NATURAL RESOURCES COMMISSION
Information Bulletin #13
Second Amendment
January 1, 2006

SUBJECT: Mediation and Facilitation in Administrative Proceedings before the Natural Resources Commission and the Department of Natural Resources

I. Introduction to Alternative Dispute Resolution

The use of "alternative dispute resolution" (or "ADR") as a methodology to resolve disputes without resort to litigation has enjoyed increasing acceptance and application in recent years by the civil courts. There are several forms of ADR, with two of the most familiar being (binding) arbitration and (non-binding) mediation.

With the success of alternative dispute resolution at the civil level, there has been a growing interest in its application at the administrative level. Both federal and state agencies are looking to mechanisms to streamline government, and ADR provides an important opportunity for doing so.

One limitation to alternative dispute resolution at the state administrative level is that there are regulatory structures that cannot be negotiated, nor typically can the authority to enforce regulatory requirements be delegated by the state agency to a third person. This limitation is perhaps most notable for, but not exclusive to, instances where a state agency has primary enforcement authority (or "primacy") for a federal program. The state agency must regularly demonstrate to its federal counterpart the ability to enforce a regulatory program in a manner that is at least as effective as at the federal level.

As a consequence, the form of alternative dispute resolution most-frequently implemented by state agencies is mediation. The mediator helps bring litigants or potential litigants together. Communications among the parties and the mediator are privileged as settlement negotiations. The mediator can urge a compromise, can help point out weaknesses in a party's position or strengths in the opposing party's position, and can assist in bringing a sense of realism to a dispute. The mediator has no authority, however, to require a negotiated settlement or to order or prohibit an enforcement action. The parties retain all of their legal rights and privileges throughout a mediation session.

II. Development of Mediation Before the Commission

Although several state agencies have used informal dispute resolution, sometimes calling the process "mediation", the natural resources commission was a pioneer in the use of a mediation process similar to what is sanctioned for civil court proceedings. An early effort was developed and codified at 310 IAC 23-7 (repealed) to help resolve disputes between timber buyers and landowners. This mediation rule was authorized by statute and patterned closely after the rules for civil mediation. 310 IAC 23-7 was used successfully on several occasions for timber buyer cases pending before the NRC's division of hearings and was, with the consent of the parties, also used in two administrative cases involving the Indiana Surface Mining and Reclamation Act.

The Indiana general assembly in 1995 created the administrative orders and procedures act (or "AOPA") study committee. One of the charges of the AOPA study committee was to "study... [w]hether alternative dispute resolution would be effective to streamline and simplify administrative adjudication." If the AOPA study committee determined ADR would be effective, a related charge was "how best to implement alternative dispute resolution" in the context of state administrative law.

With this backdrop, the governmental/regulatory agencies committee of the alternative dispute resolution section, Indiana state bar association, met in September 1995. The governmental/regulatory agencies committee agreed to discuss the use of mediation by the natural resources commission pursuant to the timber buyer law, the opportunity for mediation within the voluntary remediation program administered by the Indiana department of environmental management, and the possibility that the AOPA study committee would propose legislation with respect to one or more forms of alternative dispute resolution. A consensus was achieved with respect to three key points:

1. Mediation, with its dependence upon achieving an agreement by all parties in the final settlement, is the most conservative form of alternative dispute resolution and the form which should currently be pursued in state administrative law.
2. The mediator should enjoy technical expertise relative to the agency's programs and their application to the Indiana administrative orders and procedures act.
3. A statutory structure should be developed which would be cognizant of the worth of mediation and the need to preserve the integrity of the negotiation process, including the protection of confidential statements by the parties.

The governmental/regulatory agencies committee also recommended a simple amendment proposed to IC 4-21.5 to acknowledge and authorize the use of mediation by state agencies. The recommendations of the governmental/regulatory agency committee were subsequently forwarded to the AOPA study committee.

Subsequently, the Indiana state bar association as a whole also adopted a general resolution for submission to the AOPA study committee. The resolution provided:

> Resolved, that the Indiana State Bar Association urges Indiana administrative agencies to promote and utilize alternative dispute resolution. Further we encourage the Indiana General Assembly to take appropriate action to enable Indiana administrative agencies to effectively use alternative dispute resolution.

Resolved, that the Indiana State Bar Association commends the Administrative Orders and Procedures Act Commission for their efforts; and encourages the Commission to continue to study the administrative adjudication process in order to assure that the citizens of Indiana obtain a timely, fair and just hearing.

Be it resolved, and adopted by the Indiana State Bar Association Board of Governors this second day of December, 1995.

The AOPA study committee considered the use of alternative dispute resolution by state agencies in its 1995 summer session and proposed a legislative response. Although a much more ambitious undertaking than anticipated by the governmental/regulatory agencies committee bill draft, the AOPA study committee settled upon the use of mediation as the form of ADR to be implemented, and its legislative proposal was otherwise harmonious with that draft. The AOPA study committee proposal was ultimately embodied in Senate Bill 241, and the bill passed with only modest amendments from the version suggested by AOPA study committee.

Senate Bill 241 added a new chapter to the AOPA as P.L. 16-1996. The legislation became effective July 1, 1996 and required action by the "ultimate authority" for the agency to determine the appropriate application of mediation to the agency. The Natural Resources Commission is the "ultimate authority" for the department of natural resources pursuant to IC 14-10-2-3.

Effective August 1, 1996, the natural resources commission approved a nonrule policy document to implement P.L. 16-1996 and to set guidelines for its implementation. The nonrule policy document superseded 310 IAC 23-7, and IC 4-21.5-3.5 and the guidelines form the current foundation for mediation before this agency and the department of natural resources. The guidelines were described in 1996 as a "pilot project" likely to require refinement for mediation to achieve its full potential for dispute resolution and streamlining. Reference was also made to the potential for using facilitation. The commission also directed that the experience with mediation be presented for its subsequent review. See "Pilot Project for the Use of Mediation and Facilitation for Dispute Resolution Before the Natural Resources Commission and Before the Department of Natural Resources", Information Bulletin #13, 19 Ind. Reg. 3227 (August 1, 1996).

With the assistance of the Indiana Conflict Resolution Institute of Indiana University, five state agencies entered a memorandum of understanding in 1999 to cooperate in the implementation of mediation at the administrative level. These were the Indiana department of environmental management, the office of environmental adjudication, the state emergency management agency, the department of natural resources, and the natural resources commission. This memorandum was structured to terminate in 2000, although the participants subsequently continued to act under its guidance. This voluntary, cooperative effort has come to be known as the "Shared Neutrals Program".

A new document entitled the "2005 Memorandum of Understanding Concerning the Interagency Shared Neutrals Program for Mediation" has been prepared. The new memorandum also anticipates a voluntary, cooperative effort among state agencies but has an extended duration. The department of natural resources and the natural resources commission are authorized to join in the 2005 memorandum effective January 1, 2006.

III. Implementation of Administrative Mediation

1. Application: This document is intended to implement IC 4-21.5-3.5 for the use of mediation before the Natural Resources Commission and the Department of Natural Resources. The document should be construed liberally to achieve governmental streamlining and to help achieve consensus in the administrative functions of the agencies.

2. Application of Mediation and Facilitation to Proceedings of the Natural Resources Commission: Mediation is made available for the following matters under the jurisdiction of the commission:

(1) proceedings in which the natural resources commission, or an administrative law judge for the commission, is the "ultimate authority" pursuant AOPA (including accelerated mediation for disputes relative to temporary structures in public freshwater lakes under 312 IAC 11-3-2);

(2) where a hearing officer has been appointed for the commission regarding the creation, management, or dissolution of a conservancy district pursuant to IC 14-33;

(3) a special commission hearing held pursuant to IC 14-11-1-3; and,

(4) the mediation of disputes arising between the users of surface water pursuant to IC 14-25-1-8.

The parties may agree upon a mediator. To assist the parties in the selection of a mediator, the administrative law judge or hearing officer may identify a panel from the participants in the Shared Neutrals Program. If the parties do not agree upon a mediator, the administrative law judge or hearing officer may appoint a mediator from among the participants in the Shared Neutrals Program. The administrative law judge or hearing officer also has discretion to appoint a facilitator for any proceeding, except one governed by AOPA, where determined appropriate to assist in achieving a settlement or developing consensus on an issue that might make a settlement more likely. Unless the parties otherwise agree, a mediator shall serve without cost to them. A mediator selected under this paragraph shall be qualified under IC 4-21.5-3.5.

3. Application of Mediation and Facilitation to Proceedings of the Department of Natural Resources: Mediation is made available for the following matters under the jurisdiction of the department of natural resources:

1. a public hearing prior to a licensing action pursuant to IC 14-11-4-8 (including licenses under the flood control act, lakes preservation law, wild animal possession law, and other laws designated in that statute by the legislature);
2. where a conservancy district matter is pending before the department;

3. prior to a decision by the historic preservation review board on the addition or removal of a site from the register of Indiana historic sites and structures pursuant to IC 14-21-1-17; and,
4. for hearings held on petitions for rule change.

The parties may agree upon a mediator. To assist the parties in the selection of a mediator, the director or a deputy director may identify a panel from the participants in the Shared Neutrals Program. If the parties do not agree upon a mediator, the director or a deputy director may appoint a mediator from among the participants in the Shared Neutrals Program. The director or a deputy director also has discretion to appoint a facilitator to assist with the resolution of any dispute described in this paragraph. Unless otherwise the parties otherwise agree, a mediator shall serve without cost to them. A mediator selected under this paragraph shall be qualified under IC 4-21.5-3.5.

4. Voluntary Pool of Agency Mediators and Further Development of Mediation: Efforts should be explored by the commission's division of hearings and the department's office of legal counsel to determine the feasibility of establishing a voluntary pool of mediators outside state government. In these efforts, open communications should be maintained or developed with other state agencies, local or regional government, the Indiana state judiciary, and the Indiana state bar association.

5. Approval by the Natural Resources Commission and Publication: The first amended information bulletin was approved as by the natural resources commission as a nonrule policy document during its April 1999 meeting. The document was published in the Indiana Register at 22 IR 2949 (June 1, 1999). This amended information bulletin was approved by the commission during its November 2005 meeting and published in the Indiana Register on January 1, 2006.

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS: 03-0004; 99-0640
Gross Retail Tax
For the Years 1995 through 1997 and 1998 through 2001

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

ISSUES

I. Abatement of the Ten-Percent Negligence Penalty.

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

Taxpayer asks that the Department of Revenue exercise its discretion to abate the ten-percent negligence on the ground that taxpayer had no direct obligation to remit use tax on the purchase of certain items.

II. Food Purchases – Gross Retail Tax.

Authority: IC 6-2.5-1-1 et seq.; IC 6-2.5-3-2; IC 6-2.5-5-20(a); IC 6-2.5-5-20(c)(8); Hyatt Corp. v. Dept. of State Revenue, 695 N.E.2d 1051 (Ind. Tax Ct. 1998); 45 IAC 2.2-5-38.

Taxpayer argues that the money it received for serving prepared meals was not subject to the gross retail tax.

STATEMENT OF FACTS

Taxpayer owns and operates a "guest pavilion," parking lots, dock, restaurants, and berthing slips. These facilities serve two riverboat casinos. The two adjacent riverboats are licensed to conduct separate, but coordinated gaming operations.

The riverboats' parent companies formed taxpayer as a joint venture in 1995. The two riverboat parent companies each have a 50 percent ownership interest in taxpayer. The intent of the two parent companies was to share the initial cost and ongoing expense of the land-based, support facilities – parking lots, food service, etc. – necessary for successful operation of the riverboats' gambling business.

During 1999, the Department of Revenue (Department) conducted an audit review of taxpayer's business records and tax returns. The Department reviewed records and returns for 1995, 1996, and 1997. This first audit resulted in the issuance of proposed assessments of additional gross retail tax. Taxpayer disagreed and submitted a protest to that effect. Thereafter, taxpayer and the Department reviewed invoices and related documentation to resolve the issues raised in this first protest. According to taxpayer, taxpayer and the Department reached an "initial agreement" dated August 8, 2002, which made specific adjustments to the 1995, 1996, 1997 assessments. According to taxpayer, it paid the unresolved gross retail tax assessments in full. Taxpayer believes that the only unresolved issue stemming from this first set of assessments is the ten-percent negligence penalty.

During 2002, the Department conducted a second audit review of taxpayer's business records and tax returns for 1998, 1999, 2000, and 2001. The Department concluded that taxpayer owed additional use tax on the complimentary meals taxpayer served to the riverboats' employees and the riverboats' preferred customers. Accordingly, the Department issued notices of "Proposed Assessment." Taxpayer disagreed with the proposed assessment and submitted a second protest to that effect.

The Department and taxpayer decided that the two protests – although addressing separate issues stemming from separate audits – should be treated and resolved as one protest. An administrative hearing was conducted during which taxpayer's representative explained taxpayer's position on the two remaining, disputed issues. This Letter of Findings results.

DISCUSSION

I. Abatement of the Ten-Percent Negligence Penalty.

The ten-percent negligence penalty stems from the first audit and the consequent assessment of additional use tax. The first audit found that taxpayer should have paid use tax on the materials integrated into realty under a lump sum contract and a time and materials contract. In addition, the first audit found that taxpayer should have paid use tax on the purchase of certain communications equipment, office equipment, kitchen equipment, and other personal property.

After taxpayer submitted the first protest, the Department and taxpayer's representatives conducted a review of the initial 1995, 1996, and 1997 assessments. The two parties agreed that certain purchases were not subject to use tax because sales tax was paid on the original invoice. The parties agreed that purchases of certain kitchen equipment were exempt from sales tax. The parties agreed that taxpayer had paid sales tax on a portion of the cost of a non-exempt item. The parties agreed that certain other charges should be eliminated (without written explanation) from the use tax assessment. The parties apparently compromised on the use tax assessments attributable to the lump sum contracts for the improvement to realty. As stated in the August 8, 2002, agreement, "for the remaining purchases claimed in the protest related to lump sum contracts, it was agreed that taxing 60% of these purchases fairly reflects the true taxability."

The unresolved issue is whether the ten-percent negligence penalty related to the first set of use tax assessments should be abated in its entirety.

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

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

In the August 8 agreement, the parties agreed to compromise or otherwise resolve the contested use tax issues. As stated in that agreement, "The complexity of the paperwork, the inability to obtain every source document, and the inferences and conclusions that could be drawn from the information that was provided[,] all lead to the conclusion, that in fairness to the state as well as the taxpayer, this compromise was warranted."

Given the parties' willingness to compromise on the original use tax assessment, that both parties agreed that a substantial portion of the original assessment should be abated, and that the use tax questions were difficult to resolve because of the "complexity of the paperwork," it cannot be said that the original use tax assessments were attributable to the absence of reasonable care on the part of taxpayer or that taxpayer failed – under the circumstances – to exercise ordinary business care and prudence.

Therefore, the ten-percent negligence penalty imposed following audit review of taxpayer's 1995, 1996, and 1997 records should be entirely abated.

FINDING

Taxpayer's protest is sustained.

II. Food Purchases – Gross Retail Tax.

Taxpayer is owned by two riverboat casinos. Taxpayer supplies the ancillary, land-based services necessary for the operation of the riverboats. Each riverboat owns 50 percent of taxpayer.

Taxpayer operates a cafeteria which serves free meals to the riverboats' employees. In addition, taxpayer serves free meals to the riverboats' preferred customers. The preferred customers are those who have received a complimentary meal voucher.

Taxpayer keeps records of the meals it serves to its own employees, the meals it serves to the riverboats' employees, and the meals it serves to the riverboats' preferred customers.

Every month, taxpayer sends a bill to each of the two riverboats for the cost of the meals served to the riverboats' employees and the riverboats' customers. The two riverboats reimburse taxpayer for the cost of the meals served to these employees and customers.

The second audit review (1998 through 2001) found that taxpayer should have collected sales tax on the reimbursements received from the riverboats. As stated in the explanation of adjustments, "An adjustment was made in the audit to assess the taxpayer for sales tax that should have been charged to [the two riverboats] on the cost of these meals." However, the audit did not assess use tax on the food used to provide free meals to taxpayer's *own* employees because, as stated in the explanation of adjustments, "the food is never sold. The food was purchased free of sales tax in accordance with 45 IAC 2.2-5-39 as the purchase of food for human consumption."

Taxpayer argues that the meals served to the riverboats' employees and the riverboats' customers were exempt from sales tax under IC 6-2.5-5-20(a) which states that, "Sales of food for human consumption are exempt from the state retail tax." According to taxpayer, it "purchased only unprepared food which it prepared and provided to employees and patrons of [the two riverboats]. All of these purchases were exempt from Indiana sales and use tax under the food for human consumption exemption."

Taxpayer points to the decision set out in Hyatt Corp. v. Dept. of State Revenue, 695 N.E.2d 1051 (Ind. Tax Ct. 1998) as support for its position that the cost of the meals served to the riverboats' employees and customers was not subject to sales or use tax. In Hyatt, the petitioner-taxpayer argued that it was not subject to use tax on the food it purchased and served as complimentary meals to its own guests and employees. Id. at 1052. Petitioner-taxpayer claimed that, under IC 6-2.5-5-20(a), its food purchases were exempt because the items purchased were "food for human consumption" and that the food items were not "food furnished, prepared, or served for consumption at a location, or on equipment provided by the retail merchant." Id. at 1054. *See* IC 6-2.5-5-20(c)(8). The court agreed with petitioner-taxpayer's position. Petitioner-taxpayer was buying food for human consumption and giving away meals prepared with that food. Id. at 1056-57. The Tax Court found that, "the fact that the food [petitioner-taxpayer] purchased was not resold is irrelevant to the question of whether [petitioner-taxpayer's] food purchases qualify for an exemption under section 6-2.5-5-20." Id. at 1057.

Indiana imposes a sales tax on retail transactions and a complimentary use tax on tangible personal property that is stored, used, or consumed in the state. IC 6-2.5-1-1 et seq. The use tax "is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC 6-2.5-3-2.

As noted above, "Sales of food for human consumption are exempt from the state gross retail tax." IC 6-2.5-5-20(a). However, the phrase "food for human consumption" does not include "food furnished, prepared, or served for consumption at a location or on equipment provided by the retail merchant." IC 6-2.5-5-20(c)(8). The Department's regulation restates the rule: "The gross retail tax exempts food for human consumption. Primarily the exemption is limited to sales by grocery stores, supermarkets, and similar type businesses of items which are commonly known as grocery food." 45 IAC 2.2-5-38.

Taxpayer is reimbursed for the cost of the meals served to the riverboats' employees and the riverboats' customers. The Department agreed that taxpayer was not subject to use on the value of the food to taxpayer's *own* employees. What is at issue is whether taxpayer should have charged the two riverboats sales tax for the cost of the meals served to the *riverboats'* employees and the *riverboats'* customers. Taxpayer argues that it was simply acting as an agent for the two riverboats. According to taxpayer, it "had no prospects for earning a profit. Its sole purpose was to act as [the riverboats'] agent for the purpose of providing food to their employees and club members." Taxpayer concludes that, "All acts performed by [taxpayer] in its agency capacity, including the purchase, preparation and delivery of food to [the riverboats'] employees and patrons, are therefore treated as though such acts were performed by [the riverboats]."

Taxpayer indicates that it has acted as the riverboats' agent since its inception and that the arrangement was formally memorialized six years afterward. Taxpayer maintains that – because of the agency/principal relationship it has with the riverboats – it stands in the same shoes as the petitioner-taxpayer in Hyatt; because the riverboats could presumably have purchased food and served that food free-of-charge to the riverboats' own employees and the riverboats' own preferred customers, taxpayer stands in the stead of the two riverboats and can purchase and serve meals to the riverboats' employees and guests without collecting sales tax.

However, it should be noted that taxpayer wants something more than the petitioner-taxpayer in Hyatt. In that case, the petitioner-taxpayer wanted to buy unprepared food without paying sales tax. Hyatt, 695 N.E.2d at 1054-55. Taxpayer wants to receive tax-free payment from the riverboats for the cost of the cooked and prepared meals along with the cost of procuring, preparing, and delivering the food to riverboat employees and guests. As set out in the parties' Limited Agency Agreement, "In consideration of the [taxpayer's] performance of its duties under this Agreement, [the riverboats] shall reimburse [taxpayer] monthly for the actual cost of food purchased and other costs and expenses incurred in connection with the provision of food to [the riverboats'] employees and club members." Essentially, taxpayer wants to operate a restaurant/catering business without having to charge sales tax when it receives payment for serving meals.

The Department must respectfully disagree with taxpayer's argument because it does not conclude that the rules governing the interplay between the gross income tax and agency/principal standards are relevant in determining whether a retail transaction occurs when the riverboats pay taxpayer for the cost of meals served to other than the taxpayer's own employees. As recognized in the parties' own "Limited Agency Agreement," "[A]s part of [taxpayer's] *Business*, [taxpayer] maintains and operates in the pavilion a cafeteria for the purpose of producing, preparing and delivering food to [taxpayer's] employees and to the [the riverboats'] employees." (*Emphasis added*). Elsewhere in the same document, the parties recognize "also as a part of [taxpayer's] *Business*, [taxpayer] maintains and operates certain other facilities for the purpose of procuring, preparing and delivering food to the [the riverboats'] club members.... [Taxpayer] operates the Club Member Food Facilities and provides such food free-of-charge to club members who bear compensation certificates...." (*Emphasis added*).

The agency/principal arrangement is an irrelevancy in determining whether taxpayer should have collected sales tax on the money it received for serving meals to other than its own employees. Taxpayer is in the "business" of running a restaurant/cafeteria service. It buys and prepares food which it serves to persons other than its own employees. Taxpayer receives payments based upon the number of meals served to persons other that its own employees. These transactions are subject to the gross retail tax, and taxpayer should have collected sales tax each time it received a payment.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS: 02-0461
Indiana Corporate Income Tax
For the Tax Years 1997, 1998, and 1999

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

ISSUES

I. Elimination of Interest Income Attributable to Holding Company's Intercompany Bonds – Gross Income Tax.

Authority: 45 IAC 1.1-4-5; 45 IAC 1.1-4-5(a); 45 IAC 1.1-4-5(b); 45 IAC 1-1-166.

Taxpayer – representing members of its affiliated companies – maintains it was entitled to a deduction from its gross income. Taxpayer claims the deduction because interest was transferred from affiliated company to another. The audit disallowed the deduction, and taxpayer protests. Taxpayer argues that money received in the form of fictional intercompany interest payments during 1997, 1998, and 1999 should not have been disallowed as intercompany receipts; taxpayer admits that Holding Company was not qualified to do business in Indiana during 1997 and 1998 but that in 1998, Holding Company merged into taxpayer with taxpayer remaining as the sole surviving entity.

