INDIANA DEPARTMENT OF INSURANCE
August 22, 2003
Bulletin 121

Individual and Association or Discretionary Group Policies Pre-existing Condition Exclusion Waivers

This bulletin is directed to all insurers that write health insurance through individual policies or association or discretionary group policies. Beginning July 1, 2003, through July 1, 2005, Senate Enrolled Act No. 341 (Public Law 211-2003) allows insurers under certain conditions to issue individual policies with a waiver of coverage for a specified condition and complications directly related thereto. In addition, the Department of Insurance (Department) shall establish a two (2) year demonstration project to evaluate the value of preexisting condition exclusion waivers on coverage sold to members of associations or discretionary groups.

Individual policies

Any insurer that issues individual policies must notify the Department by September 15, 2003, that they are issuing individual policies and whether or not they intend to issue waivers pursuant to PL 211-2003. Notices shall be submitted via email to Tracey Sullivan at tsullivan@doi.state.in.us. An insurer that will be issuing waivers should include a written policy outlining their plan to ensure no waivers will be placed after July 1, 2005. All notices should include the name, telephone number and email address of a contact person. An insurer may amend this notice to the Department but must do so no less than thirty (30) days before issuing a waiver.

Association and discretionary group policies – Demonstration Project

The Commissioner shall select three (3) insurers in the association or discretionary group market who may issue waivers of coverage during the demonstration project. In order to be selected as one of the three insurers in the demonstration project, the insurer must meet the following criteria:

1. Be an insurer as defined in IC 27-1-2-3(x).
2. Prior to July 1, 2003, have offered in Indiana an individually underwritten association or discretionary group health insurance policy that is not employer based.
3. Prior to July 1, 2003, have had a documented program for administering the policy that includes consumer safeguards to:
   (A) provide prior written notice of conditions subject to the waiver;
   (B) limit the number of waivers per individual;
   (C) limit the period during which a waiver may be in effect; and
   (D) provide for full benefits upon the expiration of the waiver.

Insurers that are selected for the demonstration project shall meet all of the following requirements:

1. Each insurer may issue not more than one thousand five hundred (1,500) certificates of coverage containing a waiver during the project period.
2. The insurers shall bear all of the costs of the demonstration project, including any research, analysis, and reporting related to the project.
3. A waiver of coverage for a specified condition and complications directly related to the specified condition may not exceed two (2) years and the following conditions shall be met:
   (A) The waiver may be applied only at the time the certificate is issued;
   (B) The insurer shall provide to the applicant *before* issuance of the policy a written notice explaining the waiver of coverage for the specified condition and complications directly related to the specified condition;
   (C) The insurer shall provide a written explanation of the waiver that includes a specific description of each condition, complication, service, and treatment for which coverage is being waived. See example attached hereto as Exhibit A;
   (D) The offer of coverage and the certificate of coverage shall include the waiver in a separate section stating in bold print that the applicant is receiving coverage with an exception for the waived condition and shall specify each related condition complication, service, and treatment for which coverage is waived;
   (E) The offer of coverage and the certificate of coverage may not include more than two (2) waivers per individual;
   (F) The insurer may not place waivers for a mental health condition or a developmental disability nor for any condition for which coverage is required under state law;
   (G) The waiver period must be concurrent with and not in addition to any other applicable pre-existing condition limitation or exclusionary period;
   (H) The insurer shall require an applicant to initial the written notice and the waiver included in the offer of coverage and in the certificate of coverage to acknowledge acceptance of the waiver of coverage; and
   (I) The insurer shall provide to the certificate holder an insurance benefit card that includes a telephone number for verification of coverage waived.
4. The insurer shall review the underwriting basis for the waiver upon request one (1) time per year and remove the waiver if evidence of insurability is satisfactory.

In addition to the disclosure requirements specifically stated in P.L.211-2003, the Department is directing all participating insurers to provide notice to the insured that the waiver is issued pursuant to a demonstration project and that a representative of the Department of Insurance will contact the insured to discuss their experience with the coverage.

Any insurer writing association or discretionary group policies that is interested in participating in the demonstration project should submit a written request to the attention of Joy Long at the Department no later than September 15, 2003. The insurer's request shall include documentation to show the insurer meets the required criteria and a copy of the proposed waiver form.

Filing and reporting requirements

For all insurers issuing waivers on individual policies or under the demonstration project, the waiver form must be filed with and approved by the Department pursuant to IC 27-8-5-1.

All insurers issuing waivers on individual policies or under the demonstration project are reminded of the reporting requirements of Section 10 of P.L.211-2003. Reports should be submitted to the Department to the attention of Joy Long, Deputy Commissioner for Health Issues.

INDIANA DEPARTMENT OF INSURANCE
Sally McCarty, Commissioner

Exhibit A

The following is an example acceptable to the Department of a written explanation of a waived condition and the complications directly related to that condition.

Condition(s) excluded: Services and treatment of benign renal diseases, disorders, tumors, cysts, infections, inflammations, atrophy, hypertrophy, calculus, fibrosis, necrosis, failure, hemorrhage, and thrombus. Any progression, recurrence or complications arising therefrom are excluded from coverage.

Also excluded: Services and treatment of the excluded conditions and complications related thereto which include specifically malignant neoplasm of kidney, malignant neoplasm of other urinary organs, urinary calculi, artificial opening of urinary tract, fitting and adjustment of urinary devices, screening for other genitourinary conditions, acute and/or chronic proliferative nephritis, acute and/or rapidly progressive nephritis, acute and/or chronic flomerulonephritis, nephritic syndrome proliferative, epimembranous nephritis, membranoproliferative nephrosis, minimal change nephrosis, nephritic syndrome, rapidly progressive nephritis, renal cortical necrosis, nephritis nos/medullary necrosis, renal failure with lesion of tubular necrosis, renal failure with lesion of renal cortical necrosis, medullary necrosis, acute renal failure unspecified, renal sclerosis, renal osteodystrophy, nephrogenic diabetes insipidus, impaired renal function, unilateral or bilateral small kidney(s), pyelonephritis with or without lesion of renal medullary necrosis, renal and perinephric abscess, pyeloureteritis cystica, pyelonephritis unspecified, infection of kidney unspecified, hydronephrosis, calculus of kidney, calculus of ureter, cyst of kidney, vascular disorders of kidney, and ureteral fistula.

DEPARTMENT OF STATE REVENUE

0220010132.LOF

LETTER OF FINDINGS: 01-0132
Indiana Corporate Income Tax
For the Tax Periods Ending in 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.

ISSUE

I. Unitary Filing Requirement – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); IC 6-3-2-2(m); Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Bethlehem Steel Corp. v. Ind. Dept of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); Marshalk v. Green, 746 F.2d 927 (2d Cir. 1984); PepsiCo, Inc. v. Grapette Co, 416 F2d 825 (9^{th} Cir. 1969); Commissioner's Directive 10, February 1, 1984; J. Gilson, Trademark Protection and Practice (2001); Tax Management Multistate Tax Portfolios (1998).

Taxpayer argues that the Department of Revenue – in calculating taxpayer's Indiana income – erred when it recomputed taxpayer's adjusted gross income to reflect all members of taxpayer's federal affiliated group of companies on a unitary basis.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of operating department stores and other businesses which sell clothing. During the tax years at issue, taxpayer operated as the parent company for two subsidiaries. In turn, both subsidiaries operated separate department store chains. Both subsidiaries have stores in Indiana, and both subsidiaries do business within Indiana.

In Year 1, Subsidiary One transferred certain trademarks to a branch operating division in State X (Holding Company One). Holding Company One pre-existed the transfer of the trademarks but had previously been in the business of owning and managing a warehouse center which served Subsidiary One's stores in State X and surrounding states.

Subsidiary One transferred the trademarks in an exchange described by taxpayer as, "a contribution to the capital of [Holding Company One] by [Subsidiary One] pursuant to section 351 of the Internal Revenue Code." Following the initial transfer, Holding Company One licensed the use of the trademarks back to Subsidiary One under "arm's length licensing agreements." Subsidiary One paid royalties to Holding Company One for the privilege of using the same trademarks it had owned before entering the Year 1 transfer agreement.

Subsidiary Two – also in the business of operating a chain of department stores – was acquired by taxpayer from a third-party in Year 2. After acquiring Subsidiary Two, taxpayer arranged for Subsidiary Two to transfer its own trademarks to a second company also located in State X (Holding Company Two). The exchange was made "as a contribution to capital of [Holding Company Two]." Subsidiary Two entered into a licensing agreement whereby it paid royalties to Holding Company Two for the right to employ the trademarks Subsidiary Two owned before the transfer.

Neither Holding Company One nor Holding Company Two have property or employees outside of State X. As taxpayer explains, both Holding Company One and Holding Company Two, "employ[] various individuals and contracts with various service providers in State X to conduct its business of owning, maintaining and licensing trademarks." According to taxpayer, both Holding Company One and Holding Company Two are in the business of managing trademarks.

During 2000, the Department conducted an audit of taxpayer's business records and tax returns. The audit reviewed the tax years ending in January 1996, January 1997, and January 1998. In doing so, the audit determined taxpayer's adjusted gross income should be recomputed on a unitary basis to reflect all members of the taxpayer's federal affiliated group including both Holding Company One and Holding Company Two. It did so on the ground that the royalty payments to the two holding companies "distorted income derived from Indiana sources due to the artificially created royalty expenses." In addition, the audit "determined that computing the Indiana adjusted gross income on the unitary basis more fairly reflects the income derived from Indiana sources." As a result of the audit's decision, the Department concluded that taxpayer owed additional Indiana corporate income tax.

Taxpayer took issue with this conclusion and submitted a protest to that effect. An administrative hearing was held during which taxpayer explained the basis for its protest, and this Letter of Findings follows.

DISCUSSION

I. Unitary Filing Requirement – Adjusted Gross Income Tax.

The audit determined that taxpayer's out-of-state holding companies had a "unitary business" with taxpayer. As a result, the audit found that taxpayer had a "unitary relationship" with the two holding companies and that taxpayer was required to report its Indiana income on a unitary basis. The audit's decision had the effect of subjecting the royalty income paid the State X holding companies to Indiana corporate income tax. Taxpayer argues that the audit's decision, imposing a combined unitary filing method, is an arbitrary abuse of statutory discretion.

The audit imposed the unitary filing requirement under authority of IC 6-3-2-2(m) which provides as follows:

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

In addition, IC 6-3-2-2(l) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities.

