DEPARTMENT OF STATE REVENUE
COMMISSIONER'S DIRECTIVE #16
September 2005
(Replaces Commissioner's Directive #16 dated July 2005)

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

SUBJECT: New or Replacement Tires on Vehicles

REFERENCES: IC 13-11-2-231; IC 13-11-2-245; and IC 13-20-13-7

I. INTRODUCTION

The purpose of this Directive is to outline the procedures to be followed in collecting and remitting the tire fee. The statute does not apply to the sale of used or retreaded tires.

II. IMPOSITION OF FEE

There is a $0.25 fee imposed on each new tire sold in Indiana for use on a motor vehicle, and types of equipment, machinery, implements or other devices used in transportation, manufacturing, agriculture, construction or mining. Effective July 1, 2005, the fee includes tires mounted on farm tractors, implements of husbandry and semi trailers. The fee is also imposed on garden tractors with twenty-five (25) horsepower or more. "New tire" means a tire that has never been mounted on the wheel of a vehicle.

The fee is also imposed on each new tire mounted on a vehicle at the time the vehicle is sold, and any spare tire that is included with the vehicle. Purchases by governmental units and nonprofit organizations **are not** exempt from the tire fee. The fee imposed shall be collected by the person selling the new tire to the ultimate consumer of the tire or vehicle. If an out-of-state seller is registered to collect and remit the sales and use tax, then the out-of-state seller is required to collect and remit the tire fee.

III. EXEMPTIONS

The fee is not imposed on tires used on lawn mowers and garden tractors that are propelled by motors with less than twenty-five (25) horsepower. The fee is not imposed on new tires mounted on a non self- propelled vehicle for personal use such as a boat trailer or a camper trailer. Tires purchased for resale without being mounted on a motor vehicle are exempt from the tire fee.

IV. REMITTANCE OF THE FEE

The law requires the tire fee to be remitted at the same time as the sales tax. If a taxpayer is required to file by the 20th of the month through electronic funds transfer, the taxpayer is also required to remit the tire fee by the 20th of the month through electronic funds transfer.

The taxpayer that is remitting the tire fee is entitled to retain one percent (1%) of the amount collected as compensation for filing and remitting the fee.

The tire fee is to be remitted using Form TF-103. This form is required to be filed with the remittance of the tire fee unless the payment is remitted through electronic funds transfer and then only a quarterly recap is required to be filed.

The tire fee can also be remitted and returns can be filed by using INTAX at www.intax.in.gov.

V. USAGE OF THE FEES COLLECTED

Revenue from the tire fee is deposited in the waste tire management fund. All money deposited in the fund may be used by the Department of Environmental Management for waste reduction, recycling, removal, or remediation projects.

John Eckart
Commissioner

DEPARTMENT OF STATE REVENUE

0320030131.LOF

LETTER OF FINDINGS NUMBER: 03-0131
Income Tax Withholding
For the Year 1999 and 2000

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

ISSUE

I. Income Tax Withholding—S corporation distributions; Indiana sourced income

Authority: IC 6-8.1-5-1(b); IC 6-3-2-1(b); IC 6-3-2-2.8(2); IC 6-3-4-13(a); IC 6-3-2-2(b) and (e); Enterprise Leasing Co. v. Ind.

Dep't of State Revenue, 779 N.E.2d 1284 (Ind. Tax 2002); Revenue Cabinet, Commonwealth of Kentucky v. Rohm and Haas Kentucky, Inc., 929 S.W.2d 741 (Ky. Ct. App. 1996); Ky. Rev. Stat Ann. § 136.070(3)(d)(1); Ky. Rev. Stat. Ann. § 141.120(8)(c)(1); Ky. Rev. Stat. Ann. § 71.07(2)(c)(2)

Taxpayer protests the assessment of income tax withholding on revenues it argues are not Indiana sourced income.

II. Abatement of Penalties

Authority: IC 6-8.1-10-2.1(h); IC 6-3-4-13.

Taxpayer requests the abatement of penalties.

STATEMENT OF FACTS

Taxpayer is incorporated and headquartered in Kentucky and is taxed as an S corporation for federal and state income tax purposes. Taxpayer operates a manufacturing facility in Kentucky where it produces custom-built over-the-road trailers for sale to customers. Because the trailers are custom built, Taxpayer does not maintain an inventory to sell; the trailers are built after being ordered.

Taxpayer stated that the trailers are built, sold, and invoiced in Kentucky. If the customer's order also requests it, decals are added to advertise and identify the customer's business. The decal work is done at Taxpayer's customer service center in Indiana.

The Department conducted a field audit covering Taxpayer's 1999 and 2000 Indiana S corporation income tax returns—which resulted in proposed adjustments to the Indiana sales and property factors. Because an S corporation is exempt from Indiana adjusted gross income tax, the adjustments did not create additional Indiana corporate income tax for Taxpayer. However, a withholding audit was conducted that resulted in the assessment of additional withholding tax against Taxpayer for payments made to its non-resident shareholders during the audit period. Taxpayer contends that the Department has misinterpreted the facts and law related to its Indiana apportionment factor. Taxpayer filed a protest and a hearing was held.

I. Income Tax Withholding—S corporation distributions; Indiana sourced income

DISCUSSION

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

Taxpayer built and sold the trailers from its Kentucky offices. The customer was invoiced and received title to each trailer when the fabrication of the trailer was completed in Kentucky. If decaling had been requested, Taxpayer took the trailer to its service center in Indiana to have that work done, and from there the customer picked up the trailer. Taxpayer argues that under its course of business, the trailer was sold in Kentucky; the subsequent decaling in Indiana did not change where the sale was completed. Taxpayer states that title and ownership rights to the trailer transferred at the time of sale at the Kentucky facility, not at the completion of the decaling in Indiana.

Taxpayer argues that the income earned from the sale of the trailer was not Indiana sourced income—because the customer had been invoiced and had made arrangements to pay for the trailer, the customer owned the trailer, and the customer received title to the trailer when the fabrication in Kentucky was completed. Taxpayer argues that it acted only as a bailee when it did the decaling work in Indiana. The audit included in the sales and property formula of the adjusted gross income tax calculation those trailers that had been sent to Indiana for decaling—reasoning that the sale and delivery of the trailer had been completed in Indiana.

IC 6-3-2-1(b) imposes adjusted gross income tax upon a corporation's income derived from Indiana sources. Under IC 6-3-2-2.8(2), qualifying corporations electing S corporation status for federal income tax purposes are exempt from Indiana's adjusted gross income tax. IC 6-3-4-13(a) states that when an S corporation derives Indiana sourced income, it must withhold adjusted gross income tax on amounts credited to or distributed to its non-resident shareholders. An S corporation determines its Indiana sourced income by multiplying its income by the standard three factor property, payroll, and sales apportion formula stated in IC 6-3-2-2(b). This percentage is used to determine the amount of tax required to be withheld from amounts credited or distributed to the non-resident shareholders on their Indiana Form K-1.

Sales of tangible personal property are within Indiana if: (1) the property is delivered or shipped to the purchaser—other than the U.S. government—within Indiana, regardless of the F.O.B. point or other conditions of the sale, or (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in the state and the purchaser is the United States government or the taxpayer is not taxable in the state of the purchase. *See* IC 6-3-2-2(e).

What is at issue is where the trailers were delivered at the request of the customer. Taxpayer argues that the sale was concluded in Kentucky because this is where the title passed and the invoicing occurred. Taxpayer argues that the sale was concluded when it finished manufacturing the trailer in Kentucky, invoiced the customer, and then subsequently transferred the trailer to Indiana to complete the decaling at the request of the customer. This means that Taxpayer was acting as a bailee when it did the decaling in Indiana. This means that the trailer was delivered to the customer in Indiana at Taxpayer's Indiana service center. Taxpayer states that it invoiced customers and expected payment when each trailer was finished being fabricated in Kentucky, not when it was decaled. The invoices provided by Taxpayer state the date of billing. Concurrent with the billing are statements that each trailer was shipped on the same date as the billing and the statements that the trailer was being shipped the same day for the decaling services.

Taxpayer argued and the Department accepts for the purposes of argument only Taxpayer's assertions that Taxpayer was acting as a bailee for its customers when Taxpayer shipped and delivered the trailers to Indiana for decaling. This reintroduces IC 6-3-2-2(e) which states that sales are within Indiana when the property is shipped to the purchaser in Indiana. When Taxpayer acted as a bailee for its customers, Taxpayer delivered the trailers to its customers at the Indiana service center location. Delivery was terminated in Indiana, and thus, these are Indiana sales. As well, the Indiana location is where the customers would receive their trailer after the decaling was completed.

Kentucky views apportionment of income from sales in a manner similar to Indiana. Kentucky has statutes similar to Indiana's IC 6-3-2-2(e). *See*, Ky. Rev. Stat Ann. § 136.070(3)(d)(1); Ky. Rev. Stat. Ann. § 141.120(8)(c)(1); and Ky. Rev. Stat. Ann. § 71.07(2)(c)(2). In its protest, Taxpayer provided the Department with a Kentucky court case that defines and discusses apportionment of income from sales. In Revenue Cabinet, Commonwealth of Kentucky v. Rohm and Haas Kentucky, Inc., 929 S.W.2d 741 (Ky. Ct. App. 1996), the court stated that sales of tangible personal property should be apportioned to the state of destination. Taxpayer acted as bailee and at the request of the customer delivered the trailers to Indiana for decaling. This makes Indiana the state of destination and in accord with Indiana and Kentucky statutes, these are Indiana sales and are apportioned as Indiana income.

Accepting arguendo Taxpayer's assertions concerning the form of the sales, Taxpayer in its brief states that the form of the sales is merely a bookkeeping practice.

> For GAAP (generally accepted accounting principles) and internal book and record keeping purposes, the equipment sales are removed from inventory "prior to" shipment from the [Kentucky] manufacturing facility. The equipment inventory account is reduced by the amount of the equipment and a corresponding charge is made to cost of sales. A sale and corresponding account receivable for the sales price of the equipment is also recorded on the books at this time. Thereafter, [Taxpayer] no longer carries the equipment as inventory on its books and records as the title to the equipment has passed to the customer.

Taxpayer bases its protest upon its bookkeeping method of recording the sales. But tax transactions are evaluated on the substance, not mere form of the transaction; the Indiana Tax Court has stated so. *See* Enterprise Leasing Co. v. Ind. Dep't of State Revenue, 779 N.E.2d 1284, 1291 (Ind. Tax 2002). Taxpayer statements in its protest brief acknowledge that the trailer inventory is delivered into Indiana. That makes the sales and the inventory Indiana based. The substance of the transactions is sales and property sourced from the Indiana service center.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

II. Abatement of Penalties

DISCUSSION

Taxpayer requests that the Department abate the 20% penalties on the basis that Taxpayer failed to withhold due to reasonable cause, not willful neglect. IC 6-8.1-10-2.1(h) requires that a 20% penalty be imposed if an S-corporation fails to withhold income taxes as required under IC 6-3-4-13. IC 6-8.1-10-2.1(h) does not include a negligence standard as a qualifier for imposition of the penalty for not withholding; the penalty is statutorily applied.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420040047.LOF
0420040178.LOF
0920040048.LOF

LETTER OF FINDINGS NUMBER: 04-0047,04-0178, 04-0048
Sales Tax and County Innkeeper Tax
For Tax Years 2000-02

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

ISSUES

I. Sales Tax and County Innkeeper Tax—Long Distance Mark Up

Authority: IC 6-9-8-2; 45 IAC 2.2-4-8

Taxpayer protests imposition of sales tax and county innkeeper tax on the amount it adds to telephone fees it charges its guests.

II. Tax Administration—Negligence Penalty

Authority: 45 IAC 15-11-2

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

STATEMENT OF FACTS

Taxpayer operated two hotels in Marion County. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for sales tax and county innkeeper tax on several issues. Taxpayer disagreed with three issues of the assessments and the Department agreed to remove two of the disputed issues from the proposed assessments. Taxpayer continues to protest the imposition of tax on the mark up costs it charges its guests for long distance calls. Taxpayer also protests the imposition of a ten percent (10%) negligence penalty. Further facts will be provided a necessary.

DISCUSSION

Taxpayer charged its guests seventy-five cents ($.75) in addition to the long-distance charges when the guests made long-distance phone calls. The Department determined that the seventy-five cent mark up was subject to sales tax and the county innkeeper tax. Taxpayer protests the imposition of tax on the mark up.

The Department refers to 45 IAC 2.2-4-8, which states:

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

(b) In general, the gross receipts from renting or furnishing accommodations are taxable. An accommodation which is rented for a period of thirty (30) days or more is not subject to the gross retail tax.

(c) There is no exemption for purchases made by persons who are engaged in renting or furnishing accommodations. Such persons are deemed to purchase or otherwise acquire tangible personal property for use or consumption in the regular course of their business.

(d) The renting or furnishing of an accommodation for less than thirty (30) days constitutes a retail merchant making a retail transaction. Every person so engaged must collect the gross retail tax on the gross receipts from such transactions. The tax is borne by the person or organization who uses the accommodation.

(e) The tax is imposed on the gross receipts from "furnishing" an accommodation. The gross receipts subject to tax include the amount which represents consideration for the rendition of those services which are essential to the furnishing of the accommodation, and those services which are regularly provided in furnishing the accommodation. Such amounts are subject to tax even when they are separately itemized on the statement or invoice.

(f) The tax is imposed on the gross receipts from accommodations which are furnished from periods of less than thirty (30) days.

The Department also refers to IC 6-9-8-2, dealing with the Marion County Innkeeper tax, which states in relevant part:

(a) Each year a tax shall be levied on every person engaged in the business of renting or furnishing, for periods of less than thirty (30) days, any lodgings in any hotel, motel, inn, tourist camp, tourist cabin, or any other place in which lodgings are regularly furnished for a consideration.

(b) This tax shall be in addition to the state gross retail tax and use tax imposed on such persons by IC 6-2.5. The county fiscal body may adopt an ordinance to require that the tax be reported on forms approved by the county treasurer and the tax shall be paid monthly to the county treasurer. If such an ordinance is adopted, the tax shall be paid to the county treasurer not more than twenty (20) days after the end of the month the tax is collected. If such an ordinance is not adopted, the tax shall be imposed, paid, and collected in exactly the same manner as the state gross retail tax is imposed, paid, and collected under IC 6-2.5.

(c) All of the provisions of IC 6-2.5 relating to rights, duties, liabilities, procedures, penalties, definitions, exemptions, and administration shall be applicable to the imposition and administration of the tax imposed by this section except to the extent such provisions are in conflict or inconsistent with the specific provisions of this chapter or the requirements of the county treasurer. Specifically, and not in limitation of the forgoing sentence, the terms "person" and "gross income" shall have the same meaning in this section as they have in IC 6-2.5.

…

As IC 6-9-8-2 explains, what goes for sales tax goes for county innkeeper tax.

Taxpayer points out that 45 IAC 2.2-4-8 does not specifically state that the telephone mark up is taxable. Taxpayer believes that a telephone, while customary in a room, would not necessarily be "essential" to the furnishing of the accommodation in the same manner as providing a bed, heat, electricity or water. Taxpayer proposes that direct expenses such as payroll, payroll taxes and benefits of switchboard operators incurred in generating long distance and local telephone revenue should be considered in computing the long distance mark up. Taxpayer offers no citation to statute or regulation to support this proposal.

The Department refers to the second sentence of 45 IAC 2.2-4-8(e), which states, "The gross receipts subject to tax include the amount which represents consideration for the rendition of those services which are essential to the furnishing of the accommodation, *and those services which are regularly provided in furnishing the accommodation*." (emphasis added). The provision of long distance telephone service clearly falls within the definition of services which are regularly provided in furnishing the accommodation of the hotel room. As explained in 45 IAC 2.2-4-8(b), "The gross receipts subject to tax include the amount which represents consideration for the rendition of those services which are essential to the furnishing of the accommodation, and those services which are regularly provided in furnishing the accommodation." There is no provision for deductions from the gross receipts subject to tax.

As explained in IC 6-9-8-2(b), "This tax shall be in addition to the state gross retail tax and use tax imposed on such persons by IC 6-2.5." IC 6-9-8-2(b) also provides that the county innkeeper tax is, "…collected in exactly the same manner as the state gross retail tax is imposed, paid, and collected under IC 6-2.5." Since taxpayer has provided no citation to explain why the Department should not collect the sales tax on the long distance mark up, taxpayer has not provided any citation to explain why the Department should not collect the county innkeeper tax.

In conclusion, the long distance mark up is subject to sales tax under 45 IAC 2.2-4-8. Additionally, the long distance mark up is subject to the county innkeeper tax under IC 6-9-8-2. Taxpayer has referred to no case, statute or regulation to support its position.

FINDING

Taxpayer's protest is denied.

DISCUSSION

II. Tax Administration—Negligence Penalty

The Department issued proposed assessments and the ten percent (10%) negligence penalty for the tax years in question. Taxpayer protests the imposition of penalty. The Department refers to IC 6-8.1-10-2.1(a), which states in relevant part:

If a person:

…

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

…

the person is subject to a penalty.

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.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC 6-8.1-10-2.1(a). As explained in Issue I, taxpayer offered no citation explaining why it did not collect sales tax and county innkeeper tax. Taxpayer has not affirmatively established that its failure to pay the deficiency 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

0420040068.LOF
0420040252.LOF

LETTER OF FINDINGS NUMBER: 04-0068 & 04-0252
Sales Tax—Bad Debt Deduction
For Periods in 1999-2002

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. Sales Tax—Bad Debt Deduction

Authority: IC 6-2.5-6-9; IC 6-8.1-5-1(b); IC 24-4.5; IC 24-4.5-1-102; IC 24-4.5-2-412; Chrysler Financial Co., LLC v. Indiana Dept. of Revenue, 761 N.E.2d 909 (Ind. Tax 2002); Indiana Dept. of Revenue v. 1 Stop Auto Sales, Inc., 810 N.E.2d 686 (Ind. 2004); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the characterization of its assignments of Retail Installment Contract and Security Agreements as being with recourse—rather than being without recourse.

STATEMENT OF FACTS

Taxpayer operates a retail used motor vehicle business with numerous locations in Northern Indiana. Taxpayer is a registered retail merchant with the Department and is a registered auto dealer with the Bureau of Motor Vehicles. Taxpayer operates under its

Indiana taxpayer identification numbers (TID) with all of their locations registered under that number. Taxpayer has consolidated its TID number and reports its retail taxable sales on a consolidated filing basis.