II. Elimination of Intercompany Receipts – Gross Income Tax.

Authority: IC 6-8.1-5-1(b); IC 6-2.1-3-3; 45 IAC 1.1-1-5; 45 IAC 1.1-4-5(a); 45 IAC 1-1-166; 45 IAC 1-1-51; 45 IAC 1-1-10.

Taxpayer argues that the audit erred in disallowing as intercompany receipts money received from numerous trusts. The audit did so because the trusts were not included in the consolidated gross income tax filings. Taxpayer maintains that the income from the trusts was fictional and was merely a tax reporting convenience.

III. Exclusion of Out-of-State Income – Gross Income Tax.

Authority: IC 6-8.1-5-1(b); IC 6-2.1-3-3.

Taxpayer argues that the audit erred in disallowing the deduction of fee income reported as Indiana receipts. Taxpayer maintains that the fee income was earned at the initiation of an investment in a New York building and that the work related to the investment was completed in New York. Because the "preponderance of the work was completed outside of Indiana," taxpayer believes that the fee income should be deducted from the Indiana gross income tax base.

IV. Excluding Out-of-State Sales – Gross Income Tax.

Authority: IC 6-8.1-5-1(b); IC 6-2.1-2-2; IC 6-2.1-1-13; IC 6-2.1-1-2; 45 IAC 1.1-6-2; 45 IAC 1.1-2-5(a); 45 IAC 1-1-96; 45 IAC 1-1-54; 45 IAC 1-1-51.

Taxpayer challenges the audit's decision disallowing the exclusion of certain sales receipts attributable to non-Indiana jurisdictions. Taxpayer maintains that the sales receipts should be excluded because taxpayer has established nexus in the other jurisdictions.

V. Intercompany Aircraft Rent Payments – Apportionment / Property Factor.

Authority: IC 6-3-2-2(b); IC 6-3-2-2(c); 45 IAC 3.1-1-41.

In calculating its property factor, taxpayer included – as rented property – the value of certain airplane rental payments. The rent was paid by one member of the consolidated return to another member of the consolidated return. The audit removed the rental value from the property factor on the ground that the rent consisted of "intercompany receipts." Taxpayer disagrees.

VI. Addback of Riverboat Wagering Tax – Adjusted Gross Income.

Authority: IC 6-3-2-1(b); IC 6-3-1-3.5(b)(3); Aztar Ind. Gaming v. Dept. of State Revenue, 806 N.E.2d 381 (Ind. Tax Ct. 2004); 45 IAC 3.1-1-8(3)(a).

Taxpayer disagrees with the audit's adjustment adding back a federal deduction for Riverboat Wagering Tax.

VII. Exclusion of Dividend and Interest Income – Gross Income Tax.

Authority: IC 6-2.1-1-2(c)(6); IC 6-2.1-1-2(d).

Taxpayer owns life insurance companies located outside the state. One of the life insurance companies – located in Minnesota – paid interest and dividends to parent company. Taxpayer claims that the interest and dividends should have been excluded from the consolidated group's gross income tax calculation because the interest and dividends were earned outside of Indiana and because the Minnesota subsidiary does not have a business situs within Indiana.

VIII. Elimination of Intercompany Transactions Between Members of a Consolidated Gross Income Tax Return – Gross Premiums Privilege Tax / Gross Income Tax.

Authority: IC 27-1-18-2(a); IC 27-1-18-2(b); IC 6-3-2-2.8; 45 IAC 1.1-4-5(a); 45 IAC 1-1-166.

Taxpayer argues that, for purposes of the Gross Premiums Privilege Tax, it is entitled to exclude intercompany receipts when calculating its gross income tax.

STATEMENT OF FACTS

Taxpayer is an in-state insurance company which provides insurance, investment, and lending products. Taxpayer is also the parent company of numerous subsidiaries which together file a consolidated tax return. These subsidiaries provide support service to the parent and also to certain related insurance companies. The related insurance companies are purportedly domiciled outside of Indiana.

The Department of Revenue (Department) conducted an audit review of taxpayer's tax returns and business records. The audit resulted in the assessment of additional corporate income tax. Taxpayer protested the audit's determination and also submitted additional claims for refund. An administrative hearing was conducted during which taxpayer's representative explained the basis for its protest of the audit review's findings. In addition, taxpayer's representative attempted to justify the grounds for granting the additional refunds unrelated to the audit. This Letter of Findings, addressing both the audit and refund issues, results.

DISCUSSION

I. Elimination of Interest Income Attributable to Holding Company's Intercompany Bonds – Gross Income Tax.

For 1997, 1998, and 1999, taxpayer excluded certain amounts of money from its gross income tax calculation. Taxpayer did so on the ground that the money represented "intercompany transactions" among members of the consolidated group. The audit disallowed the deduction of money received from one of the affiliated companies – hereinafter "Holding Company" – on the ground that Holding Company was not authorized to do business in Indiana.

Taxpayer disagrees stating that the audit erred in its decision; taxpayer claims that the deduction should be reinstated for the tax year 1999.

45 IAC 1-1-166 states in part as follows:

> The total gross receipts of all affiliated group members are reported on the [consolidated] return, then receipts from intercompany sales of property and payments of dividends, rents, interest and service charges may be eliminated from taxable gross receipts. However, receipts from distributions in connection with the dissolution of any group member and income earned by any group member outside the state may not be eliminated on the return as intercompany receipts.

Effective January 1, 1999, the Department's Gross Income Tax regulations were revised. The revised regulation, designated as 45 IAC 1.1-4-5(a), states that:

> Except as provided in subsections (b) and (c), an affiliated group of corporations, as defined in IC 6-2.1-5-5, is entitled to a deduction from the gross income reported on the consolidated return. The amount of the deduction is the total gross income received from transactions between the members of the group. (b) The deduction provided by subsection (a) does not apply to gross income received because of the dissolution of a member of the affiliated group. Also the deduction does not apply to gross income derived *from sources outside Indiana*. Nor does the deduction apply to gross income derived from an affiliate not qualifying to be included in the consolidated filing. (*Emphasis added*).

Under 45 IAC 1-1-166, the audit was correct in eliminating the 1997 and 1998 deductions between taxpayer and Holding Company because Holding Company was not located in nor qualified to do business in Indiana. "[I]ncome earned by any group member outside the state may not be eliminated on the return as intercompany receipts." 45 IAC 1-1-166.

Nevertheless, taxpayer maintains that the 1999 deduction should not have been eliminated because taxpayer and Holding Company merged during 1999; taxpayer was the only surviving member. Under 45 IAC 1.1-4-5, the audit was correct in eliminating the 1999 deduction because, insofar as the contemporaneous identity of taxpayer and Holding Company, there were no "members of the group." 45 IAC 1.1-4-5(a). The Holding Company ceased to exist, and any income attributable to the now vanished Holding Company was simply taxpayer's income; by definition, there were no intercompany receipts to eliminate or deduct.

In addition, because the money attributable to the vanished Holding Company came from sources outside Indiana, it was money earned outside the state, and the intercompany deduction does not "not apply to gross income derived from sources outside Indiana." 45 IAC 1.1-4-5(b). This income is not subject to Indiana's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Elimination of Intercompany Receipts – Gross Income Tax.

The audit eliminated intercompany deductions between one of taxpayer's subsidiaries ("Subsidiary) and numerous trusts. The deductions represented fictional interest payments which were never paid. The audit did so because the trusts were not included in the consolidated gross income tax filing.

Taxpayer disagrees and states that the deductions should be allowed. Taxpayer explains as follows; taxpayer initiated financing transactions which required the establishment of various trusts. Taxpayer did so by "issuing debt" to a Delaware trust "which in turn issued preferred stock to the trust's investors." The trust interests were held by unrelated entities with the exception of a small amount of "beneficial interest held by [Subsidiary]." Taxpayer explains that the interest which was due Subsidiary had not been paid and that taxpayer has no intention of ever paying the interest.

Although the interest would never be paid, on its consolidated federal income tax return, taxpayer took a deduction for the full amount of the interest related to the debt issued to the trust. Taxpayer describes this as "fictitious income." After creating this "fictitious income," the "fictitious income" amounts were eliminated in the Indiana Gross Income Tax calculation. The audit disallowed this elimination.

45 IAC 1-1-166 states in part as follows: "The total gross receipts of all affiliated group members are reported on the [consolidated] return, then receipts from intercompany sales of property and payments of dividends, rents, interest and service charges may be eliminated from taxable gross receipts."

45 IAC 1.1-4-5(a) provides that, "an affiliated group of corporations, as defined in IC 6-2.1-5-5, is entitled to a deduction from the gross income reported on the consolidated return. The amount of the deduction is the total gross income received from transactions between the members of the group."

Under either 45 IAC 1-1-166 or 45 IAC 1.1-4-5(a), the audit was correct in eliminating these "intercompany deductions" because the trust companies were never members of the "affiliated groups of companies."

Nonetheless, taxpayer states that the amounts should be eliminated because – although reported on the federal income tax return – the interest would never actually be paid but was merely a "tax reporting convenience." The Department must disagree because the amounts – such as they are – constitute "constructive receipts" as defined in 45 IAC 1-1-10. That regulations states that, "'Constructive receipts' are those items of gross income which are not actually received by the taxpayer but which are credited to him, available for his withdrawal, paid to another for his benefit, or represent income to which he is entitled." *See also* 45 IAC 1.1-1-5.

Taxpayer has anticipated the "constructive receipts" argument. Taxpayer states that, "even if the first argument is found to be in error and constructive receipts are found to exist, clearly no Indiana nexus can be attached." Taxpayer states that the fictitious interest amounts were attributable to Subsidiary, a Delaware company, which does not have an Indiana nexus. Taxpayer's argument is as follows: "In the facts [taxpayer] remits [fictitious] interest payments to a Delaware trust pursuant to the debt instrument held by the trust. The trust remits the [fictitious] dividend income to its passive investment holders. In this instance, the entity is [Subsidiary] a Delaware holding company. No Indiana nexus is established; therefore, no income should be included in the tax base." However, as elsewhere stated by taxpayer, "This interest was for business and legal purposes and had no tax motivation in itself. The interest due [Subsidiary] has not been paid to date and [] will never be paid."

Taxpayer's "nexus" argument is apparently based on the proposition that the constructive interest income was attributable to doing business with an out-of-state entity. IC 6-2.1-3-3 provides that "[g]ross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign county is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution."

Taxpayer's "nexus" argument is unfounded because the interest amounts were not the result of taxpayer doing business with an out-of-state entity. The amounts were spun out of whole cloth as the result of a complicated trust/debt/interest scheme between itself and its own Delaware Subsidiary which was also a member of the consolidated group. As a result of that transaction, taxpayer obtained "constructive receipts" which were duly reported on its federal income tax returns. This transaction may have had unanticipated gross income tax implications, but there is nothing related to the transaction which raises questions of a constitutional dimension. In addition, taxpayer assumes that Subsidiary has established an out-of-state nexus and that the income was "directly related to an integral part of a business conducted at a 'business situs' outside Indiana." 45 IAC 1-1-51. Without additional information, the Department is unable to accept taxpayer's conclusion that the constructive receipts were attributable to a source outside Indiana. Taxpayer has not met its burden of demonstrating that the proposed assessment is incorrect. IC 6-8.1-5-1(b).

FINDING

Taxpayer's protest is respectfully denied.

III. Exclusion of Out-of-State Income – Gross Income Tax.

On its 1999 gross income tax return, taxpayer excluded certain "fee income." The "fee income" was attributable to a "Consultancy Agreement" between taxpayer and an unrelated entity. In the Consultancy Agreement, taxpayer agreed to provide business and financial consulting services related to taxpayer and its affiliates' investment in a building located in New York. Taxpayer claims that "[a] significant amount or (sic) work surrounding this engagement was incurred at the initiation of the investment and was completed in New York." Taxpayer concludes that because the parties' "contract provides for compensation relating to New York property, and the preponderance of the work was completed outside of Indiana, [taxpayer] believes that it is appropriate to exclude such from the Indiana gross receipts base."

Taxpayer is correct in pointing out that money earned from doing business outside Indiana is not subject to the Gross Income Tax. IC 6-2.1-3-3 provides that "[g]ross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign county is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution."

However, in order to establish that it is entitled to deduct the amount earned from the out-of-state contract, taxpayer must meet its burden of proving that the assessment is incorrect. "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 evidence consists of the twin assertions that the "preponderance of the work was completed outside of Indiana" and that a "significant" amount of the contract work was performed in New York. These statements alone are insufficient, and taxpayer has not met its burden of proving that the audit's determination was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

IV. Excluding Out-of-State Sales – Gross Income Tax.

A. Five Insurance Broker/Dealers.

Taxpayer has five subsidiaries which sell variable and mutual fund products. The five subsidiaries sell their investment products to customers within Indiana and to customers outside Indiana through a network of independent agents. The five subsidiaries earned commission income on each of the sales.

The audit reported that "[t]he commission income was sourced to the location where the sale and/or policyholder resided and [was] therefore deducted as out of state sales by the taxpayer." The audit disallowed the deduction of these sales as out-of-state income because the five subsidiaries "have no property or payroll located outside of Indiana," and because the "income was not directly related to a business situs outside of Indiana."

The audit did so under authority of 45 IAC 1-1-51 which states that, "If a taxpayer's commercial domicile is in Indiana, all of the income from intangibles will be taxed under IC 6-2-1-1(m)... except that income which may be directly related to an integral part of a business regularly conducted at a 'business situs' outside Indiana." *See also* 45 IAC 1.1-6-2.

Taxpayer disagrees with the audit's decision and argues that the five subsidiaries established a nexus with the out-of-state locations in which the original sales were completed. Taxpayer points out the foreign states provided services to the five subsidiaries, that it was taxpayer's intent to establish its investment products in those foreign states, that it maintained an inventory of brochures and selling materials in the foreign states, that it had filed state income tax returns in the foreign states, and that none of the foreign states had "rejected such nexus." Taxpayer maintains that the income should be apportioned to those foreign states.

Gross income tax is imposed upon the receipt of the entire taxable gross income of a resident or domiciliary of Indiana. IC 6-2.1-2-2. The term "taxable gross income" means all gross income which is not exempt from tax under IC 6-2.1-3 et seq. less all deductions which are permitted under IC 6-2.1-4 et seq. IC 6-2.1-1-13. In particular, IC 6-2.1-1-2 provides that "'gross income' means all the gross receipts a taxpayer receives (1) from trades, business, or commerce.... [and] (3) from the sale, transfer, or exchange of property, real or personal, tangible or intangible..." In regards to the taxpayer's own commission income, 45 IAC 1-1-96 provides that "[g]ross receipts from services means receipts derived from activities performed in the process of completing a service agreement or contract... Such income includes, but is not limited to commissions, fees, receipts from service contracts, or income from similar sources." *See also* 45 IAC 1.1-2-5(a).

Under the regulations governing the gross income tax, "taxable gross income" includes income that is derived from "intangibles." 45 IAC 1-1-51. The term "intangibles" includes:

> notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, "trading stamps," final judgments, leases, royalties, certificates of sale, choses in action *and any and all other evidences of similar rights capable of being transferred, acquired or sold.* (*Emphasis added*). Id. *See also* 45 IAC 1.1-6-2.

In order for Indiana to impose the gross income tax on income derived from taxpayer's intangibles, the Department must determine that the income is derived from a "business situs" within the state. Id. The regulation states that taxpayer has established a "business situs" within the state "[i]f the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana...." Id. Once the taxpayer has established a "business situs" within the state, "and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes." Id.

For purposes of the state's gross income tax, the Department concludes that commission income derived from the taxpayer's sales of investment vehicles, is income derived from a "business situs" within Indiana and is properly subject to the state's gross income tax scheme. Taxpayer provided its investment services in Indiana, the five subsidiaries do not have property or payroll in the foreign states, and neither taxpayer nor its subsidiaries have established a business situs in any of the foreign states.

Accordingly, because taxpayer's business situs is within the state and because the income at issue is "connected with that business, either actually or constructively," the income is subject to the state's gross income tax.

B. Delaware Holding Company.

Taxpayer maintains that one of its subsidiaries is a Delaware holding company and is "different from those previously discussed." Taxpayer states this Delaware holding company "received dividends from its subsidiaries." Taxpayer concludes that the Delaware holding company's "activities in the sale[] and distribution of certain financial intangibles were sufficient to establish nexus in those jurisdictions where the products were sold and to require the apportionment of business to those foreign states."

The audit's description of Delaware holding company's business differs somewhat from that of taxpayer. The audit states that – along with the five subsidiaries described previously – the Delaware holding company earned commission income from the sale of investment vehicles. The audit found that the Delaware holding company did not have payroll or property outside Indiana and that its income "was not directly related to a business situs outside of Indiana...."

Taxpayer has failed to demonstrate that the Delaware holding company's business substantively differs from that of the other five subsidiaries. The burden of demonstrating the proposed assessment is wrong rests with taxpayer. IC 6-8.1-5-1(b). Taxpayer has failed to meet that burden.

FINDING

Taxpayer's protest is respectfully denied.

V. Intercompany Aircraft Rent Payments – Apportionment / Property Factor.

During the audit period, taxpayer included as rented property the value of the aircraft taxpayer leased from one of its subsidiaries. The audit found that because both taxpayer and its subsidiary were in the consolidated return and because all intercompany receipts had been eliminated, the rental amounts should be eliminated when calculating the property factor.

The audit disagreed with taxpayer's calculation of its "property factor." According to the audit, "the taxpayer included in [r]ented property, intercompany aircraft rental from [taxpayer] to [subsidiary]. The audit concluded that because, "these companies are in the consolidated return and all intercompany receipts have been eliminated, these rents should be eliminated in calculating the property factor."

Taxpayer challenges the audit's decision stating that "[c]onfidence can be gained that the [rental] expense is not being double counted in the apportionment factor."

Taxpayer's protest somewhat misses the mark. The issue is not whether the value of the rental payments is being double counted but whether the audit was correct in excluding the value of the rental payments from the property factor.

IC 6-3-2-2(b) provides for a standardized formula for determining the tax liability of a corporation which receives income from sources both within and outside the state. That section states that: "[I]f business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three...." IC 6-3-2-2(c) states that, "The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year and the denominator which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the taxable year."

Taxpayer maintains that the value of the rental payments should be included in the property value calculation. For illustrative purposes, one of the taxpayer's subsidiaries owns a $1,000,000 airplane; the subsidiary's airplane is "rented" to taxpayer. Again for purposes of illustration, taxpayer pays subsidiary $1,000 to rent the airplane during one of the tax years here at issue. In calculating the property factor, taxpayer used the $1,000 to calculate its property factor because – according to taxpayer – the $1,000 represented "real and tangible personal property owed or rented and used in this state during the taxable year...." IC 6-3-2-2(c).

Setting aside the audit's characterization of the rental as "intercompany receipts," the audit was correct in eliminating the value of the rent payments (the $1,000 cited in the example above) from the property factor because the $1,000 is not "income producing property." The $1,000,000 airplane produces business income; the $1,000 rent payment does not. 45 IAC 3.1-1-41 states that, "The property factor includes all property owned or rented by the taxpayer which is actually used or is available for or capable of being used to produce business income."

In addition, the audit was correct in eliminating the rental receipts because the value of the income producing property has – presumably – already been included in the group's consolidated return. There is no obvious justification for including the value of the ($1,000,000) airplane in the property factor and also including the value of the rental received from that same airplane.

FINDING

Taxpayer's protest is respectfully denied.

VI. Addback of Riverboat Wagering Tax – Adjusted Gross Income.

The audit made an adjustment to taxpayer's distributive share of partnership income received from a gambling company. The adjustment added back a deduction made to taxpayer's federal return by adding back a federal deduction for Riverboat Wagering Tax.

Taxpayer states that it "disagrees with the finding that the wagering tax is a tax which is disallowed for computing [Indiana] Adjusted Gross Income."

Indiana adjusted gross income tax is imposed upon the adjusted gross income of a corporation that is derived from Indiana sources. IC 6-3-2-1(b). Indiana adjusted gross income is the same as "taxable income" as defined by I.R.C. § 63 and adjusted according to IC 6-3-1-3.5(b). One of those adjustments requires the taxpayer to "[a]dd an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States." IC 6-3-1-3.5(b)(3). *See also* 45 IAC 3.1-1-8(3)(a).

The Indiana Tax Court has addressed taxpayer's specific argument and has determined that the Riverboat Wagering Tax "is an excise tax that is measured by income." Aztar Ind. Gaming v. Dept. of State Revenue, 806 N.E.2d 381, 386 (Ind. Tax Ct. 2004). The audit was correct in making the addback adjustment because the Riverboat Wagering Tax is "subject to the add-back provision of Indiana Code § 6-3-13.5(b)(3)." Id.

FINDING

Taxpayer's protest is respectfully denied.

VII. Exclusion of Dividend and Interest Income – Gross Income Tax.

In addition to challenging determinations found within the audit, taxpayer seeks a further adjustment for calendar years 1998 and 1999. Taxpayer maintains that dividends, interest, and administrative fees received from a Minnesota company should have been eliminated from taxpayer's consolidated gross income subject to Indiana gross income tax.

Taxpayer bought Minnesota Company at the end of 1998. At the end of 1999, Minnesota Company paid taxpayer a $200,000,000 dividend. This amount was originally included in taxpayer's 1999 gross income. Including this amount increased taxpayer's gross income tax by $2,400,000. In addition, Minnesota Company made interest payments to taxpayer. Interest payments of approximately $1,000,000 were paid during 1998 and 1999. Taxpayer claims that these two amounts should have been eliminated from taxpayer's 1998 and 1999 gross income tax returns. Accordingly, taxpayer seeks a return of the gross income tax paid on the $201,000,000.

Taxpayer states that the "GIT does not include receipts of Indiana corporations from trade or business conducted at a legal situs outside Indiana or from activities incident to that trade or business." Taxpayer concludes that the receipts consisted of dividends and interest received from a company doing business outside Indiana.

As support of its contention, taxpayer points to IC 6-2.1-1-2(c)(6) which states that, "The term 'gross income' does not include... gross receipts received by corporations incorporated under the laws of Indiana from a trade or business situated and regularly carried on at a legal situs outside Indiana or from activities incident to such trade or business (including the disposal of capital assets or other properties which were acquired and used in such trade or business)."

However, "The exclusion provided by clause (6) of subsection (c) does not apply to any receipts of a taxpayer received as interest or dividends, from sales, other receipts from investments not acquired or disposed of in connection with the taxpayer's regular business, or to bonuses or commissions received by any taxpayer." IC 6-2.1-1-2(d).