> 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;
>
> (1) separate accounting;
> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is apparent from the language contained with IC 6-3-2-2(l) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment – including the unitary reporting method of which taxpayer complains – are only employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

Taxpayer argues that the standard apportionment filing method is the correct means by which to report its Indiana income. In support, taxpayer cites to Commissioner's Directive 10, February 1, 1984 (Deleted August 1994) which states that the resort to IC 6-3-2-2-2 is "available when the standard methods of apportioning income cease to fairly reflect the income derived from Indiana sources" and should only be employed "when the standard three-factor formula clearly does not fairly reflect income." In further support, taxpayer maintains that the royalty payments were not arbitrary disbursements of Indiana income but were predicated on the basis of an independent and arms-length assessment of the value of the trademarks. In addition, taxpayer states that the decisions to "compartmentalize" the trademarks was warranted by concerns that the trademarks should be protected from future, unrelated legal actions brought against the taxpayer or any of its subsidiaries.

The Department concludes that the audit was warranted in requiring that taxpayer report its Indiana income on a unitary basis because, other than the favorable tax consequences attendant upon the license-back arrangements, the taxpayer's justification for the trademark/royalty transactions is unsupported.

There is nothing to indicate that taxpayer's business operations were affected in any way by the transfer of the trademarks to the two holding companies. There is nothing to indicate that the two holding companies do anything to manage the trademarks or do anything to enhance the value of the trademarks. There is nothing to indicate that the two holding companies obtained any independent ownership of the trademarks or that taxpayer did not remain the true owner of the trademarks. There is little to indicate that two holding companies have any experience in or have any qualifications in the field of developing, managing, or exploiting intellectual property. Especially in view of Holding Company One's past experience – owning and managing warehouse property – the likelihood that Holding Company One would develop or protect the intellectual property seems dim indeed.

Taxpayer has provided information substantiating that it sought and obtained an independent evaluation of the "Marketing Intangibles and Royalty Rate Estimation." This report provides a detailed analysis of the taxpayer's business operation, the relationship between the trademarks and its business operations, and the value of the trademarks to the business operation. But the report is based on the assumption that the trademarks – consisting of slogans, catch-phrases, and words – have any value severed from the taxpayer's department store business. The notion that a holding company can own trademarks distinct from that which gives the trademarks value is unsupported in law, practice, or business-reality. Taxpayer's entire assumption is flawed because a trademark "is merely a symbol of goodwill; it has no independent significance apart from the goodwill it symbolizes." Marshalk v. Green, 746 F.2d 927, 929 (2d Cir. 1984). "There are no rights in a trademark apart from the business with which the mark has been associated; they are inseparable." Id. The trademarks themselves have no value because the trademarks are simply advertising tools symbolizing customer good will and the customer's willingness to purchase – and repurchase – the taxpayer's products. J. Gilson, Trademark Protection and Practice 1.03[6][a] (2001). The fact that the independent evaluation placed a "value" on the trademarks, is insufficient to establish that the transfer of the trademarks to the two State X holding companies was anything more than an exercise in legal formalism.

Taxpayer's argues that it transferred the trademarks to the holding companies in order to protect the marks from the consequences of unrelated legal actions brought against taxpayer or its subsidiaries. Specifically, taxpayer notes that a foreign competitor brought a trademark infringement action against taxpayer and that the litigation was avoided only by entering into a settlement agreement. However, taxpayer's argument is inherently flawed because it proceeds from the premise that the trademarks – words, slogans, and catch-phrases – can be conceptually severed from the goodwill realized from taxpayer's relationship with its customers and the value which the customers attach to taxpayer's goods. It remains to be seen whether taxpayer's pro forma trademark transfer agreements and the subsequent royalty agreements have any legal effect in an unrelated legal action brought against the taxpayer and its subsidiaries. In the meantime, the Department is not required to attach any significance to the transfer and license-back arrangements.

The Department was justified in requiring the taxpayer to report its Indiana income on a unitary basis because the trademark/royalty transactions were entirely illusory. The transfer of the trademarks to the holding companies was illusory because the trademarks have no value distinct from the subsidiaries' goodwill. The royalty payments were illusory because the two subsidiaries were paying for something which had no existence independent from the subsidiaries' own commercial activity. PepsiCo, Inc. v. Grapette Co, 416 F2d 825, 288 (9th Cir. 1969). The transfer of the trademarks to the holding companies was illusory because the holding company was incapable of managing or exploiting the intellectual property irrespective of the subsidiaries' business activities. The royalty payments were illusory because the holding companies simply "loaned" the money back to the two subsidiaries or invested the money on behalf of the two subsidiaries.

Although each of the four entities – Subsidiary One, Subsidiary Two, Holding Company One, and Holding Company Two – maintains separate and distinct identities, the relationship between the four parties has all the hallmarks of a unitary relationship. The four entities are owned, operated, managed and controlled by the same parent company; each of the four entities is one operational facet of the parent company's department store business. *See* Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).

As taxpayer correctly states, it is entitled "to keep its taxes as low as possible as permitted under well settled law." ("The state of [X] does not impose a corporate income tax." Tax Management Multistate Tax Portfolios 1100:0086 (1998)). Nonetheless, the Department is also entitled to consider the "substance rather than the form of the transaction" Bethlehem Steel Corp. v. Ind. Dept of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992) in determining the tax consequences of taxpayer's license-back arrangements. After considering the substance of the license-back agreements and the unitary relationship between the commonly-owned parties, the Department concludes that the audit was justified in determining that the royalty payments artificially distorted taxpayer's Indiana income and requiring, as a consequence, that taxpayer report its Indiana income on a unitary basis.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0220020308.LOF

LETTER OF FINDINGS: 02-0308
Indiana Corporate Income Tax
For 1998 and 1999

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

ISSUES

I. Applicability of the Throw-Back Rule – Adjusted Gross Income Tax.

Authority: 15 U.S.C.S. § 381; 15 U.S.C.S. § 381(a), (c); 15 U.S.C.S. § 381(c); 15 U.S.C.S. §§ 381 to 384; Public Law 86-272; IC 6-3-1-25; IC 6-3-2-2; IC 6-3-2-2(e); IC 6-3-2-2(n); IC 6-3-2-2(n)(1); First Chicago NBD Corp. v. Dept. of State Revenue, 708 N.E.2d 631 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-53(5); 45 IAC 3.1-1-64; Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation: Cases and Materials (7th ed. 2001); Personal Income Tax – Nexus Standards (Ohio Dept. of Taxation, Sept. 2001).

Taxpayer argues that the Department of Revenue (Department) erred when it determined that the receipts earned from sales to out-of-state customers were subject to Indiana's adjusted gross income tax.

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).

Taxpayer requests that the Department abate the ten-percent negligence penalty because the additional tax assessments – upon which the penalty is calculated – were entirely the result of the Department's own "incorrect application of the throw back rule."

STATEMENT OF FACTS

Taxpayer is an Indiana business which sells truck parts. Taxpayer sells truck parts to Indiana customers, to out-of-state customers, and to customers outside the United States. The Department conducted a review of taxpayer's business records and tax returns determining that the receipts obtained from sales to out-of-state customers should be "thrown-back" to Indiana. Taxpayer disagreed with the audit's determination, challenged the consequent assessment of additional corporate income taxes, and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for its protest and offered to supply additional information substantiating its contentions. That information was provided, received, and considered. This Letter of Findings results.

DISCUSSION

I. Applicability of the Throw-Back Rule – Adjusted Gross Income Tax.

The audit decided that the receipts taxpayer obtained from sales to its out-of-state and foreign customers should be included in the numerator of the sales factor. The audit made this decision because it found that all of taxpayer's property, inventory, and payroll were located in Indiana and because taxpayer "do[es] not file tax returns in any other state." Taxpayer disagrees maintaining that the receipts earned from the out-of-state and foreign customers should not have been thrown-back to Indiana.

The audit determined that, for purposes of calculating taxpayer's Indiana tax liability, the receipts from sales to out-of-state customers and foreign customers should be thrown back to Indiana because the sales were made within jurisdictions where the taxpayer was not subject to a state income tax. The audit based its decision on 45 IAC 3.1-1-53(5) which states that "[i]f the taxpayer is not taxable in the state of the purchaser, the sale is attributed to [Indiana] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state." Such sales are designated as "throw-back" sales. Id.

The basic rule is found at IC 6-3-2-2. IC 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if... (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and... (B) the taxpayer is not taxable in the state of the purchaser." IC 6-3-2-2(n) provides that "[f]or purposes of allocation and apportionment of income... 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." Therefore, in order to properly attribute income to a foreign state, taxpayer must show that one of the taxes listed in IC 6-3-2-2(n)(1) has been levied against him or that the state has the jurisdiction to impose a net income tax regardless of "whether, in fact, the state does or does not." Id.

Therefore, whether or not Indiana can tax receipts an Indiana resident obtains from non-Indiana customers depends on whether another jurisdiction subjects that same taxpayer to that jurisdiction's own income tax. However, Congress passed a law which restricts the states' authority to tax income received from interstate business activities. The law is codified at 15 U.S.C.S. §§ 381 to 384 but is generally referred to as Public Law 86-272. Public Law 86-272 prohibits states from imposing a net income tax on an out-of-state taxpayer if that foreign taxpayer's only business activity within the 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 in-state 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 home 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 taxpayer 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 the receipts obtained 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.

Taxpayer's argument is based on the premise that its activities outside Indiana exceed the 15 U.S.C.S. § 381(a), (c) "mere solicitation" standard. As a result, it is the out-of-state and foreign jurisdictions which have the right to tax its out-of-state and foreign income – not Indiana.

Taxpayer has provided information purporting to establish that its out-of-state agents do more than merely solicit orders. The agents handle customer complaints, deal with collection issues when customers fail to pay their bills, perform "field work" educating customers on the virtues of taxpayer's products, resolve problems stemming from defective merchandise, and – as stated by one of taxpayer's agents – generally act as taxpayer's "eyes, ears, and arms in our defined territory."

Taxpayer's argument is unavailing because its activities within the out-of-state jurisdictions do not constitute "doing business" within those jurisdictions. Although the activities of its independent representatives may indeed exceed the "mere solicitation" standard, the nature and extent of the representatives' activities is irrelevant because taxpayer is conducting its out-of-state activities through a network of independent agents. Public Law 86-272 specifically precludes each state from subjecting an out-state-taxpayer to that state's own net income based upon the activities of independent agents.

For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property. 15 U.S.C.S. § 381(c).

