 1; Ind. Const. art. X, § 8; IC 6-3-1-3.5; Cooper Industries, Inc. v. Indiana Dept. of State Revenue, 673 N.E.2d 1209 (Ind. Tax Ct. 1996); Ind. Dept. of Envtl. Management v. Chemical Waste Management, Inc., 643 N.E.2d 331 (Ind. 1994); Campbell v. Heiss, 53 N.E.2d 634 (Ind. 1944); Bissell Carpet Sweeper Co. v. Shane Co., 143 N.E.2d 415 (Ind. 1957); 45 IAC 3.1-1-1

Taxpayer argues that because he reported "0" income on his Federal income tax return, he was compelled to report "0" income on his state return for that same year. In addition, taxpayer maintains that, under the Indiana Constitution, the state may not impose a state income tax by reference to the Federal Internal Revenue Code.

II. Imposition of the State's Individual Income Tax on Taxpayer's Wages

Authority: Ind. Const. art. X, § 8; IC 6-3-1-3.5 et seq.; Butchers' Union Slaughter-House v. Crescent City Live-Stock, 111 U.S. 746 (1884); New York v. Graves, 300 U.S. 308 (1937); Merchant's Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); Doyle v. Mitchell, 247 U.S. 179 (1918); United States v. Connor, 898 F2d 942 (3rd Cir. 1990); Wilcox v. Commissioner of Internal Revenue, 848 F2d 1007 (9th Cir. 1988); Coleman v. Commissioner of Internal Revenue, 791 F2d 68 (7th Cir. 1986); United States v. Koliboski, 732 F2d 1328 (7th Cir. 1984); United States v. Ballard, 535 F.2d 400 (8th Cir. 1976); United States v. Romero, 640 F2d 1014 (9th 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)

Taxpayer argues that he did not receive taxable "income" because the exchange of labor for pay of equal value does not produce "income."

III. Payment of the Indiana Income Tax is Voluntary

Authority: IC 6-8.1-11-2; Helvering v. Mitchell, 303 U.S. 391 (1938); United States v. Gerads, 999 F.2d 1255 (9th Cir. 1993); McLaughlin v. United States, 832 F.2d 986 (7th Cir. 1987); McKeown v. Ott, No. H 84-169, 1985 WL 11176 at *2 (N.D. Ind. Oct. 30, 1985)

Taxpayer maintains that payment of the state's income tax is entirely voluntary and that he no longer "volunteers" to pay state income tax.

IV. Sufficiency of Taxpayer's Indiana Tax Return

Authority: 45 IAC 15-5-7; 45 IAC 15-5-7(f)(1)

Taxpayer argues that he fulfilled his obligations under the federal and state's adjusted gross income tax laws because he submitted a return which had been completed by writing a series of "zeroes."

STATEMENT OF FACTS

Taxpayer prepared and submitted an Indiana income tax return for 2000 in which he reported receiving "0" adjusted gross income. The Department of Revenue (Department) disagreed and subsequently sent taxpayer notices indicating that he owed unpaid state income taxes. Taxpayer answered the notices stating that the assessments were erroneous based upon various legal arguments. Taxpayer demanded the opportunity for a hearing during which he would have the opportunity to explain the basis for his protest. That opportunity was granted, and this Letter of Findings follows.

DISCUSSION

I. Imposition of State's Individual Income Tax by Reference to Taxpayer's Federal Adjusted Gross Income

Taxpayer has set out numerous arguments challenging the legitimacy of the state's income tax scheme. Those arguments have been grouped into the four general sections set out in this Letter of Findings. Taxpayer's first arguments challenge generally the legitimacy of the state's practice of referencing the federal rules in interpreting and applying the state's own tax laws.

A. Delegation of State Legislative Authority

Taxpayer argues that, "Nowhere in the Indiana Constitution did the people of this state give any power to the federal government to make laws exclusively for those living in Indiana." In effect, taxpayer argues that the Indiana Constitution does not permit references to another taxing jurisdiction's own laws and when faced with such an improper reference – such as that found within IC 6-3-1-3.5 – the taxpayer's compliance is not required.

Specifically, taxpayer cites to Ind. Const. art. I, § 25 which states that, "No law shall be passed, the taking effect of which shall be made to depend upon any authority, except as provided in this Constitution." This section of the state constitution is intended to place a limit on "the legislative activity of the General Assembly." Ind. Dept. of Envtl. Management v. Chemical Waste Management, Inc., 643 N.E.2d 331, 341 (Ind. 1994).

The Indiana Constitution vests all legislative authority in the Indiana General Assembly. "The Legislative authority of the State shall be vested in a General Assembly, which shall consist of a Senate and a House of Representatives. The style of every law shall be: 'Be it enacted by the General Assembly of the State of Indiana': and no law shall be enacted, except by bill." Ind. Const. art. IV, § 1. Taxpayer is correct in his assertion that, under Ind. Const. art. I, § 25 and art. IV, § 1, the Indiana General Assembly may not delegate either its authority or its responsibility for performing its exclusively legislative functions. "The power to legislate or to exercise a legislative function cannot be delegated to a non-governmental agency or person. Nor can the Legislature delegate its law-making power to a governmental officer, board, bureau or commission." Bissell Carpet Sweeper Co. v. Shane Co., 143 N.E.2d 415, 419 (Ind. 1957) (Internal citations omitted).

On its face, taxpayer's contention appears to have merit. The Indiana General Assembly may not delegate its responsibility for defining the state's adjusted gross income tax scheme to the federal government. Neither may the Assembly's authority to implement such a scheme be obtained under federal law. However, the cross-references to the Internal Revenue Code – such as I.R.C. § 62 cited within IC 6-3-1-3.5 – does not delegate any such authority. The state legislature did not turn over its authority to the federal government. The state legislature did not obtain its authority from the federal government. Ind. Const. art. X, § 8 unambiguously states that, "The general assembly may levy and collect a tax upon income from whatever source derived...." The Indiana Code provisions reflect merely the legislature's considered and independent decision to employ the federal calculation as the starting point for determining Indiana's adjusted gross income tax. "It is well settled that a legislative body may enact a law, the operation of which depends upon the existence of a stipulated condition." Campbell v. Heiss, 53 N.E.2d 634, 636 (Ind. 1944). The state legislature has retained its independent authority to define and enforce the state's own income tax plan. That the Indiana General Assembly has retained authority to stake out the parameters of the state's adjusted gross income tax scheme is evidenced by the Assembly's decisions to periodically reenact IC 6-3-1-3.5 the latest of which occurred in 2001. Whether the General Assembly should have avoided internal references to the Internal Revenue Code by independently drafting original statutory provisions mirroring the Internal Revenue Code and then require every Indiana taxpayer to recalculate his taxable income, is an issue beyond the scope of this Letter of Findings and irrelevant to determining taxpayer's tax liability. Suffice it to say that the General Assembly acted entirely within its authority in employing the federal adjusted gross income as the jumping off point for calculating the individual taxpayer's Indiana adjusted gross income.