Therefore, the issue is whether the $201,000,000 consisted of money received from doing business in Minnesota or whether it consisted of interest or dividends attributable to an investment in Minnesota Company.

There is no support for the contention that the $201,000,000 was earned from conducting business within Minnesota. Taxpayer freely admits that the amounts were properly characterized as "interest" and "dividends" received from investing in Minnesota Company.

FINDING

Taxpayer's request for a refund of gross income taxes on the amount of dividends and interest payments received from Minnesota Company is respectfully denied.

VIII. Elimination of Intercompany Transactions Between Members of a Consolidated Gross Income Tax Return – Gross Premium Privilege Tax / Gross Income Tax.

Taxpayer claims that one of its subsidiaries received "administrative fees and interest payments" from life insurance companies which were themselves also taxpayer's subsidiaries. Taxpayer explains that the "vast majority of the [life insurance companies] are either incorporated or registered to do business in Indiana." Taxpayer now requests an adjustment of approximately $1,000,000 for these intercompany transfers.

Pursuant to IC 6-3-2-2.8, life insurance companies are not subject to the state's adjusted gross income tax. Out-of-state life insurance companies pay Indiana Gross Premium Privilege Tax. IC 27-1-18-2(a). In lieu of paying the gross income tax, domestic life insurance companies may elect to pay Indiana Gross Premium Privilege Tax. Id. In order to do so, the domestic insurance company must file a "notice of election." IC 27-1-18-2(b).

Taxpayer's life insurance companies – both domestic and out-of-state – paid Gross Premium Privilege Tax during 1998 and 1999. Taxpayer states that its life insurance companies – at least those which would have otherwise been subject to gross income tax had they elected otherwise – paid administrative fees and interest payments to another of taxpayer's subsidiaries. Taxpayer states that these administrative fees and interest payments should be eliminated as intercompany transactions. *See* 45 IAC 1-1-166; 45 IAC 1.1-4-5(a).

Taxpayer's request for a refund of gross income tax is counter-intuitive and is supported by neither law nor common sense. The life insurance companies were either subject to or elected to pay the Gross Premium Privilege Tax; the life insurance companies were not part of the consolidated gross income tax return. Having paid the Gross Premium Privilege Tax, taxpayer's request – that it now eliminate intercompany transactions pursuant to the entirely unrelated provisions of the Gross Income Tax law – is unwarranted.

FINDING

Taxpayer's request to eliminate on its consolidated gross income tax returns intercompany transactions between itself and the life insurance companies is respectfully denied.

DEPARTMENT OF STATE REVENUE

02-20030112.LOF

LETTER OF FINDINGS NUMBER: 03-0112
Gross Income & Adjusted Gross Income Tax
For the 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. Adjusted Gross Income Tax— Intangible Holding Companies

Authority: Ind. Code § 6-3-2-2; Ind. Code § 6-8.1-5-1; *Bethlehem Steel Corp. v. Ind. Dept. of State Revenue*, 597 N.E.2d 1327 (Ind. Tax 1992); *aff'd* 639 N.E.2d 264 (Ind. 1994); *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Lee v. Comm'r*, 155 F.2d 584 (2d Cir. 1998); *Horn v. Comm'r*, 968 F.2d 1229 (D.C. Cir. 1992); *Comm'r v. Transp. Trading and Terminal Corp.*, 176 F.2d 570 (2nd Cir. 1949); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993).

Taxpayer maintains that the Department erred when it recomputed taxpayer's adjusted gross income to include one subsidiary on a consolidated basis.

II. Adjusted Gross Income Tax-Net Operating Losses

Authority: *Hi-Way Dispatch, Inc. v. Indiana Dep't. of State Revenue*, 756 N.E.2d 587 (Ind. Tax 2001); *Phoenix Coal Co. v. Comm'r*, 231 F.2d 420 (2d Cir. 1956); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993).

Taxpayer protests the disallowance of net operating loss carryforwards for Taxpayer based on combination of Taxpayer's returns with a subsidiary.

III. Gross Income Tax—Small Business Companies

Authority: Ind. Code § 6-2.1-2-2; Ind. Code § 6-2.1-3-24.5; I.R.C. § 1361; I.R.C. § 1362; *Ind. Dep't of State Revenue v. 1 Stop Auto Sales, Inc.* 810 N.E.2d 686 (Ind. 2004).

Taxpayer protests the imposition of gross income tax with respect to two subsidiaries based on their claimed status as small business companies.

IV. Gross Income Tax—Taxability of Intangibles

Authority: 45 IAC 1-1-51; 45 IAC 1.1-6-2; *Geoffrey, Inc. v. S.C. Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

Taxpayer protests the imposition of gross income tax with respect to amounts paid to a subsidiary for the use of its patents and other intellectual property.

V. Gross Income Tax-Leasing Income

Authority: Ind. Code § 6-2.1-1-9; Ind. Code 6-2.1-3-3; *Enterprise Leasing Co. v. Ind. Dep't of State Revenue*, 779 N.E.2d 1284 (Ind. Tax 2002); *First Nat'l Leasing & Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax 1992).

Taxpayer protests the imposition of gross income tax with respect to lease payments for property leased to Indiana customers.

VI. Adjusted Gross Income Tax-Property Factor

Authority: Ind. Code § 6-3-2-2; *Enterprise Leasing Co. v. Indiana Dep't. of State Revenue*, 779 N.E.2d 1284 (Ind. Tax 2002); *Twentieth Century Fox Film Corp. v. Dep't of Revenue*, 700 P.2d 1035, 1037 (Or. 1985).

Taxpayer protests the inclusion of leased property located in Indiana in the numerator of its property factor for adjusted gross income tax purposes.

VII. Tax Administration--Penalty

Authority: Ind. Code § 6-8.1-10-2.1; 45 IAC 15-11-2.

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

STATEMENT OF FACTS

Taxpayer is an out-of state company in the business of manufacturing and selling forklifts and similar equipment throughout the country. During the years in question, Taxpayer also had three wholly-owned subsidiaries. One of the subsidiaries was engaged in the leasing of Taxpayer's equipment ("Leasing Subsidiary"). A second subsidiary managed Taxpayer's trademarks and patents ("Intangible Subsidiary"). A third subsidiary located in North Carolina was engaged in the manufacture of Taxpayer's products ("NC Subsidiary"). Taxpayer has operated an Indiana sales office for several years and more recently began operations at an Indiana manufacturing facility.

During the years in question, Taxpayer was a small business company within the meaning of Indiana gross income tax laws. However, Taxpayer did not elect S Corporation status for federal income tax purposes.

Taxpayer and Leasing Subsidiary filed consolidated gross income and adjusted gross income tax returns for the years in question. Subsequently, Taxpayer was audited by the Department. The auditor determined that Intangible Subsidiary had nexus with Indiana. As a result, the Department assessed gross income tax against Intangible Subsidiary with respect to its royalty payments. Taxpayer has protested this assessment, arguing that Intangible Subsidiary did not have nexus with Indiana. In the alternative, Taxpayer argues that Intangible Subsidiary's income was not from Indiana sources, and that Intangible Subsidiary was a "small business company" for gross income tax purposes.

Leasing Subsidiary was also assessed gross income tax with respect to its operations. Taxpayer argues that Leasing Subsidiary's leasing income was not subject to gross income tax based on the fact that it was not derived from Indiana sources. In the alternative, Taxpayer argues that Leasing Subsidiary's income was subject to treatment as a "qualified lessor", and that Leasing Subsidiary was a "small business company."

In addition, the Department required the consolidation of Intangible Subsidiary with the other businesses that had previously filed Indiana returns. Taxpayer argues that, since Intangible Subsidiary did not have Indiana nexus, such combination was prohibited. Further, Taxpayer's net operating loss carryforwards from prior periods were disallowed. Taxpayer argues that the Department is estopped from such disallowance. Finally, the Department assessed penalties with respect to the assessment, which Taxpayer has protested.

I. Adjusted Gross Income Tax—Intangible Holding Companies

DISCUSSION

A. Sham transaction

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to *Gregory v. Helvering* 293 U.S. 465 (1935). In that case, the 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. *Id.* at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Id* at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." *Comm'r v. Transp. Trading and Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949). "Transactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. *Horn v. Comm'r*, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, ex ante, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" *Id*. at 1237.

The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. *Lee v. Comm'r*, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. Ind. Code § 6-8.1-5-1(b).

Here, Taxpayer entered into an arrangement that bears almost no relationship to business reality. In order to give Taxpayer's and Intangible Subsidiary's arrangement any credence, several items must be accepted. First, Taxpayer was willing to stay in business despite losing tens of millions of dollars each year. Second, Taxpayer was willing to enter into and stay in an arrangement with a subsidiary wherein the payments made to Intangible Subsidiary were greater than Taxpayer's operating profits. Third, Intangible Subsidiary was able to generate over $30,000,000 per year from royalties from one corporation (Taxpayer), with a total salary expense for three years that totaled little more than a minimum wage salary for a full-time employee for *one year*, and other non-tax expenses (including, presumably, rent, utilities, and other similar expenses) that totaled just over $1,200 for the three year period in controversy. Fourth, the intellectual property that Intangible Subsidiary held had value independent of Taxpayer's sales of property. Fifth, the arrangement between Taxpayer and Intangible Subsidiary had no reason to exist after March, 2000, when Intangible Subsidiary was dissolved, but had plenty of reasons to exist prior to March, 2000. The Department is not inclined to accept the validity of this arrangement for tax purposes.

Taxpayer is, of course, entitled to structure its business affairs in any manner its sees fit and to vigorously pursue any tax advantage attendant upon the management of those affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." *Bethlehem Steel Corp. v. Ind. Dept. of State Revenue*, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992), *aff'd* 639 N.E.2d 264 (Ind. 1994).. The transfer of the intellectual property and the royalty payments were purely matters of "form" and lack any business "substance."

B. Intangible Subsidiary has Indiana situs

Even if the transaction could not be considered a sham, Intangible Subsidiary's income was Indiana source income when it engaged in transactions related to "exploiting" intellectual property.

Here, the case *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), though not controlling, is quite persuasive. In that case, a large toy company established a holding company to which it transferred its trademarks. The toy company paid a percentage of its sales to the holding company. The holding company was located in Delaware, but had no employees. *Id.* at 15, n.1. The toy company claimed a deduction for its royalty payments to the holding company for South Carolina corporate income tax purposes, but claimed that none of the royalty payments were South Carolina source income. South Carolina claimed that the holding company had conducted business in South Carolina, while the holding company claimed that taxation of its royalty income by South Carolina was prohibited by the federal constitution pursuant to *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992). The court noted that the holding company did business in South Carolina, via the purposeful opening of stores in South Carolina and the toy company's sales of merchandise at its South Carolina stores, through which the holding company derived its revenues. *Id.* at 16-18. Accordingly, the court held that the taxation of the holding company's income was permissible under the United States Constitution and South Carolina law. The Court also distinguished *Quill* by noting the holding company's purposeful activities into South Carolina via sales of merchandise at stores in South Carolina, and by noting that the tax imposed on the holding company was rationally related to the benefits conferred upon the holding company. *Id.*

Intangible Subsidiary was engaged in the business of "managing" intellectual property-property that has no value apart from Taxpayer's sales of equipment. To state that the intangible income derived from the licensing transactions only took place in Nevada, with a mere $3,000-$4,000 of salary expense and $300-$500 of expenses other than taxes, did not fairly represent the transaction between Taxpayer and Intangible Subsidiary. Taxpayer manufactured and sold equipment for a business, in this state and several other states, and a few foreign countries. Taxpayer derived the benefit of sales made in Indiana of its equipment. To state that the royalty income was income derived only from Nevada was to very conveniently ignore that the manufacturing, sales and service that made the taxpayer a well-respected national company occurred in many states other than Nevada, and that Intangible Subsidiary's own revenues for the royalties necessarily derived from the manufacturing and sales that transpired in this state, as well as many other states and countries, rather than just Nevada. Intangible Subsidiary has entered into Indiana, and the tax rationally relates to its activities in Indiana, and accordingly it is proper to include Intangible Subsidiary on a consolidated return. Finally, Taxpayer and Intangible Subsidiary were a unitary business, and accordingly combination was proper under Ind. Code § 6-3-2-2(l) and (p).

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax-Net Operating Losses

DISCUSSION

Taxpayer also protests the disallowance of net operating losses incurred by Taxpayer during prior years. In particular, Taxpayer has noted that the Department allowed the carrybacks and carryforwards of net operating losses from 1992 to 1997, the period for which Taxpayer had been previously audited.

While Indiana statutes and case law have not dealt with this particular situation, federal law governing net operating losses have dealt with this situation. In *Phoenix Coal Co. v. Comm'r*, 231 F.2d 420 (2d Cir. 1956), a corporation incurred a net operating loss in 1947. The corporation carried back its net operating losses to eliminate its 1945 income and reduce its 1946 income. The corporation incurred a further net operating loss in 1948, which served to eliminate its 1946 income.

The Commissioner reviewed the corporation's returns. Upon review of the corporation's returns, the Commissioner determined that the corporation had underreported its 1945 income. Accordingly, the Commissioner redetermined the amount of net operating losses that could be carried forward to 1946, and assessed additional tax for that year. At the time of the assessment, the statute of limitations for imposition of additional tax for 1945 had passed, though not for 1946. The court held that, though taxes for 1945 could not be assessed due to the passing of the statute of limitations, the income for 1945 could be redetermined to compute the proper amount of net operating losses allowable for 1946. *Id.* at 421-422.

Here, Taxpayer's contentions with respect to the net operating loss carryforwards cannot be accepted. The Department has sought to revisit the determinations of the proper amount of net operating losses, along with carryforwards and carrybacks, for the prior audit period and any previous years solely for purposes of determining the proper amount of income subject to tax for 1998 to 2000, just as the Commissioner in *Phoenix Coal* recomputed the corporation's income for 1945 to determine the proper income for 1946. This does not permit assessment any year prior to 1998, just as the Commissioner's redetermination for 1945 did not permit assessment for that year. Thus, the Department was correct in reviewing and redetermining the net operating loss carryforwards available for the years in question.

Taxpayer further argues that the Department is estopped from disallowing the net operating loss carryforwards from previous years that had been previously approved by a Department auditor. The elements of an estoppel defense are: (1) a representation or concealment of material fact; (2) made by a person with knowledge of the fact and with the intention that the other party act upon it; (3) to a party ignorant of the fact; (4) which induces the other party to rely or act upon it to his detriment. *Hi-Way Dispatch, Inc. v. Indiana Dep't. of State Revenue*, 756 N.E.2d 587, 598 (Ind. Tax 2001) (*citing Salin Bancshares, Inc. v. Indiana Dep't of Revenue,* 744 N.E.2d 588, 592 (Ind. Tax 2000)).

Here, the Department apparently allowed a net operating loss. However, Taxpayer did not present any information that would have permitted the Department to review the facts and circumstances of the previous audit, such as the agreement between Intangible Subsidiary and Taxpayer (indeed, it appears that the audit did not even mention Intangible Subsidiary). The Department did not intend Taxpayer to rely on that allowance to affect its normal business behavior, nor did Taxpayer rely on that allowance in its business structure or behavior in the years. Accordingly, the Department is not estopped from disallowing the net operating losses for the period from 1998 to 2000.

Taxpayer also argues that the net operating losses should be permitted prior to the 1997 (Taxpayer's words) decision in *Geoffrey*. However, the decision was decided in 1993. Further, while the application of the decision to the particular fact situation may have been a first, the *Geoffrey* decision cited case law from states back to 1979, *Geoffrey,* 437 S.E.2d at 16 *(citing American Dairy Queen Corp. v. Taxation and Revenue Dep't,* 605 P.2d 251 (N.M. Ct. App. 1979)*; Aamco Transmissions, Inc. v. Taxation and Revenue Dep't*, 600 P.2d 841 (N.M. Ct. App. 1979)), and Supreme Court jurisprudence back to as early as 1920, *Id* at 17, for the proposition that intangibles can be taxed outside a corporation's commercial domicile. As such, Taxpayer has misstated the date of a court opinion, while ignoring the background cases that led to the court decision, in order to attempt to force the Department to accept an artifice of Taxpayer's own creation.

FINDING

Taxpayer's protest is denied.

III. Gross Income Tax-Small Business Companies

DISCUSSION

As a general rule, non-resident corporate taxpayers are subject to gross income tax on their gross receipts derived from businesses and activities conducted in Indiana. Ind. Code § 6-2.1-2-2(a)(2). However, under Ind. Code § 6-2.1-3-24.5(b), a corporation which qualifies as a small business corporation is exempt from gross income tax. For gross income tax purposes, a small business corporation is defined as having the same definition that term has in I.R.C. § 1361(b). Ind. Code § 6-2.1-3-24.5(a). As a general rule, exemption statutes are to be strictly construed against the person claiming the exemption. *Ind. Dep't of State Revenue v. 1 Stop Auto Sales, Inc.* 810 N.E.2d 686 (Ind. 2004) (*citing General Motors Corp. v. Ind. Dep't of State Revenue*, 578 N.E.2d 399, 404 (Ind. Tax 1991), *aff'd* 599 N.E.2d 588 (Ind. 1992)).

Taxpayer qualified as a small business corporation within the statutory definition of I.R.C. § 1361(b)(1). However, Taxpayer was not an S-Corporation due to the fact that it had not elected such status under I.R.C. § 1362(a).

Intangible Subsidiary and Leasing Subsidiary were not small business corporations due to the fact that they have a corporate shareholder, which renders them ineligible for small business corporation status under I.R.C. § 1361(b)(1)(B), which limits the scope of permissible shareholders to various persons or entities, but generally does not permit ownership by another for-profit corporation.

Taxpayer maintains that, because the Taxpayer is eligible for S-Corporation treatment within I.R.C. § 1361(b), Intangible Subsidiary and Leasing Subsidiary were eligible by virtue of I.R.C. § 1361(b)(3), which provides that domestic corporations wholly owned by an S-Corporation are disregarded as separate entities, and treated as part of the parent S-Corporation for tax purposes. However, at the very least, such status requires the parent corporation elect to be treated as an S-Corporation, which Taxpayer did not do in this case. Thus, Intangible Subsidiary and Leasing Subsidiary were not small business corporations within the meaning of Ind. Code § 6-2.1-3-24.5(b), and the exemption is not applicable.

FINDING

Taxpayer's protest is denied.

IV. Gross Income Tax— Taxability of Intangibles

DISCUSSION

Taxpayer protests the imposition of gross income tax with respect to its royalty payments made to Intangible Subsidiary located in Nevada.

In this case, two issues must be resolved:

1. Did Intangible Subsidiary have an Indiana situs for its intangibles?
2. Is the whole transaction a sham transaction?

With respect to situs, Taxpayer argues that the intangibles formed an integral part of a trade or business situated and regularly conducted outside Indiana, noting the location of Intangible Subsidiary in Nevada. According to Taxpayer, under Department regulations, the intangible income for Intangible Subsidiary should be attributed to that location.

However, it cannot be said that this is an entirely accurate assessment of Taxpayer's arrangement. Taxpayer's arrangement basically works in this manner: Taxpayer makes a sale of equipment to retailers or customers. Taxpayer in turn took the money and paid to Intangible Subsidiary a percentage of that money for the "right" to use Taxpayer's own name. By virtue of its control of Taxpayer's name and its exploitation in Indiana, Intangible Subsidiary acquired an Indiana situs.

Taxpayer argues that the auditor's reliance on the *Geoffrey* case cited previously is misplaced, first by noting that the case was decided in another state, and second by noting the regulations stated above. While *Geoffrey* is persuasive rather than mandatory authority in Indiana, the reasoning that the intellectual property has an Indiana situs in this circumstance is worthy of discussion. In the current case, Intangible Subsidiary only derived income upon the sale of goods. This is very similar to the intangible holding company in *Geoffrey,* which the court noted derived its income not from the mere holding of a piece of paper, but rather from retail transactions that the retailer purposely sought. Further, unlike a conventional franchise arrangement in which a holder of a name agrees to allow unrelated third parties to use its name, Intangible Subsidiary only transacted with Taxpayer. To the extent that Intangible Subsidiary yielded its "royalties" as a result of Indiana sales, the intangible formed an integral part of a business regularly carried on in Indiana; thus, the intangibles had a business situs in Indiana, and accordingly were properly subject to Indiana gross income tax. 45 IAC 1-1-51 (repealed effective January 1, 1999); 45 IAC 1.1-6-2 (effective January 1, 1999). Further, given that no exemption or deduction exists for gross income received in a sham transaction, then the income was still taxable, notwithstanding the disregard for the transaction otherwise for tax purposes.

Taxpayer further protests the imposition of gross income tax with respect to royalties derived from sales to third parties into Indiana and from sales by NC Subsidiary into Indiana. However, Taxpayer, with the relevant information in its hands that would permit it to state its income from sales and income from royalties from Indiana sales, in interstate commerce or otherwise, as opposed to any other source, failed to do so. Accordingly, the Department's assessment has not been shown to be incorrect.

FINDING

Taxpayer's protest is denied.

V. Gross Income Tax-Leasing

DISCUSSION

Leasing Subsidiary argues that the gross income from Leasing Subsidiary's leasing activities is not subject to gross income tax. In particular, Leasing Subsidiary argues that its leasing transactions took place outside Indiana, and accordingly its income is exempt as being in interstate commerce. Ind. Code § 6-2.1-3-3. In particular, Leasing Subsidiary argues that the cases of *Enterprise Leasing Co. v. Ind. Dep't of State Revenue*, 779 N.E.2d 1284 (Ind. Tax 2002) and *First Na'l Leasing & Financial Corp. v. Ind. Dept of State Revenue*, 598 N.E.2d 640 (Ind. Tax 1992) are analogous to Leasing Subsidiary's situation.

Leasing Subsidiary's arrangement differs from the leasing arrangements exempted from taxation in *Enterprise Leasing* and *First National* in one crucial respect. Unlike the lessors in those cases, who could not control where the leased property was transported, *Enterprise Leasing*, 779 N.E.2d at 1290-1293; *First Nat'l Leasing & Financia*, 598 N.E.2d at 643-645, a lessee in Leasing Subsidiary's arrangement could not remove the property from the location designated by the lessee without Leasing Subsidiary's consent. As such, Leasing Subsidiary exerts control of the property in Indiana sufficient to permit taxation of its gross income derived from leasing its equipment to customers in Indiana.

