XVI. Taxation

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A. Introduction

During the 1979-1980 survey period, the Indiana Supreme Court and Indiana Court of Appeals handed down several significant decisions in the field of state taxation. One especially gratifying feature of these decisions was the courts' frequent emphasis on a strict construction of the taxing statute, particularly when the state was seeking to find and impose tax liability. Moreover, it appears that the quality of taxpayer litigation continues to improve and that lawyers are discovering that state tax cases are to be litigated with the same care and evidentiary concerns as any product liability, personal injury, or breach of contract case.

One facet of the recent decisions may be of special concern to the two major state tax agencies, the State Board of Tax Commissioners and the Department of Revenue. The courts have continued to recognize that while these agencies, in holding taxpayer hearings, are not subject to the express requirements of the Indiana Administrative Adjudication Act,[1] they are nonetheless subject to basic administrative law hearing requirements. This recognition may indicate that these agencies should re-evaluate their hearing procedures.

On June 30, 1980, the Indiana Supreme Court handed down *Clark v. Lee*,[2] a decision which could become one of the most notable state tax developments in the last decade. In *Lee*, the supreme court held that under certain conditions a class action may be maintained to obtain on behalf of each member of the class a refund of taxes unlawfully imposed upon and collected from the individual members of the class.[3] The availability of class action relief to taxpayers, as now announced by the supreme court, may spark litigation which could conceivably lead to massive recoveries against the state in the future.

B. The Court's Emphasis on Strict Construction of the Tax Statute

In three separate decisions, the Indiana Court of Appeals has stressed the necessity to look first to the language of the governing

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[1] *See* IND. CODE §§ 4-22-1-1 to -30 (1976).

[2] 406 N.E.2d 646 (Ind. 1980).

[3] *Id.* at 648-49.

tax statute to determine a question of tax liability. Thus, in *Indiana Department of Revenue v. Glendale-Glenbrook Associates*,[4] the court was confronted with a taxpayer's contention that a partnership, consisting of several individuals and one life insurance company, should not be subjected to the gross income tax. The relevant statute provides in pertinent part: "Every partnership of which one or more of the partners is a corporation shall be liable for the tax imposed by sections 2 and 3 of IC 6-2-1 [the gross income tax] and by this article [the adjusted gross income tax]."[5] The taxpayer reasoned that because the corporate partner, the insurance company, was not itself subject to the gross income tax,[6] it made no sense for the Department to conclude that its participation in the partnership would trigger gross income tax liability for the partnership. The Revenue Department contended that the statute was plain and unambiguous and required no judicial interpretation of legislative intent. The court, responding to the taxpayer's contention that the statutory scheme must be examined as a whole in order for the true ambiguity to appear, stated: "We fear that the taxpayer confuses ambiguity in the wording of a statute, which requires judicial interpretation of legislative intent, with an apparently incomplete or illogical statutory taxing scheme, which requires a legislative overhaul."[7] *Glendale-Glenbrook Associates* is a good lesson for taxpayers and for taxing authorities. In sum, the court of appeals determined that there was no ambiguity in the statutory language and that therefore "[t]he taxpayer's argument, although steeped in logic and equity, ignore[d] the plain reading of the statute."[8]

The court in *Glendale-Glenbrook Associates* is to be commended for not succumbing to the temptation to judicially rewrite the statute in order to reach a more logical result. On the other hand, where such an illogical result pervades the statutory scheme, it would be equally commendable for the taxing authority, itself, to seek legislative clarification.

The basic concept that the language of a taxing statute should be the first determinant of tax liability was also emphasized by the court of appeals in *Park 100 Development Co. v. Indiana Department of State Revenue*.[9] This case again involved an interpretation

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[4]404 N.E.2d 1178 (Ind. Ct. App. 1980).

[5]IND. CODE § 6-3-7-1(b) (Supp. 1980).

[6]Under IND. CODE §§ 6-2-1-7(k), 6-3-2-3(d), and 6-3-7-1(a) (1976 & Supp. 1980), a life insurance company electing to pay the premium tax is excluded from gross income taxation, and the corporate partner in *Glendale-Glenbrook Associates* had so elected. 404 N.E.2d at 1179.

[7]404 N.E.2d at 1179.

[8]*Id.*

[9]388 N.E.2d 293 (Ind. Ct. App. 1979).

and application of the provision,[10] previously quoted,[11] which subjects partnerships having one or more corporate partners to gross income tax liability. However, in *Park 100*, the court's emphasis on a strict construction of the statute operated in favor of the taxpayer and against the Revenue Department.

Park 100 involved the question whether a so-called two-tiered partnership was subject to gross income tax under section 6-3-7-1(b). The concept of "two-tiered partnerships" had been devised by taxpayers to avoid the gross income tax liability imposed by that section. The mechanism was simple; corporations interested in participating in a partnership venture would first form a *partnership* consisting of one or more corporations and possibly one or more individuals (this would be the "first-tier" partnership). The first-tier partnership would in turn become a partner in the formation of an operating partnership which would actually conduct the business enterprise (the so-called "second-tier" partnership). The second-tier or operating partnership would have other partners who could be individuals or even other first-tier partnerships. In *Park 100*, the Revenue Department argued that the two-tiered partnership concept was a subterfuge to avoid section 6-3-7-1(b) and that Park 100 Development Company, a second-tier partnership engaged in the development and management of an industrial park, should be subject to the gross income tax. The court of appeals stated the issue as follows: "Park 100 presents the following issue for our review: whether IC 6-3-7-1(b) applies to a partnership that has as a partner a separate partnership consisting of two corporations."[12] The trial court had adopted the Revenue Department's rationale, but the court of appeals reversed, observing that the trial court had engaged in "an unwarranted and expansive interpretation of the statute."[13] The court once more emphasized that in construing a statute, statutory words are to be "accorded their ordinary significance and commonly accepted meaning."[14] The court further emphasized that a statute levying taxes, such as section 6-3-7-1(b), is "not to be extended by implications beyond the clear import of the language used."[15] The court accordingly concluded that "based upon these rules of statutory construction, we do not feel that Park 100 had a corporate partner within the spirit and intent of IC 6-3-7-1(b)."[16]

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[10]IND. CODE § 6-3-7-1(b) (Supp. 1980).