B. Taxpayer's Reported Federal Income Tax

Taxpayer makes a somewhat related argument. Taxpayer argues that he accurately reported his income by placing "zeroes" on his state tax return. Taxpayer bases this argument by stating that he had no legal alternative because he had also placed "zeroes" on his federal return. Taxpayer rhetorically asks, "Should I have perjured myself and claimed that I reported something other than the 'zeroes' I reported on my Federal tax returns for my Gross Income."

A copy of taxpayer's federal income tax return indicates that taxpayer did indeed fill out the form by placing numerous zeroes on that form. It is undisputed that the Indiana tax return for the tax year 2000 employs federal adjusted gross income as the starting point for determining the taxpayer's state individual income tax liability. Line one of the IT-40 form requires the taxpayer to "Enter your federal adjusted gross income from your federal return (see page 9)."

IC 6-3-1-3.5 states as follows: "When used in IC 6-3, the term 'adjusted gross income' shall mean the following: (a) In the case of all individuals 'adjusted gross income' (as defined in Section 62 of the Internal Revenue Code)...." Thereafter, the statute proceeds to delineate specific addbacks and deductions, peculiar to Indiana, which modify the federal adjusted gross income amount. The Department's regulation concisely restates the same formulary principal. 45 IAC 3.1-1-1 defines individual adjusted gross income as follows:

> Adjusted Gross Income for Individuals Defined. For individuals, "Adjusted Gross Income" is "Adjusted Gross Income as defined in Internal Revenue Code § 62 modified as follows:
>
> (1) Begin with gross income as defined in section 61 of the Internal Revenue Code.
> (2) Subtract any deductions allowed by section 62 of the Internal Revenue Code.
> (3) Make all modifications required by IC 6-3-1-3.5(a).

Both the statute, IC 6-3-1-3.5, and the accompanying regulation, 45 IAC 3.1-1-1, require that an Indiana taxpayer employ the federal adjusted gross income calculation, as determined under I.R.C. § 62, as the starting point for determining that taxpayer's Indiana adjusted gross income.

Taxpayer's contention – that he was compelled by force of law to declare "0" as Indiana adjusted gross income because he declared "0" on his federal return – is patently without merit. The statute is plain and unambiguous. Indiana adjusted gross income begins with federal taxable income as defined by I.R.C. § 62, not as reported by the taxpayer. *See* Cooper Industries, Inc. v. Indiana Dept. of State Revenue, 673 N.E.2d 1209, 1213 (Ind. Tax Ct. 1996). The directions contained within the Indiana income tax form provide the individual taxpayer with abbreviated directions for completing the form and not the means for determining the taxpayer's adjusted gross income. The Indiana tax form instructs the taxpayer to put what number in what box. Those directions notwithstanding, taxpayer is nonetheless required to actually perform the calculations necessary to determine his liability for Indiana adjusted gross income tax.

FINDING

Taxpayer's protest is denied.

II. Imposition of the State's Individual Income Tax on Taxpayer's Wages

Taxpayer's next argument is that he did not receive any "income" because he only exchanged his labor – one form of property – for money – another form of property. Therefore, because taxpayer did not receive any "gain" but merely a "like-kind" exchange, he received no taxable income.

In support of this proposition, taxpayer cites to Butchers' Union Slaughter-House v. Crescent City Live-Stock, 111 U.S. 746, 757 (1884), which states in part:

> The property which every man has in his own labor, as it is the original foundation of all other property, so it is the most sacred and inviolable... to hinder his employing this strength and dexterity in what manner he thinks proper, without injury to his neighbor, is a plain violation of this most sacred property.

Taxpayer's exact legal proposition is somewhat ambiguous; however, the argument seems to be that the government – by means of an income tax scheme – may not interfere with the individual citizen's right to exchange his labor for wages and that the wages he receives do not constitute "income." Liberally construed, taxpayer's argument is that – for purposes of determining income tax liability – "income" can only be derivative of corporate activity. Therefore, as an individual Indiana resident who by definition did not receive "corporate" income, taxpayer is not subject to the state's adjusted gross income tax.

In support of that proposition, taxpayer cites to a number of Supreme Court cases including Doyle v. Mitchell, 247 U.S. 179 (1918); Merchant's Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); and a federal circuit court case, United States v. Ballard, 535 F.2d 400 (8th Cir. 1976).

In Doyle, 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." Doyle at 185. In Smietanka, the Court stated that, "There can be no doubt that the word [income] must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the Act of 1913." Smietanka at 519. Similarly, the same Court stated, "there would seem to be no room to doubt that the word must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Corporation Excise Tax Act and that what that meaning is has now become definitely settled by decisions of this court." Id. Taxpayer reads these and the cited companion cases as supporting the proposition that the federal income tax – and by extension Indiana's adjusted gross income tax – can only be levied against corporate gain. According to taxpayer, the cases inevitably lead to the conclusion that "income" – as referred to within both the federal and companion state statutes – is exclusively limited to that definition as established under the Civil War Income Tax Act of 1867; the Corporation Excise Tax Act of 1909; and the Income Tax Acts of 1913, 1916, and 1917.

However, the cited cases do not permit such a conclusion. In the cases cited by taxpayer, the Court was asked to determine the definition of corporate income. In Doyle, the Supreme Court was asked to resolve the issue of whether the increase in value of the corporate taxpayer's standing timber constituted "income." In determining that the increase in value did not constitute corporate "income," the Court stated that the definition of corporate income had remained unchanged during the intervening recodifications of the federal corporate income tax and the ratification of the Sixteenth Amendment to the United States Constitution. In Smietanka – resolving the issue of whether a provision in a will, stipulating that accretions in the value of testamentary property should be considered additions to principal and not income – the court similarly noted that the definition of "income" had remained unchanged. The Court went on to state that. "In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets...." Smietanka at 519.

The cited cases support the proposition that corporate gain is subject to the existing federal corporate income tax scheme. The cited cases do nothing to support the assertion that *only* corporate gain is subject to the tax. Simply stated, if the courts are asked to define "corporate income," the courts will arrive at a conclusion which defines "corporate income."

In United States v. Ballard, 535 F.2d 400 (8th Cir. 1976), the court stated, in determining appellant taxpayer's individual income tax liability, that, "The general term "income" is not defined in the Internal Revenue Code." Id. at 404. Rather, the court noted that the Internal Revenue Code operates under and employs the term "gross income." Id. However, nothing in Ballard can be read to support the proposition that the federal adjusted gross income tax is only applicable to corporate gain or that individual taxpayer's wages are not subject to imposition of the federal adjusted gross income tax. To the contrary, the court found that appellant taxpayer was liable for additional income taxes on wages received from his business. Id. at 405.

The question of what constitutes individual taxable "income" has been answered by the courts. Although not binding upon Indiana'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. Domicil itself affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right

to invoke the protection 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 domicil 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.* (*Emphasis added*).

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 (3rd 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 (9th Cir. 1988) ("First, wages are income."); Coleman v. Commissioner of Internal Revenue, 791 F2d 68, 70 (7th Cir. 1986) ("Wages are income, and the tax on wages is constitutional."); United States v. Koliboski, 732 F2d 1328, 1329 n. 1 (7th 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 (9th 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 Sates 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' distinctions aside, taxpayer's income – by whatever linguistic device the taxpayer may wish to characterize that income – 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

Taxpayer's protest is denied.