What 15 U.S.C.S. § 381(c) means is that a taxpayer may conduct business in a foreign state by means of an independent agent without subjecting itself to the foreign state's net income tax. However, a taxpayer cannot have it both ways. It may insulate its foreign-source income from the foreign state's income tax by conducting activities by means of an independent agent, but it may not thereafter complain when its home-state subjects the that same income to the home-state's own income tax.

A. Ohio Sales Income.

Taxpayer maintains that there is "further support for nexus with Ohio." Taxpayer argues that its independent representative's activities inside Ohio bring taxpayer within the orbit of Ohio's income tax scheme. To that end, taxpayer recites from Ohio's "Information Release" stating that an entity – such as taxpayer – "does not have protection from [Public Law] 86-272 if the following activities are conducted in Ohio: having a sales representative or independent contractor conducting activities to establish or maintain the market for the entity; making repairs to the items sold; resolving customer complaints; accepting orders; handling collections; and issuing credits."

The Department defers to Ohio's interpretation of its own income tax laws. However, as the Ohio's Information Release states, "The limitations and extent of [Ohio's] jurisdiction to impose tax is an evolving area and this information release is not intended to be an all encompassing or all inclusive description of this subject." Personal Income Tax – Nexus Standards (Ohio Dept. of Taxation, Sept. 2001).

The Information Release seems to indicate that Ohio claims the right to subject Indiana residents to Ohio's income tax by virtue of Ohio sales activities conducted by independent contractors. However, such a conclusion would seem to contradict the plain words of 15 U.S.C.S. § 381(c). "The immunity statute [Public Law 86-272] extends to the use of sales representatives, that is persons who are not employees but are independent contractors soliciting orders or making sales of tangible property for the out-of-state vendor." Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation: Cases and Materials 385 (7th ed. 2001).

There seems little likelihood that Ohio would have the authority to subject taxpayer to Ohio's income tax; taxpayer's Ohio sales receipts were correctly "thrown-back" to Indiana pursuant to IC 6-3-2-2.

B. Michigan Sales Income.

Taxpayer argues that its Michigan sales income should not have been thrown back to Indiana because it was subject to Michigan's Single Business Tax (MSBT). Accordingly, taxpayer argues that it "has independent and additional support for nexus with the State of Michigan."

The Department must disagree with taxpayer's conclusion that imposition – or the likelihood of imposition – of the MSBT precludes Indiana from throwing back its Michigan sourced sales receipts. IC 6-3-2-2(n) precludes the state from throwing back sales receipts in those states in which "taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege for doing business, or a corporate stock tax." As the Indiana Tax Court has stated, "The MSBT is a type of value added tax VAT." First Chicago NBD Corp. v. Dept. of State Revenue, 708 N.E.2d 631, 632 (Ind. Tax Ct. 1999). "Although taxable income is one portion of the tax base formula, *the MSBT is not measured by or based on income*." Id. at 634 (*Emphasis added*). "The law [Public Law 86-272] applies only to net income taxes... and does not apply to the general business of taxes of states that do not employ a net income measure, such as Michigan's Single Business Tax, which is a form of value-added tax." Hellerstein & Hellerstein at 389.

The Michigan activities of taxpayer's independent representatives may subject taxpayer to the MSBT, but that fact is irrelevant in determining whether Indiana may throw-back taxpayer's Michigan sourced sales receipts. The Michigan sales were correctly "thrown-back" to Indiana pursuant to IC. 6-3-2-2.

C. Foreign Sales Income.

Taxpayer maintains that its sales receipts from Puerto Rico, Ecuador, and Mexico should not be thrown back to Indiana because, "P.L. 86-272 does not protect these sales from taxation in those countries."

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, "[t]he 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 to which taxpayer here refers – Puerto Rico, Ecuador, and Mexico – fall within the definition of "state" and the receipts obtained from those three jurisdictions are properly considered as potentially subject to the throw-back rule.

Taxpayer may be correct in its assertion that Public Law 86-275 does not prevent a foreign jurisdiction from levying an income tax on the receipts taxpayer obtained from customers within those foreign jurisdictions. However, taxpayer has done nothing to demonstrate that it is subject to a net income tax in Puerto Rico, Ecuador, or Mexico. Accordingly, under IC 6-3-2-2, the receipts taxpayer obtained from its customers in Puerto Rico, Ecuador, and Mexico were properly thrown-back to Indiana.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

According to taxpayer, it "had a position of substantial authority for not reflecting sales as 100 [percent] Indiana when the original returns were filed." As a result of the Department's own "incorrect application of the throw back rule, penalties should not be assessed."

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the 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) 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 Department respectfully disagrees with taxpayer's argument that it was entirely justified in not reporting any of its out-of-state income and that its decision to do so was based upon "ordinary business care." The Department must decline the opportunity to abate the consequent penalty.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

04-20020314.LOF

LETTER OF FINDINGS NUMBER: 02-0314
Gross Retail & Use Tax
For the Years 1998, 1999, 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. Gross Retail & Use Tax-Purchases of oil for rental cars

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-3-6; IC § 6-2.5-5-8; 45 IAC 2.2-4-27(4).

Taxpayer protests the tax assessment on oil and oil filter purchases to maintain the operation of vehicles in its rental car business.

II. Tax Administration-Penalty

Authority: IC § 6-2.5-5-8; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the assessment of the 10% negligence penalty.

STATEMENT OF FACTS

Taxpayer operates short-term automobile rental locations in Indiana and several surrounding states. During the audit period, taxpayer had five Indiana locations. The audit raised a number of issues; the only one taxpayer protested concerns taxpayer's purchases of oil and oil filters used in the regular maintenance of the vehicle fleet. Taxpayer did not pay gross retail tax at the time of purchase. Taxpayer did not self-assess and remit use tax on these purchases. Therefore, the auditor made those adjustments to taxpayer's tax liability. Taxpayer's protest is a purely legal argument based on differing interpretations of the applicable Indiana statutes and regulations. Taxpayer also protests the assessment of the 10% negligence penalty. Further facts will be added as required.

I. Gross Retail & Use Tax-Purchases of oil for rental cars

DISCUSSION

Taxpayer protests the assessment of use tax on its purchases of oil and oil filters. Taxpayer did not pay Indiana gross retail tax on the items of tangible personal property at the time of purchase. In its protest letter and written brief submitted as its hearing on the protest, taxpayer argued that oil changes are necessary for the proper maintenance of the cars that are rented out and are therefore not subject to tax. Taxpayer also argued that there is no basis in Indiana's statutes and regulations to tax oil and oil filters used in maintaining cars in businesses that rent out those cars to customers.

IC § 6-2.5-2-1 provides in relevant part:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

IC § 6-2.5-3-2 and IC § 6-2.5-3-4 impose the use tax on items of tangible personal property if the gross retail tax was not paid at the time of purchase. Therefore, pursuant to IC § 6-2.5-3-6, taxpayer is liable for payment of use tax on the oil and oil filters purchased to change the oil on a regular basis for the proper maintenance of the vehicles in the rental fleet. These statutes and their governing regulations provide ample support for taxing these items of tangible personal property. There are no exemptions in the statutes or regulations that would relieve taxpayer of the duty either to pay the gross retail tax at the time of purchase, or to self-assess and remit the use tax.

Taxpayer argues that these items are necessary to maintain the proper operation of the rental vehicles; otherwise, they would be inoperable. Taxpayer also argues that inasmuch as IC § 6-2.5-8 does not require tax on the purchase of the cars for rental, the maintenance oil and filters should be exempt as well. On the surface, taxpayer's argument is attractive; however, 45 IAC 2.2-4-27(4) clearly states:

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

Therefore, when taxpayer purchases oil and oil filters to change the oil in its vehicles, taxpayer consumes these supplies and must either pay gross retail tax on them at the time of purchase or self-assess use tax and remit it to the Indiana Department of Revenue.

FINDING

Taxpayer's protest concerning the assessment of use tax on the purchase and consumption of oil and oil filters, used in regular oil changes for its fleet of rental vehicles, is denied.

II. Tax Administration-Penalty

Taxpayer protests the imposition of the 10% negligence penalty on the entire assessment. Taxpayer argues that it had reasonable cause for failing to pay the appropriate amount of tax due. Taxpayer stated in its brief that there was no intent to defraud the state, and that its failure to pay the proper amount of tax was due to its interpretation of Indiana's statutes and regulations, specifically IC § 6-2.5-5-8:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the forms of the property.

The above exemption applies to businesses acting in their capacity as retail merchants; when taxpayer purchases the oil and oil filters, taxpayer is not acting as a retail merchant because the business uses the oil and oil filters. If taxpayer was in the business of changing oil, then perhaps the exemption would apply. But taxpayer does not change oil as its principal business; it rents and leases cars.

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

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

Taxpayer set forth a basis whereby the Department could conclude taxpayer exercised the degree of care statutorily imposed upon an ordinarily reasonable taxpayer. Taxpayer's interpretation of the relevant Indiana statutes and regulations, while incorrect, is not so far-fetched as to render the interpretation careless, thoughtless, or unreasonable. Further, taxpayer did self-assess the use tax at issue, but misunderstood which state was to receive the tax that was self-assessed. The state that did receive it should have recognized the error and corrected it. Plus, a prior income audit resulted in a refund. Therefore, given the totality of all the circumstances, waiver of the penalty on the entire assessment is appropriate in this particular instance.

FINDING

Taxpayer's protest concerning the proposed assessment of the 10% negligence penalty is sustained.

DEPARTMENT OF STATE REVENUE

0420020234.LOF

LETTER OF FINDINGS NUMBER: 02-0234
Sales and Use Tax
For the Years 1997-1998

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

I. Sales and Use Tax- Imposition of Sales Tax

Authority: IC 6-2.5-2-1, IC 6-8.1-5-1 (b),

The taxpayer protests the imposition of the sales tax.

II. Sales and Use Tax-Imposition of Use Tax

Authority: IC 6-2.5-3-2, IC 6-8.1-5-1 (b),

The taxpayer protests the imposition of tax.

STATEMENT OF FACTS

The taxpayer is a restaurant and banquet facility. During 1998, the taxpayer was open for ten months and filed returns for five months. 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 this assessment. In response to the protest, a hearing was scheduled. The taxpayer failed to appear or make any other contact with the department.. As a result, this Letter of Finding is based upon the information in the file.

I. Sales and Use Tax- Imposition of Sales Tax

DISCUSSION

Indiana imposes a sales tax on retail transactions made in Indiana. IC 6-2.5-2-1. All assessments made by the department are presumed to be correct. Taxpayers bear the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b).