In the alternative, Leasing Subsidiary argues that it is subject to tax treatment as a qualified lessor under Ind. Code § 6-2.1-1-9(a)(2). Under that provision, a taxpayer that:

(A) Acquires title to tangible personal property solely for the purpose of leasing it to others;

(B) Has no other purpose of ownership in the property; and

(C) Leases the property to another under a lease agreement which has a term of at least five (5) years and which requires the lessee to make rental payments, over the term of the lease, equal to the sum of: (i) the cost of the property, plus (ii) finance charges.

is considered a qualified lessor. Accordingly, under Ind. Code § 6-2.1-1-9(b), a qualified lessor is only subject to gross income tax on "the excess of the total rental payments received under a lease described in subsection (a) over the cost of the tangible personal property so leased."

However, Ind. Code § 6-2.1-1-9(e) states:

A taxpayer that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, an individual or other organization that manufactures, or is engaged in the business of selling, as a distributor or at wholesale or retail or otherwise, property covered by any lease agreement described in subsection (a), is not a qualified lessor.

Here, Taxpayer and Leasing Subsidiary are parent and subsidiary; therefore, Leasing Subsidiary is controlled by Taxpayer. Taxpayer manufactures and sells the equipment that Leasing Subsidiary leases. Accordingly, Leasing Subsidiary does not qualify for treatment as a qualified lessor.

FINDING

Taxpayer's protest is denied.

VI. Adjusted Gross Income Tax-Property factors

DISCUSSION

Taxpayer further protests the inclusion of the value of Leasing Subsidiary's leased property in Taxpayer's property numerator. Taxpayer argues that, under the Tax Court's holding in *Enterprise Leasing*, Taxpayer is required to own *and* use the property in question in order for the property to be included in its property numerator for adjusted gross income tax purposes.

Under Ind. Code § 6-3-2-2(c),

> [t]he property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the taxable year. However, with respect to a foreign corporation, the denominator does not include the average value of real or tangible personal property owned or rented and used in a place that is outside the United States. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight (8) times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals. The average of property shall be determined by averaging the values at the beginning and ending of the taxable year, but the department may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the taxpayer's property.

First, a review of the audit report with respect to Taxpayer shows minimal changes to Taxpayer's property factors, which leads to the assumption that Taxpayer believed that the leased property was owned and used by it in Indiana.

Second, if the Department accepts Taxpayer's argument, it leads to a potentially absurd result. Taxpayer is based outside Indiana. It leases its property to Indiana customers. The property in question is owned by Taxpayer. However, Taxpayer does not use the property anywhere. The acceptance of Taxpayer's argument leads to leased property being in no state's numerator and every state's denominator— a disturbing violation of the overarching policy of the Uniform Division of Income for Tax Purposes Act (UDITPA). *See Twentieth Century Fox Film Corp. v. Dep't of Revenue*, 700 P.2d 1035, 1037 (Or. 1985). (The basic purpose of UDITPA is to tax exactly 100% of a corporations' income) While Indiana has not explicitly adopted UDITPA, Indiana's statutes closely track UDITPA.

Taxpayer clearly owns the leased property. The leased property is in Indiana. To prevent the absurd result that Taxpayer asks us to reach, an either-or approach-"owned", or "rented and used" with respect to the "owned or rented and used in this state" is the only logical construction that can result in Taxpayer's situation. Accordingly, the property should be included in Taxpayer's numerator.

Further, even accepting Taxpayer's argument, under Leasing Subsidiary's arrangement, a lessee in Leasing Subsidiary's arrangement could not remove the property from the location designated by the lessee without Leasing Subsidiary's consent. As such, Leasing Subsidiary has a degree of control over the property— uses the property, though it is in the hands of a third party— within Indiana within the meaning of Ind. Code § 6-3-2-2(c).

Finally, even if Taxpayer's argument is to be accepted with respect to the numerator, Leasing Subsidiary's leased property is not owned *and* used by it anywhere, and accordingly is not part of the equal and opposite statutory inclusion in the denominator as provided by statute. Accordingly, if Taxpayer's argument with respect to the numerator is accepted, the property must also be removed from Taxpayer's denominator.

FINDING

Taxpayer's protest is denied.

VII. Tax Administration--Penalty

DISCUSSION

Taxpayer argues that it is not subject to negligence penalties with respect to the additional taxes assessed against it. In particular, Taxpayer argues that the additional tax was due to its different, but reasonable, interpretation of the statute. Accordingly, it argues that it was not negligent in its tax returns for the years in question.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
>
> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed

under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.
45 IAC 15-11-2.

Taxpayer has acted in a manner with respect to the tax laws of this state that leads the Department to believe that its actions were a negligent disregard of those laws at best. Accordingly, the penalty must stand.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220030213.LOF

LETTER OF FINDINGS NUMBER: 03-0213
Gross Income Tax
For the Years 1998, 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. Gross Income Tax—Small Business Exemption

Authority: IC 6-8.1-5-1(b); IC 6-2.1-2-2; IC 6-2.1-3-24.5; IRC § 1361.

Taxpayer protest the imposition of gross income tax upon Taxpayer's subsidiaries.

II. Gross Income Tax—Proceeds from Real Estate Property Sale

Authority: IC 6-2.1-1-2(c)(1); IC 6-2.1-3-16; IC 14-34-1-3; IC 14-34-3-1; IC 14-34-3-12; IC 14-34-6-1; IC 14-34-6-13; IC 6-2.1-1-2(b); 45 IAC 1.1-2-19(b); Department of Revenue v. 1 Stop Auto Sales, Inc., 810 N.E.2d 686 (Ind. 2004); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899)

Taxpayer protests the disallowance by the Department of a reduction of gross income tax to reflect mortgage and reclamation liabilities.

III. Gross Income Tax—Receipts from sales in brokerage or agency agreements

Authority: Department of the Treasury v. Ice Service, Inc., 41 N.E.2d 201 (Ind. 1942); (Ind. Tax 2002); Policy Mgmt. Sys. Corp. v. Department of State Revenue, 720 N.E.2d 20 (Ind. Tax 1999).

Taxpayer protests the assessment of gross income tax on the entire amount paid to it for the sale of coal—instead of gross income tax assessed only on the markup paid to it.

IV. Tax Administration—Penalty

Authority: IC 6-8.1-10-2.1(a)(3); IC 6-8.1-10-2.1(b); 45 IAC 15-11-2(b) and (c).

Taxpayer protests the imposition of a 10% negligence penalty.

STATEMENT OF FACTS

Taxpayer includes a parent holding company and two subsidiaries. The subsidiary filed on a consolidated basis with Parent. The Department conducted an audit of Taxpayer's Indiana operations. Proposed assessments of additional gross income tax, interest, and penalties were issued.

I. Gross Income Tax—Small Business Exemption

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 6-2.1-2-2 [repealed effective January 1, 2003] imposed a gross income tax on the receipt of the entire taxable gross income of a resident or domiciled Indiana taxpayer. However, under IC 6-2.1-3-24.5(b), a corporation which qualifies as a small business corporation was exempt from Gross Income Tax. IC 6-2.1-3-24.5(a) stated that for Gross Income Tax purposes, a small business corporation has the same definition as given in I.R.C. § 1361(b).

Taxpayer Parent qualified as a small business corporation within the statutory definition of I.R.C. § 1361(b)(1). However, Taxpayer Parent was not an S-corporation because Taxpayer Parent terminated its Subchapter S election effective January 1, 1998 and became a C-corporation.

The Taxpayer Subsidiaries were not small business corporations due because Taxpayer Subsidiaries had a C-corporation shareholder, Taxpayer Parent. IRC § 1361(b)(1)(B). This rendered the Taxpayer Subsidiaries ineligible for I.R.C. § 1361(b) small business corporation status.

Taxpayer Parent maintains that because it was eligible for S-corporation treatment within I.R.C. § 1361(b), Taxpayer Subsidiaries were eligible for S-corporation treatment by virtue of I.R.C. 1361(b)(3)—which provides that domestic corporations wholly owned by an S-corporation are disregarded as a separate entity and are treated as part of the parent S-corporation for tax purposes. Such status required Taxpayer Parent to elect to be treated as an S-corporation—which Taxpayer Parent terminated effective January 1, 1998. The effect of this is: (1) Taxpayer Subsidiaries were not small business corporations within the meaning of the statute; (2) Gross income tax may be assessed.

FINDING

For the reasons discussed above, the Department denied Taxpayer's protest.

II. Gross Income Tax—Proceeds from Real Estate Property Sale

DISCUSSION

Taxpayer sold one of its coal mines. Receipts from the sale were used to pay off collateralized lines of credit. In addition, the purchaser of the mine assumed the reclamation liability.

IC 6-2.1-3-16 stated that amounts received from sales of real estate are exempt from gross income tax to the extent a mortgage or similar encumbrance exists on the real estate at the time of its sale. 45 IAC 1.1-2-19(b) stated:

(b) The amount of any receipts that represent a mortgage or similar encumbrance, but not any interest due thereon, that exists on real estate at the time of its sale is exempt from the gross income tax under the following circumstances:

(1) The mortgage is paid off as a result of the sale.

(2) The mortgage is assumed by the purchaser.

(3) The property is transferred subject to the mortgage.

…

Here the amount that Taxpayer received was used to pay off a debt secured not only by real estate, but also by items of tangible personal property and by other executed instruments. Given IC 6-2.1-3-16 is an exemption statute strictly construed against Taxpayer, the amounts in question first must be construed as paying off items other than the real estate, then the real estate. Taxpayer has not provided sufficient documentation to establish that the payoff was greater than the value of the tangible personal property and other instruments the Taxpayer provided as security; and accordingly is denied with respect to this issue.

The property was transferred subject to the reclamation liability. The Indiana General Assembly has promulgated in IC 14-34 statutes regulating surface coal mining and reclamation. The statutes extend the requirements of the federal Surface Mining Control and Reclamation Act of 1977. *See* IC 14-34-1-3. Surface mining of coal is permitted only if a valid reclamation permit is secured. *See* IC 14-34-3-1. IC 14-34-3-12 requires that a reclamation plan be developed and submitted with the reclamation permit. IC 14-34-6-1 requires that a bond for performance be posted with the state; additional bonds are to be filed to cover additional reclamation costs due to continued mining. The reclamation bond is released upon the successful completion of reclamation. IC 14-34-6-13. The effect of these statutes is to ensure that the reclamation of the land is performed. The bond provides insurance—if the mining company does not reclaim the land, the bond will provide the necessary funds to reclaim the land.

Those who mine coal are required to rehabilitate the land after enjoying the mineral interest. Reclamation is a cost of doing business. IC 6-2.1-1-2(b) stated, that in general, no deduction from a taxpayer's gross income may be taken for return of capital invested, cost of property sold, cost of materials used, labor costs, interest, discounts, commissions paid or credited, losses, or any other expense paid or credited. The Indiana Supreme Court has stated that "ambiguous exemption statutes are to be strictly construed against the taxpayer." Department of Revenue v. 1 Stop Auto Sales, Inc., 810 N.E.2d 686, 689 (Ind. 2004). The Indiana Supreme Court also has 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). Reclamation is a requirement of law and no statute allows an exemption of those costs from inclusion as taxable gross income.

FINDING

For the reason discussed above, the Department denies Taxpayer's protest.

III. Gross Income Tax—Receipts from sales in brokerage or agency agreements

DISCUSSION

Upon the sale of the mine, Taxpayer entered into an agreement with the purchaser to supply coal to two of Taxpayer's customers. These customers had entered into long-term coal supply agreements with Taxpayer when it owned the mine. Taxpayer invoiced the customer for the coal supplied by Producer. The customer remitted its payment to Taxpayer, who then paid Producer for the coal. Taxpayer kept an amount of the payment for itself.

The Indiana Supreme Court in Department of the Treasury v. Ice Service, Inc., 41 N.E.2d 201 (Ind. 1942) examined an agency relationship as it relates to gross income tax. The court stated that the question of whether an agency relationship exists is ordinarily a question of fact, which may be established by direct or circumstantial evidence. *Id*. at 203. The creation of the agency relationship will depend upon the intention of the parties. *Id*. The court in Ice Service used a flexible interpretation of agency relationship to encompass the parties' business agreement. Taxpayers are not subject to gross income tax on income they receive in an agency capacity. *See* Policy Mgmt. Sys. Corp. v. Department of State Revenue, 720 N.E.2d 20, 23 (Ind. Tax 1999). Before a taxpayer may deduct income received in an agency capacity, two requirements must be met:

(1) the taxpayer must be a true agent, and

(2) the agent must have no right, title, or interest in the money or property received or transferred as an agent.

Id. A taxpayer is not subject to gross income tax on receipts received on behalf of a third person. *Id*.

In this case, the agreement signed between Taxpayer (Seller) and Producer states that title and risk of loss passes from Producer to Seller (Taxpayer), FOB Mines. Given that the coal is shipped directly to customers, the intent of the parties needs to be determined. In Ice Services, the court stated that it will ignore apparently inconsistent language and look to the real nature of the agreement between the parties: (*i.e.* what is the real purpose of the agreement and from the nature of the transaction, what must be in the minds of the parties). At the hearing, Taxpayer could not explain why the coal selling agreement stated that Taxpayer takes title to the coal. The Department confirmed that Taxpayer and Producer are true third-parties and is satisfied that the coal selling agreement is an arms-length transaction because there were no common business owners between Taxpayer and Producer.

The second requirement of agency named in Policy Mgmt. Sys. Corp. states that the agent must have no title in the property transferred as an agent. The coal selling agreement stated that title passes to Taxpayer. Taxpayer stated at the hearing that it earned a commission of only $0.50 per ton. The Department noted this and investigated the agreements between Taxpayer and Producer and the agreements between Taxpayer and customers. While the use of the term agent need not be stated for an agency relationship to exist, other evidence of the relationship will prove agency. But no such evidence has been found.

The audit report stated that when Taxpayer sold the mine to Producer under the pre-existing contracts, Taxpayer was still obligated to provide coal to certain customers in 1999 and 2000. Taxpayer stated it began brokering coal from Producer to meet those contractual obligations.

A reading of the original contracts between Taxpayer and its customers stated that the coal to be supplied is to be provided from a specific mine. The contracts indicated that the owner of the mine is not the seller of the coal. In those contracts, the owner of the mine is named as Taxpayer's Subsidiary 1 and the seller of the coal is named as Taxpayer's Subsidiary 2. So, in effect, while the revenues ended up in the pocket of Taxpayer (the parent holding company) the mine was owned by one subsidiary and the coal was sold by another subsidiary. When the mine was sold, it did not change the fact that Subsidiary 2 (the sales subsidiary) was still obligated to make good on the agreements, despite the fact that Subsidiary 1 (the owner subsidiary) no longer controlled and operated the mine.

When the mine was sold, the contracts to supply the customers could have undergone novation—substituting Producer for Taxpayer. But this did not occur. Taxpayer's Subsidiary 2 remained obligated to see that coal was supplied to the customers. This explains why the contract between Taxpayer and Producer stated that title passes to Taxpayer. The whole effect of the arrangement is that Taxpayer continued to supply coal to the customers. Taxpayer and Producer made an agreement which allowed Taxpayer to continue to receive coal supplies to sell to the customers. Taxpayer did not receive commissions for brokering; Taxpayer received coal supplies from Producer and their agreement fixed the markup margins. Taxpayer was not acting as an agent for Producer; Taxpayer was continuing the business of Subsidiary 2 despite the fact that Subsidiary 1 no longer had a mine to supply coal.

FINDING

For the reasons stated above, the Department denies Taxpayer's protest.

IV. Tax Administration—Penalty

DISCUSSION

When the Department issued the assessments, it imposed a 10% negligence penalty. Taxpayer protested the imposition of the penalty. IC 6-8.1-10-2.1(a)(3) states that if a person is examined by the Department and incurs a deficiency that is due to negligence, the person is subject to a penalty. In general, the penalty is 10%. *See* IC 6-8.1-10-2.1(b). 45 IAC 15-11-2(b), states:

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

Under 45 IAC 15-11-2(b), Taxpayer incurred a deficiency which the Department determined was due to negligence and will be subject to a penalty under IC 6-8.1-10-2.1(a). In its protest letter, Taxpayer requested a waiver of penalties—but provided no documentation to establish reasonable cause. Taxpayer supplied no affirmative explanation to the Department in its letter. At the hearing, Taxpayer provided no affirmative explanation to establish reasonable cause. Since, Taxpayer has not affirmatively established that its failure to pay the deficiency was attributed to reasonable cause and not negligence, as required by 45 IAC 15-11-2(c), the Department will impose the 10% negligence penalty.

FINDING

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

DEPARTMENT OF STATE REVENUE

02-20030317.LOF

LETTER OF FINDINGS NUMBER: 03-0317
Individual Income Tax
For the Years 1997-2001

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

ISSUES

I. Tax Administration - Best information available

Authority: Ind. Code § 6-3-1-3.5; Ind. Code § 6-8.1-5-1; Ind. Code § 6-8.1-5-2; Ind. Code § 6-8.1-5-4.

Taxpayer protests the assessment of adjusted gross income tax, based on the Department's determination of its gross receipts.

II. Tax Administration - Penalty

Authority: Ind. Code § 6-8.1-10-2.1; 45 IAC 15-11-2(b).

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

STATEMENT OF FACTS

Taxpayers are a married couple whose primary source of income is derived from sales of rental booths and food sales during festivals held during holidays. During the years in question, Taxpayers filed federal and state income tax returns. As a result of Department audit, Taxpayers' gross sales were increased substantially, with an allowance made for expenses associated with food sales. Taxpayer protested the assessment, both for the amount and the timeliness of the assessment.

I. Tax Administration-Best information available

DISCUSSION

Taxpayers argue that the assessment of additional income was too high. In addition, Taxpayers note that they filed federal income tax returns for the years in question, and their state income tax returns matched their federal income tax returns. While federal adjusted gross income is the starting point for determining an individual's Indiana income tax liability per Ind. Code § 6-3-1-3.5(a), the Department's audit is presumed to be correct. Ind. Code 6-8.1-5-1(b).

Under Ind. Code § 6-8.1-5-4, a taxpayer is required to keep records including "all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks." Here, Taxpayer has submitted handwritten records for the past several years. While these records provide a modicum of effort with respect to record keeping, a third-party record of Taxpayers' activities—e.g., bank account records showing deposits and withdrawals or some other similar records—would be necessary to verify Taxpayers' records under these circumstances. However, Taxpayers have provided sufficient information to conclude that several deductions listed on their federal income tax return in arriving at adjusted gross income were not considered by the auditor, and accordingly those deductions should be permitted.

Taxpayers have further protested the assessment of income tax for the years from 1997 to 1999, noting that the years are beyond the normal three-year statute of limitations provided by Ind. Code § 6-8.1-5-2(a). In the case of underreporting one's income by at least twenty-five percent, the statute of limitations is extended to six years. Ind. Code § 6-8.1-5-2(b). Here the amount of underreported income can only be determined after further review, and accordingly is either sustained or denied based on that determination.

FINDING

Taxpayers' protest is sustained to the extent of the excess deduction and to the extent that Taxpayers' income was not underreported by at least 25% for the years from 1997 to 1999. Taxpayers' protest is otherwise denied.

II. Tax Administration - Penalty

DISCUSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides in 45 IAC 15-11-2:

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

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

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

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

A basic duty of care exists for all taxpayers, from individuals of the most modest means to the largest corporations. That duty is one of knowledge of tax laws, knowledge of payment and filing deadlines, and record keeping of one's own business and personal affairs sufficient to retrace their prior financial transactions as necessary for a reasonable period of time. To impute less of a duty is to allow for carelessness or even intentional ignorance to be a defense-something that no effective legal system can permit. If a taxpayer is not certain of the scope of that duty, professional advice and even the occasional question to the Department is available. Taxpayer's actions did not meet the standard necessary to justify penalty waiver.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04-20030318.LOF

LETTER OF FINDINGS NUMBER: 03-0318
Sales/Use Tax
For the Years 1992-2001

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. Tax Administration - Best information available

Authority: Ind. Code § 6-2.5-4-4; Ind. Code § 6-8.1-5-1; Ind. Code § 6-8.1-5-4

Taxpayer protests the imposition of sales tax, with respect to its increased gross receipts and with respect to the rental of booths.

II. Tax Administration - Penalty

Authority: Ind. Code § 6-8.1-10-2.1; 45 IAC 15-11-2(b).

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

STATEMENT OF FACTS

Taxpayer is an individual who rents booth space to various vendors on holidays and other special occasions. During these times, the vendors also sell food to visitors. Taxpayer either did not file returns or filed returns with all zeroes for the years in question.

The Department audited Taxpayer for the years in question. During those years, Taxpayer did not provide adequate records to the auditor. As a result, Department's auditor based its audit on estimates of number of booths rented and amounts of food sold. Taxpayer protested the audit with respect to the adequacy of the information, timeliness of assessment, and the applicability of sales tax to its rentals of booths.

I. Tax Administration-Best information available

DISCUSSION

With respect to the information the Department used, "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." Ind. Code § 6-8.1-5-1(b). Under Ind. Code § 6-8.1-5-4, a taxpayer is required to keep records including "all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks."

Here, Taxpayer has submitted handwritten records for the past several years. While these records provide a modicum of effort with respect to record keeping, a third-party record of Taxpayer's activities—e.g., bank account records showing deposits and withdrawals or some other similar records—would be necessary to verify Taxpayer's records under these circumstances. This not appearing in the file, Taxpayer's protest is denied.

Taxpayer also protests whether the booths it rented were subject to sales tax. Ind. Code § 6-2.5-4-4 (a) provides:

A person is a retail merchant making a retail transaction when the person rents or furnishes rooms, lodgings, or other accommodations, such as booths, display spaces, banquet facilities, and cubicles or spaces used for adult relaxation, massage, modeling, dancing, or other entertainment to another person:

(1) if those rooms, lodgings, or accommodations are rented or furnished for periods of less than thirty (30) days; and

(2) if the rooms, lodgings, and accommodations are located in a hotel, inn, tourist camp, tourist cabin, gymnasium, hall, coliseum, or other place, where rooms, lodgings, or accommodations are regularly furnished for consideration.

Here, Taxpayer argues that its provision of booths did not constitute regularly furnishing those items for consideration. In particular, Taxpayer notes that the booths were rented for only 21 days per year. However, Taxpayer did not conduct this business on an irregular basis or as an extremely infrequent transaction; Taxpayer consistently rented a number of booths for several years, though only around holidays. Taxpayer's rentals of booths were "regularly furnished" within the meaning of the statute, and accordingly Taxpayer is denied.

FINDING

Taxpayer's protest is denied.