III. Payment of the Indiana Income Tax is Voluntary

Taxpayer argues that payment of Indiana individual income tax is voluntary and that he no longer volunteers to pay the tax. Taxpayer cites to IC 6-8.1-11-2 which states as follows:

> The general assembly makes the following findings: (3) The Indiana tax system is based largely on *voluntary compliance*. (4) The development of understandable tax laws and the education of taxpayers concerning the tax laws will improve *voluntary compliance* and the relationship between the state and taxpayers. (*Emphasis added*).

Taxpayer's argument is without merit. In describing the nature of the federal tax system, the Court has stated that, "In assessing income taxes the Government relies primarily upon the disclosure by the taxpayer of the relevant facts. This disclosure it requires him to make in his annual return. To ensure full and honest disclosure, to discourage fraudulent attempts to evade the tax, Congress imposes sanctions. Such sanctions may confessedly be either criminal or civil." Helvering v. Mitchell, 303 U.S. 391, 399 (1938).

Taxpayer's basic contention – that Indiana depends on its citizens' voluntary compliance with the tax laws – is undeniable. Indeed, the state also depends on its licensed drivers to drive on the right side of the road. However, that does not mean that failure to comply with the law is without predictable consequences. "Any assertion that the payment of income taxes is voluntary is without merit. It is without question that the payment of income taxes is not voluntary." United States v. Gerads, 999 F.2d 1255, 1256 (9th Cir. 1993). "The notion that the federal income tax is contractual or otherwise consensual in nature is not only utterly without foundation, but despite [appellant's] protestation to the contrary, has been repeatedly rejected by the courts." McLaughlin v. United States, 832 F.2d 986, 987 (7th Cir. 1987). "[A]rguments about who is a 'person' under the tax laws, the assertion that 'wages are not income', and maintaining that *payment of taxes is a purely voluntary function do not comport with common sense - let alone the law*." McKeown v. Ott, No. H 84-169, 1985 WL 11176 at *2 (N.D. Ind. Oct. 30, 1985) (Emphasis Added). Such arguments "have been clearly and repeatedly rejected by this and every other court to review them." Id. at *1.

FINDING

Taxpayer's protest is denied.

IV. Sufficiency of Taxpayer's Indiana Tax Return

Taxpayer points out that filled out his IT-40 income tax return with numerous "zeroes" and that by filling in the paper with "zeroes" he has fulfilled his obligations as a resident of the state. In support of this proposition, taxpayer cites to 45 IAC 15-5-7 which states in part that, "Any denotion by the taxpayer which clearly indicates a positive denial of liability for any tax listed on the tax form shall constitute a completed return. Thus, a return which has 'zero,' or '0' or 'none' written on a given line is not substantially blank." 45 IAC 15-5-7(f)(1).

Taxpayer makes a jaw-dropping leap of logic. The regulation which taxpayer cites relates to "the statute of limitations for the assessment of a listed tax liability...." 45 IAC 15-5-7(a) and has nothing whatsoever to do with whether taxpayer is responsible for paying Indiana income tax during the year 2000. The Department does not contend that taxpayer failed to send in his 2000 return. The Department does not disagree that, for purposes of taxpayer's 2000 return, the three-year statute of limitations specified under 45 IAC 15-5-7 began to run "from the due date of the annual return... or the date on which the annual return [was] filed."

Taxpayer's contention – that he has fulfilled his obligations under the state's tax laws and his shared obligations to the citizens of this state by filling out a piece of paper with "zeroes" – is frivolous.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

2820020452.LOF

LETTER OF FINDINGS NUMBER: 02-0452 CSET
Controlled Substance Excise Tax
For Tax Periods: 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

Controlled Substance Excise Tax – Imposition

Authority: IC 6-7-3-19(2); IC 6-7-3-5; IC 6-8.1-5-1(b)

The taxpayer protests the imposition of the controlled substance excise tax.

STATEMENT OF FACTS

On April 13, 2000 cocaine was found in the taxpayer's car. The appropriate county prosecutor sent the Indiana Department of Revenue, hereinafter the "department," a letter requesting that the department institute a controlled substance excise tax investigation. The department issued a Record of Jeopardy Finding, Jeopardy Assessment, Notice and Demand on July 18, 2002 in a base tax amount of $35,957.60. The taxpayer protested the assessment. A telephone hearing was held to determine if the controlled substance excise tax was properly imposed.

Controlled Substance Excise Tax: Imposition

DISCUSSION

The department can only commence an investigation into and collection of controlled substance excise tax after it is notified pursuant to the terms of IC 6-7-3-19 (2) as follows:

> ... in writing by the prosecuting attorney of the jurisdiction where the offense occurred that the prosecuting attorney does not intend to pursue criminal charges of delivery, possession, or manufacture of the controlled substance that may be subject to the tax required by this chapter.

In this case, the department received this notification by letter from the taxpayer's county prosecutor in the following words:

> This office requests that a Controlled Substance Excise Tax assessment be prepared on the drugs regarding **STATE VS. JOSE A. BALLESTEROS** under **CAUSE #45G04-004-CF-00080**. This office will not be prosecuting this matter due to the suppression of the evidence.

The taxpayer argues that the prosecutor's letter does not meet the requirements of the controlled substance excise tax imposition statute because the prosecutor did not voluntarily decide not to prosecute. Rather, the prosecutor was forced not to prosecute due to the Court's suppression of evidence. The department does not find this argument persuasive. The statute merely states that the prosecutor must indicate that he "does not intend to pursue criminal charges." The statute does not indicate a time frame within which the prosecutor must make this decision. Neither does the statute specify a necessary motivation on the part of the prosecutor. In his letter to the department, the prosecutor clearly writes that he, "will not be prosecuting this matter." That statement conforms to the statutory requirements for imposition of the controlled substance excise tax.

The taxpayer also argues that the department should not consider as evidence the cocaine that the Sheriff found in the taxpayer's car since it was ruled inadmissible in a criminal trial. Tax matters are, however, civil actions. The department has consistently considered evidence that was suppressed for the purposes of a criminal trial. There is no persuasive reason to change that policy in this matter.

IC 6-7-3-5 imposes the Controlled Substance Excise Tax on the possession of cocaine in the State of Indiana. Departmental 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). The taxpayer admitted that he was the driver and only occupant of the car where the cocaine was found and that he was transporting the cocaine for another party. This constitutes the possession of cocaine. The taxpayer did not sustain his burden of proving that the controlled substance excise tax was improperly imposed.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120020482.LOF

LETTER OF FINDINGS NUMBER: 02-0482
Individual Income Tax
For the Tax Year 1999

NOTICE: Under 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. Taxpayer's Indiana Income Tax Exemptions

Authority: IC 6-3-1-3.5(a)(3), (4); IC 6-3-1-3.5(a)(5)(A); IC 6-8.1-3-3(a); Johnson County Farm Bureau v. Dep't of Revenue, 568 N.E.2d 578 (Ind. Tax Ct. 1991); 45 IAC 3.1-1-5(b)(4)

Taxpayer argues that the Department erred in its assessment of additional income taxes on the ground that taxpayer overstated the number of exemptions claimed on his 1999 Indiana individual income tax return.