The department determined the taxpayer's 1997 sales tax liability by subtracting the total sales as reported from the recap of the taxpayer's returns from the total sales for the year from profit and loss statements. Sales tax was applied to the remainder.

The taxpayer operated for ten months of 1998. The taxpayer reported and paid sales tax on ST-103's for five of the ten months of operation. The taxpayer reported an average of 26.11% of taxable sales as computed by the department. Sales tax was included in total sales and was deducted prior to arriving at taxable sales per audit. The department recapped the taxpayer's daily sales cash register tapes to arrive at total sales. The taxpayer stated that the facility was open seven days a week for approximately fifteen hours per day. The taxpayer's records did not disclose any exempt sales. A review of the cash register tapes revealed some days of various months were missing. To arrive at the missing days, the totals of all days with cash register tapes were totaled and divided by the number of days with tapes for the month in question. The average daily sales for a month with missing days were multiplied by the number of missing days to arrive at adjusted taxable sales by combining estimated days and days with actual receipts. Sales tax was applied to the total sales computed by the department.

Although given ample opportunity, the taxpayer did not present any documentation to indicate that the department improperly imposed the sales tax or that the department's calculations of the sales tax due were incorrect.

FINDING

The taxpayer's protest is denied.

II. Sales and Use Tax-Imposition of Use Tax

DISCUSSION

The use tax is imposed on personal property purchased in a retail transaction and used in Indiana when no sales tax has been paid. IC 6-2.5-3-2. All assessments made by the department are presumed to be correct. Taxpayers bear the burden of proving that an assessment is incorrect. IC 6-8.1-5-1 (b).

The department examined the taxpayer's purchase records for 1998. The department made a listing of purchases that the taxpayer used in Indiana and on which no sales tax wax paid. None of the listed purchases qualified for exemption. Use tax was imposed on the taxpayer's use of these items.

The taxpayer did not present the department with any purchase records for 1997. Therefore, the department calculated a ratio of the 1998 total purchases to the 1998 total sales. This ratio was used to determine an estimate of the total purchases for 1997. The department then applied the percentage of 1998 sales that were subject to the imposition of use tax to the estimate of the 1997 total purchases to determine the taxpayer's 1997 use tax liability.

Although given ample opportunity, the taxpayer did not present any documentation to indicate that the department improperly imposed the use tax or that the department's calculations of the use tax due were incorrect.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420020323.LOF

LETTER OF FINDINGS NUMBER: 02-0323
Sales and Use Tax
For the Years 1999 – July, 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. Sales and Use Tax-Imposition

Authority: IC 6-8.1-5-1 (b), IC 6-2.5-2-1.

The taxpayer protests the imposition of additional Indiana sales tax.

STATEMENT OF FACTS

After an investigation, the Indiana Department of Revenue hereinafter referred to as the "department," assessed sales tax, interest, and penalty against the taxpayer. The taxpayer protested the assessment and a hearing was held.

I. Sales and Use Tax-Imposition

DISCUSSION

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

Indiana imposes a sales tax on retail transactions made in Indiana. Purchasers pay the tax and retail merchants remit the collected sales tax to the state. IC 6-2.5-2-1. The taxpayer limited liability corporation owned and operated a car and truck plaza. The department determined that the taxpayer did not remit to the state all the sales taxes which it had collected. The taxpayer protested this assessment on the ground that the taxes had been properly remitted. Although given ample opportunity to do so, the taxpayer did not offer any evidence that it had properly remitted all sales taxes to the state.

The taxpayer alleges that the assessment is against the incorrect limited liability corporation. In support of this contention, the taxpayer submits that the corporation has two Indiana taxpayer identification numbers. The two alleged limited liability corporations have, however, the same federal identification number. A clerical error in assigning two different Indiana numbers to one limited liability corporation does not obviate the taxpayer's duty to collect and remit sales tax to the state.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04-20020366.LOF
04-20020367.LOF

LETTER OF FINDINGS NUMBERS: 02-0366 AND 02-0367
Sales and Use Taxes
Calendar Years 1998, 1999, 2000

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

ISSUES

I. Sales Tax – Availability of additional information

Authority: IC 6-8.1-4-2

The taxpayer protests that certain information and documentation relevant to the audit assessment became available after the close of the audit.

II. Use Tax – Auditor's method of calculating tax

Authority: IC 6-8.1-4-2

The taxpayer protests the assessment of use tax on the total amount of expense items purchased during the audit period.

III. Tax Administration – Penalty

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

The taxpayer protests the penalty assessed.

STATEMENT OF FACTS

The taxpayer rents and leases cranes, man-lifts, and various other lifting devices to contractors and commercial enterprises. The department audited the taxpayer. With regard to the sales tax, the auditor requested specific information and documents from the taxpayer. The taxpayer failed to provide the information and documents within a reasonable period of time. The auditor calculated a sales tax assessment based on the best information available.

With regard to the use tax, the auditor requested that specific invoices be made available for examination. The taxpayer failed to provide these invoices within a reasonable period of time. The auditor calculated a use tax assessment based upon the total amounts of certain expense accounts selected from the taxpayer's chart of accounts.

In a letter dated July 17, 2002, the taxpayer protested the sales tax and use tax assessments asserting that the requested documentation had become available. In a letter dated March 12, 2003, the taxpayer protested the imposition of penalty. Following review and discussion, the department and the taxpayer resolved the sales and use taxes issues. Accordingly, a supplemental audit report was prepared. In a letter dated April 23, 2003, the taxpayer withdrew its protest regarding the sales and use taxes subject to the proposed supplemental adjustments. However, the taxpayer continued to protest the imposition of penalty.

I. Sales Tax - Availability of additional information

According to the auditor, specific documentation was requested from the taxpayer. This documentation was not provided. After allowing a reasonable period of time for the submission of the requested information, the auditor had no choice but to complete the audit report based on the best information available.

In its letter dated July 17, 2002, the taxpayer protested the auditor's use of the "best information available" approach asserting that the requested documents were now available for review.

IC 6-8.1-4-2 (a) (6) states:

The division of audit may: … employ the use of such devices and techniques as may be necessary to improve audit practices.

Given the absence of financial records during the audit examination, the auditor was justified in basing the assessment on the best information available.

The auditor determined that the information contained in the documents was reasonable, and, accordingly, a supplemental audit was prepared. In a letter dated April 23, 2003 the taxpayer withdrew its protest of this issue based on the proposed supplemental audit adjustments.

FINDING

The taxpayer has withdrawn its protest of this issue.

II. Use Tax – Auditor's method of calculating tax

As part of the audit examination, the auditor requested a sample of purchase invoices for review. This sample of invoices was to be used to determine projected use tax liabilities or refunds. The invoices were not provided. After allowing a reasonable period of time for the submission of the requested information, the auditor had no choice but to prepare the projection and complete the audit report based on the best information available.

In its letter dated July 17, 2002, the taxpayer protested that it did not agree with the auditor's method of calculating the use tax liability. Subsequently, the taxpayer submitted the requested invoices to the auditor for review. In accordance with the previously quoted IC 6-8.1-4-2 (a) (6), the auditor was justified in basing the assessment on the best information available.

The auditor determined that the information contained in the documents was reasonable, and, accordingly, a supplemental audit was prepared. In a letter dated April 23, 2003 the taxpayer withdrew its protest of this issue based on the proposed supplemental audit adjustments.

FINDING

The taxpayer has withdrawn its protest of this issue.

III. Tax Administration – Penalty

The taxpayer protests the imposition of penalty based upon the following:

- Ownership of the taxpayer changed during the audit period.
- The audit was the first sales and use taxes audit of the taxpayer since its incorporation.

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.

Regarding the first argument, the Department acknowledges the confusion created by changes in ownership and corporate reorganization. However, the possibility of such events should have been anticipated by the taxpayer; procedures should have been in place to assure that tax obligations were timely paid.

The argument that this audit was the taxpayer's first audit since incorporation is not sufficient to justify the waiver of penalty. A taxpayer doing business in Indiana assumes the responsibility of familiarizing itself with the Indiana Code, Indiana Administrative Code, and the various information bulletins and other pronouncements issued by the Department. This learning process should begin prior to the outset of doing business in Indiana, not after the taxpayer has been notified that it is a candidate for audit. The taxpayer's failure to understand and apply Indiana tax law to its Indiana transactions clearly indicates negligence. The imposition of penalty is appropriate.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420020516.LOF

LETTER OF FINDINGS NUMBER: 02-0516
Sales and Withholding Tax
For the Years 1999-2000

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. Sales and Withholding Tax- Imposition of Penalty and Interest

Authority: IC 6-2.5-9-3, IC 6-3-4-8 (f).

The taxpayer protests the imposition of penalty and interest.

STATEMENT OF FACTS

The taxpayer was an officer of a corporation that is no longer in business and has unpaid trust taxes. The Indiana Department of Revenue, hereinafter referred to as the "department," personally assessed the unpaid trust taxes, interest, and penalty against the taxpayer. The taxpayer agreed that he was personally liable for the trust taxes. However, he protested the assessment of interest and penalty against himself personally. In response to the protest, a hearing was scheduled. The taxpayer did not appear for the hearing. As a result, this Letter of Finding is based upon the information in the file.

I. Sales and Withholding Tax- Imposition of Penalty and Interest

DISCUSSION

The taxpayer agreed that he was an officer responsible for the payment of the taxes. He contends, however, that only the corporation would be responsible for the payment of the interest and penalty of the taxes which were not remitted to the state.

The proposed penalty and interest liability attributable to the corporation's sales tax liability was personally assessed against the taxpayer under authority of IC 6-2.5-9-3 which provides as follows:

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.

The proposed penalty and interest attributable to withholding taxes were assessed against the taxpayer pursuant to IC 6-3-4-8 (f), which provides that "In 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."

The law authorizes the assessment of tax liability, interest, and penalties against responsible officers. Therefore, the interest and penalties were properly assessed against the taxpayer.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE 04-20030184P.LOF

LETTER OF FINDINGS NUMBER: 03-0184P

Tax Administration—Penalty

For the Year 1999

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

ISSUES

I. Tax Administration—Penalty

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

Taxpayer protests the assessment of the 10% negligence penalty.

STATEMENT OF FACTS

The Department, after reviewing all the materials in the above-captioned penalty protest, and all relevant statutes and administrative regulations, denies taxpayer's requested relief, for the following reasons.