II. Tax Administration - Penalty

DISCUSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides in 45 IAC 15-11-2:

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

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

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

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

A basic duty of care exists for all taxpayers, from individuals of the most modest means to the largest corporations. That duty is one of knowledge of tax laws, knowledge of payment and filing deadlines, and record keeping of one's own business and personal affairs sufficient to retrace their prior financial transactions as necessary for a reasonable period of time. To impute less of a duty is to allow for carelessness or even intentional ignorance to be a defense-something that no effective legal system can permit. If a taxpayer is not certain of the scope of that duty, professional advice and even the occasional question to the Department is available. Taxpayer's actions did not meet the standard necessary to justify penalty waiver.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0420030362;
0420030395.LOF

LETTER OF FINDINGS NUMBER: 03-0362 and 03-0395
Sales and Use 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—Disputed Items
Authority: IC 6-8.1-5-1(b).

Taxpayer protests the inclusion of particular entries.

II. Sales Tax—Items purchased for resale
Authority: IC 6-2.5-5-8(b).

Taxpayer protests the inclusion of assessment on items it claims were purchased for resale.

III. Sales Tax—Resale to Tax-exempt purchasers
Authority: IC 6-2.5-8-8; IC 6-2.5-3-7(b).

Taxpayer protests the inclusion of assessment entries on items it claims were sold to tax-exempt organizations.

STATEMENT OF FACTS

Taxpayers are Tech and Consulting. Because the enterprises are separate, but linked, this letter of findings includes discussion of both Tech and Consulting, so as to dispose of the issues in a unified manner.

Tech provides computer training and classroom instruction. The instructors, books, and computer supplies are provided by Consulting. The Department performed an audit of Tech and Consulting. On audit, adjustments were made to sales and use tax.

Taxpayer filed a protest and the Department held a hearing.

AGREED RESOLUTIONS

Taxpayer agrees $187.10 of use tax is due on taxable sales. See page 3 of the Consulting audit summary.

The Department agrees that ASI and Asia Source are duplicate entries. Only one should be listed. The Department will remove the Asia Source entries and evaluate the ASI entries. Taxability is another issue to be determined. See page 7 of the Consulting audit summary.

The Department agrees that the Crucial Tech amount of $208.79 should be removed. The item was purchased, returned, and credited. See page 8 of the Consulting audit summary.

The Department agrees that LASTAR is the billing company for CTG. The listings are duplicates and need to be removed. See page 8 and 10 of the Consulting audit summary.

The Department agrees that VTech Data—reference 1-W404891—needs to be removed because the laptop was returned. See page 13 of the Consulting audit summary.

I. Sales Tax—Disputed Items

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 submitted documentation of duplicate entries. One entry is the invoice for the item. The other entry is the billing of the item, including shipping. Consulting paid for its items from suppliers using a credit card. The duplicate entries should be removed. The taxability of the items has to be determined.

The entry on page 10 of the Consulting audit summary: 11/22/2000 40-48426-11 Ingram Micro $6,858.00 should be removed because the item was returned as a faulty projector.

The entries on page 10 of the Consulting audit summary: 05/02/2000 69216GB005X0S Intuit Software Supply $131.24 and 08/12/2000 9621KH00MDPA Intuit Software Supply $70.86 should be removed because the taxpayer provided documentation that it paid sales tax on the purchase.

The entry on page 11 of the Consulting audit summary: 12/04/2000 STMT Nova Solutions Inc $7,563.80 should be removed because it partially duplicates 11/30/2000 49035 Nova $14,563.80.

The entry on page 13 of the Consulting audit summary: 08/19/2000 STMT VEIT Certification $55.00 is taxable. The fact it is an online testing service does not exclude it from sales tax. The test and grading were sold and billed as a unitary sale.

Likewise, the entry on page 13 of the Consulting audit summary: 08/21/2000 1034KVD412PW View $2,522.00 is taxable. The fact it is an online testing service does not exclude it from sales tax. The test and grading were sold and billed as a unitary sale.

The entry on page 14 of the Consulting audit summary: 04/04/2000 11044 South Bend Chocolate Company $980.80 should be removed because Taxpayer paid sales tax on the items when purchased. Likewise, so should the entries on page 29 of the Consulting audit summary: 06/30/2002 26002 $151.20 and 11/20/2002 27844 $901.80.

The entry on page 17 of the Consulting audit summary: 08/17/2001 CWH65201 ADI $1,491.20 should be removed because Consulting returned the item.

The entries on page 17 of the Consulting audit summary for All Pro Construction should be removed because these were payments for services. It appears that any sales tax due was listed and billed.

The entry on page 17 of the Consulting audit summary: 03/06/2001 Cody Soft $999.99 is taxable because the purchase of web hosting is a purchase of tangible personal property—a domain and associated web page code.

The entry on page 19 of the Consulting audit summary: 1/22/2001 Network Solutions $70.00 is taxable because the purchase of a domain is the purchase of tangible personal property.

The entry on page 20 of the Consulting audit summary: 12/28/2001 Security Alarm Expense $940.97 is taxable. Taxpayer has not provided an invoice to demonstrate what was provided and billed. Taxpayer stated that the alarm system was repaired. This does not demonstrate what was provided and under what terms; it is possible that tangible personal property was transferred to Taxpayer as part of the repair services. Absent evidence Taxpayer paid a sales tax on the entry or that the bill is for services alone, the Department upholds the assessment.

The entry on page 21 of the Consulting audit summary: 03/26/2001 S1616 SMR of Indiana, Inc $2,210.00 should be removed. This is a partial payment on an invoice statement that cross-references with the entry on page 5 of the Tech audit summary: 01/04/2001 STMT SMR of Indiana, Inc. $3,833.50.

The entry on page 21 of the Consulting audit summary: 02/21/2001 IWIN Tech Data $240.00 should be removed. This is a partial payment of an order listed as the entry on page 21 of the Consulting audit summary: 02/20/2001 0495851 Tech Data $743.00.

The entry on page 26 of the Consulting audit summary: 10/17/2002 Microsoft Online Srvs $65.85 is not taxable because it is a service.

The entry on page 8 of the Consulting audit summary: 11/28/2000 0073926 Chief Manufacturing, Inc $2,238.00 should be corrected. The invoice lists the total as $563.26, not $2,238.00.

The entry on page 8 of the Consulting audit summary: 06/06/2000 001091389 Comstor $170.00 should be removed. A credit memo indicates Consulting returned and received a credit for items.

The entry on page 12 of the Consulting audit summary, 07/26/2000 GXML SHC*SMARTHOUSE COM $1,278.84 should be removed. There is no record of this amount as a charge on Taxpayer's credit card, based on the invoice statement from the credit card company.

The entry on page 17 of the Consulting audit summary: 03/03/2001 STMT CDW Computer Centers $77.67 should be removed, because Taxpayer returned the item and credit was given on Taxpayer's credit card statement for the item.

FINDING

For the reasons stated above, Taxpayer's protest is sustained and denied based upon the individual comments.

II. Sales Tax—Items purchased for resale

DISCUSSION

IC 6-2.5-5-8(b) provides:

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

Taxpayer provided the Department with copies of invoices indicating the purchased items. Taxpayer submitted a file folder marked "Section 2" that lists the items Taxpayer requests be removed from the assessment because the items purchased for resale. Having read the list and inspected the invoices, the Department removes these items from the assessment.

On page 8 of the Consulting audit summary: 12/05/2000 Crucial $1252.74 was purchased by Taxpayer for resale. Taxpayer collected sales tax on the purchase by customer.

On page 8 of the Consulting audit summary: 12/18/2000 Crucial $208.79 was purchased by Taxpayer for resale. Taxpayer collected sales tax on the purchase by customer.

On page 9 of the Consulting audit summary: 08/08/2000 was purchased by Taxpayer for resale. Taxpayer collected sales tax on the purchase by customer. The price was discounted because the unit was damaged.

On page 11 of the Consulting audit summary: 08/18/2000 Progressive Distribution Partners [amount to be confirmed by Audit] was purchased by Taxpayer for resale. Taxpayer did charge the customer sales tax on the purchase. Audit is to confirm the amount.

On page 12 of the Consulting audit summary: 03/10/2000 V Tech Data $252.19 was purchased by Taxpayer for resale. Taxpayer collected sales tax from the customer.

On page 13 of the Consulting audit summary: 06/28/2000 V Tech Data $5,749.44 was purchased by Taxpayer for resale. Sales tax was collected from the customers.

On page 13 of the Consulting audit report summary: 06/29/2000 V Tech Data $280.44 and 06/30/2000 V Tech Data $280.44

were purchased by Taxpayer for resale. Sales tax was collected from the customer.

On page 14 of the Consulting audit report summary: 11/22/2000 We Buy It $720 was purchased by Taxpayer for resale. Sales tax was collected from the customer.

On page 18 of the Consulting audit report summary: 1/26/2001 Ingram Micro $995.00 was purchased by Taxpayer for resale. Sales tax was collected from the customer.

Of note, Taxpayer included other invoices and statements within the file folder marked "Section 2" that have discrepancies that do not relate to the purchased for resale argument. These discrepancies were included in the previous discussion section.

The entry on page 11 of the Consulting audit summary: 08/18/2000 136280 Progressive Distribution Partners $41,096.50 needs to be investigated and corrected. The invoice from the distributor lists 54 computers at $964.25 each. That totals to $52,069.50. Taxpayer provided documentation that Taxpayer resold 26 computers. That multiplies to $25,070.50. Taxpayer subtracted the $25,070.50 from $41,096.50 to arrive at $16,025.50, as entered on the audit summary. Taxpayer seeks to have the new assessment be $41,096.50. Taxpayer is entitled to a credit on the assessment for the 26 computers that were resold. However, audit has to confirm from what amount the Taxpayer should subtract the $25,070.50.

The entry on page 18 of the Consulting audit summary: 05/02/2001 11193 General Commercial Corporation $61.25 should remain on the assessment. Taxpayer states that the items were for an individual and were shipped to the company address. Taxpayer submitted a copy of the invoice with the individual's name listed—prompting suspicion as to why Taxpayer has this copy of the individual's invoice. It is likely the Taxpayer paid for the items for use in marketing and advertising.

The three SHC*Smarthome entries on page 20 of the Consulting audit summary: 05/23/2001 STMT $959.40; 05/24/2001 STMT $591.20, and 05/24/2001 STMT $1,551.89 should remain on the assessment. Taxpayer submitted documentation to demonstrate that these amounts were for items returned and credited. However, the amounts listed in the audit summary do not reconcile with the credit invoices submitted by Taxpayer.

FINDING

For the reasons stated above, the Department sustains the Taxpayer's protest.

III. Sales Tax—Resale to Tax-exempt purchasers

DISCUSSION

IC 6-2.5-8-8 states that a purchaser who presents a sale tax exemption certificate to a merchant is exempt from the imposition of sales tax. IC 6-2.5-3-7(b) states that a merchant is not required to produce evidence that an acquisition is exempt from the sales tax, when a purchaser presents a sale tax exemption certificate.

On page 11 of the Consulting audit summary: 01/12/2000 7594QWWH66H Prep Software $46.00 was purchased by Taxpayer and sold to an entity that had presented a tax-exempt certificate.

On page 12 of the Consulting audit summary: 07/31/2000 00073115484289 STS Web Shop $297.00 was purchased by Taxpayer and sold to an entity that had presented a tax-exempt certificate.

On page 17 of the Consulting audit summary: 12/13/2001 W1009538 Central Computers $149.99 was purchased by Taxpayer and sold to an entity that had presented a tax-exempt certificate.

On page 24 of the Consulting audit summary: 02/08/2002 77 Central Computers $279.98 was purchased by Taxpayer and sold to an entity that had presented a tax-exempt certificate.

On page 25 of the Consulting audit summary entries: 10/16/2002 and 10/18/2002 ICG Computers, Inc, each listed as $145.00, were purchased by Taxpayer and sold to an entity that had presented a tax-exempt certificate. Likewise, on page 30: 12/11/2002 1701 $145.00.

On page 10 of the Consulting audit summary: 01/17/2000 Ingram Micro $10,635.00 was purchased by Taxpayer for resale. Taxpayer sold the items to a tax-exempt organization, and was presented with a tax-exempt certificate. The organization was unable to pay the bill, Taxpayer donated the equipment to the organization. This became a donation. Use tax is due on the $10,635.

On page 11 of the Consulting audit summary: 07/27/2000 Nationwide Computer $5,725.00 was purchased by Taxpayer for resale and sold to an tax-exempt customer.

On page 12 of the Consulting audit summary: 07/31/2000 STS Webshop $297 was purchased by Taxpayer for resale. Taxpayer sold these items to tax-exempt organizations. No tax is due.

On page 13 of the Consulting audit summary: 04/10/2000 V Tech Data $1,168.00 was purchased for resale and sold to a tax-exempt customer.

On page 13 of the Consulting audit summary: 06/28/2000 V Tech Data $348.12 was purchased by Taxpayer for resale and sold to a tax-exempt customer.

On page 13 of the Consulting audit summary: 06/28/2000 V Tech Data $1,720.86 was purchased by Taxpayer for resale and sold to a tax-exempt customer.

On page 3 of the Consulting audit report summary, Taxpayer was assessed use tax on the purchase of books that were given to the students as part of the class fee. Taxpayer stated that 90% of its business is to tax-exempt organizations, most of which are governmental vocational training programs. Taxpayer submitted invoices and tax-exempt certificate to substantiate that the books were transferred to students enrolled in vocational training programs paid for by tax-exempt governmental agencies. Use tax is due on the 10% that were not transferred to students enrolled in vocational training programs paid by the agencies.

FINDING

For the reasons stated above, Taxpayer's protest is sustained or denied based upon the individual comments.

DEPARTMENT OF STATE REVENUE

0420040017P.LOF

LETTER OF FINDINGS NUMBER: 04-0017P
Sales and Use Tax for 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(a)(3); IC 6-8.1-10-2.1(b); 45 IAC 15-11-2(b) and (c).

Taxpayer protests the imposition of a 10% negligence penalty.

STATEMENT OF FACTS

Taxpayer protested the penalties assessed on sales tax liabilities issued in 2002. Taxpayer had taken a credit on monthly returns for the sales tax on bad debts. The Department determined Taxpayer was not entitled to the credit and issued assessments for the tax due. Taxpayer paid the tax liability but protested the penalty.

I. Tax Administration—Penalty

DISCUSSION

IC 6-8.1-10-2.1(a)(3) states that if a person is examined by the Department and incurs a deficiency that is due to negligence, the person is subject to a penalty. In general, the penalty is 10%. *See* IC 6-8.1-10-2.1(b). 45 IAC 15-11-2(b), states:

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

Under 45 IAC 15-11-2(b), Taxpayer incurred a deficiency which the Department determined was due to negligence subject to a penalty under IC 6-8.1-10-2.1(a). However, Taxpayer supplied satisfactory evidence in its protest letter to establish reasonable cause to rebut the assessment of penalties.

FINDING

For the reasons stated above, the Department sustains Taxpayer's protest; no penalties are due.

DEPARTMENT OF STATE REVENUE

04-20040154.LOF

LETTER OF FINDINGS: 04-0154
Sales and Use Tax
or Tax Periods 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 the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales and Use Tax—Advertising

Authority: Ind. Code § 6-2.5-4-10; Information Bulletin # 59.

Taxpayer protests the imposition of sales tax with respect to its provision of advertising space.

II. Sales and Use Tax—Imposition

Authority: Ind. Code § 6-2.5-2-1; Ind. Code § 6-2.5-3-7; Ind. Code § 6-2.5-3-8.

Taxpayer protests the imposition of sales tax with respect to transactions where the purchaser self-assesses use tax.

III. Sales and Use Tax—Inclusion of sales

Authority: Ind. Code § 6-8.1-5-1.

Taxpayer protests the imposition of sales tax with respect to amounts that Taxpayer claims were erroneously assessed twice, along with the amount of sales that the Department claimed Taxpayer underreported.

IV. Tax Administration: Negligence Penalty

Authority: Ind. Code § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the assessment of a negligence penalty.

STATEMENT OF FACTS

Taxpayer is a company engaged in the rental of advertising space. During the years at question, Taxpayer sold rental space at various Indiana locations. Taxpayer did not charge sales tax on its rentals during the years in question with respect to several advertisers. The Department assessed sales tax on these rentals, along with another rental upon which Taxpayer claims the purchaser paid use tax. Taxpayer also claims that the auditor effectively double-counted certain transactions, and erroneously assessed certain underreported sales. Taxpayer also protests the negligence penalty imposed by the Department.

I. Sales and Use Tax—Advertising

DISCUSSION

First, Taxpayer argues that its provision of advertising space constituted a service, rather than a rental of space. The crucial difference is that the rental is taxable under Ind. Code § 6-2.5-4-10, while the provision of a service is not taxable.

Here the arrangement can be described as follows: an advertiser provides a copy of its advertisement to Taxpayer. Taxpayer, upon review of the advertisement for content and suitability, installs the advertisement in its display cases. Cleaning and maintenance of the display cases may be done by Taxpayer, though Taxpayer apparently contracts for the performance of that work.

According to Information Bulletin # 59,

> The key element in determining whether the transaction is a rental or a service is who controls the property. If the person paying for the use of the advertising space controls the space, the transaction is a rental of the space and is taxable. If the person using the property does not control the property then the transaction is a service.
>
> The person paying for the use of the space has control when that person can determine the location of the advertising space or has the right to direct how the advertising space will be used. The person using the space must have exclusive use of the space. Other factors indicating control are whether the customer provides upkeep and maintenance of the space, and whether the customer pays for the posting of the advertising material.

Taxpayer's arrangement leads the Department to conclude that the sales in question are those of services rather than rentals of tangible personal property, and accordingly not subject to tax.

FINDING

Taxpayer's protest is sustained.

II. Sales and Use Tax—Imposition

DISCUSSION

Second, Taxpayer argues that it should not be assessed sales tax with respect to one of its clients. Taxpayer notes that the client pays use tax with respect to the client's purchase of advertising from Taxpayer, and has provided a statement from the client that the client pays use tax with respect to the advertising.

Under Ind. Code § 6-2.5-2-1(b), a person purchasing tangible personal property in a retail transaction shall pay the sales tax to the retail merchant. To avoid collection duties as assigned under the statute, a retail merchant must provide evidence of exemption, either by producing a Department exemption certificate from the purchaser or other evidence of the purchaser's exemption. Ind. Code § 6-2.5-3-7(b). The offsetting credit regime under Ind. Code § 6-2.5-3-8 provides a credit for a purchaser for taxes paid to the merchant, not the other way around. Accordingly, Taxpayer, who is required to collect sales tax in this situation, is denied.

FINDING

Taxpayer's protest is denied.

III. Sales and Use Tax—Inclusion of sales

DISCUSSION

Third, Taxpayer protests the assessment with respect to three items that Taxpayer maintains were erroneously included in the assessment for the first quarter of 2000. Taxpayer argues that its records of the sales in question kept a record of three supplemental sales journals for various locations in Indiana. However, Taxpayer argues, the Department added the amounts of the three items to the amounts that Taxpayer originally reported and which had already included the items in controversy. After review, Taxpayer has provided sufficient information to conclude that the amounts in controversy were added in error.

Fourth, Taxpayer protests the assessment of sales tax with respect to underreported sales for 2002. In particular, Taxpayer protests the difference between its records and Department's records. Further, Taxpayer argues that one billing represented periods in 2003, outside the scope of the audit. Here, Taxpayer has not provided sufficient information to conclude that the Department's assessment-presumably correct, per Ind. Code § 6-8.1-5-1(a)- was incorrect.

FINDING

Taxpayer's protest is sustained with respect to three items that it maintains were included twice for the first quarter of 2000. Taxpayer is denied with respect to its 2002 underreporting.

IV. Tax Administration: Negligence Penalty

The Department may impose a ten percent (10%) negligence penalty. Ind. Code § 6-8.1-10-2.1 and 45 IAC 15-11-2. Taxpayer's failure to timely file income tax returns, generally, will result in penalty assessment. Ind. Code § 6-8.1-10-2.1(a)(1). The Department, however, may waive this penalty if the taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed…." *Id*. Taxpayer has not made the necessary showing in this case.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04-20040176.LOF

LETTER OF FINDINGS NUMBER: 04-0176
Sales/Use Tax
Periods of 2000 Through 2002

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

ISSUES

I. Sales/Use Tax: Rental Invoices

Authority: IC 6-2.5-2-1; IC 6-2.5-9-4; IC 6-8.1-5-1(b); 45 IAC 15-11-2.

The taxpayer protests the proposed assessment of taxable sales on rental invoices between closely held companies.

STATEMENT OF FACTS

The taxpayer's main business is the renting of construction equipment, such as dump trucks, fork lifts, loaders, etc. The taxpayer does not provide operators for the construction equipment leased to the taxpayer's customers. More facts will be provided as needed below.

I. Sales/Use Tax: Rental Invoices

DISCUSSION

As noted, the taxpayer leases construction equipment. Regarding the taxpayer's business, the Auditor noted, "[m]ost of the equipment is leased to a 'sister' corporation, [Company X]." The Auditor found that:

[T]he taxpayer computed their sales tax liability on computer generated invoices to [Company X, the 'sister' company] by taking the total amount billed and dividing by 1.05 to arrive at their taxable sales.

The Auditor further stated that an adjustment was made "to increase the taxpayer's taxable sales … based on the fact that the taxpayer is not allowed to consider sales tax to be included in the sales figure when the tax is not separately stated on the sales invoice."

The relevant statutes at issue are IC 6-2.5-2-1 and IC 6-2.5-9-4. The former states:

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

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

And the latter states in pertinent part:

(a) Except as provided in IC 6-2.5-7, a person who:
(1) displays an advertised price, marked price, or publicly stated price that includes the state gross retail or use taxes;
(2) offers to assume or absorb part of a customer's state gross retail or use tax on a sale; or
(3) offers to refund part of a customer's state gross retail or use tax as a part of a sale; commits a Class B infraction.

The two statutes dovetail together: IC 6-2.5-2-1 requires the tax to be "a separate added amount" and IC 6-2.5-9-4 makes it a Class B infraction to display "an advertised price, marked price, or publicly stated price that includes the state gross retail or use taxes…."

The taxpayer argues that it and Company X "are operated under common ownership, share administrative office space and have enjoyed a working relationship since [the taxpayer's] inception." The taxpayer argues:

The Companies had an oral agreement that sales tax was part of the rental price as quoted for each piece of equipment. We acknowledge that the invoices did not reflect that the sales tax was included in the gross price.