Taxpayer offers it customers financing options to buy vehicles on installment credit arrangements. Taxpayer executes these arrangements by completing a Retail Installment Loan and Security Agreement with their customers. The contract is assigned to a related financing company who operates corporate offices together with Taxpayer. Taxpayer and the related financing company also share common shareholders, as well as the shared corporate offices. The related financing company services the customers' financing and holds a security interest—a lien on the vehicle—until the contract has been satisfied.

The Department conducted an audit of Taxpayer and determined that Taxpayer had incorrectly reported their taxable sales. The audit examined Taxpayer's deductions for bad debt and determined that an adjustment was necessary. Taxpayer had computed the bad debt sales tax credit based on charge-off reports provided to Taxpayer by the related financing company. The audit determined that Taxpayer was underreporting taxable sales because the charge-off report included retail sales not made by Taxpayer. The related financing company not only provides financing to Taxpayer but also provides financing to unrelated, third-party used auto dealers. The charge-off report included bad debts for contracts assigned to the related financing company by the unrelated, third-party used auto dealers. The audit determined that because these contracts had not been assigned by Taxpayer, Taxpayer had no claim to deduct a bad debt sales tax deduction. The charge-off computations included loans, purchased by the related financing company, from the third-party used auto dealers; however Taxpayer was reducing its sales tax liability by the amount of these transactions.

The following facts are included so that the entirety of the scope of the audit and its consequences leading to the filing of Taxpayer's protest can be understood.

When the Retail Installment Contracts and Security Agreements are assigned to the related financing company, the assignment section states that the assignment of the installment contracts are done with recourse. Audit determined that because the assignments are made with recourse, the related financing company has remedies against Taxpayer to recover losses. Because Audit determined that the assignment of the installment contracts are made with recourse, the related financing company has remedies against the unrelated third-party used auto dealers to recover losses.

Audit proposed adjustments to Taxpayer's sales tax liabilities—excluding the bad debt that Taxpayer had written off that did not belong to it, but was bad debt that the related financing company had recourse against the unrelated third-party used auto dealers. Subsequent to the proposed adjustments, the related financing company filed claims for sales tax refund—on the basis that the assignments were made without recourse, and thus the related financing company had claim upon the bad debt deduction—not Taxpayer.

The effect of this would increase the sales tax assessments against Taxpayer. It is important to note this so that the nature of Taxpayer's protest is understood. Taxpayer is not protesting that the assessment is overstated; Taxpayer is protesting that the assessment is understated—that the assessment should be larger to reflect the shift of the bad debt from it to the related finance company.

A hearing was held in which Taxpayer and the related financing company appeared before the hearing officer for the Department. This letter of findings addresses the protest filed by Taxpayer. An Order addresses the protest filed by the related financing company. At the hearing, the hearing officer clarified that both Taxpayer and the related financing company were appearing before the Department.

I. Sales Tax—Bad Debt Deduction

DISCUSSION

At the outset, it is important to note that an order denying the related financing company's claim for sales tax refund was issued. The Department determined that the assignments of the Retail Installment Contract and Security Agreements were made with recourse. This letter of findings—in consistency with that order—determines that because the assignments are with recourse, the bad debt deduction belongs to Taxpayer and not to the related financing company. Because the representatives for Taxpayer also represented the related financing company, and because the basis of the protest filed by Taxpayer and the related financing company is that the contracts were assigned without recourse, the representatives focused the presentation of their protest on the related financing company's protest. The title of the brief presented to the hearing officer is entitled: **BRIEF IN SUPPORT OF PROTEST OF [RELATED FINANCING COMPANY] AGAINST THE DENIAL OF ITS INDIANA GROSS RETAIL (SALES) TAX REFUND CLAIMS FOR THE 1999-2003 TAX YEARS**. The first footnote in the brief states:

> In addition to [Related Financing Company's] protest, the Department today is hearing the protests of [Taxpayer] regarding the Department's proposed assessments for the 1999-2002 tax years. The Department's total proposed assessments, including interest and penalties, exceed [$xxx,xxx]. [Taxpayer] does not waive its arguments regarding any issue raised with respect to its protests of these proposed assessments.

Because the related financing company lead the presentation of the protest at the hearing, this letter of findings is written based on the disposition of the related financing company's protest. This is necessary to do because someone is entitled to claim the bad debt deduction and Indiana statute requires that the bad debt be deducted. *See* IC 6-2.5-6-9. So the focus of the hearing was to determine whether Taxpayer or the related financing company is entitled to claim the deduction—based on whether the assignments were made with recourse or without recourse. For this reason, much of the discussion below reads from the perspective of the related financing company—since that protest had to be decided first. Having been decided that the related financing company is not entitled to the bad debt deduction, the consequence is to grant the bad debt deduction to Taxpayer—but only those bad debts from contracts that were assigned by Taxpayer to the related financing company.

IC 6-8.1-5-1(b) states that all tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-2.5-6-9 requires that a retail merchant deduct from its gross retail income receivables:

- in which the retail merchant did not collect the sales or use tax;
- on which the retail merchant previously paid the sales or use tax liability; and
- which were written off as uncollectible debt for federal tax purposes.

This provision commonly is called the **bad debt deduction**. Application of the bad debt deduction was discussed by the Indiana Tax Court in Chrysler Financial Co., LLC v. Indiana Dept. of Revenue, 761 N.E.2d 909 (Ind. Tax 2002) and by the Indiana Supreme Court in Indiana Dept. of Revenue v. 1 Stop Auto Sales, Inc., 810 N.E.2d 686 (Ind. 2004).

Discussion of Chrysler Financial and 1 Stop Auto Sales

In Chrysler Financial, the Indiana Tax Court held that automobile dealers could assign their right to a sales tax deduction under the bad debt statute to companies that finance installment sales contracts. A company that finances automobile dealers' installment sales contracts qualifies under the bad debt statute for the sales tax deduction as the dealers' assignee. It does not matter whether the company is a retail merchant; it also does not matter whether the company is the one who paid or owed the sales tax because as assignee the company stands in the shoes of the dealer. A valid assignment gives the assignee neither greater nor lesser rights than those held by the assignor. The Tax Court specifically noted in the case that the finance company was assigned the contract without recourse from the dealer. Chrysler Financial, 761 N.E.2d at 911. In its holding, the Tax Court specifically stated in a footnote in the Conclusion that remanded the case to the Department with an order that the Department refund the sales tax to the finance company:

> The record does not reflect that any of Chrysler's contracts were assigned **with recourse**. Nevertheless, **should the Department determine that such contracts exist**, then Chrysler **should receive a refund for contracts that were assigned without recourse only**....

Id. at 917, n. 18 [bold and underline emphasis added]. The Tax Court stated that the Department has the power to determine whether contracts are made with recourse or without recourse. This implies that the Department is to consider the entirety of the circumstances surrounding the assignment of installment loan contracts.

Discussion of "with recourse" and "without recourse"

Black's Law Dictionary, Seventh Edition, states that "with recourse" stipulates that one who endorses an instrument indicates that he remains liable to the holder for payment and that "without recourse" stipulates that one who endorses an instrument indicates that he has no further liability to any subsequent holder for payment. In this protest before the Department, it is important to determine whether the contracts assigned by Taxpayer to the related financing company are with recourse or without recourse. The auditor based the determination of this on what the face of each retail installment contract stated.

Discussion of the individual Retail Installment Contract and Security Agreements

The auditor for the Department stated that the audit examined 414 contracts with loan origination dates from June 1996 through September 2001. That is a period of over five years. The related financing company stated that it purchased retail loan agreements not only from Taxpayer but from third-party dealers. The related financing company provided affidavits from the secretary of Taxpayer and affidavits from three third-party dealers. Each affidavit states that the dealer does not and never has intended to assign any contract "with recourse" regardless of what box appears to be checked on the pre-printed forms used by the dealer. It is important to note that in a period of over five years no dealer contested the fact that the box for "with recourse" was checked instead of the box for "without recourse." A plain reading of the Retail Installment and Security Agreements demonstrates a representation that the assignment of the contract is "with recourse." The Department weighed the probative value of these affidavits in light of the entirety of the circumstances.

Viewed from the perspective of Taxpayer—it is difficult to believe that Taxpayer and the other dealers would allow contracts to remain marked as "with recourse." That is a substantial liability against the Taxpayer and the other dealers. A reasonable and prudent dealer would undertake some action to correct that misstatement of contract obligations and rights stated on the face of the contract. One action would be to mark out "with recourse" and mark "without recourse." Such an action would demonstrate that a misstatement has been made upon the face of the contract. No contract examined by the Department had such a correction made upon it. Another reasonable and prudent action would be to correct the alleged computer and printer errors. Over a span of five years—give or take—it is incredible that such an "error" went uncorrected for so long. Again, this is a huge liability that Taxpayer and the other dealers assumed by not fixing what is stated as being an error. The Department doubts that such a great liability would be assumed by Taxpayer and the other dealers without an attempt to correct it—manually or by bringing it to the attention of the related financing company.

Page 2 of the Retail Installment Contract and Security Agreement states the additional terms of the contract and security agreement. The bottom of the page is headed, "Assignment by Seller." Within this section is a statement in capital letters, reading:

UNLESS OTHERWISE INDICATED ON PAGE 1, THIS ASSIGNMENT IS WITHOUT RECOURSE.

Below this statement is a paragraph headed, **WITH RECOURSE**. The paragraph states that a "with recourse" assignment obligates the assignor to reimburse the assignee upon demand if the buyer defaults on the obligation of payment and performance. This statement is intended to be read by the consumer, Taxpayer, and the related financing company. The Department is unconvinced by representations that Taxpayer was assigning the contracts without recourse. A reasonable and prudent dealer would want to affirmatively state that the assignments were without recourse—so that liability would be minimized. The presence of the statement, "**UNLESS OTHERWISE INDICATED ON PAGE 1, THIS ASSIGNMENT IS WITHOUT RECOURSE,"** coupled with the marking on the face (Page 1) of the contract to indicate with recourse, coupled with the proximity to the statement of a definition and explanation of the liability assumed by marking "with recourse," coupled with a lack of correction over a five year period of the error of marking "with recourse" on the face of the contract is overwhelming evidence of the intent of the assignors and assignees; these contracts were intended to be assigned with recourse. Affidavits by Taxpayer and the other dealers of their intent that the contracts are "without recourse" is weak evidence to rebut the outstanding documentation and lack of correction of "with recourse."

Discussion of the Loan Purchase Agreement

Taxpayer's representatives stated that Taxpayer and the other dealers signed a Loan Purchase Agreement that demonstrates that the assignments were without recourse. This document is silent on the matter. Nothing in the document implies that the contracts are without recourse. The proffered affidavits—with duplicated language that the intent of the parties is that the assignments are without recourse—are unconvincing.

But for the sake of developing the analysis—let it be assumed that the intent of the parties is that the assignments be without recourse. Below is pertinent language from the Loan Purchase Agreement. Emphasis by underlining is added to the text where needed.

4. **Representation, Warranties, and Covenants of Seller:**

A. The loan documents represent the genuine obligation of the name obligor thereon, are valid and binding in accordance with their terms, are enforceable by Buyer and its assigns, and are subject to no legal or equitable defenses, set-offs or counterclaim.

C. <u>Seller has complied with and the applicable Loan Documents are in compliance with all applicable federal and state laws</u>, rules and regulations including, but not limited to, the Truth-in-Lending Act, the Equal Credit Opportunity Act <u>and all federal and state laws relating to consumer credit transactions</u>.

D. Seller will deliver or cause to be delivered to Buyer the original motor vehicle title issued by the applicable state authority, Buyer, as owner of the Loan, will have a valid perfected security interest in the collateral described in the Loan Documents and will be entitled to enforce its rights in the collateral as provided in the Loan Documents.

J. <u>The Loan Documents are complete in all respects</u>, including placing N/A in any spot not utilized, and <u>all disclosures required by law were made in the manner required by law prior to the borrower's execution of the Loan Documents</u>.

L. <u>Knowledge of any fact that would impair the validity or value of the Loan documents will be communicated to Buyer before document execution</u>.

O. (6) <u>seller warrants that all documents delivered pursuant to this agreement do not contain any false or misleading statements</u> and that all signatures are genuine …

5. **Repurchase Obligations:** <u>Upon breach of any representation</u>, warranty, covenant or condition <u>of this Agreement</u> as to any Loan, Seller will, <u>on demand</u>, repurchase such Loan. The repurchase price shall be equal to the then remaining unpaid balance of the amount financed under the Loan less any unamortized discount. In addition, Seller shall pay all cost incurred by Buyer for any action previously taken to enforce the terms and conditions of the Loan Documents.

6. **Waiver of Notices:** Other than notice as required by paragraph 5, Seller waives any further notice of any breach under the Loan Document.

9. **Entire Agreement:** <u>This document contains the entire Agreement of the parties</u>. Buyer retains the right to amend this Agreement by written notice to Seller Specifying the effective date of the amendment and all Loans purchased by Buyer from and after the effective date shall be governed by the terms of the amendment.

12. **Governing Law:** This agreement shall be governed and construed in accordance with the laws of the State of Indiana.

The Department notices some important provisions of this agreement. One is that statement in Paragraph (9.) **Entire Agreement**. The parties state that the document is the entire agreement of the parties. The agreement is silent as to whether the assignments are made with recourse or without recourse. Since the agreement is silent, it is each Retail Installment Contract and Security Agreement that states whether the assignment is made with recourse or without recourse. The Retail Installment Contracts are marked as "with recourse." Those contracts are assigned by Taxpayer to the related financing company with recourse against Taxpayer. Taxpayer wishes to introduce extra-contractual evidence of the parties' intentions. This invokes the parol evidence rule—the gist of which is that a written agreement is the final expression of the agreement of the parties, not to be varied or contradicted by prior or contemporaneous oral or written negotiations.

Clause (4. J) states that each dealer is to warrant that the contracts are complete in all respects. Clause (4. L) states, "Knowledge of any fact that would impair the validity or value of the Loan documents will be communicated to Buyer before document execution." If the understood agreement between Taxpayer and a dealer is that the assignments are without recourse, the representation on a Retail Installment Contract that the assignment is with recourse would affect the validity and value of the contract. This would trigger the right of the related financing company to invoke Paragraph (5.), which states that a breach of a representation permits the related financing company to seek on-demand reimbursement from Taxpayer.

It seems that a legal conundrum has been created. Taxpayer and the other dealers do not correct the misrepresentation of "with recourse." The Retail Installment Contract and Security Agreement is assigned to the related financing company. As soon as it is assigned, Taxpayer and the others dealers have breached the Loan Purchase Agreement with the related financing company, thus allowing the related financing company to seek on-demand reimbursement for the misrepresentation. Not only does the face of the Retail Installment Contract make the assignment with recourse, but by incorrectly marking “with recourse” and assigning the instrument to the related financing company, this misrepresentation is a breach of the Loan Purchase Agreement—so the related financing company has a right to recourse.

Taxpayer's representatives stated at the hearing that the assignments were without recourse as a course of trade. This requires a discussion of consumer credit laws.

Discussion of federal and Indiana credit laws

Indiana and the federal government have enacted several laws to protect the rights of consumer borrowers. The federal **Truth in Lending Act,** which is part of the **Consumer Credit Protection Act,** was enacted with the purpose to strengthen the informed use of credit by consumers. It requires clear disclosure of key terms of the lending arrangement and all costs. Indiana has enacted the **Uniform Consumer Credit Code (UCCC)**, found at IC 24-4.5. IC 24-4.5-1-102 states the purposes of the UCCC. Those purposes include furthering consumer understanding of the terms of credit transactions, IC 24-4.5-2-102(2)(c), and protecting consumer buyers, lessees, and borrowers against unfair practices, IC 24-4.5-2-102(2)(d). IC 24-4.5-2-412, **Notice of assignment**, states that a consumer pays the original seller unless the consumer receives notification of assignment. The provision also states that notification which does not reasonably identify the rights assigned is ineffective.

The face of the Retail Installment Contract and Security Agreement—seen and signed by the consumer—has a section for assignment that names the related financing company as the one to whom the contract will be assigned. The consumer sees that the assignment is marked as “with recourse.” The back of the Agreement explains to the consumer what “with recourse” and “without recourse” means. Consumer also sees on the back of the Agreement that the assignment is made without recourse unless otherwise indicated on the face (Page 1) of the Agreement. A reasonable and prudent consumer will see that “with recourse” is marked on the face of the Agreement he is signing. A reasonable and prudent consumer will understand that this means that either Taxpayer or the financing company may be coming after him if he does not pay the loan or breaches the agreement in other ways. Since the consumer lending laws were put into place to protect the rights of consumers, to expect consumer to know and understand that the course of dealing between Taxpayer and the related financing company is that the contracts are assigned without recourse—despite the fact they are marked “with recourse” defeats the purposes of the consumer lending protection laws. It is a misrepresentation of how that individual contract will be assigned. Marking “with recourse” signifies to the consumer that the related financing company or Taxpayer may be the one who may come to collect on the debt. It is inequitable for Taxpayer to state that it and the related financing company have an agreement that the contracts will be assigned without recourse—but to represent to consumers that Taxpayer or the related financing company may be the one seeking collection. The consumer lending laws were enacted to promote informed consumers who were told what the costs of the credit would be, their rights and their responsibilities, and how the loan will be handled. Taxpayer and the related financing company allowing a computer and printer “error” to exist for five years without informing or correcting the mistake becomes estoppel. Whatever agreement Taxpayer and the related financing company may claim to have concerning “with recourse” or “without recourse,” both have represented to their consumers and to others that the assignments are “with recourse.”

Discussion of the charge-off reports

The most telling indicator of Taxpayer's intentions regarding whether the assignments were with recourse or without recourse is the issuing of the charge-off reports to them by the related financing company. This is strong evidence that the contracts were assigned with recourse because the contracts were returned to Taxpayer to write off the bad debt.