STATEMENT OF FACTS

Taxpayer filed a joint 1040 federal return reporting income received during 1999. On the 1040 return, taxpayer claimed three exemptions. Taxpayer claimed himself, his wife, and one dependent child as exemptions. Nevertheless, taxpayer states that he was entitled to claim four exemptions on the federal return.

Thereafter, taxpayer filed a joint IT-40 state return reporting income received during 1999. On the IT-40 return, taxpayer claimed four exemptions including an "additional exemption" for a total of two dependent children.

On July 30, 2002, the Department issued taxpayer a notice of "Proposed Assessment." The assessment of additional taxes was apparently based on the facial inconsistency between taxpayer's federal and state 1999 returns. The Department's notice stated that, "We have compared the federal adjusted gross income and exemptions reported on your federal and state tax returns for the indicated taxpayer period. These amounts do not agree as they should."

Taxpayer protested the additional tax assessment, an administrative hearing was conducted, and this Letter of Findings results.

DISCUSSION

I. Taxpayer's Indiana Income Tax Exemptions

In preparing his 1999 federal return, taxpayer determined – for reasons not immediately relevant – that it would be advantageous to claim three exemptions on his federal return despite believing that he was legitimately *entitled* to claim a total of four exemptions. On his federal return, taxpayer claimed himself, his wife, and the first of his dependent children as exemptions. Taxpayer chose not to claim a second dependent child on the federal return.

However, taxpayer argues that he was legitimately entitled to claim all four exemptions on his state return even though he chose to claim only three on the corresponding federal return. Taxpayer maintains that his decision, not to claim the second of his two dependent children on the federal return, did not preclude him from claiming that second child on the state return.

Insofar as relevant to taxpayer's "Line 8" deductions, IC 6-3-1-3.5(a)(3), (4) states that the Indiana taxpayer is to "Subtract one thousand dollars ($1,000), or in the case of a joint return filed by a husband and wife, subtract for each spouse one thousand dollars ($1,000). Subtract one thousand dollars ($1,000) for each of the exemptions provided by Section 151(c) of the Internal Revenue Code. Insofar as relevant to taxpayer's "Line 9" deductions, IC 6-3-1-3.5(a)(5)(A) permits an Indiana taxpayer to "subtract one thousand ($1,500) for each of the exemptions allowed under Section 151(c)(1)(B) of the Internal Revenue Code for taxable years beginning after December 31, 1996."

The statutory formula is straightforward; an Indiana taxpayer may claim a $1,000 exemption on line 8 of his Indiana return if that exemption is allowed under I.R.C. § 151(c). The Indiana taxpayer may claim a $1,500 deduction on line 9 of his Indiana return if that exemption is allowed under I.R.C. § 151(c)(1)(B). There is nothing apparent in the statute which requires – as a condition precedent to claiming those Indiana exemptions – that the taxpayer first claim the identical exemptions on his federal return.

The explanatory language on the 1999 IT-40 return is equally straightforward; line eight on the form states that the taxpayer is to report the "[n]umber of exemptions claimed on your federal return." The IT-40 also states that the taxpayer is entitled to claim an [a]dditional exemption for certain dependent children" and to report that number on line nine.

Relevant to line eight, the Department's accompanying instructional booklet states that, "You are allowed a $1,000 exemption on your Indiana tax return for each exemption *you claim on your federal return*." (*Emphasis added*). Relevant to line nine, the booklet states that, "An additional exemption, which has been increased to $1,500, is allowed for certain dependent children."

On their face, the IT-40 directions would seem to preclude taxpayer from claiming the second dependent child – a total of four exemptions – on his state return when he declined to report the otherwise qualifying second dependent child on the federal return. The mandatory nature of the instructional language is reinforced by 45 IAC 3.1-1-5(b)(4) which directs the taxpayer to "[s]ubtract $1000 for each exemption taken on the Federal return for taxpayer or spouse aged 65 or above..." and to subtract "$500 [now $1,500] for each exemption *taken on the Federal return* for a qualified dependent." (*Emphasis added*).

The instructions printed on the Indiana tax form, the accompanying instructional booklet, and the Department's regulation preclude an Indiana taxpayer from claiming an exemption unless the exemption has also been claimed on the corresponding federal return. The tax form, the instructional booklet, and accompanying regulation have interposed an additional requirement – not immediately apparent on the face of the statute – that the Indiana taxpayer claim the exemption on the federal return before claiming the exemption on the Indiana return.

The legislature has delegated to the Department the authority to interpret and apply the tax statutes. IC 6-8.1-3-3(a) states the "The department shall adopt, under IC 4-22-2, rules governing: (1) the administration, collection, and enforcement of the listed taxes; (2) the interpretation of the statutes governing the listed taxes; (3) the procedures relating to the listed taxes; and (4) the methods of valuing the items subject to the listed taxes."

There is nothing to indicate that the Department acted beyond its authority in promulgating a regulation mandating that Indiana taxpayers first claim the exemption on their federal returns before claiming the exemption on the corresponding Indiana return. Specifically, there is nothing to indicate that the Department acted beyond the scope of its authority in noting the discrepancy between taxpayer's federal and state 1999 returns and rendering an additional assessment based upon that discrepancy. "A rule issued by an agency pursuant to its statutory authority to implement the statute has the force of law." Johnson County Farm Bureau v. Dep't of Revenue, 568 N.E.2d 578, 584 (Ind. Tax Ct. 1991).

Taxpayer argues that the "spirit of the Indiana law allows exemptions where they are qualified and [does not] intend to deprive taxpayers of receiving an exemption but for the taxpayer's own decision to forego a qualifying exemption on their federal return." Taxpayer makes an argument – based on general principles of equity and fairness – that the Department circumvent the regulation and permit taxpayer to maximize the tax advantages attendant on his decision to claim three exemptions on his 1999 federal return. The Department has no such equitable authority and must decline taxpayer's request.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0120020489.LOF

LETTER OF FINDINGS NUMBER: 02-0489
Indiana Individual Income Tax
For the Tax Year 2001

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. Legislative Authority to Impose State Adjusted Gross Income Tax

Authority: Ind. Const. art. I, § 25; Ind. Const. art. IV, § 1; Ind. Const. art. X, § 8; IC 6-3-1-3.5; Ind. Dept. of Envtl. Management v. Chemical Waste Management, Inc., 643 N.E.2d 331 (Ind. 1994); Campbell v. Heiss, 53 N.E.2d 634 (Ind. 1944); Bissell Carpet Sweeper Co. v. Shane Co., 143 N.E.2d 415 (Ind. 1957)

Taxpayer argues that the state legislature acted outside its constitutional authority in imposing the individual state adjusted gross income by reference to the federal Internal Revenue Code.