In addition, the taxpayer also intimated that it did not run afoul of the "added amount" language of IC 6-2.5-2-1(b). However, the language of IC 6-2.5-2-1(b) is clear, particularly so when read in conjunction with IC 6-2.5-9-4. The tax law does not allow for an "oral contract" to circumvent the statutory requirements outlined above. (It should also be noted a negligence penalty was imposed, but the taxpayer did not develop any arguments regarding the penalty and is thus denied on the penalty too—*See* IC 6-8.1-5-1(b) regarding the taxpayer's burden of proof, and 45 IAC 15-11-2 regarding the penalty).

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

04-20040227.SLOF

SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 04-0227
Sales/Use Tax
For the Year 2001

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

Authority: Ind. Code § 6-2.5-2-1; Ind. Code § 6-2.5-3-6; Ind. Code § 6-2.5-3-7; Ind. Code § 6-2.5-4-1; Ind. Code § 6-2.5-5-15.

Taxpayer protests the Department's assessment of sales tax with respect to the sale of trailers by Taxpayer, which Taxpayer claims were titled outside Indiana.

II. Sales and Use Tax-Services

Authority: Ind. Code § 6-8.1-5-4.

Taxpayer protests the imposition of sales tax with respect to charges that Taxpayer maintains were for services.

III. Sales and Use Tax-Imposition

Authority: Ind. Code § 6-2.5-3-2; Ind. Code § 6-2.5-3-5.

Taxpayer protests the imposition of use tax with respect to items that were purchased outside Indiana or constituted overhead expenses.

STATEMENT OF FACTS

Taxpayer is a corporation engaged in the sale of cargo trailers. Taxpayer purchases the trailers from another company, and then in turn sells them to purchasers, both in and out of Indiana according to Taxpayer.

During late 2002, Taxpayer's office was burglarized. After the burglary, Taxpayer reported a number of items stolen during the burglary. Later that same year, Taxpayer was audited by the Department. In the early part of 2003, after the Department notified Taxpayer of the audit, Taxpayer amended the original police report to include many other items, including Taxpayer's business records.

During the audit, the Department noted a difference between Taxpayer's sales reported for income tax purposes and sales reported for sales tax purposes. Taxpayer has protested this assessment, arguing that the sales were shipped to out-of-state purchasers or that the sales represented fees received for services performed by Taxpayer. Taxpayer has further protested the imposition of use tax with respect to several items that Taxpayer maintains were purchased outside Indiana or represented overhead expenses.

I. Sales and Use Tax-Vehicles

DISCUSSION

Taxpayer argues that the sales in controversy were to out of state purchasers, and therefore exempt from sales tax. Taxpayer maintains, however, that the records were stolen in a burglary in late 2002. Taxpayer provided a list of sales indicating the various destinations of the trailers in controversy.

Under Ind. Code § 6-2.5-4-1, the sale of tangible personal property in the regular course of a person's regularly conducted trade or business is subject to sales tax. The sale of trailers constituted Taxpayer's regularly conducted trade or business, and accordingly Taxpayer had a responsibility to collect sales and use tax with respect to the sale of trailers. Ind. Code § 6-2.5-2-1(b); Ind. Code § 6-2.5-3-6(b).

Further, under Ind. Code § 6-2.5-3-7, property purchased in Indiana is presumed to be purchased for use in Indiana unless the seller has either been provided an exemption certificate by the purchaser or the seller or purchaser can otherwise establish that the property purchased was not used in Indiana, or was used for an exempt purpose.

However, Ind. Code § 6-2.5-5-15 stated that, for the years in question, trailers were exempt from sales tax if the purchaser immediately transports the trailer outside Indiana, titles or registers the vehicle in another state and does not title or register the trailer in Indiana.

Taxpayer has two avenues for establishing that Taxpayer is not liable for the tax in question. The first is to demonstrate that Taxpayer received an exemption certificate from the purchaser at the time of the purchase. Ind. Code § 6-2.5-3-7(b). Taxpayer has not done this.

In the alternative, Taxpayer can establish that the property was transported for use outside Indiana. To do this, Taxpayer would need to establish that the property was titled outside Indiana. Under the laws of Indiana and many other states, trailers are required to be registered with a relevant state agency. Taxpayer has provided sufficient documentation to conclude that the sales that Taxpayer indicated were shipped out-of-state were in fact shipped out-of-state.

FINDING

Taxpayer's protest is sustained.

II. Sales and Use Tax-Services

DISCUSSION

Taxpayer further argues that a portion of the sales in controversy actually represented service fees rather than the sale of tangible personal property, but lost his records in the 2002 burglary.

While Taxpayer does make a correct statement of law if the charges in question were separately stated on the taxpayer's records, the issue becomes Taxpayer's records. Under Ind. Code § 6-8.1-5-4, a taxpayer is required to maintain books and records necessary to permit Department review of a taxpayer's liability by reference to those books and records. Otherwise, the taxpayer becomes subject to liability best on the best information available to the Department. Without the records to substantiate this claim, the best information available in this case is Taxpayer's gross sales per his federal income tax return. Accordingly, Taxpayer's protest is denied.

FINDING

Taxpayer's protest is denied.

III. Sales and Use Tax-Imposition

DISCUSSION

Taxpayer protests the imposition of use tax with respect to several items. In particular, Taxpayer argues that the items constituted overhead expenses or were purchased outside of Indiana (both representations were contained in Taxpayer's protest), and accordingly is not subject to use tax on these items.

Indiana, like other states with sales taxes, imposes a use tax to complement its sales tax. In Indiana, a taxpayer is generally responsible for use tax with respect to all tangible personal property purchased in retail transactions, along with automobiles, watercraft and aircraft regardless of whether those items are purchased at retail, if the property in question is used in Indiana. Ind. Code § 6-2.5-3-2. If a taxpayer has paid sales or use tax to another state, the taxpayer is eligible for a credit against the use tax. Ind. Code § 6-2.5-3-5.

Several items are in question here. Taxpayer has not provided sufficient documentation, and accordingly is denied.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120040318.SLOF

SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 04-0318

Adjusted Gross Income Tax for 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

Adjusted Gross Income Tax—Imposition

Authority: IC 6-8.1-5-1(b); IC 6-3-2-1(a); IC 6-3-1-12; State Election Board v. Evan Bayh, 521 N.E.2d 1212 (Ind. 1988); NRS 483.245; NRS 483.141; NRS 483.230; NRS 483.240.

The taxpayer protests the imposition of the adjusted gross income tax.

STATEMENT OF FACTS

Taxpayer moved to Nevada in April 2003. He filed an Part-Year Non-Resident Indiana Adjusted Gross Income Tax return for 2003 (IT-40PNR). On the form, he sought a refund of excess income tax that had been withheld and paid to the State of Indiana. The Department denied Taxpayer's request for refund and issued an assessment for underpayment of income tax on the basis that Taxpayer had been a full-year resident of Indiana in 2003 despite having moved to Nevada in April 2003. Taxpayer protested the refund denial and assessment; a hearing was scheduled.

Taxpayer submitted documentation to support his request for refund and to rebut the income tax assessment. Taxpayer requested that the decision be based upon review of the submitted documentation in lieu of a hearing. A letter of findings was issued denying the refund and upholding the assessment. Taxpayer filed a request for rehearing. Taxpayer submitted additional documentation and requested that the decision in this supplemental letter of findings be based upon review of the additional submitted documentation in lieu of a rehearing.

Adjusted Gross Income Tax—Imposition

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).

Indiana imposes an adjusted gross income tax pursuant to the provisions of IC 6-3-2-1(a):

> Each taxable year, a tax at the rate of three and four-tenths percent (3.4%) of adjusted gross income is imposed upon the adjusted gross income of every resident person, and on that part of the adjusted gross income derived from sources within Indiana of every nonresident person.

The Department denied Taxpayer's request for refund of the Indiana adjusted gross income taxes remitted to Indiana for the period May 2003 through December 2003. Taxpayer asserts that he earned that income as a non-resident of Indiana and is not subject to the imposition of the tax. The issue to be determined is whether Taxpayer was an Indiana resident for purposes of Indiana adjusted gross income taxation for all of 2003. Because Nevada does not have an adjusted gross income tax, no issue exists concerning the imposition of double taxation.

For purposes of adjusted gross income tax, IC 6-3-1-12 defines the term "resident" as "any individual who was domiciled in this state during the taxable year." In accordance with this definition, Taxpayer would be considered an Indiana resident and subject to tax on income earned during the period when he was domiciled in Indiana.

The Indiana Supreme Court considered the issue of the meaning of domicile in State Election Board v. Evan Bayh, 521 N.E.2d 1212 (Ind. 1988). In the case, Mr. Bayh desired to run for governor of Indiana. Pursuant to public discussion concerning whether he met the residency requirements for governor, Mr. Bayh sought a declaratory judgment. The Indiana Supreme Court affirmed the trial court's decision that the standard for residency was whether or not Mr. Bayh had an Indiana domicile. The court affirmed that Mr. Bayh was domiciled in Indiana.

Domicile in Indiana is defined as "the place where a person has his true, fixed, permanent home and principal establishment, and to which place he has, whenever he is absent, the intention of returning." *Id.* at 1317. Once established, a person's domicile is presumed to continue until the person's actions provide adequate evidence that along with moving to another jurisdiction, the person intends to establish a domicile in the new residence. Whether the person has successfully established a new domicile is a question of fact to be determined by the trier of fact. *Id.* Some of the facts considered were that Mr. Bayh paid in-state tuition at Indiana University, out-of -state tuition at the University of Virginia law school and voted in the elections in Vigo County, Indiana. He also registered for the draft from Indiana. The Supreme Court considered these acts adequate evidence to prove that Mr. Bayh intended to return to Indiana and retained his Indiana domicile even though he had lived outside the state for several years.

Taxpayer accepted a transfer to a job in Nevada in April 2003. Taxpayer argues that this move established his domicile in Nevada in April 2003. However, Taxpayer did not move his car to Nevada, obtain a Nevada driver's license, or register to vote in Nevada until 2004. In September 2003—four months after Taxpayer moved to Nevada—he took the time and trouble to renew the expired Indiana license plate for his car. These acts on the part of the taxpayer indicate that he did not establish his domicile in Nevada until 2004.

Taxpayer argues that waiting until 2004 to move his car, obtain a Nevada driver's license, and registering to vote were acts of oversight. Taxpayer asks the Department to consider his state of mind. Nevada has strict vehicle registration requirements and even stricter driver's license requirements. Nevada law requires a resident to obtain a Nevada driver's license within 30 days of becoming a resident. NRS 483.245 (1995). That means Taxpayer was required to have obtained a Nevada driver's license by May 2003 to have established residency and to have legally driven within Nevada. *See* NRS 483.141 (1997), defining "resident". Taxpayer stated that he drove a rental car until his car was shipped to him in January 2004. Taxpayer was provided a rental car by the company he worked for and that the car was made available to him upon his arrival in Nevada in April 2003. Nevada prohibits someone from driving within the state unless he has a valid driver's license. *See* NRS 483.230 (1969) and NRS 483.240 (1969). Taxpayer was legally able to drive within Nevada because he held a valid Indiana driver's license obtained as a domiciled resident of Indiana.

Taxpayer has not meet his burden of proving that he changed his domicile from Indiana to Nevada during the 2003 tax period.

FINDING

The taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0120040388.LOF

LETTER OF FINDINGS NUMBER: 04-0388
Individual Income Tax for 2000 and 2001

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

ISSUE

Income Tax—Overstated Income
Authority: IC 6-8.1-5-1(b).

Taxpayer protests the assessment of income tax due, asserting that the income was overstated by the Department.

STATEMENT OF FACTS

Taxpayer is the majority shareholder of a for-profit Indiana S-corporation that sells and installs manufactured housing. The Department audited the corporation and assessed sales tax on the sale of an asset deemed to not be a casual sale. The Department also conducted an income tax audit. Because the corporation is a pass-through entity, the assessments were levied against the shareholders. Taxpayer filed a protest, asserting that the income was overstated due to the sale of the fixed asset. A hearing was held.

Income Tax—Overstated 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). The audit report revealed that the corporation had elected to report its revenues and expenses on an accrual basis. Because income is reported in the year it is earned, the audit determined that Taxpayer understated the pass-through receipts. As well, the audit revealed that the corporation had understated the cost-of-goods sold. This adjusted Taxpayer's income. The audit also revealed that the corporation had overstated the interest expense. This adjusted Taxpayer's pass-through income. Taxpayer is protesting the overstatement of income due to the sale of a fixed asset. Nothing in the audit addressed such an adjustment. The Department find no basis for a protest.

FINDING

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

DEPARTMENT OF STATE REVENUE

0120040389.LOF

LETTER OF FINDINGS NUMBER: 04-0389
Individual Income Tax for 2000 and 2001

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

ISSUE

Income Tax—Overstated Income
Authority: IC 6-8.1-5-1(b).

Taxpayer protests the assessment of income tax due, asserting that the income was overstated by the Department.

STATEMENT OF FACTS

Taxpayer is the minority shareholder of a for-profit Indiana S-corporation that sells and installs manufactured housing. The Department audited the corporation and assessed sales tax on the sale of an asset deemed to not be a casual sale. The Department also conducted an income tax audit. Because the corporation is a pass-through entity, the assessments were levied against the shareholders. Taxpayer filed a protest, asserting that the income was overstated due to the sale of the fixed asset. A hearing was held.

Income Tax—Overstated 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). The audit report revealed that the corporation had elected to report its revenues and expenses on an accrual basis. Because income is reported in the year it is earned, the audit determined that Taxpayer understated the pass-through receipts. As well, the audit revealed that the corporation had understated the cost-of-goods sold. This adjusted Taxpayer's income. The audit also revealed that the corporation had overstated the interest expense. This adjusted Taxpayer's pass-through income. Taxpayer is protesting the overstatement of income due to the sale of a fixed asset. Nothing in the audit addressed such an adjustment. The Department find no basis for a protest.

FINDING

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

DEPARTMENT OF STATE REVENUE

0420040390.LOF

LETTER OF FINDINGS NUMBER: 04-0390

Sales Tax for Period Ending 11/30/2002

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

Sales Tax—Casual sale; isolated sale

Authority: IC 6-8.1-5-1(b); IC 6-2.5-2-1; IC 6-2.5-6-1; 45 IAC 2.2-1-1(d).

Taxpayer protests the assessment of sales tax on an asset it sold in the course of its business.

STATEMENT OF FACTS

Taxpayer is a for-profit Indiana S-corporation that sells and installs manufactured housing. In 1999 Taxpayer purchased a manufactured home which it used as an office. Taxpayer later sold the asset. The Department conducted an audit and found that although Taxpayer primarily operated as a lump sum contractor, it did collect but did not remit the sales tax due on the sale of this manufactured home. The Department assessed the sales tax due that should have been remitted. Taxpayer filed a protest, stating that no sales tax was due on the sale of the asset.

Sales Tax—Casual sale; isolated sale

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. The retail merchant is required to collect the sales tax as agent for the state. *Id*. IC 6-2.5-6-1 requires a merchant to remit to the Department the sales tax it has collected on behalf of the State.

Taxpayer asserts that when it sold the manufactured house that had been used as an office, it sold an asset and for this reason sales tax was not due on the sale. 45 IAC 2.2-1-1(d) states:

> Casual Sales. The Indiana gross retail tax is not imposed on gross receipts from casual sales except for gross receipts from casual sales of motor vehicles and sales of rental property. A casual sale is an isolated or occasional sale by the owner of tangible personal property purchased or otherwise acquired for his use or consumption, where he is not regularly engaged in the business of making such sales.

Taxpayer is in the business of selling manufactured housing. The sale of the house that previously served as an office was not a casual or isolated sale because the sale of manufacturing housing is Taxpayer's business. For this reason, sales tax was due on the sale to the customer and Taxpayer was required by Indiana law to submit the sales tax.

FINDING

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

DEPARTMENT OF STATE REVENUE

0220040427.LOF

LETTER OF FINDINGS NUMBER: 04-0427
Corporate Income Tax
For the Years 2000 and 2001

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

ISSUE

I. **Gross Income Tax—Indiana sales**

Authority: IC 6-8.1-5-1(b); IC 6-2.1-2-2(a)(2); IC 6-7-1 *et seq.*; 45 IAC 1.1-3-3(c); Indiana Dep't of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994).

Taxpayer protests the imposition of Gross Income Tax, arguing it did not solicit sales from within Indiana.

II. Adjusted Gross Income Tax—Royalty payments

Authority: IC 6-3-2-2(*l*) and (m); Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Horn v. Commissioner, 968 F.2d 1229 (D.C. Cir. 1992); Lee v. Commissioner, 155 F.2d 584 (2d Cir. 1998).

Taxpayer protests the Department requiring the filing of a unitary return of Taxpayer and an affiliated royalty company.

III. Penalty

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

Taxpayer requests an abatement of penalties

STATEMENT OF FACTS

Taxpayer, a manufacturer of cigarettes, is domiciled in North Carolina. Taxpayer is a multistate corporation with sales to Indiana. All products sold in Indiana are shipped from warehouses located outside Indiana. Taxpayer's only sales into Indiana are sales to direct account distributors. The distributors are wholesalers licensed by the State of Indiana to place a cigarette tax stamp on the cigarette pack. Because the cigarette tax stamp has to be placed on the packs, cigarettes coming into Indiana may be sold only to authorized distributors. These direct account wholesalers then resell the cigarettes to Indiana retailers.

Taxpayer paid royalties of 4.5% of its Indiana revenue sales to Royalty, a subsidiary domiciled in North Carolina. Taxpayer deducted the royalty payments as an expense on its Indiana return. Royalty is domiciled in North Carolina.

Taxpayer filed amended income tax returns for 1997, 1998, and 1999. The Department denied the refunds claimed by Taxpayer and conducted an audit for 2000 and 2001. Taxpayer was issued an assessment, which included imposition of gross income tax and adjusted gross income tax. The assessment of adjusted gross income tax was caused by the Department's requiring a unitary return to be filed by both Taxpayer and Royalty to fairly reflect the Indiana source income.

Taxpayer protested the denial of refund and the imposition of an assessment. A hearing was held. The determination of the assessment issues is binding upon the refund claims.

I. **Gross Income Tax—Indiana sales**

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).

Under IC 6-2.1-2-2(a)(2), a nonresident taxpayer was subject to gross income tax only on the taxable gross income derived from activities, businesses, or any other sources within Indiana. Indiana Courts have held that gross income tax may not be imposed upon receipts received by a taxpayer from the sale of tangible personal property if the activities giving rise to the receipts are interstate in character and the in-state activities are *de minimis*. *See*, Indiana Dep't of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994). Where the Indiana activities are merely incidental to a corporation's total operation, they are insufficient for the Indiana Department of State Revenue to seize upon in attempting to apply IC 6-2.1-2-2(a)(2). *Id.* at 271.

45 IAC 1.1-3-3(c) states that gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana. 45 IAC 1.1-3-3(c)(5) states that a sale to an Indiana buyer by a nonresident with an in-state business situs or activities but the situs or activities are not significantly associated with the sale because it was initiated, negotiated, and serviced by out-of-state personnel and the goods are shipped from out of state is not Indiana source income. However, Taxpayer had in-state personnel who initiated, negotiated, and serviced the retail stores in conjunction with the sales to the distributors.

For the years in question, Taxpayer had at least fifty customer service representatives (CSR) whose responsibilities included visiting retail locations to promote the products and maintain quality standards. The duties of the CSRs included monitoring contracts for product placements within the retail stores; handling outdated and damaged products; assembling and placing promotions and displays; monitoring competitor activity; and completing requests for information, such as surveys. Taxpayer states that the CSRs did not solicit sales, but the representatives were servicing the retail stores. According to the audit report, the CSRs negotiated and contracted for desirable product placement within the retail locations. The CSRs also evaluated the store's inventory and authorized returns of product to the distributor for credit or replacement. While the retail stores were required under IC 6-7-1 *et seq.* to purchase the cigarettes from a distributor, it was Taxpayer who monitored and serviced the retail locations to encourage and promote sales. Without a demand for product, the orders would not be placed by the retail store to the distributor. It is significant to note that Taxpayer authorized the return of damaged and outdated product to the distributor.

Taxpayer seeks to isolate the sale of product to the distributor alone. And while the orders were sent to out-of-state locations and were shipped from out-of-state warehouses, Taxpayer was actively working with both the distributor and the retailers to solicit, promote, and service the Indiana sales. When taken as a whole, the activities of Taxpayer's in-state employees show that the sales were made within Indiana.

FINDING

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

II. Adjusted Gross Income Tax—Royalty payments

DISCUSSION

Taxpayer reported large deductions on its federal return for royalty payments to an affiliated company, Royalty. Royalty is a wholly-owned subsidiary of Taxpayer and its sole business is the ownership and administration of trade names, trademarks, service marks, and related trade marks formally owned by Taxpayer in its cigarette business. The auditor for the Department stated in the audit report that the use of the intellectual property by Taxpayer is integral to its operations. For this reason, the activities of Royalty is unitary with Taxpayer.

IC 6-3-2-2(*l*) states:

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

(1) separate accounting;

(2) the exclusion of any one (1) or more of the factors;

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

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

In addition, IC 6-3-2-2(m) states:

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

Because Royalty is a wholly owned subsidiary of Taxpayer, common control is not at issue.

The issue remains as to whether Taxpayer and Royalty in fact constituted a unitary business. It needs to be stated that Taxpayer framed its protest as a disallowed deduction of royalties paid by Taxpayer to Royalty. While the functional effect may be a disallowance of the deduction, the audit technically did not disallow the deduction, but instead had Taxpayer and Royalty file a unitary return.

Under the agreement between Taxpayer and Royalty, Taxpayer paid Royalty a royalty of 4.5% of Taxpayer's sales. Taxpayer sold cigarettes in Indiana. The value of the trade names, trademarks, and other intellectual properties is inextricably connected with the quality of the cigarette products manufactured by Taxpayer. The effect of the royalty payments was to shift 4.5% of the sales income from Taxpayer to Royalty. The filing of a unitary return better reflects the intercompany transaction.

The "sham transaction" doctrine is well established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). The United States Supreme Court held in the case 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. *Id*. at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance; "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. Courts subsequently have held that in construing words of a tax statute which describe any commercial transactions, the court is to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950). Transactions that are invalidated by the sham transaction doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. Horn v. Commissioner, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Commissioner, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. IC 6-8.1-5-1(b).