When an audit of Taxpayer was conducted, the auditor for the Department determined that Taxpayer was deducting bad debt that the third-party dealers had assigned to the related financing company. Proposed assessments were issued against Taxpayer to adjust its sales tax liability to exclude amounts written off as bad debt that had not been incurred by Taxpayer. This meant that Taxpayer would be liable for a substantial assessment to reimburse the State of Indiana for bad debt deductions that the Taxpayer had claimed. This would affect the profitability of taxpayer; this would affect what the shareholders would receive. Taxpayer and the related financing company have common shareholders and share corporate offices.

Subsequent to the proposed assessment, the related financing company filed claims for refund—asserting that the assignments were without recourse, despite what the face of the Retail Installment Contract and Security Agreements were marked as. To sustain these claims for refund would allow the bad debt to be swept in and deducted by the related financing company for both Taxpayer and the third-party dealers. The deduction of the bad debt assigned by Taxpayer would be a wash. The bad debt is shifted from Taxpayer to the related financing company, and that portion of overall profitability—as perceived by the common shareholders—is not affected. But eliminating the bad debt deduction of the third-party dealers that now has to be repaid to the State of Indiana by Taxpayer would affect the profitability of Taxpayer—and would affect what the common shareholders would receive. Having the Department believe that the assignments were without recourse would nullify the effect of having to reimburse the State of Indiana for bad debt that Taxpayer had been deducting.

Summary

The Department has determined that these assignments were made with recourse. Despite what Taxpayer, the third-party dealers, and the related financing company would have the Department believe the assignments are, the assignments were represented as with recourse. The rights of Taxpayer, the third-party dealers, the related financing company, the consumers, and the Department are affected by this representation. The fact that no one in five years corrected the "error" demonstrates that Taxpayer, the other dealers, and the related financing company were willing to adopt the "error." The fact that the related financing company issued charge-off reports to Taxpayer indicates that the related financing dealer intended that Taxpayer deduct the bad debt against Taxpayer's sales tax liability. This is the most telling indicator that the assignments were with recourse.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220040198.LOF

LETTER OF FINDINGS NUMBER: 04-0198
Corporate Income Tax
For the Years 2000-2002

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

Corporate Income Tax—Unrelated Business Income

Authority: IC 6-8.1-5-1(b); IC 4-33-1-1; IC 4-33-1-2; IC 4-33-6; IC 4-33-6-1; 4-33-6-3.5; IC 4-33-7; 4-33-8; IC 4-33-8-2; IC 4-33-8-4; IC 4-33-8-6; IC 4-33-8-3; IC 4-33-9-8; IC 4-33-9-12; IC 4-33-13-1; IC 4-33-13-1.5; IC 6-3-2-1(b); 68 IAC 2-6-29(1); IRS Publication 598, 3079, and 3386.

Taxpayer protests that the income from its unsanctioned electronic gambling machines is not unrelated business income.

STATEMENT OF FACTS

Taxpayer is a tax exempt veterans organization under IRC § 501(c)(19). Taxpayer was assessed unrelated business income on revenues from unsanctioned electronic gambling machines operated by Taxpayer. The income was computed by deducting payouts from receipts. The Department assessed gross income tax, adjusted income tax, and supplemental income tax on this unrelated business income. Taxpayer protested the assessment—stating that the IRS does not consider the revenues to be unrelated business income and because the IRS does not, neither should the State of Indiana.

DISCUSSION

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

The Indiana General Assembly has passed into law what is permitted and unpermitted gambling in the State of Indiana. IC 4-30 establishes an Indiana state lottery. IC 4-31 establishes pari-mutuel wagering on horse races. 4-32 establishes games of chance. And IC 4-33 establishes riverboat gambling. Gambling in Indiana is highly regulated—organizations are required to be registered and licensed.

The people of Indiana—acting through the General Assembly—restrict casino gambling solely to licensed riverboats. Casino gambling is restricted to counties that border Lake Michigan, the Ohio River, or a historic hotel district. *See* IC 4-33-1-1. The General Assembly highly restricts where casino gambling may be conducted. The Indiana General Assembly has stated that the purpose of permitting riverboat casino gambling is "to benefit the people of Indiana by promoting tourism and assisting economic development. The public's confidence and trust will be maintained only through: (1) comprehensive law enforcement supervision; and (2) the strict regulation of facilities, persons, associations, and gambling operations under this article." IC 4-33-1-2, Legislative intent. Owners are to be licensed. *See* IC 4-33-6. There are restrictions on who may be an owner, *id*., and how many licenses may be issued, IC 4-33-6-1 and 4-33-6-3.5. Suppliers are to be licensed. *See* IC 4-33-7. The occupational employees of a riverboat are to be licensed. *See* IC 4-33-8. The backgrounds of the employees are investigated and they are fingerprinted. *See* IC 4-33-8-2, IC 4-33-8-4, and IC 4-33-8-6. Felons are not permitted to hold an occupational license. IC 4-33-8-3. An occupational license is valid for only one year—it must be renewed annually. IC 4-33-8-2. The person only may be employed by one riverboat. IC 4-33-8-4(2). All of the above mentioned statutes have been named, so as to outline the strict regulatory guidelines established by the people of the State of Indiana—acting through their elected voice in the General Assembly.

Under IC 4-33-9-8 casino gambling equipment and supplies may be purchased or leased only from licensed suppliers. IC 4-33-9-12 does not permit those under the age of twenty-one to be in any area in which casino gambling is occurring. IC 4-33-13-1 and IC 4-33-13-1.5 state the tax schedules for revenues earned from casino gambling. This tax rate is as low as 15% and as high as 35%. Currently, the corporate income tax rate is 8.5%. See IC 6-3-2-1(b). The 8.5% corporate income rate is substantially less than the 15% minimum tax assessed against casino gambling on riverboats—at a little over one-half. Stated another way—were Taxpayer legally sanctioned to operate a casino, it would have to pay almost double the tax rate that the Department assessed for Taxpayer's unsanctioned operation of electronic gambling machines. Were Taxpayer legally operating its machines, it would be held to the gaming regulations as to the payout requirements. *See* 68 IAC 2-6-29(1).

It is important to note that tax assessments on activities are not based upon the morality or legality of the activities. The Department does not base an assessment upon whether the income earned by a taxpayer is earned legally; the Department simply applies the tax statutes and regulations. At issue in this case is income earned by Taxpayer from unrelated business activities. This requires a discussion of gaming income earned by non-profit organizations.

The IRS has issued three publications useful to this discussion:

Publication 598 Tax on Unrelated Business Income of Exempt Organizations (3/05)
Publication 3079 Gaming Publication for Tax-Exempt Organizations (4/98).
Publication 3386 Tax Guide—Veterans' Organizations (6/99)

These publications discuss charitable gaming, which primarily include bingo, pull-tabs, tip board, raffles, and other similar games of chance. Publication 598 states on page 7 that income from bingo games is unrelated business income if the games are conducted in violation of state and local law. The principle behind the statement is that the gaming must be conducted in compliance with state and local law in order to be considered as tax-exempt income in furtherance of the non-profit organization's purpose; income earned in violation of state and local law is unrelated business income. The federal government defers to state and local regulations regarding such income; such unrelated business income becomes unrelated business income not only for state purposes but for federal purposes. IRS Publication 3079 states on page 2 that tax-exempt organizations may be subject to unrelated business income on gambling receipts. On page 5, the Publication 3079 states:

> The conduct of gaming is no different than the conduct of any other trade or business carried on for profit. The fact that an organization may use the proceeds from its gaming to pay for the expenses associated with the conduct of its charitable programs will not make the gaming a "charitable" activity.

Publications 598, 3079, and 3386 discuss bingo and other similar games in detail. But there is little discussion of casino games—because the IRS does not in general consider casino games to be charitable gaming eligible for consideration as non-taxable income. Page 6 of Publication 3079 states that certain bingo games are eligible for an exception to the unrelated business income guidelines. The assessment in this case is not related to charitable bingo games—but to income from electronic casino machines.

Publication 3386 is specifically addressed to veteran organizations. The reinforced theme throughout the booklet is that income from activities and services confined to members may be eligible for non-taxable status. But the booklet outlines that activities and services provides to the general public jeopardize a veteran organization's tax-exempt status and such income is taxable as unrelated business income. The fact that veteran organizations are permitted under IRS guidelines to conduct recreational gaming activities for their members and not jeopardize their tax-exempt status does not automatically sanction either legal or illegal gambling at the state and local level nor does it automatically exclude the revenues from taxability. The other IRS publications and respect of state and local laws work in concert to determine whether income is unrelated business income.

The federal government, acting through the Internal Revenue Service, states that revenue from unsanctioned gambling conducted by a tax-exempt organization is unrelated business income. Likewise it is unrelated business income for Indiana purposes.

FINDING

Taxpayer's protest is denied. The assessment of corporate income tax is due.

DEPARTMENT OF STATE REVENUE

0420040226.LOF

LETTER OF FINDINGS NUMBER: 04-0226
Use Tax for the Period 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. Sales Tax—Game birds that are hunted

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-4; IC 6-2.5-3-5; 6-2.5-5-1; IC 6-2.5-4-1(b); IC 6-2.5-5-8(b).

Taxpayer argues the assessment of use tax on game birds it asserts were purchased as food.

STATEMENT OF FACTS

Taxpayer's main business is a hunting preserve for sportsmen to shoot pheasants, quail, partridges, and chukars during the legal hunting season. The hunters purchase the number of game birds they wish released into the fields. The hunters are allowed to bring their dogs or they may use Taxpayer's dogs to flush the birds from cover. The hunter must retrieve any birds shot and take them home as required by the wanton waste rules of the Indiana Department of Natural Resources. Any birds that fly away unharmed are left in the surrounding fields to remain free in the wild.

Taxpayer purchased game birds from various farms in and outside Indiana. Sales tax was not paid by Taxpayer at the time it purchased the birds. Taxpayer then used these birds as the game birds released into the field for hunting. Audit determined that the hunters were paying for the right to hunt the birds, which is not a taxable transaction; therefore, the birds purchased by Taxpayer for release to be hunted were not purchased as food and were subject to use tax.

Taxpayer protested—asserting that the game birds on the hunting grounds were food for human consumption.

I. Sales Tax—Game birds that are hunted

DISCUSSION

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

IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction. Credit is given if sales or use tax has already been paid. *See* IC 6-2.5-3-4 and IC 6-2.5-3-5. Under IC 6-2.5-3-4, use tax is not due if the property was acquired in a transaction that is wholly or partially exempt from the state gross retail tax under any part of IC 6-2.5-5.

IC 6-2.5-5-1 exempts animals, feed, seed, and other tangible personal property if the taxpayer acquiring the property acquires it for direct use in the direct production of food and food ingredients or commodities for sale or for further use in the production of food and food ingredients or commodities for sale; and the taxpayer is occupationally engaged in the production of food and food ingredients or commodities which are sold for human or animal consumption or used for further food and food ingredient or commodity production.

Taxpayer is not occupationally engaged in the production of food; Taxpayer is occupationally engaged in operating an animal preserve and a shooting preserve. Taxpayer asserts that the game birds are food. Admittedly, the game birds can be eaten and likely are being eaten by those who hunt them. But Taxpayer is not raising and maintaining an inventory of game birds for hunters to purchase and eat; Taxpayer is raising and maintaining an inventory of game birds for hunters to flush and shoot. Taxpayer offer its patrons the opportunity to hunt game birds—with no guarantee of success. Taxpayer stated in its hearing brief:

> If what is being offered is the opportunity to hunt game fowl, there is no selling at retail. From that analysis, the hunter does not acquire the fowl, but only the opportunity to hunt. The opportunity to hunt game fowl is not a retail transaction and is not subject to tax.

Taxpayer is correct. Under the facts of this particular case, this opportunity is not considered a retail transaction subject to tax. IC 6-2.5-4-1(b) defines selling at retail:

> A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
>
> (1) acquires tangible personal property for the purpose of resale; and
>
> (2) transfers that property to another person for consideration.

Taxpayer did not purchase the game birds for the purpose of reselling them and transferring them to the hunters. While hunters likely will go home with game birds, this is the result of having shot the birds after having purchased the opportunity to hunt those birds. The audit progress report states that Taxpayer has not sold any birds directly to individuals for food. All the birds taken from Taxpayer's property are the result of having been shot and bagged after having been released. Taxpayer is not operating as a butcher shop, a grocery store, or a farm market.

The Department has issued Sales Tax Information Bulletin #70 which addresses farm markets. The bulletin states that persons selling produce and various items of food for human consumption are not required to charge and remit sales tax on these items. Taxpayer is not a market; hunters do not select the game birds they wish and then leave with them. There is the intervening activity of hunting the game birds. For Taxpayer to argue that it is a farm market, Taxpayer would need to show that there is a direct one-to-one correlation between the birds selected and sold and the birds taken away by the customer. There is not; while hunters get to choose the birds to be released, the hunters are not guaranteed they will receive what they have selected. Using common principles of contract and retail law, if Taxpayer were operating as a farm market, the customer would select the game birds and the merchant would then transfer those game birds to the customer.

Taxpayer is not entitled to the exemption for resale provided in IC 6-2.5-5-8(b); Taxpayer is not selling at retail. Because Taxpayer is not selling at retail, sales tax is not charged the hunter for the opportunity to flush and shoot. Taxpayer is liable for the use tax on the sales tax it did not pay when it acquired the game birds that would be hunted. Taxpayer did not acquire the game birds to transfer to the hunters as food; Taxpayer acquired the game birds so that the hunters had a target at which to aim and shoot.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120040237.LOF

LETTER OF FINDINGS NUMBER: 04-0237
Income Tax for 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

Abatement of Penalty

Authority: IC 6-8.1-5-1(b); IC 6-8.1-10-2.1.

Taxpayer requests the abatement of the 10% penalty.

STATEMENT OF FACTS

An examination of Taxpayer's state income tax return revealed that in 2000 Taxpayer received $67,480 in gambling winnings from various casinos. Taxpayer reported the winnings on a federal schedule C and deducted an equal amount for gambling losses. Consequently, the gambling winnings were not included in Taxpayer's Indiana adjusted gross income. The Department assessed the income tax due and assessed a 10% negligence penalty. Taxpayer protested the penalty. A hearing was scheduled and Taxpayer was notified, but Taxpayer did not appear at the hearing. This LOF is written based upon the information available in the file.

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b). Taxpayer requests that the Department waive the 10% penalty. IC 6-8.1-10-2.1 subjects a Taxpayer to a 10% penalty if the Department has determined a deficiency in taxes due exists due to negligence. Taxpayer has presented no evidence to rebut the imposition of the penalty, other than the request to waive the penalty.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420040238.LOF

LETTER OF FINDINGS NUMBER: 04-0238
Sales Tax
For the Periods 2000, 2001, and 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. Sales Tax—Requirement to withhold and submit sales tax

Authority: IC 6-8.1-5-1; IC 6-2.5-2-1; IC 6-2.5-6-1; IC 6-2.5-9-3.

Taxpayer protests the assessment of sales tax due, requesting the opportunity to provide additional documentation.

II. Abatement of Penalties

Authority: IC 6-8.1-10-3(b).

Taxpayer requests the abatement of penalties.

STATEMENT OF FACTS

Taxpayer is a cleaning service that cleans floors and furniture for residential and commercial purposes. The Department conducted an examination of Taxpayer's sales invoices. The audit revealed that although Taxpayer was not registered with the Department as a retail merchant, Taxpayer had collected a sales tax charge for cleaning services provided to Indiana customers; the sales tax charge collected was not remitted to the Department.

Taxpayer filed a protest to the assessment of withholding sales tax due. A hearing was scheduled. Taxpayer was notified of the hearing, but did not appear at the hearing. This letter of finding is based upon the information available in the case file.

Taxpayer filed for Chapter 13 bankruptcy in December 2001; therefore, a separate sales tax audit was prepared for the post-bankruptcy period. There are two sales tax audits: one for pre-bankruptcy activities and one for post-bankruptcy activities. This LOF consolidates the two audit reports for efficiency of disposition.

I. Sales Tax—Requirement to withhold and submit sales tax

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b). IC 6-2.5-2-1 imposes sales tax on retail transactions made in Indiana and a retail merchant is required to collect the tax as agent for the state. IC 6-2.5-6-1 requires the merchant to remit the collected sales tax to the Department. IC 6-2.5-9-3 states that a responsible officer of the merchant is required to remit the collected sales taxes to the Department, and failure to do so makes the responsible officer personally liable for payment of the taxes due. If the Department reasonably believes that a person has not reported the proper amount of tax due, the Department is required by IC 6-8.1-5-1 to make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the Department.

Although Taxpayer was asked to provide all of their 2000, 2001, and 2002 invoices for examination, it only produced a portion of those invoices. The Department was able to retrieve additional invoices by requesting copies from three of Taxpayer's largest customers. However, in total, the Department was able to examine only one-quarter of Taxpayer's invoices; the others were not available. As allowed by IC 6-8.1-5-1, the Department issued an assessment based on the best information available. Taxpayer filed a protest, requesting the opportunity to present additional invoices so as to substantiate a different calculation of the sales tax that should have been charged, collected, and remitted. Taxpayer has not submitted the additional documentation and did not appear at the scheduled hearing to support its protest. Based on this, there is not evidence to support a different assessment.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

II. Abatement of Penalties

DISCUSSION

Taxpayer requests that the Department waive the 20% penalty. IC 6-8.1-10-3(b) subjects a Taxpayer to a 20% penalty if the Department has to prepare a return on unpaid taxes on behalf of the Taxpayer. Because the Department prepared the required returns for Taxpayer, the penalty was imposed. Taxpayer has presented no evidence to rebut the imposition, other than the request to waive the penalty.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0320040270.LOF

LETTER OF FINDINGS NUMBER: 04-0270
Withholding Tax
Responsible Officer
For the Tax Period March, 1998-April, 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

1. Withholding Tax-Responsible Officer Liability

Authority: IC 6-8.1-5-1(b), IC 6-3-4-8(f).

The taxpayer protests the assessment of responsible officer liability for unpaid corporate withholding taxes.

STATEMENT OF FACTS

The taxpayer was an incorporator, officer and employee of a corporation that did not remit the proper amount of withholding taxes during the tax period of March, 1998-April, 2000. The Indiana Department of Revenue assessed the unpaid withholding taxes, interest, and penalty against the taxpayer as a responsible officer of that corporation. The taxpayer protested the assessment of tax and a hearing was held.