II. Voluntary Nature of the State's Adjusted Gross Income Tax

Authority: IC 6-8.1-11-2; Couch v. United States, 409 U.S. 322 (1975); Helvering v. Mitchell, 303 U.S. 391 (1938); United States v. Gerads, 999 F.2d 1255 (9th Cir. 1993); McLaughlin v. United States, 832 F.2d 986 (7th Cir. 1987); McKeown v. Ott, No. H 84-169, 1985 WL 11176 at *2 (N.D. Ind. Oct. 30, 1985)

Taxpayer maintains that the payment of the state's individual adjusted gross income is voluntary. Therefore, taxpayer states that he no longer volunteers to pay the tax.

III. Imposition of the State's Adjusted Gross Income Tax on Wages

Authority: U.S. Const. amend. XIV; I.R.C. § 61; I.R.C. § 871; I.R.C. § 911; New York v. Graves, 300 U.S. 308 (1937); Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926); Irwin v. Gavit, 268 U.S. 161 (1925); United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924); Goodrich v. Edwards, 255 U.S. 527 (1921); Merchant's Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); Doyle v. Mitchell, 247 U.S. 179 (1918); Stratton's Independence, Ltd. V. Howbert, 231 U.S. 399 (1913); United States v. Connor, 898 F2d 942 (3rd Cir. 1990); Wilcox v. Commissioner of Internal Revenue, 848 F2d 1007 (9th Cir. 1988); Coleman v. Commissioner of Internal Revenue, 791 F2d 68 (7th Cir. 1986); United States v. Koliboski, 732 F2d 1328 (7th Cir. 1984); United States v. Ballard, 535 F.2d 400 (8th Cir. 1976); United States v. Romero, 640 F2d 1014 (9th 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).

Taxpayer states the federal adjusted gross income tax may only be levied against corporate profits. Because the state's individual income tax is based upon the federal scheme and because, by definition, taxpayer did not receive "corporate profits," taxpayer is not subject to the state's income tax. In addition, taxpayer maintains that, under I.R.C. § 861, only income from foreign sources or income received by nonresident aliens is subject to federal income tax.

STATEMENT OF FACTS

Taxpayer submitted Indiana income tax returns for the years 2000 and 2001. Those returns were filled in with "zeroes." The Department of Revenue (Department) disagreed with taxpayer's calculations, assessed an amount of unpaid taxes, and sent taxpayer notices to that effect. Taxpayer submitted a series of protests in which he disputed the Department's conclusions and demanded an opportunity to explain the basis for the protest. The Department, in a letter dated October 29, 2002, informed taxpayer that a protest of the 2000 assessment was untimely because it was submitted more than 60 days after the 2000 assessment was made; taxpayer does not challenge the Department's conclusion regarding that 2000 assessment. Nonetheless, taxpayer was given provided the opportunity to explain the basis of his protest of the 2001 assessment. This Letter of Findings results.

DISCUSSION

I. Legislative Authority to Impose State Adjusted Gross Income Tax

Taxpayer argues that, "Nowhere in the Indiana Constitution did the people of this state give any power to the federal government to make laws exclusively for those living in Indiana." In effect, taxpayer argues that the Indiana Constitution does not permit references to another taxing jurisdiction's own laws and when faced with such an improper reference – such as that found within IC 6-3-1-3.5 – the taxpayer's compliance is not required.

Specifically, taxpayer cites to Ind. Const. art. I, § 25 which states that, "No law shall be passed, the taking effect of which shall be made to depend upon any authority, except as provided in this Constitution." This section of the state constitution is intended to place a limit on "the legislative activity of the General Assembly." Ind. Dept. of Envtl. Management v. Chemical Waste Management, Inc., 643 N.E.2d 331, 341 (Ind. 1994).

The Indiana Constitution vests all legislative authority in the Indiana General Assembly. "The Legislative authority of the State shall be vested in a General Assembly, which shall consist of a Senate and a House of Representatives. The style of every law shall be: 'Be it enacted by the General Assembly of the State of Indiana': and no law shall be enacted, except by bill." Ind. Const. art. IV, § 1. Taxpayer is correct in his assertion that, under Ind. Const. art. I, § 25 and art. IV, § 1, the Indiana General Assembly may not delegate either its authority or its responsibility for performing its exclusively legislative functions. "The power to legislate or to exercise a legislative function cannot be delegated to a non-governmental agency or person. Nor can the Legislature delegate its law-making power to a governmental officer, board, bureau or commission." Bissell Carpet Sweeper Co. v. Shane Co., 143 N.E.2d 415, 419 (Ind. 1957) (Internal citations omitted).

On its face, taxpayer's contention appears to have merit. The Indiana General Assembly may not delegate its responsibility for defining the state's adjusted gross income tax scheme to the federal government. Neither may the Assembly's authority to implement such a scheme be obtained under federal law. However, the cross-references to the Internal Revenue Code – such as I.R.C. § 62 cited within IC 6-3-1-3.5 – do not delegate the Assembly's taxing authority. The state legislature did not turn over its taxing authority to the federal government. The state legislature did not obtain its taxing authority from the federal government. Ind. Const. art. X, § 8 unambiguously states that, "The general assembly may levy and collect a tax upon income from whatever source derived...." The Indiana Code provisions reflect merely the legislature's independent decision to employ the federal calculation as the starting point for determining Indiana's adjusted gross income tax. "It is well settled that a legislative body may enact a law, the operation of which depends upon the existence of a stipulated condition." Campbell v. Heiss, 53 N.E.2d 634, 636 (Ind. 1944). The state legislature has retained its independent authority to define and enforce the state's own income tax plan. That the Indiana General Assembly has retained exclusive authority to stake out the parameters of the state's adjusted gross income tax scheme, is evidenced by the Assembly's decisions to periodically reenact IC 6-3-1-3.5 the latest of which occurred in 2001. Whether the General Assembly should have avoided internal references to the Internal Revenue Code by independently drafting original statutory provisions mirroring the Internal Revenue Code and then require every Indiana taxpayer to recalculate his taxable income, is an issue beyond the scope of this Letter of Findings and irrelevant to determining taxpayer's tax liability. Suffice it to say that the General Assembly acted entirely within its authority in employing the federal adjusted gross income as the jumping off point for calculating the individual taxpayer's Indiana adjusted gross income.

FINDING

Taxpayer's protest is denied.

II. Voluntary Nature of the State's Adjusted Gross Income Tax

Taxpayer argues that payment of Indiana individual income tax is voluntary and that he no longer volunteers to pay the tax. Taxpayer cites to IC 6-8.1-11-2 which states as follows:

> The general assembly makes the following findings: (3) The Indiana tax system is based largely on *voluntary compliance*. (4) The development of understandable tax laws and the education of taxpayers concerning the tax laws will improve *voluntary compliance* and the relationship between the state and taxpayers. (*Emphasis added*).

Taxpayer's argument is without merit. In describing the nature of the federal tax system, the Court has stated that, "In assessing income taxes the Government relies primarily upon the disclosure by the taxpayer of the relevant facts. This disclosure it requires him to make in his annual return. To ensure full and honest disclosure, to discourage fraudulent attempts to evade the tax, Congress imposes sanctions. Such sanctions may confessedly be either criminal or civil." Helvering v. Mitchell, 303 U.S. 391, 399 (1938).