Taxpayer stated at the hearing that the purpose of establishing Royalty was to be able to exploit the intellectual properties. However, in light of the fact that the value of the intellectual properties is based on the quality of the products sold by Taxpayer, the royalty payments have the effect of shifting income from Taxpayer to Royalty. While this had no effect on the federal tax returns, it does effect Taxpayer's Indiana return because Taxpayer has claimed a deduction for a transaction that shifted 4.5% of Taxpayer's revenues generated within the State of Indiana to an out-of-state affiliated entity. The value of the intellectual properties held by Royalty and the revenues received by Royalty were generated by the sale of Taxpayer's product within Indiana. This explains why a unitary return is appropriate to fairly reflect the transactions. Further, even if a unitary return is not permissible for whatever reason, the transaction is still a sham, and thus the deduction for expenses from Taxpayer to Royalty should be disallowed.

FINDING

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

III. Penalty

DISCUSSION

Taxpayer asks the Department to abate the 10% negligence penalties because the position of Taxpayer and its Parent for the audit years in question were based upon reasonable and proper interpretation of both state and federal law.

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 has not shown it used 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

0120050015.LOF

LETTER OF FINDINGS NUMBER: 05-0015
Individual Income Tax
For the Years 1998 and 1999

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

ISSUE

Individual Income Tax—Validity of assessment

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

Taxpayer protests the validity of the assessment of individual income tax by the State of Indiana.

STATEMENT OF FACTS

Taxpayer failed to file Indiana individual income tax returns for 1998 and 1999. The Department prepared returns for Taxpayer based on information obtained from the Internal Revenue Service and issued assessments for the tax due. Taxpayer protested asserting that the assessments were grossly in error and that no valid assessment was ever made. The Department wrote Taxpayer asking him to present any information to refute the assessments. Taxpayer submitted no additional documentation. The Department forwarded the protest to a hearing officer so that a hearing could be scheduled. Taxpayer did not respond to requests to schedule a hearing; a fixed date to respond by was stated. That date having passed, this letter of findings is written based upon the information contained within 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 was informed of this in correspondence replying to his protest.

IC 6-3-2-1(a) imposes an individual income tax upon the adjusted gross income of Indiana residents and on the portion of adjusted gross income of nonresidents derived from Indiana sources. IC 6-3-4-1 requires Indiana residents to file an income tax return if they have adjusted gross income in excess of the modifications provided under IC 6-3-1-3.5(a)(3) and IC 6-3-1-3.5(a)(4). Taxpayer had adjustable gross income in excess of these modifications. IC 6-3-4-5 states that if a taxpayer is required to file an income tax return, he shall pay any tax due and is entitled to take as credit toward the tax due any payments made for the taxable year.

IC 6-8.1-5-1(a) states that of if the Department reasonably believes that a person has not reported the proper amount of tax due, the Department is required by law to issue an assessment of the amount of the unpaid tax on the basis of the best information available to the Department. The Department received information from the Internal Revenue Services concerning Taxpayer's income for 1998 and 1999 and based upon this issued assessments. IC 6-8.1-5-1(b) states that the notice of assessment is prima facie evidence that the Department's claim for unpaid tax is valid; the burden of proving that the assessment is wrong rests with the person against whom the assessment is made. Taxpayer has been afforded opportunities to rebut the assessments and has not presented documentation or information sufficient to rebut the assessments.

FINDING

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

DEPARTMENT OF STATE REVENUE

0220050019P.LOF

LETTER OF FINDINGS NUMBER: 05-0019P
Income Tax
For Tax Year 2001

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

ISSUES

I. Income—Overpayment Application

Authority: IC 6-3-4-4.1; IC 6-8.1-9-2

Taxpayer protests that the Department misapplied overpayment credits resulting in proposed assessments of income tax due.

II. Tax Administration—Negligence Penalty and Interest

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

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

STATEMENT OF FACTS

Taxpayer is an out-of-state business doing business in Indiana. The Indiana Department of Revenue ("Department") conducted an audit and issued proposed assessments for income tax, penalty and interest for 2001. Taxpayer protests the assessments. Further facts will be supplied as required.

I. Income—Overpayment Application

DISCUSSION

Taxpayer had an overpayment credit available on its 2001 return. Taxpayer asked that the full amount of the overpayment credit be carried forward to 2002. As the result of an audit, the Department determined that taxpayer had an outstanding withholding tax liability due to unfiled returns from 1999. Taxpayer subsequently filed the returns and the Department returned the overpayment credit to the 2001 corporate return and applied the overpayment to the 1999 deficiencies. The remaining portion of the overpayment was carried forward to 2002 as requested by taxpayer. As the result of another audit, the Department determined that taxpayer owed additional taxes for 2001. The Department issued a proposed assessment for the base liability along with penalty and interest.

Taxpayer protests that it should be allowed to take the overpayment which it had previously requested to have applied as a credit to 2002 and have it reapplied back to 2001, which would cover the underpayment. This is not the correct method. IC 6-3-4-4.1(d) states:

> Every corporation subject to the adjusted gross income tax liability imposed by IC 6-3 shall be required to report and pay an estimated tax equal to twenty-five percent (25%) of such corporation's estimated adjusted gross income tax liability for the taxable year, less the credit allowed by IC 6-3-3-2 for the tax imposed on gross income. Such estimated payment shall be made at the same time and in conjunction with the reporting of gross income tax as provided in IC 6-2.1-5. The department shall prescribe the manner and forms for such reporting and payment.

Also of significance is IC 6-8.1-9-2, which states in relevant part:

> (a) If the department finds that a person has paid more tax for a taxable year than is legally due, the department shall apply the amount of the excess against any amount of that same tax that is assessed and is currently due. The department may then apply

any remaining excess against any of the listed taxes that have been assessed against the person and that are currently due. If any excess remains after the department has applied the overpayment against the person's tax liabilities, the department shall either refund the amount to the person or, at the person's request, credit the amount to the person's future tax liabilities.

Since taxpayer elected to have the 2001 overpayment applied to 2002 under IC 6-8.1-9-2(a), that credit became part of the 2002 estimated payments required by IC 6-3-4-4.1. Once the payment for 2002 was made, it was made. The Department is not a quasi-financial institution and the overpayment for 2001 was not a floating deposit in an "account" at such an institution. Once taxpayer elected to apply the overpayment to 2002, the application ended the availability of the credit. When the audit revealed the liabilities for 2001, the previous overpayment credit had already been applied to 2002 and no longer existed.

FINDING

Taxpayer's protest is denied.

II. Tax Administration—Negligence Penalty and Interest

DISCUSSION

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). Taxpayer has not 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).

IC 6-8.1-10-1(e) states that the Department may not waive interest. However, in discussions with taxpayer prior to the writing of this Letter of Findings, the Department determined that it had miscalculated the interest. The Department agreed to recalculate the interest, which will result in a lesser amount of interest. Under IC 6-8.1-10-1(e), the interest may not be waived.

FINDING

Taxpayer's protest is denied.

DEPARTMENT OF STATE REVENUE

0220050031.LOF

LETTER OF FINDINGS NUMBER: 05-0031
Corporate Income Tax
For the Years 2000 and 2001

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

ISSUE

I. Gross Income Tax—Royalty Income from trade names, trademarks, and other intellectual property

Authority: IC 6-8.1-5-1(b); IC 6-2.1-2-2; 45 IAC 1-1-51.

Taxpayer protests the imposition of Gross Income Tax on royalties receipts.

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

Taxpayer requests an abatement of penalties

STATEMENT OF FACTS

Taxpayer is a wholly-owned subsidiary of a manufacturer. Taxpayer is domiciled in North Carolina and its sole business is the ownership and administration of trade names, trademarks, service marks, and related trademarks formally owned by the parent in its business. Parent pays Taxpayer 4.5% of its sales revenues in exchange for Parent's use of the intellectual property.

Parent filed amended income tax returns for 1997, 1998, and 1999. The Department denied the refunds claimed by Parent and conducted an audit for 2000 and 2001 of Parent and Taxpayer. Taxpayer was issued a gross income tax assessment on the royalties paid by Parent on Indiana revenue sales.

Taxpayer protested the assessment. A hearing was held. The determination of the assessment issues is binding upon the refund claims.

I. Gross Income Tax—Royalty Income from trade names, trademarks, and other intellectual property

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).

Indiana imposed gross income tax on the taxable gross income of a taxpayer which is a resident or domiciliary of Indiana and on the taxable gross income from Indiana sources by a taxpayer who is not a resident or domiciliary of Indiana. IC 6-2.1-2-2.

Under the regulation governing the gross income tax, "taxable gross income" includes income that is derived from intangibles. 45 IAC 1-1-51. The term "intangibles" includes royalties. *Id*. In order for Indiana to impose the gross income tax on income derived from taxpayer's intangibles, the Department must determine that the income is derived from a "business situs" within the state. *Id*. The regulation states that a taxpayer has established a "business situs" within the state if the intangible or the income derived from the intangible forms an integral part of a business regularly conducted at a situs in Indiana. *Id*. Once the taxpayer has established a "business situs" within the state, and the intangible or the income derived from the intangible is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes. *Id*.

The income derived from Taxpayer's licensing of its intellectual property within the state is income derived from a "business situs" within Indiana and is properly subject to the state's gross income tax scheme. The intellectual property is localized within Indiana because the intellectual is integrally related to the products sold within Indiana. The income at issue is not derivative of taxpayer's out-of-state activity in developing, managing, and protecting the intellectual property; the value of this intellectual property lies in Taxpayer's ability to license the property for use within Indiana, to maintain rigorous control over the use of the property, and to derive the economic benefits attributable to the intangible property's Indiana business situs.

Taxpayer was paid royalties on the products sold within Indiana. It was the efforts of the company to promote products within Indiana that generated the royalties. The value of the intangibles is inextricably tied to the company's efforts. Taxpayer received royalties based upon the company's gross income received in Indiana. The amount of that gross income is directly attributable to the success in marketing and labeling within Indiana. Taxpayer's gross income is a measure of the company's success within Indiana.

Because the intangible intellectual property has acquired a business situs within Indiana and because the income at issue is connected with that business, either actually or constructively, the income is subject to Indiana gross income tax.

FINDING

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

II. Penalty

DISCUSSION

Taxpayer asks the Department to abate the 10% negligence penalties because the position of Taxpayer and its Parent for the audit years in question were based upon reasonable and proper interpretation of both state and federal law.

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 has not shown it used 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

02-20050206.LOF
02-20050207.LOF

LETTER OF FINDINGS NUMBERS: 05-0206, 05-0207
CORPORATE INCOME TAX
For Years 2000-2002

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. Gross Income Tax – Consolidated Returns

Authority: Ind. Code § 6-2.1-5-5

Taxpayers protest the disallowance of consolidated returns between two entities.

STATEMENT OF FACTS

Taxpayers are two companies that are registered to do business in Indiana. Taxpayers are wholly owned subsidiaries of a parent corporation that is not registered to do business in Indiana. Taxpayers filed consolidated gross income tax returns for the years in question, but did not file consolidated adjusted gross income tax returns. However, upon review, the Department disallowed the consolidation for gross income tax purposes and assessed additional tax and penalty.

I. Gross Income Tax – Consolidated Returns

DISCUSSION

Taxpayers argue that, because they are wholly owned by a common corporation, they meet the affiliation test provided by Ind. Code § 6-2.1-5-5, which provides a statutory test for eligibility for consolidation. In this case, Taxpayers have provided sufficient information to conclude that the protest should be sustained.

FINDING

The taxpayer is sustained.

DEPARTMENT OF STATE REVENUE

02-20050213.LOF

LETTER OF FINDINGS NUMBER: 05-0213
Corporate Income Tax
For the Years 1998-2004

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. Corporate Income Tax—Assessment

Authority: IC 6-8.1-5-1(b); IC 4-30; IC 4-31; IC 4-32; IC 4-33; IC 4-30-1-1; IC 4-30-18-1; IC 4-31-1-2; IC 4-31-6; IC 4-31-9; IC 4-32-1-2; IC 4-32-4-1; IC 4-32-4-2; IC 4-32-9; IC 4-32-9-16; IC 4-32-9-18; IC 4-32-9-30, -31, -32, -33; 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; IC 4-33-8; IC 4-33-8-2; IC 4-33-8-4; IC 4-33-8-6; IC 4-33-8-3; IC 4-33-8-2; IC 4-33-8-4(2); IC 4-33-9-8; IC 4-33-9-12; 4-33-13-1; IC 4-33-13-1.5; IC 6-3-2-1(b); 68 IAC 2-6-29(1); IRC § 501(c)(19); IRS Publication 3386; IRS Publication 598; IRS Publication 3079

Taxpayer protests the method by which the audit arrived at the amount of taxpayer's tax liability.

STATEMENT OF FACTS

Taxpayer is a tax exempt veterans organization under IRC § 501(c)(19). Taxpayer was assessed unrelated business income on receipts from nineteen unsanctioned slot machines operated by Taxpayer. The income was computed by deducting payouts and a portion of the business expenses from the gambling receipts. The building expenses were calculated based on the square footage of floor space covered by the slot machines.

Taxpayer protests the method the audit used to calculate the amount of taxpayer's liability, arguing that expense deductions for telephones, repairs, payroll processing, office supplies, dues, advertising, and kitchen wages should have been allowed to offset the income earned from gambling.

DISCUSSION

Under Indiana code, passed into law by the Indiana General Assembly, all tax assessments are presumed to be valid and 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 permissible and impermissible gambling in the State of Indiana. IC § 4-30 establishes an Indiana state lottery. IC § 4-31 establishes pari-mutuel wagering on horse races. IC § 4-32 establishes games of chance. And IC § 4-33 establishes riverboat gambling. Gambling in Indiana is regulated; organizations are required to be registered and licensed.

The Indiana General Assembly has stated that the purpose of establishing state lottery games is to "enable the people of Indiana to benefit from significant additional money for capital improvements." IC 4-30-1-1. No person or organization may operate a lottery in Indiana; only the state lottery commission may operate a lottery. IC § 4-30-18-1.

The Indiana General Assembly has stated that the purpose of permitting pari-mutuel wagering on horse races in Indiana is "to ensure that [it] will be conducted with the highest of standards and the greatest level of integrity." IC § 4-31-1-2. Racetrack personnel and racing participants are required to be licensed. *See*, IC § 4-31-6. Taxation and distribution of pari-mutuel revenues is highly regulated. *See*, IC § 4-31-9.

The Indiana General Assembly has stated that the purpose of permitting games of chance is "to permit a licensed qualified organization (1) to conduct bingo events, charity game nights, door prize drawings, and raffles; and (2) to sell pull tabs, punchboards, and tip boards; as a fund raising activity for lawful purposes of the organization." IC § 4-32-1-2. Organizers are required to withhold state income tax on prizes awarded to a winner and to submit that tax. *See*, IC § 4-32-4-1 and IC § 4-32-4-2. Organizations are required to be licensed and are regulated in the conduct of the games. *See*, IC § 4-32-9. Under IC § 4-32-9-16, the Department is permitted by rule to set the allowable expenditures of a qualified organization. The Department has the authority, granted by the Indiana General Assembly, to set the guidelines for allowable expenditures. This directly implies that the Department also may set the guidelines for permissible deductions of expenses. All net proceeds from an allowable event and related activities may only be used for the lawful purposes of the qualified organization. *Id*. There are limits on the number and frequency of events that may be held. IC § 4-32-9-18. There are limits on the value of prizes. IC §§ 4-32-9-30, -31, -32, -33. There are many more statutes regulating charity gaming; these are named to demonstrate that strict regulations and statutes exist.

Additionally, there is the issue and existence of casino gambling. 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. 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 IC § 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 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 duly elected voices 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 outline 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 less than the 15% minimum tax assessed against casino gambling on riverboats. 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 slot machines. Were Taxpayer legally operating these slot machines, it would be held to the gaming regulations as to the payout requirements. *See*, 68 IAC 2-6-29(1). According to the Indiana Gaming Commission, riverboat casinos' payouts average around 93%. Taxpayer pays out at around 80%. Taxpayer states that the bartender at the post pays out any winnings.

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 as to the functions and purposes of an IRC § 501(c)(19) veterans' organization.

The IRS has issued three publications useful to this discussion:

Publication 3386 Tax Guide—Veterans' Organizations (6/99)

Publication 598 Tax on Unrelated Business Income of Exempt Organizations (3/00)

Publication 3079 Gaming Publication for Tax-Exempt Organizations (4/98).

Publication 3386 provides that: "[v]eterans' organizations occupy a special place in the world of exempt organizations." *Id.* at 3. Over the years, Congress has provided more flexible exemption provisions to veterans' organizations to help keep them vibrant contributors to veterans and their communities at large. *See id*. Originally, veterans' organizations were required to have a membership of at least 75% war veterans in order to be tax-exempt; but because of waning membership over the years, Congress changed the membership requirement to 75% veterans. *See id,* and IRC § 501(c)(19)(B). However, Congress still requires that no more than 2.5% of the members be non-veteran related persons in order for the organization to maintain tax-exempt status. *See id*.

Congress has stated that appropriate purposes of an IRC 501(c)(19) veterans' organization include:

A. promoting the social welfare of the community,
B. assisting needy and disabled veterans, widows, or orphans of deceased veterans,
C. providing entertainment, care and assistance to hospitalized veterans or members of the Armed Forces of the United States,
D. perpetuating the memory of veterans and comforting their survivors,
E. conducting programs for religious, charitable, scientific, literary, or educational purposes,
F. sponsoring or participating in patriotic activities,
G. providing insurance benefits to members or members' dependents, and
H. providing social and recreational activities for members.

See IRS Pub. 3386 at 9. IRS Publication 3386 states that a veteran's organization can jeopardize its tax-exempt status if it does not limit its activities and operations to post members—but instead opens its facilities to the general public. A post may operate a bar & restaurant and also may provide gambling, but these must be restricted to members and their invited guests. All expenses of an invited guest are to be paid by the post member.

Taxpayer engages in many activities and opens its post to the general public for many reasons. Taxpayer has a kitchen area, restaurant area, bar area, indoor pool, banquet/meeting rooms, and several other rooms. Taxpayer receives income from dues, sales of food and beverages, miscellaneous sales of merchandise to members, renting out rooms for banquets, wedding receptions, meetings, etc. Income is also received from having bingo three times a week and selling pull-tabs during bingo and at the bar area. Taxpayer also has twenty-six Cherry masters slot machines. In the Department's audit of Taxpayer, only the income from the unsanctioned slot machines was assessed tax as being unrelated business income. The Department has sought only to tax the unsanctioned gambling as unrelated business income. The Department has computed the reasonable deductions related to the generation of that income.

Expenses, but not losses, directly related to the earning of unrelated business income can be used as a deduction in calculating the income. There is no evidence to establish that any of the food and beverage related expenses, or other expenses taxpayer wishes to take as deductions, are directly related to gambling receipts. Taxpayer's organizational purpose would have to be gambling in order for Taxpayer's position to be valid. The Department has allowed a reasonable estimate of building expenses to offset the unrelated business income. No evidence has been submitted to support further deductions for expenses.

FINDING

Taxpayer's protest concerning the method the audit used to arrive at its tax liability is denied.

DEPARTMENT OF STATE REVENUE

0420050263.LOF

LETTER OF FINDINGS NUMBER: 05-0263
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 6-6-6.5-2; IC 6-6-6.5-9; IC 6-2.5-3-2(b); IC 23-18-12-4; Department of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Cambria Iron Co., v. Union Trust Co., 55 N.E. 745 (Ind. 1899).

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 October 2003. In May 2004, the Department received an annual aircraft report from [IEA], an Indiana airport. The report listed Taxpayer's aircraft as being based at the airport. The name of the owner attributed to the aircraft was listed as [JM], a member of Taxpayer LLC. In July 2004, the Department sent JM a letter informing him that the aircraft was not registered with the State of Indiana; an application was enclosed with the letter.

In September 2004, Taxpayer sent a letter to the Department stating that Taxpayer had enclosed the Aircraft Registration application. The application listed Taxpayer LLC as the owner of the aircraft. Taxpayer claimed an exemption from sales and use tax due on the purchase of the aircraft, checking off rental and lease to others. Taxpayer did not enter its registered retail merchant number on the application, nor did Taxpayer check off whether the aircraft was purchased from a registered Indiana dealer. Additionally, Taxpayer stated on the application that the aircraft was purchased in October 2003, but was moved to Indiana in March 2004.

The Department sent Taxpayer a letter in November 2004 requesting Taxpayer to substantiate the eligibility of the rental and lease exemption. Enclosed with the letter was a proposed assessment. Taxpayer submitted documentation to the Department. In December 2004, the Department requested additional documentation to substantiate the exemption.

In December 2004, the aircraft was registered with the FAA under the corporate name [MPA LLC]. The owner of the aircraft currently named on the FAA certificate is [MPA LLC]. When the Department had checked on the registration of the aircraft several months earlier, in June 2004, the FAA had listed the registration of the aircraft as pending. "Registration pending" is the term used by the FAA when it receives notice of a sale of an aircraft and the previous owner has released claim on the aircraft, but the new owner has not submitted an application for registration. The FAA marked the aircraft as registration pending in January 2004.

In April 2005, the Department sent Taxpayer a letter denying the exemption. The basis of the denial of the exemption was that the lease agreement named Taxpayer as a party to the agreement, but the aircraft was not registered with the FAA as being owned by Taxpayer. As well, Taxpayer had not submitted the required sales and use tax returns and had submitted no sales tax payments collected on the leases. It needs to be noted that in November 2004, Taxpayer had submitted a check in the amount of $485.60. Taxpayer also had included a completed Form ST-103, *Sales and Use Tax*, for the period January through December 2003, listing zero as the amount of sales and use tax due. The coupon had been due on or before February 2, 2004—as stated on the coupon. The Department returned the check to Taxpayer, stating in a letter that the Department cannot accept and process the payment for sales and use tax for Tax Year 2004 until February 2005 since Taxpayer was an annual filer.

Taxpayer filed a protest and a hearing was held. Because Taxpayer did not appear at the hearing, this letter of finding is written based upon the information within the file.

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).

IC 6-6-6.5-2 requires an Indiana resident who owns an aircraft to register the aircraft with the state no later than 31 days after the purchase date. IC 6-6-6.5-9 lists eight exemption provisions not requiring registration; IC 6-6-6.5-9(6) states that an aircraft owned by an Indiana resident is exempt from registration if the aircraft is not based in this state at any time—provided that the owner files the required form, Form AE-1, not later than 31 days after the date of purchase; and furnishes the Department with evidence, satisfactory to the Department, verifying where the aircraft is based during the year. Form AE-1, *Based Out of State Certificate of Exemption for Aircraft*, requires that the Indiana resident attach to the form as evidence of basing out of state: (1) the hangar lease agreement, the hangar rent receipts (minimum 11 months), or a letter from the airport manager; and (2) a paid sales tax receipt or the current state registration.