1. Withholding Tax-Responsible Officer Liability

DISCUSSION

Indiana Department of Revenue assessments are prima facie evidence that the taxes are owed by the taxpayer who has the burden of proving that the assessment is incorrect. IC 6-8-1-5-1(b).

The proposed 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 taxpayer was the secretary/treasurer of the corporation. As the secretary/treasurer, the taxpayer is presumed to be in a position to exercise control over the fiscal aspects of the corporation. She argues, however, that in reality she had no control over the finances and did not determine which creditors would be paid. Since she did not produce any documentation to substantiate this claim, she failed to sustain her burden of proving that she did not have a duty to deduct and remit withholding taxes to the state.

The taxpayer also argued that she was removed from the Board of Directors on January 12, 1999 and had no management authority after that date. She did produce substantial documentation supporting this contention. Therefore, she had no duty to collect and remit withholding taxes after January 12, 1999. She is not personally responsible for the payment of the corporate withholding tax liabilities due after January 12, 1999.

FINDING

The taxpayer's protest is sustained for all corporate withholding taxes due after January 12, 1999.

DEPARTMENT OF STATE REVENUE

0420040278.LOF

LETTER OF FINDINGS NUMBER: 04-0278
Use Tax for the Periods 2001 - 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. Sales Tax—Game birds that are hunted

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-4; IC 6-2.5-3-5; 6-2.5-5-1; IC 6-2.5-4-1(b); IC 6-2.5-5-8(b).

Taxpayer argues the assessment of use tax on game birds it asserts were purchased as food.

STATEMENT OF FACTS

Taxpayer's main business is a sporting place to shoot pheasant, quail, partridge, and clay skeet. The hunters purchase the number of game birds they wish released into the fields. Hunters also may purchase reloading supplies and participate in tournaments. Hunters are allowed to bring their own dogs.

Taxpayer purchased game birds from various farms in and outside Indiana. Sales tax was not paid by Taxpayer at the time it purchased the birds. Taxpayer then used these birds as the game birds released into the field for hunting. Audit determined that the hunters were paying for the right to hunt the birds, which is not a taxable transaction; therefore, the birds purchased by Taxpayer for release to be hunted were not purchased as food and were subject to use tax.

Taxpayer protested—asserting that the game birds on the hunting grounds were food for human consumption.

I. Sales Tax—Game birds that are hunted

DISCUSSION

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

IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction. Credit is given if sales or use tax has already been paid. *See* IC 6-2.5-3-4 and IC 6-2.5-3-5. Under IC 6-2.5-3-4, use tax is not due if the property was acquired in a transaction that is wholly or partially exempt from the state gross retail tax under any part of IC 6-2.5-5.

IC 6-2.5-5-1 exempts animals, feed, seed, and other tangible personal property if the taxpayer acquiring the property acquires it for direct use in the direct production of food and food ingredients or commodities for sale or for further use in the production of food and food ingredients or commodities for sale; and the taxpayer is occupationally engaged in the production of food and food ingredients or commodities which are sold for human or animal consumption or used for further food and food ingredient or commodity production.

Taxpayer is not occupationally engaged in the production of food; Taxpayer is occupationally engaged in operating an animal preserve and a shooting preserve. Taxpayer asserts that the game birds are food. Admittedly, the game birds can be eaten and likely are being eaten by those who hunt them. But Taxpayer is not raising and maintaining an inventory of game birds for hunters to purchase and eat; Taxpayer is raising and maintaining an inventory of game birds for hunters to flush and shoot. Taxpayer offer its patrons the opportunity to hunt game birds—with no guarantee of success. Taxpayer stated in its hearing brief:

> If what is being offered is the opportunity to hunt game fowl, there is no selling at retail. From that analysis, the hunter does not acquire the fowl, but only the opportunity to hunt. The opportunity to hunt game fowl is not a retail transaction and is not subject to tax.

Taxpayer is correct. Under the facts of this particular case, this opportunity is not considered a retail transaction subject to tax. IC 6-2.5-4-1(b) defines selling at retail:

> A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
> (1) acquires tangible personal property for the purpose of resale; and
> (2) transfers that property to another person for consideration.

Taxpayer did not purchase the game birds for the purpose of reselling them and transferring them to the hunters. While hunters likely will go home with game birds, this is the result of having shot the birds after having purchased the opportunity to hunt those birds. All the birds taken from Taxpayer's property are the result of having been shot and bagged after having been released. Taxpayer is not operating as a butcher shop, a grocery store, or a farm market.

The Department has issued Sales Tax Information Bulletin #70 which addresses farm markets. The bulletin states that persons selling produce and various items of food for human consumption are not required to charge and remit sales tax on these items. Taxpayer is not a market; hunters do not select the game birds they wish and then leave with them. There is the intervening activity of hunting the game birds. For Taxpayer to argue that it is a farm market, Taxpayer would need to show that there is a direct one-to-one correlation between the birds selected and sold and the birds taken away by the customer. There is not; while hunters get to choose the birds to be released, the hunters are not guaranteed they will receive what they have selected. Using common principles of contract and retail law, if Taxpayer were operating as a farm market, the customer would select the game birds and the merchant would then transfer those game birds to the customer.

Taxpayer is not entitled to the exemption for resale provided in IC 6-2.5-5-8(b); Taxpayer is not selling at retail. Because Taxpayer is not selling at retail, sales tax is not charged the hunter for the opportunity to flush and shoot. Taxpayer is liable for the use tax on the sales tax it did not pay when it acquired the game birds that would be hunted. Taxpayer did not acquire the game birds to transfer to the hunters as food; Taxpayer acquired the game birds so that the hunters had a target at which to aim and shoot.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

ADDITIONAL DISPOSITION

Subsequent to Taxpayer's filing of its protest, Taxpayer submitted additional invoices to audit to rebut an assessment. After review of the invoices, Taxpayer and audit agreed that the total tax due on that assessment should be reduced by $298.66 to reflect invoices upon which sales tax was paid or for services not subject to tax. The reduction has not yet been made, and at the request of audit, the reduction agreement is incorporated into this letter of findings. The assessment needs to be reduced by $298.66.

DEPARTMENT OF STATE REVENUE

0120040281P.LOF

LETTER OF FINDINGS NUMBER: 04-0281P
Income Tax
For the Calendar Year 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 negligence penalty.

STATEMENT OF FACTS

The negligence penalty was assessed on the missing payment from the filing of an income tax return for the calendar year 2003.

The taxpayer is a resident of Indiana.

I. Tax Administration – Penalty

DISCUSSION

The taxpayer requests the negligence penalty be abated as the taxpayer forgot to send the check with the income tax return, and, the taxpayer has a good compliance record.

The Department will waive penalty in the event of an unusual error coupled with a good compliance record. The Department agrees that the taxpayer has a good compliance record. However, forgetting to send the check is not an unusual error.

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

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

FINDING

The taxpayer's penalty protest is denied.

DEPARTMENT OF STATE REVENUE

0420040296.LOF

LETTER OF FINDINGS NUMBER: 04-0296
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.

ISSUES

I. Sales and Use Tax-Exemption Certificates

Authority: IC 6-8.1-5-1 (b), IC 6-2.5-2-1, IC 6-2.5-5-8, IC 6-2.5-8-8, 45 IAC 2.2-8-12.

The taxpayer protests the disallowance of certain exemption certificates.

II. Tax Administration-Penalty

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

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

STATEMENT OF FACTS

The taxpayer is a corporation engaged in the rental of lifts, primarily to contractors. 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 a portion of the sales tax and penalty. A hearing was held and this Letter of Findings results.

I. Sales and Use Tax-Exemption Certificates

DISCUSSION

The department assessed sales tax on certain rentals of lifts to contractors. The taxpayer did not have a properly executed exemption certificate in its files and did not obtain an exemption certificate from its customers at the time of the audit for the protested sales tax assessments. In support of its protest, the taxpayer provided affidavits signed by its president alleging that the protested rentals were not properly subject to the imposition of sales tax. The issue to be determined is whether the department properly imposed sales tax on these rentals.

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

Indiana retail sales of tangible personal property are subject to the Indiana sales tax unless they qualify for a statutory exemption. The sellers of the property are required to collect the sales tax from the purchasers and remit that tax to the state. IC 6-2.5-2-1. The rental of tangible personal property is defined as a retail sale for purposes of the imposition of sales tax. IC 6-2.5-5-8. There is no statutory exemption for the rental of lifts to contractors. Therefore, the taxpayer's rentals of lifts to contractors were subject to the sales tax.

IC 6-2.5-8-8 provides for exemption certificates from sales tax in pertinent part as follows:

(a) A person, authorized under subsection (b), who makes a purchase in a transaction which is exempt from the state gross retail and use taxes, may issue an exemption certificate to the seller instead of paying the tax. The person shall issue the certificate on forms and in the manner prescribed by the department. A seller accepting a proper exemption certificate under this section has no duty to collect or remit the state gross retail or use tax on that purchase.

45 IAC 2.2-8-12 clarifies the law concerning exemption certificates in pertinent part as follows:

(a) Exemption certificates may be issed [sic.]only by purchasers authorized to issue such certificates by the Department of Revenue. Retail merchants, manufacturers, wholesalers and others who must register with the Department of Revenue and who qualify to purchase exempt from tax under this Act [IC 6-2.5] may issue exemption certificates with respect to exempt transactions. All persons or entities not required to register with the Department as retail merchants, manufacturers, or wholesalers, and who are exempt under this [Act IC 6-2.5] with respect to all or a portion of their purchases are authorized to issue exemption certificates with respect to exempt transaction provided an exemption number has been assigned by the Department of Revenue, or provided that the Department of Revenue has specifically provided a form and manner for issuing exemption certificates without the need for assigning an exemption number...

Pursuant to the statute and explanatory regulation, the production of a valid exemption certificate exempts the merchant from the duty of collecting and remitting sales tax. Without a valid exemption certificate, the burden shifts back to the merchant to prove that the sales were not actually subject to sales tax as provided in 45 IAC 2.2-8-12 as follows:

(d) Unless the seller receives a properly completed exemption certificate the merchant must prove that sales tax was collected and remitted to the state or that the purchaser actually used the item for an exempt purpose. It is, therefore, very important to the seller to obtain an exemption certificate in order to avoid the necessity for such proof...

The taxpayer never produced exemption certificates executed by the taxpayer's customers on department forms as required by the law. Rather the taxpayer presented affidavits signed by its own president stating that certain rentals were exempt from the Indiana sales tax. These affidavits do not meet the statutory requirements for valid exemption certificates. They did not absolve the taxpayer of collecting and remitting the sales tax due to the state on the subject rentals.

FINDING

The taxpayer's protest is denied

II. Tax Administration-Penalty

The taxpayer protested 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 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.

During the period of the audit, the taxpayer ignored the law and departmental instructions for the payment of Indiana sales tax. The taxpayer did not pay sales tax on office and cleaning supplies as clearly required by the law. This breach of the taxpayer's duty constitutes negligence.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220040313P.LOF

LETTER OF FINDINGS NUMBER: 04-0313P
Income Tax
For the Calendar Year 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 negligence penalty.

STATEMENT OF FACTS

The negligence penalty was assessed on the non-filing of a calendar year income tax return for the year 2002.

The taxpayer is a company located in Indiana.

I. Tax Administration – Penalty

DISCUSSION

The taxpayer requests the negligence penalty be abated as the taxpayer had an incapacitating illness.

The Department points out that the taxpayer has not provided any documentation with regard to the incapacitating illness.

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

The Department finds the taxpayer was inattentive of tax duties as the taxpayer has not provided documentation for the incapacitating illness. Inattention is negligence and negligence is subject to penalty. As such, the Department finds the penalty proper and denies the penalty protest.

FINDING

The taxpayer's penalty protest is denied.

DEPARTMENT OF STATE REVENUE

04-20040347.LOF

LETTER OF FINDINGS NUMBER: 04-0347
STATE GROSS RETAIL TAX
For Years 2001 AND 2002

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. State Gross Retail Tax —Adequate Documentation

Authority: 45 IAC 15-5-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4

Taxpayer protests the proposed assessments of Indiana's State Gross Retail tax.

STATEMENT OF FACTS

Taxpayer is a sole proprietorship. An audit found that taxpayer's reported taxable sales was less than the amount of sales on taxpayer's Federal Schedule C. Taxpayer insisted that a portion of its sales were to exempt customers, although there were no exempt purchases noted in the sales originally reported to the department. Taxpayer, at the time of the audit could not provide either exemption certificates or sales invoices to support its' claim of exempt sales.

Taxpayer filed a protest and a hearing was held. At the hearing, taxpayer's representative stated that further effort by the taxpayer had secured additional documentation for the Department's review. The hearing officer for the Department granted additional time to Taxpayer after the hearing to produce and provide coherent documentation to substantiate taxpayer's claim of exempt sales.

I. State Gross Retail Tax —Adequate Documentation

DISCUSSION

This issue revolves around the burden of proof in an audit situation, which IC § 6-8.1-5-4 defines as:

> Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

Subject to the guidelines above, the Department will grant credit for the applicable transactions for which valid documentation has been provided. Also, as required by the above guidelines, no credit will be granted for transactions for which no documentation has been provided. Taxpayer provided documentation that, aside from being disorganized, was internally inconsistent, incomplete, and frequently demonstrated nothing more than the fact that the purchaser of the item had an out of state address. In short, taxpayer has failed to provide documentation establishing the exemptions taxpayer wishes to claim. Pursuant to the above statute and the requirements of IC § 6-8.1-5-1 and 45 IAC 15-5-4, taxpayer has not established a basis for reversal of the sales tax assessment.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04-20040392P.LOF

LETTER OF FINDINGS NUMBER 04-0392P
TAX ADMINISTRATION—NEGLIGENCE PENALTY FOR
THE PERIOD COVERING CALENDAR YEARS 1998-2000

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

ISSUE

I. Tax Administration—Negligence Penalty

Authority: I.R.C. (26 U.S.C.) § 6651(a)(1) and (a)(3) (1976) (current version at *id.* (2000)); IC §§ 6-8.1-1-1 and -5-1(b) (2004); IC § 6-8.1-10-2.1 (1998) (current version at *id.* (2004)); *United States v. Boyle,* 469 U.S. 241 (1985); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.,* 765 N.E.2d 1257 (Ind. 2002); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs,* 715 N.E.2d 1018 (Ind. Tax Ct. 1999); 45 IAC art. 2.2 and § 15-11-2(b) and (c) (1996) (current respective versions at *id.* (2004))

The taxpayer protests the assessment of the negligence penalty for incurring a deficiency of gross retail (sales) and use tax for calendar years 1998-2000.

STATEMENT OF FACTS

The Department conducted a sales and use tax audit of the taxpayer for its calendar years 1998-2000 (hereinafter "the audit period"). During these years the taxpayer was a for-profit corporation engaged in the manufacture of furniture and furniture parts. It had its commercial domicile outside Indiana. The taxpayer was authorized to do business in Indiana from December 1974 to December 1987, when it briefly withdrew from the state. It was reauthorized to do business in Indiana in November 1988 and has been in good standing with the Business Services Division (formerly the Corporations Division) of the Secretary of State's office ever since. The taxpayer operated three manufacturing plants in Indiana during the audit period.

The Audit Division of the Department issued and mailed the taxpayer Notices of Proposed Assessment advising it of its potential tax liability for each year of the audit period. The base tax set out in each notice consisted of both sales and use tax, along with accrued interest and a negligence penalty. The taxpayer tendered the Department a check for the full amount of the base tax and accrued interest, and filed a timely protest of the negligence penalty. The Department will provide additional facts as needed.

DISCUSSION

The field auditor made adjustments to the taxpayer's sales and use tax liability for the audit period in fifteen categories of tangible personal property purchases he selected from the taxpayer's chart of accounts. In the Audit Summary he cited to a Department regulation to support each adjustment. One of these was to sales tax liability, two were to combined sales and use tax liability, and the remaining twelve were solely to use tax liability. The combined sales/use adjustment and two of the twelve use tax adjustments reclassified the category in question from wholly taxable to wholly tax-exempt. Four other use tax adjustments were to categories of property used partly in the production process (i.e., tax-exempt) and partly outside that process (i.e., taxable).

The remaining adjustments imposed or increased liability. One of these was a sales tax adjustment for vending machine soft drink sales. The four adjustments for partial taxability imposed use tax on non-exempt purchases of property in the Shipping, Equipment Parts, Forklifts and Rentals of Tangible Pers[onal] Prop[erty] categories. The remaining seven were also use tax adjustments. The taxpayer failed to pay either sales or use tax on some purchases in each of four of these latter categories. A fifth category, Building Supplies, consisted of purchases of materials the taxpayer had originally bought exempt for resale, but used for construction or maintenance of one or more of its Indiana buildings instead. A sixth, Tools/Consumables, was made up of purchases of such items for taxable uses (i.e., maintenance and repairs) from vendors that held exemption certificates from the taxpayer. The seventh category, Tax Paid to Wrong State, consisted of purchases on which the taxpayer had paid tax on an Indiana sale to another state. The Audit Division assessed and, as previously noted, billed, a negligence penalty.

IC § 6-8.1-10-2.1 (1998) (current version at *id.* (2004)) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person:… (3) [i]ncurs, upon examination by the department, a deficiency that is due to negligence; … the person is subject to a penalty." *Id.* Title 45 IAC § 15-11-2(b) (1996) (current version at *id.* (2004)) defines "negligence" in relevant part as follows:

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

Id. (Emphasis added.) "[L]isted tax laws" refers to the definition of the term "listed taxes" found in IC § 6-8.1-1-1 (2004). The listed taxes are all of the tax laws for which the General Assembly has explicitly made the Department responsible. They include the Gross Retail and Use Tax Act of 1963, IC article 6-2.5 (1998) (current version at *id.* (2004)) ("GRUTA").

"If a person subject to the penalty imposed under this section [IC § 6-8.1-10-2.1] can show that the failure to…pay the deficiency determined by the department was *due to reasonable cause* and not due to willful neglect, the department shall waive the penalty." IC § 6-8.1-10-2.1(d) (emphasis added.). The implementing regulation restates this requirement as requiring the taxpayer to show that the failure to discharge its tax duties "was due to reasonable cause and not due to negligence." 45 IAC § 15-11-2(c). This subsection of the regulation goes on to state that "[i]n 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." *Id.* (Emphasis added.) The taxpayer "must make an affirmative showing of all facts alleged as a reasonable cause for [its] failure to … pay the deficiency[.]" IC § 6-8.1-10-2.1(e). The evidentiary showing the taxpayer must make under IC § 6-8.1-10-2.1(d) and (e) and 45 IAC § 15-11-2(c) is consistent with IC § 6-8.1-5-1(b), which places the burden of proof in all protests on the person against whom a proposed assessment is made to prove that it is wrong.