Taxpayer's basic contention – that Indiana depends on its citizens' voluntary compliance with the tax laws – is undeniable. Indeed, the state also depends on its licensed drivers to drive on the right side of the road. However, that does not mean that failure to comply with the law is without predictable consequences. "Any assertion that the payment of income taxes is voluntary is without merit. It is without question that the payment of income taxes is not voluntary." United States v. Gerads, 999 F.2d 1255, 1256 (9th Cir. 1993). "The notion that the federal income tax is contractual or otherwise consensual in nature is not only utterly without foundation, but despite [appellant's] protestation to the contrary, has been repeatedly rejected by the courts." McLaughlin v. United States, 832 F.2d 986, 987 (7th Cir. 1987). "[A]rguments about who is a 'person' under the tax laws, the assertion that 'wages are not income', and maintaining that *payment of taxes is a purely voluntary function do not comport with common sense - let alone the law*." McKeown v. Ott, No. H 84-169, 1985 WL 11176 at *2 (N.D. Ind. Oct. 30, 1985) (Emphasis Added). Such arguments "have been clearly and repeatedly rejected by this and every other court to review them." Id. at *1.

The Supreme Court has stated that the government's entire tax systems is "largely dependent upon honest self-reporting." Couch v. United States, 409 U.S. 322, 335 (1975). Taxpayer's bare assertion, that, based on the precatory language contained within IC 6-8.1-11-2, he no longer "volunteers" to pay income taxes and that it is sufficient to fill in his tax returns with numerous "zeroes," does not fall within a reasonable definition of "honest self-reporting."

FINDING

Taxpayer's protest is denied.

III. Imposition of the State's Adjusted Gross Income Tax on Wages

Taxpayer sets out a number of arguments concerning the relevance and applicability of the income tax laws. Taxpayer maintains that the only corporate profits are subject to income tax. In addition, taxpayer maintains that only income received from foreign sources or income received by nonresident aliens is subject to federal income tax.

A. Corporate Profits

Taxpayer maintains that the Department erred when it decided that taxpayer owed income tax. According to taxpayer, only corporate profits are subject to income tax and that – as a private individual – he did not receive any compensation which was subject to the federal or state's income tax scheme.

In support of that proposition, taxpayer cites to a number of Supreme Court cases including Doyle v. Mitchell, 247 U.S. 179 (1918); Merchant's Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921); and a federal circuit court case, United States v. Ballard, 535 F.2d 400 (8th Cir. 1976).

In Doyle, 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." Doyle at 185. In Smietanka, the Court stated that, "There can be no doubt that the word [income] must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the Act of 1913." Smietanka at 519. Similarly, the same Court stated, "there would seem to be no room to doubt that the word must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Corporation Excise Tax Act and that what that meaning is has now become definitely settled by decisions of this court." Id. Taxpayer reads these and the cited companion cases as supporting the proposition that the federal income tax – and by extension Indiana's adjusted gross income tax – can only be levied against corporate gain. According to taxpayer, the cases inevitably lead to the conclusion that "income" – as referred to within both the federal and companion state statutes – is exclusively limited to that definition as established under the Civil War Income Tax Act of 1867; the Corporation Excise Tax Act of 1909; and the Income Tax Acts of 1913, 1916, and 1917.

However, the cited cases do not permit such a conclusion. In the cases cited by taxpayer, the Court was asked to determine the definition of corporate income. In Doyle, the Supreme Court was asked to resolve the issue of whether the increase in value of the corporate taxpayer's standing timber constituted "income." In determining that the increase in value did not constitute corporate "income," the Court stated that the definition of corporate income had remained unchanged during the intervening recodifications of the federal corporate income tax and the ratification of the Sixteenth Amendment to the United States Constitution. In Smietanka – resolving the issue of whether a provision in a will, stipulating that accretions in the value of testamentary property should be considered additions to principal and not income – the court similarly noted that the definition of "income" had remained unchanged. The Court went on to state that. "In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets...." Smietanka at 519.

The cited cases support the proposition that corporate gain is subject to the existing federal corporate income tax scheme. The cited cases are useful in determining whether income from the sale of mining stock is subject to corporate income tax, Goodrich v. Edwards, 255 U.S. 527 (1921), whether dividends paid on loans to German banks during World War I are subject to corporate income tax, Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926), whether life insurance proceeds paid to corporate beneficiaries are subject to corporate income tax, United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924), and whether income received from a will and designated for a granddaughter's education was subject to income tax. Irwin v. Gavit, 268 U.S. 161 (1925). The cited cases do nothing to support the assertion that *only* corporate gain is subject to the tax. Simply stated, if the courts are asked to define "corporate income," the courts will arrive at a conclusion which defines "corporate income."

In United States v. Ballard, 535 F.2d 400 (8th Cir. 1976), the court stated, in determining appellant taxpayer's individual income tax liability, that, "The general term "income" is not defined in the Internal Revenue Code." Id. at 404. Rather, the court noted that the Internal Revenue Code operates under and employs the term "gross income." Id. However, nothing in Ballard can be read to support the proposition that the federal adjusted gross income tax is only applicable to corporate gain or that individual taxpayer's wages are not subject to imposition of the federal adjusted gross income tax. To the contrary, the court found that appellant taxpayer was liable for additional income taxes on wages received from his business. Id. at 405.

The question of what constitutes individual taxable "income" has been answered by the courts. Although not binding upon Indiana'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. Domicil itself affords a basis for such taxation. Enjoyment of the privileges of residence in the state and the attendant right to invoke the protection 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 domicil 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.* (*Emphasis added*).

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 (3rd 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 (9th Cir. 1988) ("First, wages are income."); Coleman v. Commissioner of Internal Revenue, 791 F2d 68, 70 (7th Cir. 1986) ("Wages are income, and the tax on wages is constitutional."); United States v. Koliboski, 732 F2d 1328, 1329 n. 1 (7th 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).

In addressing the identical question, the Indiana Tax Court has held that, "Common definition, an overwhelming body of case law by the United Sates 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).

B. Wages and Earnings of Private Citizens

Nevertheless, taxpayer maintains that even if he did receive taxable "income," because he is a private citizen and a resident this country, he is not subject to the tax. According to taxpayer, only income received from foreign sources or income received by nonresident aliens is subject to federal income tax.

Taxpayer maintains that I.R.C. § 61 does not include "wages" or "salaries." The cited federal code section reads as follows:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

Thereafter, taxpayer cites to I.R.C. § 871, 911 which discuss the taxability of, inter alia, the "wages, and salaries" received by "Non-resident aliens and foreign corporations." Taxpayer reads I.R.C. §§ 61, 911, and 871 together and reaches the following conclusion: I.R.C. § 61, which defines "gross income" – from which "taxable income" for both federal and state purposes is calculated – does not include the terms "wages" or salaries." I.R.C. §§ 871, 911 – setting out the responsibility for non-resident aliens, Americans living abroad, and foreign corporations to pay income tax – *does* specifically refer to both "wages" and "salaries." Therefore, I.R.C. § 61, by not specifically referencing "wages" and "salaries," excludes the wages and salaries of the average American from income tax.