The penalty was proposed in the first instance because the auditor determined taxpayer had not self-assessed and remitted use tax even though taxpayer was aware of its duty to do so. A supplemental audit revealed that taxpayer was owed a refund based on taxes remitted to the Department with taxpayer's ST-103 forms. Therefore, taxpayer's initial tax liability was reduced from $4,119.06, plus penalty and interest, to $1,413.25, plus penalty and interest. Taxpayer received a refund of $3,648.21. Taxpayer filed its letter of protest in May of 2003, requesting an abatement of the penalty, but listed the interest amount assessed, not the penalty amount. On the same day that taxpayer mailed its protest letter, the Department issued its refund letter and check to taxpayer. They apparently crossed in the mail.

The Department then requested that taxpayer send further information that would support a waiver of the penalty assessed, $141.32, on the proper amount of tax due.

I. Tax Administration-Penalty

DISCUSSION

Taxpayer has not sent in any further information. Interest is imposed by statute, and cannot be waived. Penalty assessments depend on a number of factors outlined in the statute and regulation cited *supra*, and can be waived based on a showing of sufficient cause. Since taxpayer has not made this showing, the Department denies taxpayer's request to abate the penalty assessment.

FINDING

Taxpayer's request to abate the 10% negligence penalty is denied.

DEPARTMENT OF STATE REVENUE

0420030186P.LOF

LETTER OF FINDINGS NUMBER: 03-0186P
Sales and Use Tax
For Tax Years 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 superceded 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—Negligence Penalty

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

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

STATEMENT OF FACTS

Taxpayer is a clothing retailer. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments of use taxes for 2000 and 2001. Taxpayer paid the assessments, but protested the imposition of a ten percent negligence penalty. Further facts will be provided as necessary.

I. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent negligence penalty on assessments for tax years 2000 and 2001. The Department imposed the negligence penalty due to underpayment of use tax for the two years in question, as provided in IC 6-8.1-10-2.1.

Taxpayer paid the assessments, but did not pay the penalty amounts. Taxpayer states in its protest that it paid use tax consistently and timely during the audit period and was unaware that any use tax had been omitted. Also, taxpayer explained that it has taken steps to improve its tax collection and payment in the future. The Department refers to 45 IAC 15-11-2(b), which states:

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

45 IAC 15-11-2(c) provides in pertinent part:

> 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.

Taxpayer is an established business, and should have had adequate tax payment procedures in place. Taxpayer has not affirmatively established that failure to pay the full amount of tax due for 2000 and 2001 was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120030189.LOF

LETTER OF FINDINGS: 03-0189
Indiana Individual Income Tax
For the Tax Years 1997 through 2002

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

ISSUES

I. Definition of "Taxpayer" for the Purpose of Assessing the State's Individual Income Tax.

Authority: Ind. Const. art. X, § 8; IC 6-2.1-1-16; IC 6-2.1-2-2; IC 6-3-1-1 et seq.; IC 6-3-1-9; IC 6-3-1-12.

Taxpayer argues that he does not come within the definition of "taxpayer" for purposes of Indiana's individual income tax.

II. Imposition of the State's Adjusted Gross Income 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 that his wages are not "income" and that only corporations are subject to federal or state income tax.

III. Voluntary Nature of the Indiana'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 (N.D. Ind. Oct. 30, 1985).

Taxpayer maintains that both the federal and state income taxes are voluntary; having so concluded, taxpayer has decided he no longer wishes to pay income taxes and has "unvolunteered."

IV. Federal Obligations Exempt from Taxation.

Authority: 12 U.S.C.S. § 411; 18 U.S.C.S. § 8; 18 U.S.C.S. § 471; 18 U.S.C.S. § 477; 18 U.S.C.S. § 642; 31 U.S.C.S. § 3124; 31 U.S.C.S. § 3124(a); Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983); Smith v. Davis, 323 U.S. 111 (1944); Provenza v. Comptroller of the Treasury, 497 A.2d 831 (Md. App. Ct. 1985).

Taxpayer argues that because he is paid or ordinarily deals in Federal Reserve Notes and because federal obligations such as Federal Reserve Notes are not subject to federal or state income tax, he is not required to pay income tax.

V. Sufficiency of Taxpayer's Indiana Tax Return.

Authority: IC 6-3-1-3.5; Cooper Industries, Inc. v. Indiana Dept. of State Revenue, 45 IAC 3.1-1-1; I.R.C. § 62.

Taxpayer states that he has fulfilled his obligation under state and federal law by filing – or proposing to file – income tax returns which are filled out with "zeroes."

STATEMENT OF FACTS

Taxpayer received notices of "Proposed Assessment" from the Department of Revenue (Department). In the belief that he did not owe Indiana or federal income taxes, taxpayer submitted a written protest challenging the validity of the assessments. An administrative hearing was conducted during which taxpayer explained the basis for the protest. In addition, taxpayer submitted additional written materials to support his contentions. This Letter of Findings follows.

DISCUSSION

I. Definition of "Taxpayer" for the Purpose of Assessing the State's Individual Income Tax.

Taxpayer argues that the Department erred in assessing individual income tax because he is not a statutorily defined "taxpayer." In support of his assertion, taxpayer cites to IC 6-2.1-1-16 stating that he does not fall within one of the enumerated categories defining "taxpayer." IC 6-2.1-1-16 states in its entirety:

> "Taxpayer" means any: (1) assignee; (2) receiver; (3) commissioner; (4) fiduciary; (5) trustee; (6) institution; (7) national bank; (8) bank; (9) consignee; (10) firm; (11) partnership; (12) joint venture; (13) pool; (14) syndicate; (15) bureau; (16) association; (17) cooperative association; (18) society; (19) club; (20) fraternity; (21) sorority; (22) lodge; (23) corporation; (24) municipal corporation; (25) political subdivision of the state of Indiana or the state of Indiana, to the extent engaged in private or

proprietary activities or business; (26) trust; (27) limited liability company (other than a limited liability company that has a single member and is disregarded as an entity for federal income tax purposes); or (28) other group or combination acting as a unit.

Taxpayer is correct in his basic assertion that he does not fall within one of the enumerated categories of "taxpayer" set out in IC 6-2.1-1-16. Taxpayer is also correct in claiming that he is in not subject to the state's gross income tax scheme. However, that determination is ultimately pointless because no individual is *ever* subject to gross income tax. The state's gross income tax is imposed exclusively on corporate business entities which are either residents or domiciliarys of Indiana or on non-resident business entities which nonetheless derive income from doing business within the state. IC 6-2.1-2-2.

Taxpayer's concern is – or should be – with the provisions of the individual adjusted gross income tax provisions as set out in IC 6-3-1-1 et seq. In establishing the adjusted gross income tax, the Indiana General Assembly exercised its prerogative, under Ind. Const. art. X, § 8, to impose the tax on both individuals and corporations. In doing so it defined an individual, subject to the adjusted gross income tax as, "a natural born person, whether married or unmarried, adult or minor." IC 6-3-1-9.

Given that taxpayer is a "natural born person," was a resident of Indiana for the year 2000 (IC 6-3-1-12), and presumptively received taxable income, the statutes imposing the state's individual adjusted gross income tax apply to the taxpayer.

FINDING

Taxpayer's protest is denied.

II. Imposition of the State's Adjusted Gross Income On Wages.

Taxpayer maintains the federal and state income tax provisions do not apply to the "wages" earned by ordinary citizens. Instead, taxpayer states both the federal and state income tax provisions are directed exclusively at the income received by corporations.

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 the 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 of 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."

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.

III. Voluntary Nature of the Indiana'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 apparently refers 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.

IV. Federal Obligations Exempt from Taxation.

Taxpayer maintains that because he is paid in Federal Reserve Notes and because he customarily deals in Federal Reserve notes, he is not subject to federal or state income tax.

Taxpayer points to 31 U.S.C.S. § 3124(a) which states in relevant part:

> Stocks and obligations of the United States Government are exempt from taxation by a state or political subdivision of the state. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both to be considered in computing a tax except-
>
> (1) a nondiscriminatory tax franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

Taxpayer next cites to 18 U.S.C.S. § 8 which states:

The term "obligation or other security of the United States" includes all bonds, certificates of indebtedness, national bank currency, *Federal Reserve notes*, Federal Reserve bank notes, coupons, United States notes, Treasury notes, gold certificates, silver certificates, fractional notes, certificates of deposit, bills, checks, or drafts for money, drawn by or upon authorized officers of the United States, stamps and other representatives of value, of whatever denomination, issued under any Act of Congress, and canceled United States stamps. (*Emphasis added*).

Taxpayer reads 31 U.S.C.S. § 3124(a) and 18 U.S.C.S. § 8 together for the proposition that because the term "federal obligations" includes "Federal Reserve Notes," his own income – in the form of Federal Reserve Notes – is not subject to Indiana income tax. As taxpayer states, "Your Federal government has eliminated your power to tax 'money.'"

31 U.S.C.S. § 3124 exempts federal obligations from state tax. "Section [3124] on its face applies only to written interest-bearing obligations issued pursuant to Congressional authorization." Smith v. Davis, 323 U.S. 111, 116-117 (1944). The term "obligations of the United States" as used in 21 U.S.C.S. § 3124... refers to interest bearing instruments such as United States bonds. Provenza v. Comptroller of the Treasury, 497 A.2d 831, 834 (Md. App. Ct. 1985). *See also* Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 395-96 (1983). The definition of Federal Reserve Notes as 'obligations of the United States' within the context of 12 U.S.C.S. § 411 [authorizing the issuance of Federal Reserve Notes] is clearly distinguishable from the meaning used in 31 U.S.C.S. § 3124." Id.

Nonetheless, taxpayer cites to 18 U.S.C.S. § 8 which specifically states the term "obligation or other security of the United States" includes Federal Reserve Notes. What taxpayer neglects to mention is that he is citing to the criminal code and that 18 U.S.C.S. § 8 defines the term "obligation or other security of the United States" for purposes of the defining criminal activities such as counterfeiting, 18 U.S.C.S. § 471, possessing counterfeiting tools, 18 U.S.C.S. § 477, and the theft of tools for counterfeiting purposes. 18 U.S.C.S. § 642.

31 U.S.C.S. § 3124 was not intended to encompass Federal Reserve Notes because Federal Reserve Notes do not produce interest income. If the federal government should at some future date decide to pay interest on the cash we keep in our wallets, taxpayer's argument would be justified. However, until the day arrives that the federal government starts sending us interest checks based on the number of Federal Reserve Notes we then currently possess, taxpayer's argument is premature.

As the court in Provenza stated, "If [taxpayer's] argument were accepted, it would have the absurd effect of preventing state taxation of any income which may be received in Federal Reserve Notes." Provenza at 834.