The taxpayer's argument in support of its protest is twofold. First, it claims that it takes all prudent measures to collect and pay taxes due. However, it has not substantiated this conclusory generality by proving any facts concerning the specifics of its use tax self-assessment system, procedures or internal controls that would constitute reasonable cause, as IC §§ 6-8.1-5-1(b) and -10-2.1(d) require. Second, the taxpayer submits that the purchases giving rise to the deficiency represented only a small fraction of its total purchases for the audit period. The taxpayer is essentially arguing that the Department should waive the negligence penalty because the amount of the purchases on which it failed to pay tax is, in the taxpayer's view, *de minimis*.

There is nothing in IC § 6-8.1-10-2.1(d) or (e) that even authorizes the Department to waive a negligence penalty on *de minimis* grounds, much less anything setting out a number, or a formula to determine a number, that the Department could treat as being *de minimis*. Had the General Assembly wanted to set a floor number below which it would deem the taxpayer not to have been negligent as a matter of law, it could have done so, analogously to what it did in making contributory fault of negligence plaintiffs a bar to recovery from the defendant/s in some circumstances. *Cf.* IC § 34-51-2-6 (1998) (current version at *id.* (2004)) (negligence claimant whose contributory fault percentage is greater than the combined fault percentage of the defendant/s barred from recovery).

The only ground on which IC § 6-8.1-10-2.1(d) requires the Department to waive a negligence penalty is "reasonable cause," *id.* The legislature's use of this term necessarily implies that the determinative factor for the Department in deciding whether to waive a negligence penalty is causation, not the number, amount or percentage of compliance failure. The only material reference to a number concerning the negligence penalty IC § 6-8.1-10-2.1(a) imposes, and the only purpose for which it is relevant under that subsection, is to the amount of unpaid, underpaid, unreported or underreported taxes. Subsection (b) uses the relevant amount as the multiplicand to which the Department applies the ten percent multiplier to determine the amount of the subsection (a) penalty. *See* IC § 6-8.1-10-2.1(b) (setting out the computation formulae). The size of this multiplicand, standing alone, is irrelevant to answering the questions of why and how it came into being and whether or not the failure that created it was the taxpayer's fault.

The taxpayer has not made any alternative argument, much less submitted any evidence in support of such an argument, as to why its "failure to…pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect[.]" IC § 6-8.1-10-2.1(d). Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated its rationale for this rule later in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review],…administrative agenc[ies] that already bear[ ]…difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities] would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25. The Department will therefore base its determination of the presence or absence of reasonable cause for the taxpayer's failures solely on the evidence in the audit file.

The audit adjustments, summarized above, indicate the taxpayer's failures to collect sales tax on its vending machine transactions, and to self-assess and remit use tax, were not "due to reasonable cause[.]" IC § 6-8.1-10-2.1(d). Rather, they were due to the taxpayer's negligence. The taxpayer has been doing business in Indiana almost continuously for over thirty years and has been subject to GRUTA for all of those years. The Department promulgated the regulations the auditor cited in the Audit Summary to support those adjustments on December 1, 1982. 45 IAC art. 2.2, LSA Doc. #82-86(F), 6 I.R. 8 (Jan. 1, 1983) (codified as amended at *id.* (1996) (current version at *id.* (2004)). They thus have been in effect for over twenty-two years. The taxpayer is charged with constructive knowledge of all of these authorities. The auditor nevertheless had to point out that the taxpayer's purchases in three categories were wholly, and in four others partially, exempt. More relevantly for penalty purposes, he also had to make adjustments imposing liability in whole or in part, or increasing the tax due, on no less than twelve purchase or sale categories.

Indeed, in three of these latter categories the taxpayer's negligence was at least gross, and may have amounted to "willful neglect," IC § 6-8.1-10-2.1(d), i.e. "a conscious, intentional failure or reckless indifference." *United States v. Boyle,* 469 U.S. 241, 245-46 (1985) (defining the same term in I.R.C. (26 U.S.C.) § 6651(a)(1) (1976) (current version at *id.* (2000)) (penalizing failure to file, or timely file, a tax return). *See also* I.R.C. § 6651(a)(3) (using the same term and penalizing failure to pay any tax not shown on a return). The taxpayer obtained tools and consumables under exemption certificates when it knew or should have known it was not entitled to do so, and used property it had rightfully bought as exempt for what it knew or should have known were taxable purposes. The taxpayer even made the elementary error of paying sales tax to the wrong state when it knew or should have known Indiana was the proper taxing authority.

The taxpayer's overall failures to remit sales or use tax on the assessed transactions are hardly consistent, and the failures described in the immediately preceding paragraph in particular are positively inconsistent, with "ordinary business care and prudence[.]" 45 IAC § 15-11-2(c). They therefore cannot constitute "reasonable cause[.]" *See id.* Rather, they are evidence of either "carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code [and] department regulations[,]" "[i]gnorance of the listed tax laws, rules and/or regulations[,]" or both. 45 IAC § 15-11-2(b). As such, the foregoing failures constituted "negligence" as 45 IAC § 15-11-2(b) defines that word. Accordingly, the Department finds that the taxpayer was negligent and the Audit Division properly assessed the negligence penalty.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

03-20040393P.LOF

LETTER OF FINDINGS NUMBER 04-0393P
TAX ADMINISTRATION—NEGLIGENCE PENALTY FOR
THE PERIOD COVERING CALENDAR YEAR 1999

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

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

ISSUE

I. Tax Administration—Negligence Penalty

Authority: IC § 6-2.1-1-17 and ch. 6-2.1-6 (1998) (repealed 2003); IC §§ 6-8.1-1-1 and -5-1(b) (2004); IC § 6-8.1-10-2.1 (1998) (current version at *id.* (2004)); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.,* 765 N.E.2d 1257 (Ind. 2002); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs,* 715 N.E.2d 1018 (Ind. Tax Ct. 1999); 45 IAC §§ 1.1-1-24 and -5-8 (Supp. 1999) (both repealed 2003); 45 IAC § 15-11-2(b) and (c) (1996) (current version at *id.* (2004))

The taxpayer protests the assessment of the negligence penalty for the withholding tax deficiency incurred for calendar year 1999.

STATEMENT OF FACTS

The Department conducted a withholding tax audit of the taxpayer for its calendar years 1999-2000 (hereinafter "the audit period"). During these years the taxpayer was a for-profit corporation engaged in the manufacture of furniture and furniture parts. It had its commercial domicile outside Indiana. The taxpayer was admitted to do business in Indiana from December 1974 to December 1987, when it briefly withdrew from the state. It was readmitted to do business in Indiana in November 1988 and has been in good standing with the Business Services Division (formerly the Corporations Division) of the Secretary of State's office ever since. The taxpayer operated three manufacturing plants in Indiana during the audit period.

The Department issued and mailed the taxpayer a Notice of Proposed Assessment advising it of its potential withholding tax liability for 1999. That notice set out the base tax for which the auditor made the adjustment, along with accrued interest and a negligence penalty. The taxpayer tendered the Department a check for the full amount of the base tax and accrued interest, and filed a timely protest of the negligence penalty. The Department will provide additional facts as needed.

DISCUSSION

During the audit period the taxpayer hired various contractors to perform services for it at its Indiana locations. Most were headquartered or authorized to do business in Indiana. However, a few of the foreign corporations were not so authorized when they performed their respective contracts. The taxpayer failed to check with the Business Services Division of the Secretary of State's office to see which of its out-of-state contractors were authorized to do business in Indiana. As a result, the taxpayer also failed to withhold and remit to the Department gross income tax (GIT) from the respective payments the taxpayer made in 1999 to its unauthorized foreign corporate contractors (hereinafter "nonresident contractors"). *See* IC § 6-2.1-6-1(a) (1998) and 45 IAC § 1.1-1-24(c) (Supp. 1999) (both repealed 2003) (both defining "nonresident contractor" as excluding "a foreign corporation qualified to do business in Indiana[ ]"). *See generally* IC ch. 6-2.1-6 (1998) and 45 IAC § 1.1-5-8 (Supp. 1999) (both repealed 2003) (setting out the duties of a withholding agent and the powers of the Department regarding the withholding, reporting and remitting of GIT from payments to nonresident contractors), and IC § 6-2.1-1-17 and 45 IAC § 1.1-1-24(a) (both defining "withholding agent" as a person or entity "required to withhold gross income taxes under IC 6-2.1-6[ ]"). The field auditor accordingly adjusted the 1999 withholding tax liability to assess the taxpayer the GIT it should have withheld from its total payments to each such nonresident subcontractor in excess of one thousand dollars ($1,000). As authority for this adjustment, the auditor cited to 45 IAC § 1.1-1-24(b)(1), (4) and (5), which are examples of the kind of service work requiring withholding from a nonresident contractor. (The auditor made no other adjustment to the taxpayer's 1999 withholding tax liability, and no change to its liability for 2000).

IC § 6-8.1-10-2.1 (1998) (current version at *id.* (2004)) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person:… (3) [i]ncurs, upon examination by the department, a deficiency that is due to negligence; … the person is subject to a penalty." *Id.* Title 45 IAC § 15-11-2(b) (1996) (current version at *id.* (2004)) defines "negligence" in relevant part as being "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" *Id.*

"If a person subject to the penalty imposed under this section [IC § 6-8.1-10-2.1] can show that the failure to…pay the deficiency determined by the department was *due to reasonable cause* and not due to willful neglect, the department shall waive the penalty." IC § 6-8.1-10-2.1(d) (emphasis added.). The implementing regulation restates this requirement as requiring the taxpayer to show that the failure to discharge its tax duties "was due to reasonable cause and not due to negligence." 45 IAC § 15-11-2(c). This subsection of the regulation goes on to state that "[i]n 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." *Id.* (Emphasis added.) The taxpayer "must make an affirmative showing of all facts alleged as a reasonable cause for [its] failure to … pay the deficiency[.]" IC § 6-8.1-10-2.1(e). The evidentiary showing the taxpayer must make under IC § 6-8.1-10-2.1(d) and (e) and 45 IAC § 15-11-2(c) is consistent with IC § 6-8.1-5-1(b), which places the burden of proof in all protests on the person against whom a proposed assessment is made to prove that it is wrong.

The taxpayer's argument in support of its protest is twofold. First, it claims that it takes all prudent measures to collect and pay taxes due. However, it has not substantiated this conclusory generality by proving any facts concerning the specifics of its use tax self-assessment system, procedures or internal controls that would constitute reasonable cause, as IC §§ 6-8.1-5-1(b) and -10-2.1(d) require. Second, it submits that it failed to withhold gross income tax on only two nonresident contractors out of all the contractors with which it dealt during the audit period. The taxpayer is essentially arguing that the Department should waive the negligence penalty because these compliance failures are, in the taxpayer's view, *de minimis*.

There is nothing in IC § 6-8.1-10-2.1(d) or (e) that even authorizes the Department to waive a negligence penalty on *de minimis* grounds, much less anything setting out a number, or a formula to determine a number, that the Department could treat as being *de minimis*. Had the General Assembly wanted to set a floor number below which it would deem the taxpayer not to have been negligent as a matter of law, it could have done so, analogously to what it did in making contributory fault of negligence plaintiffs a bar to recovery from the defendant/s in some circumstances. *Cf.* IC § 34-51-2-6 (1998) (current version at *id.* (2004)) (negligence claimant whose contributory fault percentage is greater than the combined fault percentage of the defendant/s barred from recovery).

The only ground on which IC § 6-8.1-10-2.1(d) requires the Department to waive a negligence penalty is "reasonable cause," *id.* The legislature's use of this term necessarily implies that the determinative factor for the Department in deciding whether to waive a negligence penalty is causation, not the number, amount or percentage of compliance failure. The only material reference to a number concerning the negligence penalty IC § 6-8.1-10-2.1(a) imposes, and the only purpose for which it is relevant under that subsection, is to the amount of unpaid, underpaid, unreported or underreported taxes. Subsection (b) uses the relevant amount as the multiplicand to which the Department applies the ten percent multiplier to determine the amount of the subsection (a) penalty. *See* C § 6-8.1-10-2.1(b) (setting out the computation formulae). The size of this multiplicand, standing alone, is irrelevant to answering the questions of why and how it came into being and whether or not the failure that created it was the taxpayer's fault.

The taxpayer has not made any alternative argument, much less submitted any evidence in support of such an argument, as to why its "failure to…pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect[.]" IC § 6-8.1-10-2.1(d). Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated its rationale for this rule later in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review],…administrative agenc[ies] that already bear[ ]…difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities] would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25. The Department will therefore base its determination of the presence or absence of reasonable cause for the taxpayer's failures solely on the evidence in the audit file.

The audit adjustment, summarized above, indicates the taxpayer's failures to investigate and discover the nonresident status of the contractors, to withhold GIT from, and to report and remit GIT to the Department on, the nonresident contractors, are inconsistent with "ordinary business care and prudence[,]" 45 IAC § 15-11-2(c). For that reason, these failures therefore were not "due to reasonable cause[.]" IC § 6-8.1-10-2.1(d). Rather, they were due to the taxpayer's negligence. They are evidence of either a "failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer[,]" "carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code [and] department regulations[,]"or both. 45 IAC § 15-11-2(b). As such, the foregoing failures constituted "negligence" as 45 IAC § 15-11-2(b) defines that word. Accordingly, the Department finds that the taxpayer was negligent and the Audit Division properly assessed the negligence penalty.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

02-20040422P.LOF

LETTER OF FINDINGS NUMBER 04-0422P
TAX ADMINISTRATION—NEGLIGENCE PENALTY FOR
THE PERIOD COVERING CALENDAR YEAR 1997

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

ISSUE

I. Tax Administration—Protest--Negligence Penalty

Authority: I.R.C. (26 U.S.C.) § 63 (1994 and Supp. III 1997); IC §§ 6-3-1-3.5(b) and -11(b) (Supp. 1997) (current respective versions at *id.* (2004)); IC § 6-3-8-2(b) (1993) (repealed 2003); IC §§ 6-8.1-1-1, -5-1(b) (2004); IC § 6-8.1-10-2.1 (1993) (current version at *id.* (2004)); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.,* 765 N.E.2d 1257 (Ind. 2002); *Ind. Dep't of State Revenue v. Endress & Hauser, Inc.,* 404 N.E.2d 1173 (Ind. Ct. App. 1980); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs,* 715 N.E.2d 1018 (Ind. Tax Ct. 1999); *Cooper Indus., Inc. v. Ind. Dep't of State Revenue,* 673 N.E.2d 1209 (Ind. Tax Ct. 1996); 45 IAC § 15-11-2(b) (1996) (current version at *id.* (2004))

The taxpayer has protested the negligence penalty the Department assessed for incurring a deficiency of adjusted gross income tax and supplemental net income tax for calendar year 1997.

STATEMENT OF FACTS

The Department conducted an income tax audit of the taxpayer for its calendar years 1997-2000 (hereinafter "the audit period"). During these years the taxpayer was a for-profit corporation with its commercial domicile outside Indiana and engaged in the manufacture of furniture and furniture parts. The taxpayer's business was unitary. It was admitted to do business in Indiana from December 1974 to December 1987, when it briefly withdrew from the state, but was readmitted to do business in Indiana in November 1988. The taxpayer has been in good standing with the Business Services Division (formerly the Corporations Division) of the Secretary of State's office ever since. It operated three locations in Indiana during the audit period. Although the taxpayer joined in consolidated returns for federal income tax purposes, it filed separate Indiana income tax returns during the audit period.

Among other adjustments not relevant here, the field auditor adjusted the taxpayer's liabilities for adjusted gross income tax ("AGIT") and supplemental net income tax ("SNIT") for 1997. Part of the AGIT component of the adjustment for this year was as a result of changes to the taxpayer's federal taxable income the IRS had made in an audit it conducted that also included calendar year 1997. The taxpayer tendered this Department's auditor a Form IT-20X for that year with a copy of the IRS Revenue Agent Report ("RAR") attached documenting the federal adjustments for 1997 available to this Department's auditor in lieu of amended Indiana income tax returns. In particular, the RAR increased federal taxable income, and the Department's auditor made a corresponding increase to pre-apportionment adjusted gross income ("AGI") for that year, by over seven and one-tenth percent (7.1%). The auditor also corrected the taxpayer's computation of the property apportionment factor by adding the rental values of certain equipment listed on Statement 3 of the taxpayer's 1997 Form 1120 to the "property everywhere" denominator. Lastly, the auditor also adjusted the taxpayer's SNIT liability for 1997. The result of these adjustments was that the taxpayer incurred a mid-four-figure deficiency for that year.

The Department issued and mailed the taxpayer a Notice of Proposed Assessment advising it of its potential income tax liability for 1997. The base tax set out in that notice consisted of both AGIT and SNIT, along with accrued interest and a negligence penalty. The taxpayer tendered the Department a check for the full amount of the base tax and accrued interest, and filed a timely protest of the negligence penalty. The Department will provide additional facts as needed.

DISCUSSION

IC § 6-8.1-10-2.1 (1993) (current version at *id.* (2004)) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person:… (3) [i]ncurs, upon examination by the department, a deficiency that is due to negligence; … the person is subject to a penalty." *Id.* Title 45 IAC § 15-11-2(b) (1996) (current version at *id.* (2004)), which defines "negligence," states in relevant part that "[i]gnorance of the listed tax laws, rules and/or regulations is treated as negligence." *Id.* "[L]isted tax laws" refers to the definition of the term "listed taxes" found in IC § 6-8.1-1-1 (2004). The listed taxes are all of the tax laws for which the General Assembly has explicitly made the Department responsible. They include those imposed under the Adjusted Gross Income Tax Act of 1963 ("AGITA"), codified as amended at IC chapters 6-3-1 to -7 (1993) (current version at *id.* (2004)). The listed taxes also include any SNIT assessed for tax periods ending before the 2003 repeal of the Supplemental Corporate Net Income Tax Act, IC chapter 6-3-8 (1993) ("SCNITA") (including the SNIT component of the taxpayer's deficiency for 1997).