Taxpayer's conclusion – that "gross income" excludes "wages" or "salaries" – does not withstand close scrutiny. It is not uncommon for statutes to omit fundamental definitions of legal concepts or for tax statutes to omit fundamental definitions of what is being taxed. One will search the Indiana property tax statutes in vain for a definition of "land" but it is undisputed that Indiana jurisdictions levy a tax against real property. Although the Constitution does not define the words, there is no contention that "due process" is not a fundamental right guaranteed under the federal constitution and that a citizen's rights to "due process" is protected under U.S. Const. amend. XIV which states that no state shall "deprive any person of life, liberty, or property without due process of law; or deny any person within its jurisdiction the equal protection of the laws." Indeed, taxpayer himself stated that a denial of his right to a hearing and an opportunity to explain the basis for his protest would be a violation of the Due Process Clause of both the federal and state constitutions.

I.R.C. § 61 states that "gross income" includes "all income from whatever source derived." The citation itself specifically refers to "[c]ompensation for services." There is not a single court decision which has ever concluded that the average citizen's wages are not subject to either federal or state income tax. "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." United States v. Romero, 640 F.2d 1014, 1016 (9th Cir. 1986). "[T]he earnings of the human brain and hand when unaided by capital... are commonly dealt with as income in legislation." Stratton's Independence, Ltd. V. Howbert, 231 U.S. 399, 415 (1913).

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120020515.LOF

LETTER OF FINDINGS NUMBER: 02-0515
Individual Adjusted Gross Income Tax
For the 1996 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.

ISSUE

I. Claim-of-Right Deduction – Indiana Adjusted Gross Income Tax

Authority: Ind. Const. art. 10, § 8; IC 6-3-1-3.5; I.R.C. § 62; I.R.C. § 1341; Reference Copies of Federal Tax Forms and Instructions (1996)

Taxpayer argues that the Department erred when it disallowed a deduction taken on his 1996 Indiana income tax return. The deduction consisted of an amount of money which taxpayer paid as restitution.

STATEMENT OF FACTS

Taxpayer embezzled sums of money from his former employer over a period of years prior to 1996. Taxpayer's theft of funds was detected, and taxpayer repaid the amount in July of 1996. Afterwards, taxpayer submitted amended state and federal tax returns in September of 1996 reflecting the amounts of money which had been embezzled during those years. To pay the additional taxes incurred as a result of the amended returns, taxpayer entered into an extended payment plan with the state.

Thereafter, taxpayer submitted his 1996 Indiana tax return. On that 1996 return, taxpayer claimed a deduction of approximately $240,000 representing the amount taxpayer repaid to the former employer. The amount deducted was listed on Indiana schedule one, line 18 as "repayment of income without claim of right." The Department disallowed the deduction and assessed an additional amount of taxes.

Taxpayer challenged the disallowance, an administrative hearing was held, and this Letter of Findings follows.

DISCUSSION

I. Claim-of-Right Deduction – Indiana Adjusted Gross Income Tax

Having been granted a claim-of-right deduction on his 1996 federal return, taxpayer argues that he is entitled to a similar deduction on his corresponding state return.

Taxpayer's deduction on his federal return was apparently based on I.R.C. § 1341. The federal rule provides in part:

> If (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item.

The Department does not challenge taxpayer's assertion that, in calculating his federal income tax, he was entitled to claim the repayment amount as a specific income adjustment under I.R.C. § 1341. Taxpayer – in filing his amended federal returns – reported the amounts embezzled during the years in which those amounts were received. Thereafter, on his 1996 federal return, taxpayer was entitled under I.R.C. 1341 to claim the amount repaid as a deduction because taxpayer did not have "an unrestricted right" to the embezzled funds.

Indiana levies an income tax under authority of Ind. Const. art. 10, § 8 which states that, "The general assembly may levy and collect a tax upon income from whatever source derived, at such rates, in such manner, *and with such exemptions as may be prescribed by law*." (*Emphasis added*).

In levying that tax, Indiana has largely adopted the federal definition of adjusted gross income. "When used in IC 6-3, the term 'adjusted gross income' shall mean the following: (1) In the case of all individuals, 'adjusted gross income' (as defined in Section 62 of the Internal Revenue Code)...." IC 6-3-1-3.5.

Thereafter, the Indiana statute lists a number of specific modifications to the federal adjusted gross income amount. None of the specific modifications – peculiar to the Indiana tax scheme – are relevant to taxpayer's claim that he is entitled to deduct the amount paid in restitution during 1996.

Because Indiana's definition of "adjusted gross income" borrows from the federal definition, a citation to the federal authority is helpful. In part, I.R.C. § 62 states that, "For purposes of this subtitle, the term 'adjusted gross income' means, in the case of an individual, gross income minus the following deductions...." Again, the subsequent federal provisions are irrelevant to taxpayer's argument.

The federal rules permit a taxpayer to claim a repayment of money included as income in an earlier year. The repayment amount is reported on line 27 of "Schedule A" which allows a "Deduction for repayment of amounts under a claim of right if over $3,000." Reference Copies of Federal Tax Forms and Instructions, p. 98 (1996). The total amount of "Itemized deductions from Schedule A" is then subtracted from the amount of federal adjusted gross income yielding federal "taxable income." What all of this means is that the "claim-of-right" adjustment is a "below the line" deduction computed after the taxpayer calculates the amount of federal adjusted gross income.

Taxpayer was entitled to the repayment deduction in determining his federal "taxable income," but that particular amount is immaterial in calculating the taxpayer's Indiana income tax. Under IC 6-3-1-3.5, federal adjusted gross income as defined in I.R.C. § 62 is the starting point for determining Indiana taxable income. The Indiana income tax act contains no provision authorizing the I.R.C. § 1341 "below the line" adjustment claimed on taxpayer's 1996 federal return. The "claim-of-right" adjustment is not used to arrive at federal adjusted gross income which – subject to specified adjustments – becomes Indiana taxable income.

Taxpayer argues that he is entitled to the deduction "[l]ogically and under a sense of fairness." The result may appear inequitable, but the Department has no authority to grant taxpayer's request.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0220020552P.LOF

LETTER OF FINDINGS NUMBER: 02-0552P
Gross and Adjusted Gross Income Tax
For 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.

STATEMENT OF FACTS

Taxpayer filed its return with payment of $18,866 on October 15, 1999 and was assessed a late penalty. The original due date of the return was April 15, 1999.

Taxpayer filed a penalty protest dated July 10, 2002. Taxpayer states that it paid well over one hundred percent (100%) of the prior year's tax, which should release it from any penalties. Taxpayer enclosed a check for interest in the amount of $1,215.11.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the penalty assessed and states that it paid well over one hundred percent (100%) of the prior year's tax.

Taxpayer was assessed a penalty for the late payment of its taxes.

Taxpayer failed to remit its tax by the original due date of the return as required under IC 6-8.1-10-2.1(a)(2). The penalty is ten percent (10%) of the amount of tax not paid, if the person fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment.

Taxpayer made payment after the due date of the return and has not provided reasonable cause to allow the Department to waive the penalty.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220020576P.LOF

LETTER OF FINDINGS NUMBER: 02-0576P
Gross and Adjusted Gross Income Tax
For 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.