FINDING

Taxpayer's protest is denied.

V. Sufficiency of Taxpayer's Indiana Tax Return.

Taxpayer maintains that he was not required to file an Indiana income return containing anything other than "zeroes." According to taxpayer, since he was not required to file federal returns, he was compelled under penalty of perjury to do no more than file an Indiana return containing "zeroes."

It is undisputed that the Indiana tax return for the tax years here at issue employs federal adjusted gross income as the starting point for determining the taxpayer's state individual income tax liability. Line one of each 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" federal adjusted gross income – 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.

Taxpayer sets out numerous other arguments challenging the validity and applicability of Indiana's individual income tax: "There are no provisions in the Internal Revenue Code (26 USC) that require anyone to submit a form 1040." Because the form 1040 does not contain a "valid OMB number," it is a "bootleg document and may be disregarded." Each of taxpayer's remaining arguments is equally as frivolous as those addressed within this Letter of Findings. The Department of Revenue will not expend further resources addressing the remaining arguments each of which unreservedly defies ordinary, common sense.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030199P.LOF

LETTER OF FINDINGS NUMBER: 03-0199P
Sales Tax
Period September 2002 through March 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 the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Tax Administration – Penalty

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

The taxpayer protests the late filing penalty.

STATEMENT OF FACTS

The late filing penalty was assessed on the late filing of monthly sales tax returns for the period September 2002 through March 2003.

The taxpayer is a refrigeration service company located out-of-state.

I. Tax Administration – Penalty

DISCUSSION

The taxpayer requests the penalty assessment be waived due to the situation that the error was the result of an inadvertent omission.

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

The Department finds the taxpayer did not act with reasonable care in that the taxpayer was inattentive to tax duties. Inattention is negligence and negligence is subject to penalty. As such, the taxpayer's penalty protest is denied.

FINDING

The taxpayer's penalty protest is denied.

DEPARTMENT OF STATE REVENUE

0420030220P.LOF

LETTER OF FINDINGS NUMBER: 03-0220P
Sales and Use Tax
For Tax Years 1999 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

I. Tax Administration–Negligence Penalty

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

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

STATEMENT OF FACTS

Taxpayer manufactures caskets and urns. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments of use taxes for 1999 and 2001 and corrected for overpayment of use taxes in 2000. Taxpayer paid the assessments, but protested the imposition of a ten percent negligence penalty. Further facts will be provided as necessary.

I. Tax Administration–Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent negligence penalty on assessments for tax years 1999 and 2001. The Department imposed the negligence penalty due to underpayment of use tax for the two years in question, as provided in IC 6-8.1-10-2.1.

Taxpayer paid the assessments, but did not pay the penalty amounts. Taxpayer states in its protest that failure to pay was due to reasonable cause and not willful neglect. The Department refers to 45 IAC 15-11-2(b), which states:

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

45 IAC 15-11-2(c) provides in pertinent part:

> 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.

Taxpayer is an established business, and has been audited many times over the years. Taxpayer has not provided any evidence to support its assertion that it was not negligent. Taxpayer has not affirmatively established that failure to pay the full amount of tax due for 1999 and 2001 was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030228P.LOF

LETTER OF FINDINGS NUMBER: 03-0228P
Sales and Use Tax
For the Years 2000-2001

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

I. Tax Administration- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer is in the business of manufacturing tents, awnings, canopies, and similar items made of canvas or vinyl. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional income tax, interest, and penalty. The taxpayer protested the imposition of the ten percent (10%) negligence penalty. The taxpayer was given ample opportunity to schedule a hearing on the protest and/or submit additional information. Since the taxpayer did neither, this finding is based on the information in the file.

I. Tax Administration- Ten Percent (10%) Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent (10%) negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

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

During the period of the audit, the taxpayer failed to pay Indiana use tax on such clearly taxable items as office supplies, promotional items, and magazine subscriptions. These actions constitute negligence.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030229P.LOF

LETTER OF FINDINGS NUMBER: 03-0229P
Sales and Use Tax
For Tax Years 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

I. Tax Administration—Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 2.2-2-2; 45 IAC 15-11-2

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

II. Tax Administration—Registration Fee

Authority: IC 6-2.5-8-1

Taxpayer protests imposition of the registration fee for a registered retail merchant's certificate.

STATEMENT OF FACTS

Taxpayer is a for-profit day care center. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments of sales and use taxes for 2000 and 2001. Taxpayer paid a portion of the assessments, but protested the imposition of a ten percent negligence penalty and retail merchant's registration fee. Further facts will be provided as necessary.

I. Tax Administration—Negligence Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent negligence penalty on assessments for tax years 2000 and 2001. The Department imposed the negligence penalty due to underpayment of sales and use tax for the two years in question, as provided in IC 6-8.1-10-2.1.

Taxpayer paid the assessments, but did not pay the penalty amounts. Taxpayer held fundraising sales in the form of catalog sales and did not collect sales tax at the time of the sales, as required by 45 IAC 2.2-2-2. Taxpayer explains in its protest that it did not intend to be a retail merchant and that it ceased its retail activities when it learned of the tax consequences.

The Department refers to 45 IAC 15-11-2(b), which states:

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

Also, 45 IAC 15-11-2(c) provides in pertinent part:

> 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.

While taxpayer may not have intended to act as a retail merchant, 45 IAC 15-11-2(b) explains that ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Taxpayer has not affirmatively established that failure to pay the full amount of tax due for 2000 and 2001 was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

II. Tax Administration—Registration Fee

DISCUSSION

Taxpayer protests imposition of the twenty-five dollar ($25) registration fee for obtaining a registered retail merchant's certificate. Taxpayer states that it will not act as a retail merchant in the future, and that forcing it to pay the registration fee will result in sales tax reports that are meaningless and ultimate cancellation of its registration number.

The Department refers to IC 6-2.5-8-1, which states in relevant part:

(a) A retail merchant may not make a retail transaction in Indiana, unless he has applied for a registered retail merchant's certificate.

(b) A retail merchant may obtain a registered retail merchant's certificate by filing an application with the department and paying a registration fee of twenty-five dollars ($25) for each place of business listed on the application. The retail merchant shall also provide such security for payment as the department may require under IC 6-2.5-6-12.

Taxpayer made retail transactions in Indiana with one place of business. Therefore, taxpayer was required by IC 6-2.5-8-1 to pay a twenty-five dollar registration fee. Taxpayer's future activities are not at issue here. The fact that taxpayer will not continue to act as a retail merchant does not alter the fact that taxpayer was required to register and pay the registration fee in the first place.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030233P.LOF

LETTER OF FINDINGS NUMBER: 03-0233P
Sales Tax
For the Month December 2002

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

ISSUE

I. Tax Administration – Penalty

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

The taxpayer protests the late penalty.

STATEMENT OF FACTS

The late penalty was assessed on a monthly sales tax filing for the month of December 2002.

The taxpayer is a retailer of luggage and gifts. The taxpayer is headquartered out-of-state.

I. Tax Administration – Penalty

DISCUSSION

The taxpayer requests the penalty assessment be waived as the error was the result of using the wrong date. Furthermore, the taxpayer asks for waiver as the taxpayer has been timely in the past.

The Department says the taxpayer was late ten days. The taxpayer has been deemed an early filer where the due date of the monthly sales tax return is on the 20th of the month. In regard to the month in question, the taxpayer's monthly tax return was postmarked the 30th, ten days late.

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

circumstances of each taxpayer."

The Department finds the taxpayer did not act with reasonable care in that the taxpayer was inattentive to tax duties. Inattention is negligence and negligence is subject to penalty. As such, the taxpayer's penalty protest is denied.

FINDING

The taxpayer's penalty protest is denied.

DEPARTMENT OF STATE REVENUE

0220030259P.LOF

LETTER OF FINDINGS NUMBER: 03-0259P
Income Tax
For the Years 1997-2001

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

I. Tax Administration- Penalty

Authority: IC 6-8.1-10-2.1(g).

The taxpayer protests the imposition of penalty.

STATEMENT OF FACTS

The taxpayer is primarily engaged in the sale, installation, and repair of lubrication equipment. 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 the imposition of the penalty. Although given ample opportunity to do so, the taxpayer did not request a hearing or submit additional documentation. Therefore, this Letter of Findings is based upon the information in the file.

I. Tax Administration- Penalty

DISCUSSION

The taxpayer protests the imposition of a two hundred fifty dollar ($250) penalty pursuant to IC 6-8.1-10-2.1(g) as follows:

> A person who fails to file a return for a listed tax that shows no tax liability for a taxable year, other than an information return (as defined in section 6 of this chapter), on or before the due date of the return shall pay a penalty of ten dollars ($10) for each day that the return is past due, up to a maximum of two hundred fifty dollars ($250.)

The taxpayer contends that the imposition of the penalty is inappropriate because it did not know that it was required to file returns for the years in question. The statute, however, requires the imposition of the penalty if returns are not filed properly. There is no statutory basis given to waive the penalty. Therefore, since the taxpayer did not file the required returns, the penalty properly applies.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030267P.LOF

LETTER OF FINDINGS NUMBER: 03-0267P
Sales Tax
For the Years 1995-2001

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

I. Tax Administration- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer manufactures and sells leotards and warm-up suits used to participate in competitive gymnastics. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional sales tax, interest, and penalty. The taxpayer protested the imposition of the ten percent (10%) negligence penalty. A hearing was held by telephone.

I. Tax Administration- Ten Percent (10%) Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent (10%) negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

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

When it started its business, the taxpayer sold its wares in Indiana by mail order. All sales in Indiana were in interstate commerce and not subject to the Indiana sales tax. In November, 1995, the taxpayer changed its business practices by adding sales representatives in Indiana. These representatives established a nexus for the taxpayer in Indiana. At that time, the Indiana sales became subject to the Indiana sales tax. In 2001 the taxpayer reviewed its practices and determined that it owed sales tax on the Indiana sales after the establishment of its nexus with Indiana. Therefore the taxpayer filed as a retail merchant with the department. An audit determined the amount of Indiana sales subject to the sales tax from November, 1995 and 2001. After the audit, the department assessed the negligence penalty against the taxpayer. The taxpayer contends that since it voluntarily reassessed its practices, determined that it owed the tax, and registered with the department, it should not be assessed the negligence penalty. The department disagrees. For six years the taxpayer ignored the department's instructions concerning the effect of the Indiana salesmen on the taxpayer's Indiana sales tax liability. The reasonably prudent taxpayer would attempt to assess the effect of the Indiana salesmen on Indiana tax liabilities at the time the salesmen were established in the state rather than waiting six years. The taxpayer's inattention to its duty to determine its proper tax liability and failure to follow the department's instructions for six years constitutes negligence.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030273P.LOF

LETTER OF FINDINGS NUMBER: 03-0273P
SalesTax
For the Years 1999-2001

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

I. Tax Administration- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer is a retailer in the food and beverage industry. 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 the imposition of the ten percent (10%) negligence penalty. A telephone hearing was held on July 23, 2003.