In addition, the "listed tax laws" to which 45 IAC § 15-11-2(b) refers include those provisions of the Internal Revenue Code (26 U.S.C.) ("I.R.C.") that IC § 6-3-1-11(b) incorporates into IC article 6-3. IC § 6-3-1-11(b) coordinates the federal and Indiana net income tax laws applicable to a given tax year by using as a reference point January 1 of a stated year (hereinafter "the benchmark date"). It "incorporates into Indiana law all pertinent provisions of the Internal Revenue Code, together with the rules and [Treasury] [R]egulations of the Code[ ] [in effect on the benchmark date]." *Ind. Dep't of State Revenue v. Endress & Hauser, Inc.,* 404 N.E.2d 1173, 1175 (Ind. Ct. App. 1980) (discussing former IC § 6-3-1-17 (1988) (repealed and recodified in 1990 as IC § 6-3-1-11(b)). The incorporated sections of the Code thereby also become part of the "listed tax laws" as 45 IAC § 15-11-2(b) uses that term in defining "negligence." (The legislature regularly makes technical amendments to IC § 6-3-1-11 to keep the benchmark date current or nearly current. The version of IC § 6-3-1-11(b) in effect for calendar year 1997 was *id.* (Supp. 1997), as enacted by P.L. 60-1997, § 2, 1997 Ind. Acts 1833, 1834 (emergency effective retroactive to Jan. 1, 1997, *id.* and § 4 at 1836, respectively)).

"If a person subject to the penalty imposed under this section [IC § 6-8.1-10-2.1] can show that the failure to…pay the deficiency determined by the department was *due to reasonable cause and not due to willful neglect*, the department shall waive the penalty." IC § 6-8.1-10-2.1(d) (emphasis added.). The taxpayer "must make an affirmative showing of all facts alleged as a reasonable cause for [its] failure to … pay the deficiency[.]" IC § 6-8.1-10-2.1(e). This requirement is consistent with IC § 6-8.1-5-1(b), which places the burden of proof in all protests on the person against whom a proposed assessment is made to prove that it is wrong.

The taxpayer argues that the Department should waive the 1997 negligence penalty because the 1997 deficiency stemmed from the RAR adjustment, and as such was due to reasonable cause and not willful neglect. At the outset, the Department notes that this argument by its own terms cannot apply to the part of this penalty attributable to the portion of the deficiency derived separately from the RAR. Since the taxpayer has made no independent argument concerning this component of the penalty, the Department summarily denies the taxpayer's protest to that extent.

The RAR argument implies that the taxpayer's incurring of the proposed 1997 Indiana deficiency was due to the action of a third party, i.e. the IRS, and as such was beyond the taxpayer's control. The Department disagrees. The RAR merely documents the IRS' discovery of the taxpayer's own failure to include one or more items in its 1997 federal taxable income, among other matters. It is that failure, and not the action of the IRS in memorializing it, that in part prompted this Department's field auditor to adjust the taxpayer's 1997 AGIT and SNIT liability. An Indiana corporate taxpayer's failure to report federal taxable income is also a failure to report income for AGIT and SNIT purposes. IC § 6-3-1-3.5(b) (Supp. 1997) (current version at *id.* (2004)) defines corporate AGI as being "the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code)[,]" *id.*, "not *as reported by* the taxpayer." *Cooper Indus., Inc. v. Ind. Dep't of State Revenue,* 673 N.E.2d 1209, 1213 (Ind. Tax Ct. 1996) (emphasis in original). For SNIT purposes, former IC § 6-3-8-2(b) defined "net income" as being "adjusted gross income [i.e., I.R.C. § 63 taxable income] derived from sources within the state of Indiana," *id.* (In addition, IC § 6-3-1-3.5(b) contains, and former IC § 6-3-8-2(b) contained, certain modifications to the starting points for their respective definitions not material here.) "Thus, computation of the supplemental corporate net income tax [also] is basically determined by the concept of [corporate] adjusted gross income." *Endress & Hauser,* 404 N.E.2d at 1175. The taxpayer had been authorized to do business in Indiana almost continuously for over two decades by 1997 and was chargeable with constructive knowledge of the listed tax laws, including the above-cited authorities. Its actual ignorance of, or failure to follow, them, was therefore negligent as 45 IAC § 15-11-2(b) defines "negligence."

The taxpayer has not made any alternative argument, much less submitted any evidence in support of such an argument, as to why its failure to…pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect[.]" IC § 6-8.1-10-2.1(d). Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs,* 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.,* 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated its rationale for this rule later in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review],…administrative agenc[ies] that already bear[ ]…difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities] would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

1820040430.LOF

LETTER OF FINDINGS NUMBER: 04-0430
Financial Institutions Tax
For the Period December 1, 1998 – November 30, 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. Constitutionality of the Financial Institutions Tax

Authority: IC 6-8.1-5-1(b); IC 6-5.5-2-1; IC 6-5.5-1-17(d); IC 6-5.5-3-1.

Taxpayer argues that it does not have "substantial nexus" with Indiana to meet the Commerce Clause requirements to impose the Financial Institutions Tax (FIT) upon it and its affiliates.

II. Application of the Financial Institutions Tax

Authority: IC 6-5.5-1-17(d)(2), IC 6-2.1-2-2a(2), IC 6-3-2-1, IC 6-3-2-2, IC 6-3-8-1, IC 6-3-8-2(b), IC 6-5.5-9-4(a).

Taxpayer asserts that one of its affiliates should not be included in the unitary group assessment because the affiliate does not meet the definition of "transacting the business of a financial institution."

III. Abatement of Penalties

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

Taxpayer requests the abatement of penalties.

STATEMENT OF FACTS

Taxpayer and affiliates are wholly owned subsidiaries of Parent Company. Parent Company is the result of a merger. The headquarters of the financial services operations is in Illinois.

Taxpayer is a Delaware corporation, headquartered in Illinois. During the audit period, Taxpayer was the only entity filing Indiana tax returns. Taxpayer primarily issued consumer loans consisting of mortgages, home equity loans, and auto loans throughout the United States. Taxpayer held consumer loans during the entire audit period which were secured by personal or real property located in Indiana. Taxpayer's returns—as filed—indicated large losses or offset income by carryforward losses for the audit period.

One of the affiliates, CC Bank, is a state-chartered bank organized under the laws of Delaware and is commercially domiciled in Delaware. Most of the company's proprietary general purpose credit cards are issued by this subsidiary. The audit report states that CC Bank had no physical locations in Indiana during the audit period, but that CC Bank had approximately one million Indiana resident cardholders. CC Bank's revenue consisted of credit card interest income and related fees. CC Bank states that it paid income tax to Delaware on 100% of its net income.

CC Services provides the majority of the operation support for the credit cards. CC Services is responsible for acquiring merchants to accept the credit cards, sells transaction authorization equipment, and owns the merchant agreements. The audit report states that CC Services had no physical presence in Indiana during the audit period, but acquired contracts, equipment sales, and merchant agreements with Indiana merchants. In the audit report, CC Services was included in the unitary group. CC Services argues that it does not meet the definition required to subject it to the Financial Institutions Tax.

Financial Bank, located in Utah, issued a specialized credit card. The audit report states that Financial Bank had no physical locations in Indiana during the audit period, but that Financial Bank had approximately 48,000 Indiana resident cardholders.

Taxpayer's position is that it and its affiliates do not have the requisite nexus to subject them to the Indiana Financial Institutions Tax.

I. Constitutionality of the Financial Institutions Tax

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b). IC 6-5.5-2-1 imposes a franchise tax on a taxpayer's adjusted gross income or apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana. The phrase "transacting the business of a financial institution" is defined in IC 6-5.5-1-17(d). It includes the following activities: making, acquiring, selling, or servicing loans or extensions of credit; leasing or acting as an agent, broker, or advisor in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes; and operating a credit card, debit card, charge card, or similar business. *Id.* Taxpayer, CC Bank, and Financial Bank fall squarely within the definition. Taxpayer concedes this. A discussion of whether CC Services falls within the definition is discussed below.

While Taxpayer concedes that it, CC Bank, and Financial Bank are defined as transacting the business of a financial institution, it challenges the constitutionality of the statutes requiring a taxpayer transacting business in Indiana to be subject to the Financial Institutions Tax (FIT). IC 6-5.5-3-1 defines transacting business within Indiana—for the imposition of FIT. A taxpayer is transacting business within Indiana if the taxpayer has activities that include the following:

(1) maintains an office in Indiana;

(2) has an employee, representative, or independent contractor conducting business in Indiana;

(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;

(4) regularly solicits business from potential customers in Indiana;

(5) regularly performs services outside Indiana that are consumed within Indiana;

(6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;

(7) owns or leases tangible personal or real property located in Indiana; or

(8) regularly solicits and receives deposits from customers in Indiana.

Id. The business activities of Taxpayer, CC Bank, and Financial Bank in Indiana do include many of these listed activities with Indiana customers—notably (3), (4), (5), (6), and (8). According to the statute, IC 6-5.5-3-1, Taxpayer, CC Bank, and Financial Bank are liable for the Financial Institutions Tax.

Taxpayer does not argue that the application of the statute as to this taxpayer is unconstitutional. Rather Taxpayer argues that the statute itself is unconstitutional. The Department does not rule on the constitutionality of a statute. That issue is to be addressed by the Indiana Tax Court.

Taxpayer meets the requirements of the Financial Institutions Tax statutory scheme; the tax is due.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

II. Application of the Financial Institutions Tax

DISCUSSION

CC Services argues that it does not meet the definition of FIT taxpayer under the statute. CC Services is a Delaware Corporation, commercially domiciled in Illinois. Taxpayer states that CC Services is primarily engaged in the marketing, data processing, and administrative services business. During the audit years, CC Services stated it performed credit card processing services at locations outside Indiana. CC Services provided data processing, payment processing, and billing services pursuant to its agreement with CC Bank. CC Services also provided similar services to other credit card companies. CC Services stated that the service fee income it received was in excess of 55% of its total receipts.

CC Services also contracted with merchants across the country to accept CC Bank credit cards and to provide data processing services for these merchants. These services included credit card authorization to cover a cardmember's purchase at the merchant's location. The authorization includes determining whether the cardmember's account is active and has a sufficient credit line to cover the purchase. CC Services also receives from the merchant the detail totals at the end of each day, and it also settles with the merchant, electronically depositing payments into the merchant's bank account. CC Services stated that receipts from these services represented about 35% to 40% of its total receipts during the audit period.

CC Services stated that it did not lend or extend credit. It is not the issuer of any credit cards. It is a service provider and its income is attributable to the services it performs. CC Services further states that it has not filed nor has been required to file as a financial institution in states where there is a separate financial institutions classification for tax purposes. CC Services did not state what category it has been required to file as in those states—be it gross or adjusted gross income tax returns.

IC 6-5.5-1-17(d)(2) states that the definition of "business of a financial institution" means a taxpayer that has at least 80% of its income from, as would apply in this case, credit card loans, or operating a credit card, debit card, or similar business. According to CC Services, it merely is a service provider, not a credit card company.

The determination of the status of CC Services bears into whether it is included in the unitary audit and assessment. Assuming for a moment that CC Services does not fit into the definition of "transacting the business of a financial institution," that would mean that CC Services would have been subject in Indiana to file a gross income, an adjusted gross income, and/or a supplemental income tax return for the years in question—which it did not do.

For the periods in dispute, Indiana required businesses deriving income from sources within Indiana to file income tax returns. This required the calculation of gross income tax, adjusted gross income tax, and supplemental net income tax. Gross income tax was imposed on the taxable gross income derived from activities and businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana. *See* IC 6-2.1-2-2a(2) [repealed]. Since CC Services contracted to provide services and goods to merchants and others across the United States—including Indiana, it earned gross income from sources within Indiana and a return would need to have been filed. Adjusted gross income tax was imposed on income derived from sources from within Indiana, which included income from doing business within Indiana. *See* IC 6-3-2-1 and IC 6-3-2-2. Since CC Services contracted to provide services and goods to merchants and other across the United States—including Indiana, it earned income from sources within Indiana and a return would need to have been filed. Supplemental net income tax was imposed on the net income of all corporations. *See* IC 6-3-8-1 and IC 6-3-8-2(b). Since CC Services contracted to provide services and goods to merchants and other across the United States—including Indiana, it earned income from sources within Indiana and a return would need to have been filed. But no income tax returns were filed by CC Services during the periods in question on the income it earned from Indiana sources.

Those subject to FIT during the periods in question were not also subject to gross income tax, adjusted gross income tax, or supplemental net income tax. *See* IC 6-5.5-9-4(a) [amended 2002] and IC 6-3-8-1 [repealed].

Viewing the activities of CC Services, it is engaged in the business of a financial institution. The company was responsible for acquiring merchants to accept the cards, sold transaction authorization equipment, and owned the merchant agreements. Taxpayer solicited and acquired contracts, equipment sales, and agreements with Indiana merchants. This is the heart of credit card services—the servicing of loans and extensions of credit which IC 6-5.51-17(d)(2) includes in the business of a financial institution. CC Services provided the core extension of credit services necessary to conduct credit card transactions.

CC Services falls within the definition of "business as a financial institution." It services the extension of credit.

FINDING

For the reasons stated above, CC Services protest is denied.

III. Abatement of Penalties

DISCUSSION

Taxpayer asks the Department to abate the 10% negligence penalties because the position of Taxpayer and its affiliates for the audit years in question were based upon reasonable and proper interpretation of both state and federal law. Taxpayer adds it was acting consistently with longstanding interpretations of Commerce Clause limitations on state taxation.

IC 6-8.1-10-2.1 requires that a 10 % penalty be imposed if the tax deficiency results from the taxpayer's negligence. 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." 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...."

Taxpayer is a substantial and sophisticated business receiving large amounts of money from sources within Indiana. Taxpayer's larger constitutional question aside, the decision to overlook Indiana's Financial Institutions Tax is not the evidence of the "ordinary business care and prudence" expected of an "ordinary reasonable taxpayer" that would warrant abatement of the negligence penalty.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120050008.LOF

LETTER OF FINDINGS: 05-0008
Individual Adjusted Gross Income Tax
For the Year 2000

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

ISSUE

I. Proposed Assessment – Individual State Income Tax.

Authority: IC 6-8.1-5-1(b); 45 IAC 3.1-1-25.

Taxpayer argues that the notice of proposed assessment of Indiana income tax is incorrect because taxpayer was not an Indiana resident during 2000.

STATEMENT OF FACTS

The Department of Revenue (Department) issued taxpayer a notice of "Proposed Assessment" on July 6, 2004. Taxpayer challenged the assessment. Taxpayer stated that he was not a resident of Indiana during 2000 and was not employed by a company based in Indiana during that year. The Department accepted taxpayer's challenge as a protest, and the matter was assigned to a Hearing Officer. Taxpayer declined the opportunity to take part in an administrative hearing on the matter; however, taxpayer spoke by telephone with the Hearing Officer and sent a number of letters setting out taxpayer's various arguments. This Letter of Findings has been prepared based upon these phone conversations, taxpayer's correspondence submitted to the Hearing Officer, and the information contained within the Department's file.

DISCUSSION

I. Proposed Assessment – Individual State Income Tax.

Taxpayer did not file a federal 2000 return. Instead, the IRS conducted an audit and prepared a return on taxpayer's behalf. The IRS return was prepared in 2004 and listed taxpayer as having an Indiana address. The return indicated that taxpayer had earned approximately $31,000 during 2000.

Based upon that federal return, the Department sent taxpayer a notice of "Proposed Assessment" Taxpayer responded in writing stating that he "did not file any tax returns – state or federal – for the tax years in question because [he] did not receive gross income over the threshold amounts which trigger any requirement to file said returns." In addition, taxpayer stated that he was not an Indiana resident during 2000 but was living in Colorado that year.

45 IAC 3.1-1-25 states in relevant part that, "All persons who are not residents of Indiana are required to report that portion of their entire income directly or constructively from or attributable to business activities or any other source within Indiana... A nonresident must include on his tax return all gross income received from a business, activities or any other source in Indiana whether taxable or not." Therefore, even if taxpayer was a Colorado resident during 2000, he would have been required to file an Indiana return if he received Indiana source income.

Taxpayer was initially unwilling to supply any documentary information establishing his Colorado residency and establishing the fact that he did not obtain Indiana source income during 2000. Instead taxpayer "[swore] and affirmed that [he] was NOT a resident of Indiana in the year in question and require[d] you and the state to hold this and my two previous declarations as Prima Facie evidence as such." (Emphasis in original). As a matter of law, the Department is unwilling to accept the proposition that a self-serving affidavit alone is sufficient to overcome the presumption of correctness which attaches to the notice of proposed assessment. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b). Taxpayer's sworn attestation standing alone does not meet that burden.

However, taxpayer eventually agreed to provide unredacted copies of his 2000 W-2 forms. Taxpayer provided unredacted copies of two W-2 forms. The first W-2 form indicated that taxpayer received approximately $13,000 in income during 2000 from a Colorado employer while living at a Colorado address. The second W-2 form indicated that taxpayer received approximately $18,000 in income during 2000 from a Texas employer while taxpayer was living at that same Colorado address.

Setting aside the obvious question of whether taxpayer should have filed a Colorado income tax return for 2000, taxpayer has met his burden of proving that the proposed assessment of Indiana income tax was erroneous. Taxpayer has provided W-2 forms demonstrating that he earned approximately $31,000 in income from sources outside Indiana while living at a Colorado address during 2000. This income amount corresponds with the amount reported on the federal 2000 return prepared by the IRS and upon which the July 6, 2004 Indiana assessment was based.