STATEMENT OF FACTS

Taxpayer filed a short year return for the period January 1, 1998 through July 23, 1998 on August 27, 1999.

Taxpayer filed a penalty protest dated June 21, 2002. Taxpayer states that a valid federal extension was obtained and a copy was appropriately submitted with the Indiana return for the period ending July 23, 1998. Taxpayer states that the return was timely filed and no late filing penalty is due the department.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the penalty assessed for the late payment of tax because it had a valid extension of time until October 15, 1999 to file the Indiana tax return.

IC 6-8.1-6-1 (c) states:

"If the Internal Revenue Service allows a person an extension on his federal income tax return, the corresponding due dates for the person's Indiana income tax return are automatically extended for the same period as the federal extension, plus thirty (30) days. However, the person must pay at least ninety percent (90%) of the Indiana income tax that is reasonably expected to be due on the original due date by that due date, or he may be subject to the penalties imposed for failure to pay the tax."

Taxpayer failed to remit its tax timely and has not provided reasonable cause to allow the department to waive the penalty.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420020597P.LOF

LETTER OF FINDINGS NUMBER: 02-0597P
Use Tax
For Calendar Years 1999, 2000, and 2001

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

ISSUE(S)

I. Tax Administration – Penalty

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

Taxpayer protests the penalty assessed.

STATEMENT OF FACTS

Taxpayer was audited for calendar years 1999, 2000, and 2001. Upon audit it was discovered that the taxpayer failed to remit use tax on all of its taxable purchases and had no use tax accrual system in place.

Taxpayer requests abatement of the penalty because the local revenue office did not advise him when he started his construction business.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the penalty assessed and states that the Department did not advise him regarding use tax when he began his construction business.

45 IAC 15-11-2(b) states, "Negligence, on behalf of the 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.

Taxpayer failed to remit use tax due on one hundred (100%) of its clearly taxable items and had no use tax accrual system in place. Taxpayer filed yearly returns indicating no tax is due. Taxpayer has not provided reasonable cause to allow the department to waive the penalty.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420020598P.LOF

LETTER OF FINDINGS NUMBER: 02-0598P
Use Tax
For Calendar Years 1999, 2000, and 2001

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

ISSUE(S)

I. Tax Administration – Penalty

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

Taxpayer protests the penalty assessed.

STATEMENT OF FACTS

Taxpayer was audited for calendar years 1999, 2000, and 2001. Upon audit it was discovered that the taxpayer failed to remit use tax on all of its taxable purchases and had no use tax accrual system in place.

Taxpayer requests abatement of the penalty because it maintained a reputation as a good corporate citizen in the State of Indiana. Other than the use tax owed on tractors and trailers purchased out of state, the remainder of the audit was minimal.

I. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the penalty assessed and states that the assessment was minimal except for the tractors and trailers purchased out of state. It has maintained a good reputation in Indiana and requests an abatement of the penalty.

45 IAC 15-11-2(b) states, "Negligence, on behalf of the 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."

Taxpayer failed to remit use tax due on one hundred (100%) of its clearly taxable items and had no use tax accrual system in place. Taxpayer filed monthly returns indicating no use tax was due. Taxpayer has not provided reasonable cause to allow the department to waive the penalty.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

Revenue Ruling #2003-01 FIT

January 8, 2003

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 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

Treatment of Conditional Sales/Finance Lease income for purposes of calculating the 80% test to determine if a corporation qualifies as a "Taxpayer" under the Financial Institutions Tax [IC 6-5.5].

Authority: IC 6-5.5; IC 6-5.5-1-17(d)(2); 45 IAC 17-2-4(e)(2)

The Taxpayer, a corporation which is a financial organization primarily engaged in Making loans through a variety financing arrangements worldwide.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation headquartered outside of Indiana. Taxpayer is a Wholly-owned Subsidiary of "XYZ" [the Parent] also a Delaware corporation headquartered outside of Indiana. The parent and certain other subsidiaries are engaged in the manufacture and sale of heavy equipment, including construction and agriculture machinery, engines and related equipment. Taxpayer is a financial organization primarily engaged in making loans through a variety of financing arrangements. Taxpayer and its subsidiaries offer these financing arrangements to the independent dealers of Parent and its affiliates and the dealers' customers in acquiring Parent Equipment worldwide. Generally, these financing arrangements are initiated either by Taxpayer or, alternatively, by the dealer and subsequently acquired by Taxpayer.

Taxpayer may enter into a financing agreement directly with the customer after the dealer and customer have agreed on the purchase price and method of delivery of the Equipment. Under this scenario, Taxpayer may purchase the Equipment from the dealer and will have the dealer deliver Equipment to the customer. Under the terms of the financing agreement, Taxpayer pays the purchase price to the dealer, and the customer agrees to repay Taxpayer pursuant to the terms of the financing arrangement.

Alternatively, the dealer may issue the loan documents and assign the documents to Taxpayer. The dealer negotiates the terms of the financing arrangement, enters into a financing agreement with the customer, executes the agreement and completes both the sale and the financing. If the terms of the arrangement meet Taxpayer's requirements, Taxpayer may purchase the financing agreement.

Taxpayer engages in four primary retail financing arrangements which are:
(1) Sales by Dealer
(2) Conditional Sales/Finance Leases
(3) Installment Sales
(4) Long Term Operating Leases

Taxpayer's conditional sales/finance leases are treated as loans, not leases, for federal income tax purposes. Federal law requires Taxpayer to divide each rental payment into interest and principal. The interest component is reported as interest income on its Federal Form 1120 in the year the payment is received. Taxpayer reports 100% of the principal amount to be paid over the life of the lease on line (1a) of its Federal Form 1120 in the year the year the lease is executed. Taxpayer is in the business of financing the sale of Equipment, not selling such equipment at a profit. Accordingly, the principal payments under the finance lease equal the amount Taxpayer paid for the equipment and Taxpayer does not report any gross profit on finance leases.

The issue is how conditional sales/finance leases are treated for purposes of calculating the 80% test provided in IC 6-5.5-1-17(d) (2).

RULING

The Department rules that for purposes of determining Taxpayers requirement to report and pay tax under the Indiana Financial Institutions Tax [IC 6-5.5] it must derive at least 80% of its gross income from doing the "business of a financial institution". In the matter of conditional sales/financing leases IC 6-5.5-1-17(d) (2) (B) provides that

> "Leasing or acting as an agent, broker, or advisor in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes".

45 IAC 17-2-4(e) (2) provides:

> "Leasing or acting as an agent, broker, or advisor, in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes. If the lease is the economic equivalent of the extension of credit, and the lease is not treated as a lease for federal income tax purposes, the income derived from the lease is included in gross income for purposes of satisfying the eighty percent (80%) test whether the corporation is leasing its own real or personal property or is the lessor of real or personal property owned by another."

Thus the Taxpayer is required to include the gross income derived from conditional sales/financing leases in calculating the 80% test to determine the requirement to file and pay tax under the Indiana Financial Institutions Tax.

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 taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.