I. Tax Administration- Ten Percent (10%) Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent (10%) negligence penalty pursuant to IC 6-8.1-10-2.1. The taxpayer contends that the negligence penalty is inappropriate in this situation because there was no willful failure to pay tax and the tax due as a result of the audit is a small percentage of the tax it paid during the audit period.

Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

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

The department's standard for the negligence penalty, as stated in the regulation, is significantly lower than willful nonpayment of tax as argued by the taxpayer. Rather, the penalty can be properly imposed when the taxpayer is inattentive to its duties or disregards department's instructions. In this case, the taxpayer repeatedly failed to pay tax on clearly taxable canned computer software and signage. This failure to follow departmental instructions constitutes negligence.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02990438.SLOF

SUPPLEMENTAL LETTER OF FINDINGS: 99-0438SLOF
Indiana Corporate Income Tax
For the Tax Years 1989 through 1996

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

ISSUES

I. Income Received from the Sale of Pharmaceutical Division – Business / Nonbusiness Income - Adjusted Gross Income Tax.

Authority: IC 6-3-1-20; IC 6-3-1-21; IC 6-3-2-2(b); IC 6-3-2-2(g) to (k); Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); F.W. Woolworth v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Exxon Corp. v. Dep't. of Revenue of Wisconsin, 447 U.S. 207 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; Ind. R. App. P. 65D; Chief Industries v. Indiana Dept. of Revenue, 2000 Ind. Tax LEXIS 42 (Ind. Tax Ct. Oct. 24, 2000).

Taxpayer argues that the audit erred in classifying money it received from the sale of a pharmaceutical company as "business income." According to taxpayer, the Department of Revenue (Department) compounded that error by sustaining the audit's determination in the original Letter of Findings.

II. Losses From Contingent Value Rights – Business / Nonbusiness Income – Adjusted Gross Income Tax.

Authority: I.R.C. § 1001 et seq.; 72 Wash. U. L.Q. 1231 (1994).

Taxpayer argues that the audit erred by inconsistently categorizing losses attributable to Contingent Value Rights as business income during certain years and non-business income during other years.

III. Computational Errors.

Authority: IC 6-8.1-5-1(b).

Taxpayer maintains that the audit made numerous computational errors and that these errors resulted in the incorrect assessment of additional corporate income taxes.

STATEMENT OF FACTS

Taxpayer describes itself as being in the chemical business. Taxpayer sells these chemicals to manufacturers as raw materials. An audit was conducted of taxpayer's business records resulting in a proposed adjustment of Indiana corporate income tax liability. Taxpayer disagreed with the proposed adjustments and submitted a protest. An administrative hearing was held, and a Letter of Findings was issued in which taxpayer's protest was affirmed in part and denied in part. Believing that the Letter of Findings was – at least in part – erroneous, taxpayer requested a rehearing; this Supplemental Letter of Findings results.

FINDINGS

I. Income Received from the Sale of Pharmaceutical Division – Business / Nonbusiness Income - Adjusted Gross Income Tax.

Taxpayer bought shares of stock in a pharmaceutical company. The number of shares it bought gave taxpayer a controlling interest in the pharmaceutical company. Shortly thereafter, taxpayer combined one of its pre-existing pharmaceutical divisions with the newly acquired pharmaceutical company. Taxpayer retained its interest in the pharmaceutical company for approximately five years. When it sold its interest in the pharmaceutical company in 19XX, it reported the income as "non-business" income. The audit disagreed and reclassified this income as "business" income. The original Letter of Findings agreed with the audit's conclusion.

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. IC 6-3-2-2(b). In contrast, nonbusiness income is allocated to Indiana or it is allocated to another state. IC 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or nonbusiness income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer maintains that the money it earned from the sale of the pharmaceutical company was nonbusiness income, and the money should be allocated elsewhere. Both the audit and the original LOF determined that the money was business income subject to apportionment under the state's adjusted gross income tax scheme.

A. Unitary Relationship.

In part, taxpayer arrives at its conclusion – that the income is not subject to apportionment – on the ground that it did not have a "unitary relationship" with the pharmaceutical company; as a result, Indiana is precluded from apportioning the income. Taxpayer states that before Indiana can apportion the income, "it is necessary to [first] determine whether the income results from a unitary business." Taxpayer indicates that it maintained a hands-off relationship with the pharmaceutical company; there was no centralized management, purchasing, advertising, or any other "controlled interaction" between taxpayer and the pharmaceutical company. According, to taxpayer, the pharmaceutical company was permitted to operate as an independent entity. Taxpayer explains noting that it is "engaged in the manufacture and sale of chemicals and plastics." In contrast, the pharmaceutical company was "engaged in the manufacture and sale of pharmaceutical products... which it sold and marketed to doctors, hospitals, and individuals for human consumption." Taxpayer explain that it would have been counterproductive for it maintain anything more than a strictly passive relationship with the pharmaceutical company because it had no experience in that company's business.

Taxpayer emphasizes it did not have a unitary relationship with the pharmaceutical company and that is made clear by the assertion that it permitted the pharmaceutical company to exercise a substantial degree of self-governance during the five-year ownership period. The two companies did not have the same corporate officers or managers. In fact, by the terms of the stock acquisition agreement, taxpayer was precluded from having more than three out of the possible 17 board members during the initial ownership period. Even after that initial period expired, taxpayer maintains that it never exercised actual control over the company but that the two entities operated separately. According to taxpayer, the pharmaceutical company "performed all the functions that one would expect a stand-alone company to perform."

In sum, taxpayer describes itself as a "passive investor" in the pharmaceutical company and that its role in the company was "limited to mere stewardship or oversight of its investment."

The unitary business principle to which taxpayer alludes "allows a state to consider all of a corporate enterprise's income arising from the enterprise's unitary business in calculating that state's apportioned share of income." Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999). For purposes of resolving the unitary group issue, the Supreme Court has developed a three-part test to determine whether a unitary relationship exists between different entities. The test consists of the following factors; common ownership, common management, and common use or operation. Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); F.W. Woolworth v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Exxon Corp. v. Dep't. of Revenue of Wisconsin, 447 U.S. 207 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980).

Plainly, the first part of the test is met because taxpayer acquired a majority ownership interest in the pharmaceutical company. The remaining two parts of the test – common management and common use or operation – are less easily quantifiable. Taxpayer argues that it never had a unitary relationship with the pharmaceutical company and that it permitted the company to retain its own management, administrative structure, and headquarters. According to taxpayer, it simply invested money in the company, allowed that company an entirely independent existence for five years, and only revisited its interest in the company when it became appropriate to divest itself of its majority ownership interest.

Taxpayer's assertion that its relationship with the pharmaceutical company was simply that of a passive investor is somewhat overstated. When taxpayer assumed control over the pharmaceutical company, it combined one of its pre-existing pharmaceutical divisions within the targeted company. When taxpayer assumed control over the pharmaceutical business, it renamed the target company merging its own corporate identity with that of the target company. At least to the outside world, the pharmaceutical company's original identity was discarded, and the company became clearly identifiable as another of taxpayer's various divisions.

Moreover, taxpayer's assertion that it was engaged in an entirely different business than that of the pharmaceutical company is also somewhat overstated. Taxpayer's assertion that it is engaged simply in "the manufacture and sale of chemicals and plastics" is excessively modest and substantially understates the scope of its business interests. At the time the audit was completed, taxpayer was engaged in the manufacture of household goods, agricultural products, and agriculture chemicals. It was a supplier of more than 2,400 product "families" including performance plastics, performance chemicals, plastics, chemicals, metals, hydrocarbons, and energy. In addition, taxpayer had more than 100 subsidiaries engaged in a wide variety of activities including insurance, management services, telecommunications, engineering, natural gas pipelines, petroleum, construction, coal gasification, electrical generation, and electric transmission. Furthermore, taxpayer has two entirely separate subsidiaries – distinct from the target pharmaceutical company and the successor pharmaceutical division which it combined into the targeted company – which are also in the pharmaceutical business. Taxpayer's description of itself as a simple producer of raw chemicals understates the extent of its business interests.

Taxpayer maintains that there was no common use or management because the pharmaceutical company operated entirely independent of taxpayer. Although taxpayer may have made a business decision to allow the targeted pharmaceutical company to retain a substantial degree of operational independence, once taxpayer acquired ownership of the company, that company shed its individual identity and was incorporated into and became another facet in an enormously complex and multi-faceted business conglomerate. Given the complexity and scale of taxpayer's business operation and the degree to which the pharmaceutical company was subsumed into taxpayer's business operation, the Department concludes that a "unitary" relationship existed between the pharmaceutical company and taxpayer's diverse business operation.

However, even if the taxpayer is correct in its assertion that it did not have a unitary relationship with the pharmaceutical company, the result does not necessarily preclude a determination that the income received from the subsequent sale of the company was nonetheless "business income." As the Supreme Court has stated, "The existence of a unitary relation between payee and payor is one justification for apportionment, but not the only one." Allied-Signal, 504 U.S. at 787. The Court stated that it did not "…establish a general requirement that there be a unitary relation between the payor and payee to justify apportionment…." Id.

B. Indiana Sourcing.

Taxpayer raises an alternative though related argument. Taxpayer maintains that the money received from its sale of the pharmaceutical company was not Indiana source income. Taxpayer cites to Chief Industries v. Indiana Dept. of Revenue, 2000 Ind. Tax LEXIS 42 (Ind. Tax Ct. Oct. 24, 2000) in support of its position. Taxpayer cites to an unpublished case. Taxpayer's reliance on this case is unwarranted because the Tax Court's unpublished decision has no precedential value. *See* Ind. R. App. P. 65D. In addition, the Department declines the opportunity to attempt to harmonize the decision in Chief Industries concerning Indiana source income with the Tax Court's teachings concerning the business / non-business income distinction.