FINDING

Taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420050049.LOF

LETTER OF FINDINGS NUMBER: 05-0049
Sales and Use Tax for 2004

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-2-1; IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-2.5-8-8; IC 6-6-6.5-2; IC 6-2.5-3-2; IC 6-2.5-3-4; IC 6-2.5-3-5; IC 6-2.5-4-10(a); 45 IAC 2.2-3-6(c)(1); FAR 1, 91, 121, 135; Form ST-108AC; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C, Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in July 2004 which it leases to affiliated entities, Truck Company and Trailer Company. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

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

In July 2004, Taxpayer purchased an aircraft from an Indiana dealer for $345,000. At the time of sale, a licensed Indiana aircraft dealer is required to collect sales tax from the purchaser. 45 IAC 2.2-3-6(c)(1). The dealer is required to complete Sales Tax Form ST-108AC and record the selling price of the aircraft and the amount of sales tax collected. *Id.* Form ST-108AC is used by the purchaser as proof of payment of sales tax when registering the aircraft in Indiana. *Id.* The dealer is required to send the original to the Department within 31 days. *See* Form ST-108AC. The purchaser must file a copy of the ST-108AC with his application for aircraft registration, Form 7695. *See id.* The third copy of the ST-108AC is retained by the aircraft dealer. *See id.*

IC 6-2.5-2-1 imposes an excise tax, commonly known as the sales tax, on retail transactions made in Indiana. The person who acquires property in a retail transaction is liable for the tax on the transaction and is required to pay the sales tax to the retail merchant as a separate added amount to the consideration in the transaction. *Id.* The retail merchant is required to collect the tax as agent for the state. *Id.* The purchase of an aircraft from a dealer is a retail transaction.

Exemptions to the imposition of sales tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003). IC 6-2.5-8-8 states that a person who makes a purchase exempt from the sales or use taxes may issue an exemption certificate to the seller to not be charged the tax. No sales tax was collected by the dealer from Taxpayer. On the Form ST-108AC, the dealer recorded that $345,000 was subject to sales or use tax, but that $0 was collected from Taxpayer. In the Sales or Use Tax Exemption box on the ST-108AC, Taxpayer certified under penalty of perjury that the aircraft was purchased by a retail merchant to be rented or leased to others in the course of purchaser's business as provided in 6-2.5-5-8.

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. The owner files a Form 7695 and attaches a copy of Form ST-108AC if the aircraft was purchased through a dealer. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-3-2 imposes a complementary excise tax to the sales tax, known as the use tax. Use tax is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction. *Id.* The use tax is imposed on the storage, use, and consumption of an aircraft, if it (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. *Id* If sales or use tax has been paid, a person is given credit for that payment against the imposition of the use tax. IC 6-2.5-3-4 and IC 6-2.5-3-5. IC 6-2.5-3-4 states if a person issues a state gross retail or use tax exemption certificate for the acquisition of tangible personal property and subsequently uses, stores, or consumes that property for a nonexempt purpose, then the person shall pay the use tax.

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the related Truck Company and the related Trailer Company when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with the related Truck Company and the related Trailer Company. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

<u>Analysis of the form and function</u>

The related Truck Company and the related Trailer Company each have a need for an aircraft to transport their officers and employees. Because the companies are related, many of the officers and employees of Taxpayer and the affiliated companies are the same persons. If each company had purchased an aircraft or a fractional share in an aircraft, sales tax would have been due because the aircraft is acquired in a retail transaction and no exemption exists. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The 6% sales tax on $335,000 is $20,100. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of the related Truck Company and the related Trailer Company. Under FAA regulations, control of the aircraft has to be placed with the related Truck Company and the related Sales Company. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of the related Truck Company and related Trailer Company. Taxpayer was asked to produce copies of the insurance policies held by the related companies. Taxpayer did not produce copies of those insurance policies and stated that only Taxpayer maintains insurance coverage on the aircraft to protect its asset. However, the policy states:

THE USE OF THE AIRCRAFT: The aircraft will be used for your pleasure and business related purposes where no charge is made for such use and also will be used for the following purposes:
NO OTHER USE APPROVED.

These statements indicate that the insurance covers the use of the aircraft by Taxpayer and no other use. This contradicts the leasing arrangement that Taxpayer has with the affiliated companies. Taxpayer obtained insurance at a favorable rate based on the use it stated to the insurance company. But Taxpayer does not and cannot operate the aircraft because the sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft—it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.

…

In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliated companies seek to limit liability and protect assets, but these related companies have not secured insurance for their operations of the aircraft. Since under Part 91, operational control has to be transferred to the lessee, it is the lessee—in this case Truck Company and Trailer Company—that bears liability when operating the aircraft. Neither Truck Company nor Trailer Company have provided evidence that they have purchased insurance coverage on the aircraft. Taxpayer has stated that the only insurance policy on the aircraft is the one held and paid for by Taxpayer. The leases between Taxpayer and the related companies require that the related companies maintain liability insurance covering public liability and property damage of no less than $1 million. The lease outlines other insurance requirements. The lack of insurance coverage by the affiliated companies is an indication that the relationship between Taxpayer and the affiliated companies can be collapsed.

Application of the Sham Transaction Doctrine

The lease agreements and the effect of the operation of the aircraft fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helving, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If the affiliated companies were required to purchase transportation services in accordance with FAA regulations, they would need to secure a third-party to provide them with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What the affiliated companies would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But the affiliated companies do not wish to pay those costs—and they need not. What the affiliated companies want is an aircraft of their own that they can control. And that is what they have acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated companies structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of the related Truck Company and the related Trailer Company; Taxpayer has to give the aircraft and operational control to each of them and each is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is $85. Taxpayer acknowledges the fair market value comparison rate is $245 per hour. Taxpayer states that the rental rate paid by the affiliated companies is reduced because they are responsible for maintaining the aircraft. The net effect of all this is that the Truck Company and Trailer Company get what they wanted all along—control and use of an aircraft; but they have avoided the upfront, one-time cost of having to pay the sales tax due. If the related businesses had purchased the aircraft outright, they still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as they have, while they still pay those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the related companies. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer, Truck Company, and Trailer Company is interfamilial. On both leases, the member who signs for Taxpayer is the same person who signs as president of the related company. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0320050069P.LOF

LETTER OF FINDINGS NUMBER: 05-0069P
Withholding Tax
For the Calendar Year 2003

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. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1; IC 6-3-4-8; 45 IAC 15-11-2

The taxpayer protests the penalty assessed for failure to remit its withholding tax due by the due date of its return.

II. Tax Administration – Interest

Authority: IC 6-8.1-10-1

The taxpayer protests the assessment of interest.

STATEMENT OF FACTS

The taxpayer filed its annual withholding tax return for 2003 after the due date. The calculated amount of tax due was remitted with the return. Accordingly, the department assessed a penalty for the taxpayer's failure to timely remit its tax. In his letter of protest, the taxpayer's representative requested that the penalty be abated due to reasonable cause.

I. Tax Administration – Penalty

The representative asserts that the taxpayer filed its return and remitted its tax late because it relied on the advice of its tax preparer. The preparer failed to provide the taxpayer with the appropriate withholding tax form and instructions until after the due date of the return. In the view of the representative, "…the reasonable cause was due to reliance on a tax professional for advice on the correct time and amount to pay when filing Form WH-1." The department does not consider this to be reasonable cause.

IC 6-3-4-8 states in relevant part:

> (a)…every employer making payments of wages subject to tax under this article, …shall, at the time of payment of such wages, deduct and retain therefrom the amount prescribed in withholding instructions issued by the department. …Such employer making payments of any wages:
>
> (1) shall be liable to the state of Indiana for the payment of the tax required to be deducted and withheld under this section;... and…
>
> (b) An employer shall pay taxes withheld under subsection (a) during a particular month to the department no later than thirty (30) days after the end of that month. However, in place of monthly reporting periods, the department may permit an employer to report and pay the tax for:
>
> (1) a calendar year reporting period, if the average monthly amount of all tax required to be withheld by the employer in the previous calendar year does not exceed ten dollars ($10);…

The statute does not provide for any transfer of responsibility from the employer (taxpayer) to the tax preparer. The taxpayer is responsible for the timely filing of returns and payment of the tax due.

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

> "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard

or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The taxpayer has not established that its failure to timely file the return in question and pay the appropriate tax was due to reasonable cause and not due to negligence.

FINDING

The taxpayer's protest is denied.

II. Tax Administration – Interest

The taxpayer requests that the department waive the imposition of interest. According to IC 6-8.1-10-1(e), the department does not have the authority to waive the interest on tax liabilities.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050081.LOF

LETTER OF FINDINGS NUMBER: 05-0081
Sales and Use Tax for 2004

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-2.5-3-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; FAR 1, 91, 121, 135; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C, Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in June 2003 which it leases to affiliated entity, Logo. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

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

In June 2003, Taxpayer purchased an aircraft for $88,527. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of use tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from use tax, property acquires for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. The owner files a Form 7695. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the related entity, Logo, when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with affiliate Logo. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

Analysis of the form and function

The related entity, Logo, has a need for an aircraft to transport its officers and employees. Because the companies are related, some of the officers and employees of Taxpayer and Logo are the same persons. If Logo had purchased an aircraft or a fractional share in an aircraft, sales and use tax would have been due. But if the aircraft is purchased by an affiliated company, in this case—Taxpayer, and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The sales tax on $88,527 is $5,312. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of Logo. Under FAA regulations, control of the aircraft has to be placed with Logo. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of Logo.

Taxpayer does not and cannot operate the aircraft because the sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft—it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

> The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.
>
> …
>
> In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliated company, Logo, seek to limit liability and protect assets. But under Part 91, operational control has to be transferred to the lessee, it is the lessee—Logo—that bears liability when operating the aircraft.

Application of the Sham Transaction Doctrine

The effect of the operation of the aircraft by Logo and the ownership by Taxpayer falls squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helving, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If Logo were required to purchase transportation services in accordance with FAA regulations, it would need to secure a third-party to provide it with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What Logo would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But Logo does not wish to pay those costs—and it need not. What Logo wants is an aircraft of its own that it can control. And that is what it has acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated company, Logo, structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of the related company; Taxpayer has to give the aircraft and operational control to Logo and Logo is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is $60. Taxpayer acknowledges the fair market value comparison rate is $550 per hour. Taxpayer states that the rental rate paid by Logo is reduced because Logo is responsible for maintaining the aircraft. The net effect of all this is that Logo gets what it wanted all along—control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales tax due. If Logo had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as they have, while Logo still pays those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the related companies. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer and the related entity, Logo, is interfamilial. On both leases, the member who signs for Taxpayer is the same person who signs as president of the related company. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050082.LOF

LETTER OF FINDINGS NUMBER: 05-0082
Sales and Use Tax for 2002

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-6-6.5-2; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003).

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts was rented and leased.

STATEMENT OF FACTS

Taxpayer is a corporation. It purchased an aircraft in August 2002. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC

6-8.1-5-1(b).

In August 2002, Taxpayer purchased an aircraft for $1,350,000. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, a taxpayer is to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales and use tax, property acquires for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.
> Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

The Department sent letters to Taxpayer requesting documentation to support the leasing of the aircraft to others. Specifically, the Department requested copies of insurance policies and copies of the rental and lease agreements. No copies of insurance policies have been submitted to the Department. A draft of a rental agreement between Taxpayer and another was submitted, but the draft was blank; it was not signed or dated. There is no documentation that the agreement was ratified and there is no documentation as to whom the agents for the parties are. Thus, there is no proof or documentation that the aircraft was leased or rented. Taxpayer has been asked repeatedly to supply copies of the insurance and the lease agreement and has failed to do so. Taxpayer has not established that it leased or rented the aircraft. Taxpayer has not established it is entitled to an exemption.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050083.LOF

LETTER OF FINDINGS NUMBER: 05-0083
Sales and Use Tax for 2003

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-6-6.5-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; FAR 1, 91, 121, 135; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in April 2003 which it leases to two affiliated entities, Consulting and RE. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

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

In April 2003, Taxpayer purchased an aircraft for $575,000. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales and use tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the related affiliates, Consulting and RE when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with the affiliates Consulting and RE. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

Analysis of the form and function

The affiliates, Consulting and RE, each have a need for an aircraft to transport their officers and employees. Because the companies are related, many of the officers and employees of Taxpayer and the affiliated companies are the same persons. If each company had purchased an aircraft or a fractional share in an aircraft, sales and use tax would have been due. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The 6% sales tax on $575,000 is $34,500. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of the affiliates, Consulting and RE. Under FAA regulations, control of the aircraft has to be placed with the lessee, Consulting and RE. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of Consulting and RE. Taxpayer was asked to produce copies of the insurance policies held by the related companies. Taxpayer did not produce copies of those insurance policies and stated that only Taxpayer maintains insurance coverage on the aircraft to protect its asset.

This contradicts the leasing arrangement that Taxpayer has with the affiliated companies. Taxpayer does not and cannot operate the aircraft on behalf of the affiliated entities and still remain in compliance with FAA regulations. The sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft—it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

> The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.
>
> …
>
> In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliated companies seek to limit liability and protect assets, but these related companies have not secured insurance for their operations of the aircraft. Since under Part 91, operational control has to be transferred to the lessee, it is the lessee—in this case Consulting and RE—that bears liability when operating the aircraft. Neither Consulting nor RE have provided evidence that they have purchased insurance coverage on the aircraft. Taxpayer has stated that the only insurance policy on the aircraft is the one held and paid for by Taxpayer. The leases between Taxpayer and the related companies require that the related companies maintain liability insurance covering public liability and property damage of no less than $1 million. The lease outlines other insurance requirements. The lack of insurance coverage by the affiliated companies is an indication that the relationship between Taxpayer and the affiliated companies can be collapsed.

Application of the Sham Transaction Doctrine

The lease agreements and the effect of the operation of the aircraft fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helving, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If the affiliated companies were required to purchase transportation services in accordance with FAA regulations, they would need to secure a third-party to provide them with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What the affiliated companies would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But the affiliated companies do not wish to pay those costs—and they need not. What the affiliated companies want is an aircraft of their own that they can control. And that is what they have acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated companies structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of the affiliates, Consulting and RE; Taxpayer has to give the aircraft and operational control to each of them and each is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. Consulting was required to pay a $2,000 deposit on the first year's rent and to pay an hourly rental rate of $60. Taxpayer acknowledges the fair market value comparison rate is $1,100 per hour. RE was required to pay a $2,000 deposit on the first year's rent and to pay an hourly rate of $200. Taxpayer acknowledges that the fair market comparison rate is $1,100 per hour. Taxpayer states that the rental rate paid by the affiliated companies is reduced because they are responsible for maintaining the aircraft. The net effect of all this is that the Consulting and RE get what they wanted all along—control and use of an aircraft; but they have avoided the upfront, one-time cost of having to pay the sales and use tax due. If the related businesses had purchased the aircraft outright, they still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as they have, while they still pay those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the related companies. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer, Consulting, and RE is interfamilial. On both leases, the member who signs for Taxpayer is the same person who signs as president or member of the related company. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050084.LOF

LETTER OF FINDINGS NUMBER: 05-0084
Sales and Use Tax for 2004

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-2-1; IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-2.5-8-8; IC 6-6-6.5-2; IC 6-2.5-3-2; IC 6-2.5-3-4; IC 6-2.5-3-5; IC 6-2.5-4-10(a); 45 IAC 2.2-3-6(c)(1); FAR 1, 91, 121, 135; Form ST-108AC; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C, Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in March 2002 which it leases to affiliated entity, Automation. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

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

In March 2002, Taxpayer purchased an aircraft from an Indiana dealer for $316,900. At the time of sale, a licensed Indiana aircraft dealer is required to collect sales tax from the purchaser. 45 IAC 2.2-3-6(c)(1). The dealer is required to complete Sales Tax Form ST-108AC and record the selling price of the aircraft and the amount of sales tax collected. *Id.* Form ST-108AC is used by the purchaser as proof of payment of sales tax when registering the aircraft in Indiana. *Id.* The dealer is required to send the original to the Department within 31 days. *See* Form ST-108AC. The purchaser must file a copy of the ST-108AC with his application for aircraft registration, Form 7695. *See id.* The third copy of the ST-108AC is retained by the aircraft dealer. *See id.*

IC 6-2.5-2-1 imposes an excise tax, commonly known as the sales tax, on retail transactions made in Indiana. The person who acquires property in a retail transaction is liable for the tax on the transaction and is required to pay the sales tax to the retail merchant as a separate added amount to the consideration in the transaction. *Id.* The retail merchant is required to collect the tax as agent for the state. *Id.* The purchase of an aircraft from a dealer is a retail transaction.

Exemptions to the imposition of sales tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales tax, property acquires for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003). IC 6-2.5-8-8 states that a person who makes a purchase exempt from the sales or use taxes may issue an exemption certificate to the seller to not be charged the tax. No sales tax was collected by the dealer from Taxpayer. On the Form ST-108AC, the dealer recorded that $316,900 was subject to sales or use tax, but that $0 was collected from Taxpayer. In the Sales or Use Tax Exemption box on the ST-108AC, Taxpayer certified under penalty of perjury that the aircraft was purchased by a retail merchant to be rented or leased to others in the course of purchaser's business as provided in 6-2.5-5-8.

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. The owner files a Form 7695 and attaches a copy of Form ST-108AC if the aircraft was purchased through a dealer. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-3-2 imposes a complementary excise tax to the sales tax, known as the use tax. Use tax is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction. *Id.* The use tax is imposed on the storage, use, and consumption of an aircraft, if it (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. *Id* If sales or use tax has been paid, a person is given credit for that payment against the imposition of the use tax. IC 6-2.5-3-4 and IC 6-2.5-3-5. IC 6-2.5-3-4 states if a person issues a state gross retail or use tax exemption certificate for the acquisition of tangible personal property and subsequently uses, stores, or consumes that property for a nonexempt purpose, then the person shall pay the use tax.

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the affiliate, Automation, when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with the Automation. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

<u>Analysis of the form and function</u>

The related company, Automation, has a need for an aircraft to transport its officers and employees. Because the companies are related, many of the officers and employees of Taxpayer and the affiliated company, Automation, are the same persons. If Automation had purchased an aircraft or a fractional share in an aircraft, sales tax would have been due because the aircraft is acquired in a retail transaction and no exemption exists. But if the aircraft is purchased by an affiliated company, in this case—Taxpayer, and Taxpayer holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The sales tax on $316,900 is $19,014. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of the affiliate, Automation. Under FAA regulations, control of the aircraft has to be placed with Automation. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of the affiliate, Automation. Taxpayer was asked to produce copies of the insurance policies held by the related companies. Taxpayer did not produce copies of those insurance policies and stated that only Taxpayer maintains insurance coverage on the aircraft to protect its asset. This contradicts FAA regulations. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

> The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.
>
> …
>
> In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliated company seek to limit liability and protect assets, but Automation has not secured insurance for its operations of the aircraft. Since under Part 91, operational control has to be transferred to the lessee, it is the lessee—Automation—that bears liability when operating the aircraft. Automation has not provided evidence that it has purchased insurance coverage on the aircraft. Taxpayer has stated that the only insurance policy on the aircraft is the one held and paid for by Taxpayer. The lack of insurance coverage by the affiliated company is an indication that the relationship between Taxpayer and Automation can be collapsed.