Summarizing Indiana law as it applies to Taxpayer—under the requirements of Indiana statute, an Indiana resident that owns an aircraft is required to inform the state whether its newly purchased aircraft is based within or outside Indiana by filing either a registration form or an exemption from registration form within 31 days of the purchase date. Taxpayer did neither. The aircraft was purchased in October 2003, which means that the State of Indiana needed to be informed by November 2003.

On October 1, 2003 Taxpayer applied to the Department to register as a retail merchant, presumably in contemplation of an aircraft purchase. This indicates that Taxpayer contacted the Department concerning its enterprise. Since the name of Taxpayer includes the term, "Aviation, LLC" within its name, it is reasonable to believe Taxpayer's enterprise involved aircraft—for which Taxpayer has a duty under Indiana law to register if an aircraft is purchased.

Under IC 6-2.5-3-2(b), use tax is imposed on the storage, use, or consumption of an aircraft, if the aircraft is: acquired in a transaction that is an isolate of occasional sale; and is required to be titled, licensed, or registered by this state for use in Indiana. Taxpayer as an Indiana resident has the responsibility to demonstrate that sales and use tax does not apply to its purchase of the aircraft. The Indiana Supreme Court has held that exemption statutes are strictly construed against a taxpayer; a taxpayer has the burden of establishing its entitlement to an exemption. Department of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

The Department would have become alerted to Taxpayer's purchase of the aircraft sooner than it did in this case. Because the aircraft was not registered with the FAA until December 2004—fourteen months after the purchase—the Department did not know Taxpayer had based an aircraft in Indiana until May 2004—over six months after the purchase. The Department discovered the aircraft when it was listed by [IEA], an Indiana airport, on its annual report of aircraft based there. The name listed as having acquired a hangar was not Taxpayer's name, but that of the LLC's member, [JM]. This raises suspicion on several levels, including whether the aircraft was being used personally and why the aircraft was not registered in Indiana. Documentation from another Indiana airport, [IIA], indicates that the aircraft had been hangared and based in Indiana since January 2004. The lease was a one-year agreement, set to expire in January 2005. The lessee named on the lease was [JM], not Taxpayer. [JM] listed his title as owner on the hangar lease agreement.

The insurance policy providing liability coverage named the insured as [MPA LLC], not as Taxpayer. The period covered was December 2003 to December 2004 and the covered permitted uses included "Pleasure and Business." The bill of sale for the aircraft, signed in October 2003, listed [MPA] as the purchaser. Lease agreements to rent the aircraft list Taxpayer as the lessor. The Department has asked Taxpayer to explain why three differing representations of owners appear contemporaneously. Taxpayer has not provided adequate documentation and explanation. Taxpayer did provide documentation of the change of entity name from [MPA LLC] to Taxpayer. However, the Certificate of Amendment changing the LLC name from [MPA] to Taxpayer was not filed until the end of November 2004. The Department spoke with the Secretary of State office; its representatives explained that the date sealed on the amendment as the effective date of the name change is the date the request was filed. This complies with IC 23-18-12-4. For the first year the aircraft was owned, [JM], [MPA], and Taxpayer are represented as the owners on various documents.

Indiana Form 7695, Application for Aircraft Registration or Exemption, submitted by Taxpayer in September 2004, listed the name of the owner of the aircraft as Taxpayer. The Department originally denied the tax exemption filed by Taxpayer on the basis that the leases to rent the aircraft were signed by Taxpayer, but the owner of the aircraft was [MPA]. This cannot be lightly overlooked. The leases to rent the aircraft were signed in January and February 2004. The name change amendment was filed over ten months later. In overview, for the first fourteen months, Taxpayer, [MPA LLC], and [JM] all stated public representations as to the ownership and control of the aircraft. Taxpayer has been lax in its duties to file paperwork with both the Department and the FAA. Taxpayer seeks the benefits of an exemption, but has been unwilling to assume the associated responsibilities to establish the exemption. The Indiana Supreme Court has long held that a party may not have the benefits without the burden. *See* Cambria Iron Co., v. Union Trust Co., 55 N.E. 745, 749 (1899).

Taxpayer has not demonstrated to the Department a coherent chain of ownership and control. Tax exemption determinations are based upon an analysis of the transaction. In this case, the Department is unable to trace the transactions in a coherent manner. Taxpayer has not been responsive to explain who was using the aircraft in what manner at what time. Three separate entities held themselves out as owning and controlling the aircraft. The law allows the establishment of separate entities to protect against liability. But the entity formalities must be observed. Taxpayer, [MPA LLC], and [JM] have blurred and blended the formalities. Taxpayer did not affirmatively fulfill his regulatory and statutory obligations to register the aircraft in a timely manner. As well, Taxpayer has not sufficiently substantiated its entitlement to a sales and tax exemption for rental and leasing.

FINDING

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

DEPARTMENT OF STATE REVENUE

0420050265.LOF

LETTER OF FINDINGS: 05-0265
Gross Retail Tax
For 2004

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. Like-Kind Exchange – Gross Retail Tax.

Authority: IC 6-2.5-1-5(a); IC 6-2.5-1-6(a); IC 6-2.5-1-6(a)(2); IC 6-2.5-1-6(c).

Taxpayer challenges the decision denying a trade-in allowance – and the attendant assessment of gross retail tax – on the purchase of a Cessna aircraft.

STATEMENT OF FACTS

Taxpayer purchased a Cessna aircraft from seller on February 4, 2004. The price of the Cessna was $1,800,000. At the time of the purchase, a trade-in allowance of $1,000,000 was given for a Beechcraft airplane. Taxpayer paid seller $800,000 in cash. The seller did not collect sales tax on any portion of the transaction.

The Department of Revenue (Department) determined that taxpayer did not own the Beechcraft on February 4, 2004. Accordingly, the Department found that taxpayer was not entitled to the trade-in allowance and assessed taxpayer for use tax based on the purported $1,000,000 trade-in allowance.

Taxpayer challenged the Department's decision arguing that when it "entered into the transaction, it did so under the belief that a like kind exchange would take place." An administrative hearing was conducted during which taxpayer's representatives explained the basis for its protest. This Letter of Findings results.

DISCUSSION

Taxpayer argues that at the time it purchased the Cessna on February 4, 2004, it contemplated that a like-kind exchange would take place. Taxpayer concludes that the $1,000,000 is exempt from gross retail tax under IC 6-2.5-1-5(a). IC 6-2.5-1-5(a) states in relevant part as follows:

> "Gross retail income" means the total gross receipts of any kind or character, received in a retail transaction, except that part of the gross receipts attributable to: (1) the value of any tangible personal property received in a like kind exchange in the retail transaction[.]

Like-kind exchanges are defined in IC 6-2.5-1-6(a) which states that:

> "Like kind exchange" means the reciprocal exchange of personal property between two (2) persons, when:
>
> (1) the property exchanged is of the same kind or character, regardless of grade or quality; and (2) the persons exchanging the property both own the property prior to the exchange.

Taxpayer claims that it was organized as a limited-liability company (LLC) on February 4, 2004. Taxpayer indicates that the original owners of the LLC transferred the Beechcraft as a "capital contribution" to the LLC on February 6, 2004. According to taxpayer (the LLC), it owned the Beechcraft at the time the LLC purchased the Cessna. Taxpayer errs. The "Aircraft History Report" indicates that the Beechcraft remained the property of one of the LLC's organizers until August 31, 2004 when it was transferred – not to taxpayer – but to a third party not directly involved in the Cessna purchase.

Taxpayer asks that the Department honor the "spirit" of the transaction. Taxpayer claims that – despite the Beechcraft's muddled ownership history – the "spirit of [the] transaction was always to use the [Beechcraft] as a trade in aircraft." Taxpayer's intention to the contrary, taxpayer is essentially correct in noting that the Cessna purchase agreement "was based upon incomplete and ill thought out advice."

The Department is unable to overlook the simple fact that taxpayer (the LLC) did not own the Beechcraft at the time taxpayer purchased the Cessna. Despite taxpayer's assertion that the Beechcraft was transferred as a capital contribution on February 6, 2004, there is no substantive indication that taxpayer *ever* owned the Beechcraft.

The statutory requirement is clear. In order to qualify as a like-kind exchange, "the persons exchanging the property [must] both own the property prior to the exchange." IC 6-2.5-1-6(a)(2). Moreover, the statute states that "a 'like kind exchange' *does not* occur when (1) the transaction involves more than two (2) persons[.]" IC 6-2.5-1-6(c) (*Emphasis added*).

Taxpayer did not own the Beechcraft when it bought the Cessna; taxpayer was not entitled to offer the Beechcraft as a trade-in at the time it bought the Cessna.

FINDING

Taxpayer's protest is respectfully denied.

DEPARTMENT OF STATE REVENUE

0420050364.LOF

LETTER OF FINDINGS NUMBER: 05-0364
Use Tax for 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

Use Tax—Rental and lease of aircraft

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

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

STATEMENT OF FACTS

Taxpayer is a for-profit Indiana S-corporation. In November 2003, Taxpayer purchased an aircraft and submitted its Application for Aircraft Registration, as required by law. On the application, Taxpayer claimed an exemption from sales and use tax on the purchase, asserting "Rental or Lease to others." The Department requested documentation from Taxpayer to substantiate the exemption. The Department determined that the aircraft was not being used for rental or lease and assessed use tax. Taxpayer protested and a hearing was held.

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(b) imposes use tax on the storage, use, or consumption of an aircraft if the aircraft is acquired in an isolated or occasional sale and is required to be registered by the State of Indiana. Because Taxpayer is an Indiana corporation with an aircraft based within Indiana, it was required to register the aircraft with the State. *See* IC 6-6-6.5-2. Taxpayer promptly registered the aircraft. On the registration form, Taxpayer claimed exemption from sales and use tax, asserting rental or lease to others, as provided by IC 6-2.5-5-8(b).

The Department requested documentation to substantiate the claim for exemption. Taxpayer provided copies of leases and a copy of the aircraft insurance. The leases all stated:

[Taxpayer] will maintain an insurance policy for liability and physical damage on the Aircraft.

[Taxpayer] will ensure that Renter is listed as a named insured under such insurance policy.

An examination of Taxpayer's insurance policy on the aircraft reveals under Item 4 that the aircraft will be used only for non-commercial use. The policy defines "non-commercial" to mean:

private pleasure and business use, excluding any use for hire, money or any form of reward or compensation. Being reimbursed for or sharing the direct expenses of a **flight** if the sum of these expenses does not result in a profit to **you** or anyone is not excluded. [Bold original]

The definition of "insured" within the policy, states in relevant part:

But excluded as an **insured** is any:

…

(b) person or organization renting **your aircraft**

…

[Bold original]

Since the rental agreement states that Taxpayer will ensure that the renter is listed as a named insured under Taxpayer's insurance policy, the agreements for use tax purposes do not establish a qualified exemption for rental or lease to others.

Taxpayer is a for-profit corporation. However, the rental rate set by Taxpayer is significantly below the market rate to rent comparable aircraft. While the Department cannot establish at what rate a taxpayer should rent an aircraft, the Department can use that rate as indicia as to whether Taxpayer has a genuine motive to rent the aircraft for profit to others or whether Taxpayer is using the exemption to avoid paying sales and use tax on the purchase of the aircraft.

The past and present shareholders of Taxpayer corporation are [DT], [SM], [DP], [MS], [GB], [DD], and [FK]. Of the four aircraft rental agreements submitted to the Department by Taxpayer to support its claim for a tax exemption, all four of the executed agreements were between Taxpayer and its shareholders [DT], [SM], [DD], and [FK] as individuals. Taxpayer is not engaged in renting and leasing to others; this is a cost-sharing arrangement.

The lease agreements between Taxpayer and several of its shareholders as individuals fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helvering, 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, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

The purchase of the aircraft by Taxpayer triggered sales and use tax. The individual shareholders who executed agreements with Taxpayer were able to secure the use of an aircraft for themselves without having to pay $18,300 of sales and use tax at the time of the purchase. By setting the rental rate substantially below market rate, the individuals who desire to use the aircraft pay only a nominal sales tax when they "rent" the aircraft to themselves. Because renters are also shareholders, the money paid to Taxpayer S-corporation is passed back through to the shareholders. The net result is a wash transaction, and the shareholders, by way of the S-corporation, have avoided paying the upfront sales and use tax due on the purchase of the aircraft.

The shareholders have structured the "rental" transactions to secure the benefits of an exemption—but have not assumed the associated burdens. The Indiana Supreme Court has stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 55 N.E. 745, 749 (Ind. 1899). 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).

The relationship between Taxpayer and its "renters" is interfamilial. These agreements are not arms-length transactions with others. 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 purports to operate as a business, but does not have a profit motive. The Department determined that Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax exemption statutes.

FINDING

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

DEPARTMENT OF STATE REVENUE

04-20050368P.LOF

LETTER OF FINDINGS NUMBER: 05-0368P
STATE GROSS RETAIL TAX
For Years 2001 AND 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.

ISSUES

I. State Gross Retail Tax —Penalty Assessment

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

Taxpayer protests the proposed assessments of penalty on an assessment.

STATEMENT OF FACTS

Taxpayer is an Indiana Limited Liability Company that provides telecommunication services to customers within Indiana. Services include telephone, data (internet) and video (cable television or CATV) services through a single fiber-optic and coaxial cable system. After an initial audit of the Company's operations, the Department assessed additional use tax. Taxpayer protested the imposition of penalty.

I. State Gross Retail Tax —Penalty Assessment

DISCUSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1. The Indiana Administrative Code further provides in 45 IAC 15-11-2:

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

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

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

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

Taxpayer argues that the penalty was inappropriate based on taxpayer's overall compliance and the relatively new technology and products taxpayer provides. Standing alone neither of the taxpayer's arguments are dispositive but they are factors which are indicative of the taxpayer's reasonable care, caution, or diligence.

FINDING

Taxpayer protest sustained.

DEPARTMENT OF STATE REVENUE
Revenue Ruling #2005-13ST
November 10, 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 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/Use Tax – Parent's acquisition of tools and subsequent sale of same to subsidiary
Authority: IC 6-2.5-5-8

The taxpayers request the Department to rule on the application of sales/use tax to the acquisition of tools and subsequent sale of same by the parent to the subsidiary.

ISSUE #2

Sales/Use Tax – Subsidiary's purchase of tools from parent
Authority: IC 6-2.5-5-8, IC 6-2.5-3-2

The taxpayers request the Department to rule on the application of sales/use tax to the purchase of tools from the parent by the subsidiary.

STATEMENT OF FACTS

Beginning on July 1, 2002, Distributor, headquartered in Indiana, entered into an agreement with its parent company, Supplier, also headquartered in Indiana, to distribute (sell) Supplier products throughout the United States. Effective July 1, 2003, Distributor and Supplier executed a new revised distribution agreement. Hereinafter, the distribution agreement between Distributor and Supplier in effect beginning July 1, 2002, through June 30, 2003, is referred to as the "First Agreement," and the revised distribution agreement between the Distributor and Supplier effective July 1, 2003, through the present date is referred to as the "Second Agreement." Under both the First Agreement and the Second Agreement, in addition to buying products from Supplier for resale, Distributor also purchased from Supplier certain tools that are required to correctly install or adjust the products.

Supplier purchases approximately 75% of the tools from third-party suppliers located both inside and outside of Indiana. These tools are delivered to Supplier in Indiana, where Supplier inspects the tools and holds them in inventory. The remaining tools (approximately 25%) are machined by a subsidiary of Supplier also located in Indiana, that provides industrial processing services to Supplier in connection with those tools not acquired from third-party vendors. Supplier procures, owns and causes to be delivered to subsidiary all materials used to machine the tools by subsidiary. When completed, these tools are delivered by subsidiary to Supplier and inspected and held in inventory by Supplier, along with those tools acquired from third party suppliers. When Distributor informs Supplier that it wishes to purchase one or more tools, the tools are removed from inventory and they are then etched by Supplier to include the logo, trademark, work order, part number, size, diameter, and a tool code. After etching, the tools are then packaged, and delivered to Supplier's warehouse in Indiana, from which location they are shipped.

When Distributor purchases the tools from Supplier, in lieu of formal invoicing, the tools are charged to Distributor at Supplier's cost, removed from inventory on Supplier's books and records, and capitalized on Distributor's books and records, at cost.

While Distributor sells the products to its customers, Distributor only sometimes sells the tools for an extra charge. In most cases, Distributor supplies such tools to its customers at no extra charge. Distributor also makes available to its independent sales representatives a limited number of tools at no charge, for use by Distributor customers. Distributor continues to hold title to the tools supplied to its customers and sales representatives which must be returned to Distributor upon its request. However, after the Tools have been supplied to a hospital or medical care facility where they are used in patient care, they are only on rare occasions returned to Distributor.

Under the First Agreement, upon receipt of an order, Supplier would arrange for the shipment and delivery of the requisite products and tools from its inventory located in Indiana directly to Distributor's customer or sales representative by common carrier, and Distributor would pay and reimburse Supplier for all freight costs. Pursuant to the terms of the First Agreement, title and risk of loss to the products and tools passed from Supplier to Distributor either upon the delivery of those items to Distributor's customer if the delivery destination was inside the State of Indiana or at the Indiana state line if the delivery destination was outside the State of Indiana.

The First Agreement provided in part as follows:

> Section 2.6 Delivery. Supplier shall cause delivery of the Products to the locations identified by Distributor in each purchase order. Title and risk of loss to the Products shall pass from Supplier to Distributor (i) upon delivery to Distributor's customer, if the delivery destination is inside the State of Indiana, and (ii) at the Indiana state line, if the delivery destination is outside the State of Indiana. Distributor shall pay and reimburse Supplier for all freight costs and each party shall bear its own insurance costs associated with the shipment and delivery of the Products. Supplier reserves the right to split an order and make delivery in installments or partial shipments, and in such event, each installment or partial shipment shall be separately invoiced and paid

for when due, without regard to subsequent deliveries.

Under the Second Agreement, upon receipt of an order, Supplier would remove the requisite Supplier-made products and tools from its inventory in its Indiana warehouse and then move them to the packaging area in that warehouse for shipment by common carrier to Distributor's customer's or sales representative's location. Although all of this activity takes place in the Supplier warehouse, under the Second Agreement, Supplier is deemed to have delivered the products and tools to Distributor upon physical delivery of those items to the packaging area in Supplier's Indiana warehouse. Risk of loss and title to these items pass from supplier to Distributor at this point under the Second Agreement. Distributor is responsible for final packaging and shipping the product and tools under the Second Agreement.

The Second Agreement provides in part as follows:

Section 2.6 Delivery; Risk of Loss.

(a) The terms of delivery of the ordered Products shall be EXW, [Indiana] (Incoterms 2000), except that in addition to being responsible for shipping the Products, Distributor also shall be responsible for packaging all Products at Supplier's warehouse prior to shipment. Supplier shall be deemed to have delivered all Products to Distributor upon delivery of the Products to the packaging area at Supplier's warehouse in [Indiana] ("Delivery"). Upon and after the Delivery of the Products, Distributor shall be solely responsible for packaging the Products and all aspects of the loading, handling and shipment of the Products to Distributor's desired destination, and all costs, liabilities and obligations related thereto. Without limiting the foregoing, Distributor shall be responsible for identifying and contracting with all carriers and insuring the Products after Delivery. Supplier reserves the right to split an order and make Delivery in installments, and in such event, each installment shall be separately invoiced and paid for when due, without regard to any subsequent Delivery of Products. Distributor shall use commercially reasonable efforts to cause the Products to be packaged and shipped within two (2) business days of the Products being delivered to the packaging area of Supplier's warehouse in [Indiana].

(b) Title and risk of loss to the Products shall pass from Supplier to Distributor at the time of Delivery of the Products.

(c) Supplier shall designate a secure holding area in its [Indiana] plant where Distributor may store, keep or locate Products for which Distributor has taken Delivery. Products in such holding area shall be segregated from products of Supplier and its other customers. Supplier shall use commercially reasonable efforts to maintain secure and environmentally consistent conditions for such holding area comparable to the conditions it maintains for its own products. Notwithstanding the foregoing, Distributor understands and acknowledges that Supplier shall not be liable for loss or damage of any kind to the Products after Delivery of the Products by Supplier.

DISCUSSION – ISSUE #1

The taxpayers request the Department to rule on the application of sales/use tax to the acquisition of tools and subsequent sale of same by parent to the subsidiary.

IC 6-2.5-5-8(b) states:

Transactions involving tangible personal property other than a new motor vehicle are exempt from the state gross retail tax if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business without changing the form of the property.

In the instant case, it is clear both the acquisition of tools by the Supplier (parent) and the subsequent sale of same to the Distributor (subsidiary) fall within the "resale" exemption afforded by above IC 6-2.5-5-8, therefore, these transactions are not subject to sales/use tax.

RULING – ISSUE #1

The Department rules the Supplier's (parent's) acquisition of tools from third-party suppliers and tools machined by a subsidiary of the Supplier on behalf of the Supplier, the Supplier's inspection, etching, and packaging of the tools, and the Supplier's sale of tools to the Distributor (subsidiary) are not subject to Indiana sales/use tax.

DISCUSSION – ISSUE #2

The taxpayers request the Department to rule on the application of sales/use tax to the purchase of tools from the parent by the subsidiary.

The "resale" exemption (IC 6-2.5-5-8; see Discussion - Issue #1) is applicable to the purchase of tools from the Supplier (parent) by the Distributor (subsidiary) in instances where the Distributor sells the tools to customers or sales representatives. In instances where the Distributor supplies tools to the customers or sales representatives located in Indiana at no charge, the Distributor is subject to Indiana use tax on same pursuant to IC 6-2.5-3-2 (imposition statute for use tax). In instances where the Distributor supplies tools to customers or sales representatives located outside of Indiana, the Distributor is not subject to Indiana sales and use tax on such tools, but might be subject to use tax in the state to where the tools are shipped.

RULING – ISSUE #2

The Department rules the purchase of tools from the Supplier (parent) by the Distributor (subsidiary) is not subject to sales/use tax when the Distributor sells the tools to customers or sales representatives. In cases where the Distributor supplies tools at no charge and ships them to customers or sales representatives located in Indiana, the Distributor is subject to Indiana use tax on the tools. In cases where the Distributor supplies tools at no charge and ships them to customers or sales representatives located outside of Indiana, the Distributor is not subject to Indiana sales and use tax on the tools, but might be subject to use tax in the state to where the tools are shipped.

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.

DEPARTMENT OF STATE REVENUE
Revenue Ruling 2005-15ST
December 12, 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.

Revenue Ruling #2005-09ST, printed at 28 IR 3747, is repealed.