C. Business / Nonbusiness Income.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation. IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May, 749 N.E.2d at 656. In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income

for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

This business / nonbusiness issue arises from the classification of the money taxpayer received from the sale of the pharmaceutical company. Taxpayer asserts that it is in the business of selling chemicals and is not in the business of selling pharmaceutical companies. However, this characterization oversimplifies the nature of taxpayer's business operations. If taxpayer were simply and solely in the business of selling bulk, raw chemicals, taxpayer's argument might have some cogency. However, the scope of taxpayer's business activity is not nearly so limited. Taxpayer is involved in the production and sale of over 2,400 product "families." Taxpayer has more than 100 subsidiaries engaged in an extraordinarily diverse variety of activities. It is apparent that taxpayer's decision to divest itself of its interest in the pharmaceutical company – after maintaining that interest for approximately five years – was not such an unusual transaction entirely outside the scope of taxpayer's normal business operations. Although taxpayer may not be "in the business" of buying and selling drug companies, the acquisition, operation, and ultimate disposition of an independent operating division was not necessarily a "once-in-a-lifetime" occurrence.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. May, 749 N.E.2d at. 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

Taxpayer decided that it was in its interest to acquire the pharmaceutical company and combine one of its existing pharmaceutical divisions with the target company. Taxpayer made a considered and independent business decision that it was in its own best interests to allow the pharmaceutical company to exercise a degree of operational and managerial independence; in part that decision was based on its agreement with the predecessor shareholders to forego exercising the degree of corporate governance it was entitled to exercise by virtue of its majority ownership interest. Nonetheless, taxpayer's decision to permit the pharmaceutical company a degree of independence was not a decision imposed on taxpayer; the decision was one which taxpayer willingly made. A taxpayer's independent decision to allow one its divisions a degree of self governance – made freely and for its own considered self-interest – may not be the means by which a taxpayer subsequently determines the tax consequences attendant upon the ultimate disposition of that asset. In taxpayer's own case, it may be reasonably presumed that the 1995 sale of the pharmaceutical company was based upon taxpayer's consideration of its global operational, financial, and corporate needs. The 19XX sale was not dictated by an outside entity. It was not a decision dictated by happenstance or whim. The decisions to purchase the pharmaceutical company, permit that company a degree of self-governance, hold the company for five years, and eventually dispose of the asset were entirely integral to taxpayer's overall business needs.

Under both the transactional and the functional test, the money received from the 19XX sale of the pharmaceutical company was clearly "business income" subject to apportionment under this state's adjusted gross income tax laws.

FINDING

Taxpayer's protest is respectfully denied.

II. Losses From Contingent Value Rights – Business / Nonbusiness Income – Adjusted Gross Income Tax.

When taxpayer bought controlling interest in the pharmaceutical company, it issued Contingent Value Rights (CVRs) to the previous shareholders. The CVRs were issued to the former shareholders as a partial purchase price for the interest that taxpayer acquired in the pharmaceutical company. As the issuer of the CVRs, taxpayer "promise[d] to pay the holder the difference between a stated target price and the market price at a specified exercise date (or the average price over a specified period." Alexander J. Triantis & George G. Triantis, Conversion Rights and the Design of Financial Contracts, 72 Wash. U. L.Q. 1231, 1255 n.36 (1994). The CVRs were partial consideration granting the holder of the CVR a degree of price protection against a decline in the value of the stock.

Taxpayer maintains that it experienced annual "losses" attributable to the CVRs. According to taxpayer, the audit classified these "losses" as business income during certain years and as non-business income during other years. Taxpayer maintains that if Indiana determines that the money it received from the sale of the pharmaceutical company was "business income," then the Department should treat the losses attributable to the CVRs in the same manner.

The Department concludes that payments taxpayer expended pursuant to its obligations under the CVRs were not losses. The CVRs represented a collective contingency obligation which would potentially – as is the case here – increase the cost taxpayer incurred in acquiring the pharmaceutical company. The fact that taxpayer entered into a purchase agreement whereby the final purchase price was subject to certain defined variables, does not render any portion of aggregate cost for the pharmaceutical company into a "loss." The question of whether these yearly payments were "business" or "nonbusiness" losses is irrelevant. Taxpayer may be entitled to adjust the "basis" of the property it acquired; it is not entitled to claim any portion of that adjusted basis as a loss for years in which that adjustment occurred. *See* I.R.C. § 1001 et seq.

FINDING

Taxpayer's protest is respectfully denied.

III. Computational Errors.

Taxpayer maintains that the audit made numerous computational errors and these errors resulted in an additional, unwarranted assessment of corporate income taxes. For example, taxpayer asserts that the audit failed to carry forward a net capital loss incurred in 19SS to 19XX. As an additional example, taxpayer claims that it discovered an error regarding the 19UU foreign dividend deduction assessment.

IC 6-8.1-5-1(b) states that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The administrative hearing process is not the means by which the purported computational errors may be analyzed, corrected, or refuted. Nonetheless, taxpayer has met its burden under IC 6-8.1-5-1(b) of demonstrating that its numerous assertions are neither frivolous nor entirely groundless. Accordingly, the audit division is requested to undertake a supplemental review of the specific claimed errors and make whatever corrections it deems appropriate.

FINDING

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

DEPARTMENT OF STATE REVENUE

0220020304.SLOF

SUPPLEMENTAL LETTER OF FINDINGS: 02-0304SLOF
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.

ISSUE

I. Excess-Value Reinsurance Premiums – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(l); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); I.R.C. § 482.

Taxpayer challenges the Department of Revenue's decision to include, as taxpayer's own income, reinsurance payments received from taxpayer's customers and subsequently paid to a domestic insurance company and to a foreign insurance business.

STATEMENT OF FACTS

Taxpayer is in the business of shipping packages. The Department of Revenue (Department) conducted an audit of taxpayer's 1996, 1997, and 1998 business records and tax returns. The audit review made a number of adjustments which resulted in an assessment of additional Indiana corporate income tax. Taxpayer protested the audit's conclusions. The Department sustained in part and denied in part taxpayer's protest in a written Letter of Findings. Taxpayer disagreed with the Department's conclusion that the reinsurance premiums – received from taxpayer's customers and paid over to a foreign and a domestic insurer – should be treated as taxpayer's own gross income. The Department agreed to rehear taxpayer's challenge, and this Supplemental Letter of Findings revisits the issue.

DISCUSSION

I. Excess-Value Reinsurance Premiums – Adjusted Gross Income Tax.

When taxpayer ships one of its customer's packages, the package is automatically insured for a base amount. If the customer decides to do so, the customer may purchase additional insurance. This amount charged for this additional insurance is called an "excess value charge."

Taxpayer entered into an arrangement minimizing the potential tax effect on profits obtained from insuring its customers' packages. Taxpayer formed and capitalized a Bermuda corporation. The Bermuda corporation's shareholders were essentially identical to taxpayer's own shareholders. Thereafter, taxpayer bought an insurance policy – on behalf of its excess value insureds – from a domestic insurance company. The domestic insurance company assumed the risk of damage or loss to customers' excess value packages. Nonetheless, taxpayer continued to administer the day-to-day claims submitted by its customers.

The domestic insurance company then entered into a reinsurance treaty with the Bermuda corporation. The Bermuda corporation agreed to assume the entire amount of risk borne by the domestic insurance company and owed to taxpayer.

Pursuant to the parties' agreement, taxpayer collected its customers' excess value insurance payments, investigated claims, settled verified claims, and paid over the remaining premium amount to the domestic insurance company. The difference between the amount taxpayer received from its customers and the amount of money taxpayer paid for losses, constituted the premiums owed on the policy with the domestic insurance company.

The domestic insurance company accepted the premiums, and – after retaining a portion of those proceeds – forwarded the remainder to the Bermuda corporation as consideration for the reinsurance agreement.

Taxpayer did not report on its federal income tax returns the amount of excess value insurance premiums received from its customers. The Internal Revenue Service (IRS) disagreed with this decision and assessed a deficiency equal to the value of the excess charges taxpayer collected. Taxpayer appealed the IRS decision to the U.S. Tax Court. In a 1999 Memo, that court agreed with the IRS determination concluding that the taxpayer's insurance arrangement was a "sham."

During an audit of taxpayer's state returns, the Department reached a conclusion which closely paralleled the IRS decision. Taxpayer's state returns were adjusted to include the amount of money taxpayer collected as excess value charges.

After protesting the Department's decision, a Letter of Findings (LOF) was issued which denied that protest. In that LOF, the Department concluded that the reinsurance agreement came "within the definition of the sham transaction doctrine." The LOF stated that "it is apparent that the reinsurance agreements were entered into for no independent purpose other than obtaining the tax benefits attendant upon those arrangements and that it is the taxpayer who is earning this [reinsurance] money and not the domestic insurance company and not the Bermuda corporation."

Having concluded that the reinsurance agreement was a "sham," the Department found that under IC 6-3-2-2(l), the taxpayer was required to "report the entirety of the excess value premiums as taxpayer's own income because the taxpayer's reinsurance agreements have no substantive economic substance or business purpose." In support of that decision, the LOF cited to <u>Bethlehem Steel Corp. v. Ind. Dept. of State Revenue</u>, 597 N.E.2d 1327 (Ind. Tax Ct. 1992) pointing out that the Department was required to consider "the substance rather than the form of the transaction." <u>Id</u>. at 1331.

Taxpayer – in its request for a rehearing – has asked that the Department revisit its initial decision in light of taxpayer's appeal of the 1999 U.S. Tax Court decision to the United States Court of Appeals. In an opinion issued by the Court of Appeals, that court accepted taxpayer's contention that the reinsurance agreements were not a "sham" but that the agreements evidenced sufficient economic substance to warrant favorable tax treatment. Having arrived at that conclusion, the Court of Appeals reversed the U.S. Tax Court decision and remanded for a determination of taxpayer's potential liability under the reallocation provisions of I.R.C. §§ 482, 845(a).

However, during 2003 taxpayer and the IRS reached a settlement agreement regarding federal tax treatment of the disputed excess value premiums. The settlement agreement addressed the I.R.C. § 482 allocation of the excess value premiums for the years at issue. Thereafter, taxpayer submitted information to the Department reflecting the terms of the settlement agreement and tendering payment of its consequent Indiana corporate income tax liability.

The Department concludes that it is required to accept the U.S. Court of Appeals decision that the reinsurance agreements with the domestic insurance company and the Bermuda corporation were not a "sham" and that taxpayer is entitled to the attendant tax benefits. Accordingly, to the extent that the 2003 settlement agreement resolved the I.R.C. § 482 allocation of income from the Bermuda corporation to taxpayer, the Department is prepared to abide by the terms of that agreement.

FINDING

Taxpayer's protest is sustained.