<u>Application of the Sham Transaction Doctrine</u>

The lease agreements and the effect of the operation of the aircraft fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helving, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If Automation were required to purchase transportation services in accordance with FAA regulations, it would need to secure a third-party to provide it with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What Automation would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But Automation does not wish to pay those costs—and it need not. What Automation wants is an aircraft of its own that it can control. And that is what Automation has acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated company structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of Automation; Taxpayer has to give the aircraft and operational control to the affiliated company and Automation is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is $120. Taxpayer acknowledges the fair market value comparison rate is $280 per hour. Taxpayer states that the rental rate paid by Automation is reduced because it is responsible for maintaining the aircraft. The net effect of all this is that Automation gets what it wanted all along—control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales tax due. If Automation had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as they have, while Automation still pays those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the Automation. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer and Automation is interfamilial. On the lease, the member who signs for Taxpayer is the same person who signs as CEO of Automation. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050085.LOF

LETTER OF FINDINGS NUMBER: 05-0085
Sales and Use Tax for 2004

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-6-6.5-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; FAR 1, 91, 121, 135; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Cambria Iron Co.,

v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in May 2002 which it leases to affiliated entity, Courier. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

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

In May 2002, Taxpayer purchased an aircraft for $750,000. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales and use tax, property acquires for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.
>
> Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the affiliate, Courier, when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with its affiliate, Courier. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

Analysis of the form and function

The affiliate, Courier, has a need for an aircraft to transport its officers and employees. Because the companies are related, many of the officers and employees of Taxpayer and Courier are the same persons. If Courier had purchased an aircraft or a fractional share in an aircraft, sales and use tax would have been due. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The sales and use tax on $750,000 is $45,000. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of the affiliate, Courier. Under FAA regulations, control of the aircraft has to be placed with Courier. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of the affiliate, Courier. Taxpayer was asked to produce copies of the insurance policies held by Courier. Taxpayer did not produce copies of those insurance policies and stated that only Taxpayer maintains insurance coverage on the aircraft to protect its asset. However, the policy states:

> THE USE OF THE AIRCRAFT: The aircraft will be used for your pleasure and business related purposes where no charge is made for such use and also will be used for the following purposes:
>
> NO OTHER USE APPROVED.

These statements indicate that the insurance covers the use of the aircraft by Taxpayer and no other use. This contradicts the leasing arrangement that Taxpayer has with Courier. Taxpayer obtained insurance at a favorable rate based on the use it stated to the insurance company. But Taxpayer does not and cannot operate the aircraft because the sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft—it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

> The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.
>
> …
>
> In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliate, Courier, seek to limit liability and protect assets, but Courier has not secured insurance for its operations of the aircraft. Since under Part 91, operational control has to be transferred to the lessee, it is the lessee—Courier—that bears liability when operating the aircraft. Courier has not provided evidence that it has purchased insurance coverage on the aircraft. Taxpayer has stated that the only insurance policy on the aircraft is the one held and paid for by Taxpayer. The leases between Taxpayer and the affiliate, Courier, require that the Courier maintain liability insurance covering public liability and property damage of no less than $1 million. The lease outlines other insurance requirements. The lack of insurance coverage by Courier is an indication that the relationship between Taxpayer and the affiliated company can be collapsed.

Application of the Sham Transaction Doctrine

The lease agreements and the effect of the operation of the aircraft fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helving, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If Courier were required to purchase transportation services in accordance with FAA regulations, it would need to secure a third-party to provide it with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What Courier would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But Courier does not wish to pay those costs—and it need not. What Courier wants is an aircraft of its own that it can control. And that is what Courier has acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated company structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of Courier; Taxpayer has to give the aircraft and operational control to the affiliate and Courier is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is $150. Taxpayer acknowledges the fair market value comparison rate is $875 per hour. Taxpayer states that the rental rate paid by Courier is reduced because Courier is responsible for maintaining the aircraft. The net effect of all this is that Courier gets what it wanted all along—control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales and use tax due. If Courier had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as its has, while Courier still pays those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by Courier. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer and the affiliate, Courier, is interfamilial. Taxpayer and Courier have the same address. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050086.LOF

LETTER OF FINDINGS NUMBER: 05-0086
Sales and Use Tax for 2004

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

ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-6-6.5-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; FAR 1, 91, 121, 135; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C. Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a limited liability company. It purchased an aircraft in August 2002 which it leases to affiliated entity, GHH. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

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

In August 2002, Taxpayer purchased an aircraft from an Indiana dealer for $345,000. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales and use tax, property acquires for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.
> Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the related entity GHH when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with the affiliate, GHH. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

<u>Analysis of the form and function</u>

GHH has a need for an aircraft to transport its officers and employees. Because Taxpayer and GHH are affiliated, officers and employees of Taxpayer and GHH are the same person. If GHH had purchased an aircraft or a fractional share in an aircraft, sales and use tax would have been due. But if the aircraft is purchased by an affiliated company, Taxpayer, and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales and use tax by claiming to "rent" the aircraft to themselves. The sales and use tax on $5,200,000 is $312,000. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of the affiliate, GHH. Under FAA regulations, control of the aircraft has to be placed with GHH.

Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer doesn't operate the aircraft—it merely holds the asset for the benefit of the GHH. In its brief submitted to Department, Taxpayer stated:

> The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.
>
> …
>
> In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than $100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and GHH seek to limit liability and protect assets. But under Part 91, operational control has to be transferred to the lessee; it is the lessee—GHH—that bears liability when operating the aircraft.

<u>Application of the Sham Transaction Doctrine</u>

The effect of the operation of the aircraft by GHH and the ownership by Taxpayer falls squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In <u>Gregory v. Helving</u>, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* <u>Horn v. Commissioner of the Internal Revenue</u>, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If the affiliated company, GHH, were required to purchase transportation services in accordance with FAA regulations, they would need to secure a third-party to provide them with air travel services—operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What GHH would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But GHH does not wish to pay those costs—and it need not. What GHH wants is an aircraft of its own that it can control. And that is what its has acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and the affiliated company, GHH, structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court—as well as courts across the land—have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of GHH; Taxpayer has to give the aircraft and operational control to the affiliate company and GHH is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is $617. Taxpayer acknowledges the fair market value comparison rate is $2100 per hour. Taxpayer states that the rental rate paid by GHH is reduced because GHH is responsible for maintaining the aircraft. The net effect of all this is that the GHH gets what it wanted all along—control and use of an aircraft; but GHH has avoided the upfront, one-time cost of having to pay the sales and use tax due. If GHH had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as they have, while GHH still pays those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the related company, GHH. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer and GHH is interfamilial. The relationship between Taxpayer and GHH can be collapsed. The member who signed for Taxpayer, "Bob," was a shareholder and responsible officer for the affiliated company, GHH. The officer who signed the lease for GHH, "Sam," is a directly related to "Bob." Bob and Sam were common shareholders and responsible officers in GHH. There is no arms-length transaction to others; the same persons are benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050099.LOF

LETTER OF FINDINGS NUMBER: 05-0099
Sales Tax
Responsible Officer
For the Tax Period October, 2002 through June, 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

1. Sales Tax-Responsible Officer Liability

Authority: IC 6-2.5-9-3, IC 6-8.1-5-1(b).

The taxpayer protests the assessment of responsible officer liability for unpaid corporate sales taxes.

STATEMENT OF FACTS

The taxpayer was an owner and officer of a corporation that did not remit the proper amount of sales taxes during the tax period October, 2002 through June, 2003. The Indiana Department of Revenue assessed the unpaid sales taxes, interest, and penalty against the taxpayer as a responsible officer of that corporation. The taxpayer protested the assessment of tax. A hearing was held and this Letter of Findings results.

1. Sales Tax-Responsible Officer Liability

DISCUSSION

Indiana Department of Revenue assessments are prima facie evidence that the taxes are owed by the taxpayer who has the burden of proving that the assessment is incorrect. IC 6-8-1-5-1(b).

The proposed sales tax liability was issued under authority of IC 6-2.5-9-3 that 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 taxpayer agrees that he was the person with the duty to remit corporate sales taxes to the state. However, he disagreed with the amount of the assessment which was a "best information available" assessment. This means that the department did not have actual returns and based the assessment on estimates of the sales tax liability. Since the issuance of the assessments, the taxpayer has provided sufficient documentation and proof of the actual sales made and subsequent liabilities to warrant adjustment to the original assessments. The taxpayer has now filed the actual returns. Therefore, the proper amount of sales tax due the state is the amount on the filed and accepted returns.

FINDING

The taxpayer's protest is sustained to the extent supported by the documentation submitted.

DEPARTMENT OF STATE REVENUE

0220050114P.LOF

LETTER OF FINDINGS NUMBER: 05-0114P
Income Tax
For the Calendar Year 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 penalty.

STATEMENT OF FACTS

The late penalty was assessed on the late payment of a calendar year corporate income tax return for the year 2003. The error is the result of the federal income number being understated at the original due date. Upon completion of the Indiana return at the extension date, the taxpayer realized the federal income number was understated. This understatement resulted in a deficiency for the Indiana income tax return which the taxpayer paid upon the filing of the Indiana income tax return. The payment was six months late.

The taxpayer is an out-of-state company.

I. Tax Administration – Penalty

DISCUSSION

The taxpayer argues that the penalty be abated as the taxpayer paid the tax that was reasonably expected at the original due date. Furthermore, the taxpayer has a good compliance record.

With regard to the compliance record, the taxpayer has had two previous corporate income tax errors, the Department does not believe these two errors equate to a good compliance record. The Department feels the taxpayer's compliance record is not a factor in the waiver of penalty.

With regard to "reasonably expected" at the original due date, the Department takes the position that "reasonably expected" equates to "reasonable cause" and "reasonable cause" is governed by 45 IAC 15-11-2(b). The Department points out the taxpayer stated in hearing that the taxpayer did not know why the federal income number was understated at the original due date.

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

The Department finds the taxpayer was inattentive of tax duties as the taxpayer miscalculated the federal income tax number needed for the Indiana income tax return. Inattention is negligence and negligence is subject to penalty. As such, the Department finds the penalty proper and denies the penalty protest.

FINDING

The taxpayer's penalty protest is denied.

DEPARTMENT OF STATE REVENUE

0420050153.LOF

LETTER OF FINDINGS NUMBER: 05-0153
Sales and Withholding Tax
Responsible Officer
For the Tax Period 1995-1996

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

ISSUE

1. Sales and Withholding Tax-Responsible Officer Liability

Authority: IC 6-8.1-5-1(b), IC 6-3-4-8(f), IC 6-2.5-9-3.

The taxpayer protests the assessment of responsible officer liability for unpaid corporate withholding taxes.

STATEMENT OF FACTS

The taxpayer was an officer and employee of a corporation that did not remit the proper amount of sales and withholding taxes during the tax period of 1995-1996. The Indiana Department of Revenue assessed the unpaid sales taxes, withholding taxes, interest, and penalty against the taxpayer as a responsible officer of that corporation. The taxpayer protested the assessment of tax and a hearing was held.

1. Sales and Withholding Tax-Responsible Officer Liability

DISCUSSION

Indiana Department of Revenue assessments are prima facie evidence that the taxes are owed by the taxpayer who has the burden of proving that the assessment is incorrect. IC 6-8-1-5-1(b).

The proposed 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 proposed sales tax liability was issued under authority of IC 6-2.5-9-3 that 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 taxpayer was the treasurer of the corporation. As the treasurer, the taxpayer is presumed to be in a position to exercise control over the fiscal aspects of the corporation. She argues, however, that in reality she had no control over the finances and did not determine which creditors would be paid. Since she did not produce any documentation to substantiate this claim, she failed to sustain her burden of proving that she did not have a duty to deduct and remit corporate sales and withholding taxes to the state.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050164P.LOF

LETTER OF FINDINGS NUMBER: 05-0164P
Sales and Use Tax
For the Years 2001-2003

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- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer is a manufacturing concern. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional use tax, interest, and penalty. The taxpayer paid the tax assessments and protested the imposition of the ten percent (10%) negligence penalty.

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 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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2 (c) as follows:

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

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

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

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420050165P.LOF

LETTER OF FINDINGS NUMBER: 05-0165P
Sales and Use Tax
For the Years 2001-2003

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-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.

II. Tax Administration-Interest

Authority: IC 6-8.1-10-1

The taxpayer protests the imposition of interest on its tax liability.

STATEMENT OF FACTS

The taxpayer is a dairy. 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 and interest. 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 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 taxpayer argues that it did not timely pay the assessed sales and use taxes because it was a new business and misunderstood the sales and use tax laws. In support of this contention, it argues that it did not know that some of its electricity use was exempt. After it learned of the electricity exemption, the taxpayer requested and was granted a refund of some of the sales taxes paid on electricity. In fact, the refund of sales taxes paid was greater than the taxpayer's sales and use tax liability pursuant to the audit.

The taxpayer's successful request of a refund of some taxes paid does not obviate the taxpayer's failure to pay the proper amount of sales and use tax. The statute clearly states that "ignorance of the listed tax laws, rules and/or regulations is treated as negligence."

The taxpayer's failure to pay tax on clearly taxable items such as office supplies, a lawn mower, and repair parts for non-exempt machinery constitutes negligence.

FINDING

The taxpayer's protest is denied.

II. Tax Administration-Interest

DISCUSSION

The taxpayer requests that the department waive the imposition of penalty. Pursuant to IC 6-8.1-10-1(e), the department does not have the authority to waive the interest on tax liabilities.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420050167P.LOF

LETTER OF FINDINGS NUMBER: 05-0167P
Sales and Use Tax
For the Years 2001-2003

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- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer produces hardwood and wood veneer products. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional use tax, interest, and penalty. The taxpayer paid the tax assessments and protested the imposition of the ten percent (10%) negligence penalty.

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 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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2 (c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it

exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420050168P.LOF

LETTER OF FINDINGS NUMBER: 05-0168P
Sales and Use Tax
For the Years 2001-2003

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- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer provides sales services for various corporations. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional use tax, interest, and penalty. The taxpayer paid the tax assessments and protested the imposition of the ten percent (10%) negligence penalty.

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 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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2 (c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420050169P.LOF

LETTER OF FINDINGS NUMBER: 05-0169P
Sales and Use Tax
For the Years 2001-2003

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- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer is the general accounting office for several related corporations. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional use tax, interest, and penalty. The taxpayer paid the tax assessments and protested the imposition of the ten percent (10%) negligence penalty.

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 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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

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

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

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

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE

0420050170P.LOF

LETTER OF FINDINGS NUMBER: 05-0170P
Sales and Use Tax
For the Years 2001-2003

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- Ten Percent (10%) Negligence Penalty

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

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

STATEMENT OF FACTS

The taxpayer provides design, engineering, manufacturing, packaging and distribution of electronic assemblies and circuit boards on a contract basis to a variety of industries. After an audit, the Indiana Department of Revenue, hereinafter referred to as the "department," assessed additional use tax, interest, and penalty. The taxpayer paid the tax assessments and protested the imposition of the ten percent (10%) negligence penalty.

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 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 standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

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

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

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

The taxpayer provided substantial documentation to indicate that its failure to pay the assessed use tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest is sustained.

DEPARTMENT OF STATE REVENUE
Revenue Ruling #2005-11ST
August 11, 2005

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

ISSUES

Sales Tax—Environmental Control Equipment

Authority: IC 6-2.5-2-1; IC 6-2.5-5-3; 45 IAC 2.2-5-8(g) and (j).

STATEMENT OF FACTS

The taxpayer manufactures stainless steel and plastic surgical instruments and accessories. All of the taxpayer's sales are to original equipment manufacturers for resale; the taxpayer has no sales which are subject to Indiana sales tax. All operations—including manufacturing, fabrication, assembly, product engineering, and administration—take place at the taxpayer's Indiana location.

Taxpayer intends to purchase and install an environmental control system. The taxpayer states that the environmental control system is required to satisfy the medical industry's high standards for quality and product cleanliness; if the quality standards are not met, the products will be rejected by the taxpayer's customers and will be ultimately scrapped.

Taxpayer states that the machinery within the plant operates at extremely accurate and precise measurements; however, the accuracy and precision is diminished by humidity and temperature variations within the plant. As well, the steel and plastic materials used in the manufacturing can be affected by the temperatures within the plant and by the plant cleanliness. The environmental control system will ensure that the raw materials remain within tolerance through all phases of production and also will prevent dust and other particles from contaminating the final product.

The taxpayer seeks a ruling as to whether the environmental control system meets the criteria to qualify for the manufacturing exemption from sales tax.

DISCUSSION

IC 6-2.5-2-1 imposes sales tax on all retail transactions made within Indiana. IC 6-2.5-5 names the transactions that are exempt from sales tax. IC 6-2.5-5-3 exempts from sales tax the purchase of manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. The taxpayer does produce tangible personal property. The question is whether the environmental control system is directly used in the direct production of tangible personal property.

The determination of exempt use is fact sensitive. 45 IAC 2.2-5-8(g) interprets IC 6-2.5-5-3. The regulation discusses equipment having an immediate effect upon the article being produced. It states:

> Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced." Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

The environmental control system may be considered to be essential, but it needs to be an integrated part of an integrated process. The equipment does maintain a controlled environment to facilitate the manufacturing process, but the controlled environment is a general environment, not an environment restricted and integrated only to the manufacturing process. Additional support that the environmental control system does not qualify for exempt status is the fact that the prior system appears to have been adequate for production.

45 IAC 2.2-5-8(j) states that ventilation and cooling equipment for general temperature control is taxable. The environmental control system affects all stages of production, from pre-production, production, and post-production. It's effect is not upon the production phase alone but also upon storage before and after production. For this reason, it is general ventilation and cooling equipment, not production equipment.

RULING

The Department rules that the environmental control system does not qualify for a sales tax exemption under IC 6-2.5-2-1.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances, as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford taxpayer any protection. It should be noted that subsequent to the publication of this ruling, a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.