[11]*See* text accompanying note 5 *supra*.

[12]388 N.E.2d at 295.

[13]*Id.*

[14]*Id.*

[15]*Id.*

[16]*Id.*

As in *Glendale-Glenbrook Associates*,[17] it is probably true that a more logical result could have been reached in *Park 100* if the court had abandoned the unambiguous language of the statute. Courts are often confronted with unambiguous statutory language which, if construed in accordance with its ordinary meaning, would produce an untenably absurd result. In some of those situations, courts will consider the entire context of the taxing statute to reach a reasonable interpretation. Nevertheless, the courts are on solid ground when, as a general principle, they decline to embark on judicial excursions into the field of redrafting tax legislation by judicial interpretation.

In *Indiana Department of State Revenue v. Endress & Hauser, Inc.*,[18] the court of appeals, in interpreting a key provision of the Adjusted Gross Income Tax Act,[19] asserted that "legislatures make the tax statutes and courts enforce them as written, not as departments of revenue may wish they had been written."[20] The issue in *Endress & Hauser* was whether a corporate taxpayer, in computing its adjusted gross income tax liability, was entitled to a net operating loss carry-forward deduction incurred by the taxpayer prior to the date it entered Indiana and became subject to the Indiana adjusted gross income tax.[21] The Revenue Department argued that although the adjusted gross income tax was based on an apportionment of a corporate taxpayer's "taxable income," as defined in section 63 of the Internal Revenue Code,[22] nevertheless a net operating loss carry-forward deduction could not be taken in determining "taxable income" if the loss had been incurred at a time when the taxpayer was not subject to the Indiana tax. The Department's contention was based on the underlying premise that the overriding objective of the law was to impose the adjusted gross income tax on "only business income which is derived from sources within the state of Indiana."[23] The court of appeals agreed that the Department's position was logical and could result in a more equitable distribution of the tax burden, but the court, again resorting to a strict construction of the statutory language, concluded that the Act's definition of "taxable income" was unambiguous.[24] Accordingly, neither the Revenue Department nor the court could modify that definition

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[17]*See* notes 4-8 *supra* and accompanying text.

[18]404 N.E.2d 1173 (Ind. Ct. App. 1980).

[19]IND. CODE § 6-3-1-3.5(b) (Supp. 1980).

[20]404 N.E.2d at 1178.

[21]Endress & Hauser had ceased operations as a Massachusetts corporation in 1973 with a large net operating loss. Subsequently, Endress & Hauser reincorporated as an Indiana corporation. *See* I.R.C. § 368(a)(1)(F).

[22]I.R.C. § 63.

[23]404 N.E.2d at 1176.

[24]*Id.* at 1178.

which unambiguously accorded the taxpayer a deduction for its net operating loss carry-forward based on section 63 of the Internal Revenue Code. The court stated in conclusion: "The Department's remedy lies . . . in legislative changes in the tax laws, not in the judicial construction of a statute whose definition is plain on its face and which can be read in harmony with other tax statutes . . . ."[25]

C. *Taxpayer Class Actions*

In *Clark v. Lee*,[26] the Indiana Supreme Court affirmed the maintenance of a taxpayer's class action for the refund of unlawfully imposed taxes collected by the Indiana Revenue Department. This decision is startling, and could lead to substantial class action tax refund recoveries against the state in the future. Presumably, resourceful legal representatives of such taxpayer classes will be appropriately rewarded for their successful efforts. From the state's viewpoint, the decision could produce serious revenue concerns but perhaps the time has come to recognize that the small taxpayer can only obtain really adequate representation through the availability and maintenance of a class action.

The principal issue urged by the taxpayers in *Lee* concerned the constitutionality of the Indiana Occupation Income Tax law.[27] The challenged occupation income tax was a local option income tax which had been adopted by only a few local governmental entities. The tax under the statute was imposed on the income of individuals who devoted more than fifty percent of their working time to services performed within the local governmental entity adopting the tax.[28] Although the tax was theoretically imposed on all individuals who met the fifty percent test, as a practical matter, only nonresidents of the state were paying the tax. Indiana residents did not actually pay the tax because of a tax credit provision which provided that an individual's Indiana state income tax liability could be applied as an offsetting credit against any local occupation tax liability.[29] Because a resident's state income tax liability would invariably be greater than any local occupation tax liability, the state tax credit eliminated the latter.

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[25]*Id.*

[26]406 N.E.2d 646 (Ind. 1980).

[27]Ind. Code §§ 6-3.5-3-1 to -14 (1976 & Supp. 1980).

[28]*Id.* § 6-3.5-3-2 (1976) provides that a local government may adopt an ordinance which imposes an occupation tax on employees who are "principally employed in the county." *Id.* § 6-3.5-3-1 (3) defines an "[e]mployee who is principally employed in the governmental entity imposing the tax" as "an employee who devotes more than fifty percent of the time that he works for his employer to services which he provides in the county, city, or town, imposing the occupation income tax."

[29]*See id.* § 6-3.5-3-6.

The taxpayers in *Lee* were residents of Kentucky who worked in Clark County, Indiana, one of the local governmental entities which had adopted the local occupation income tax. Under the Indiana-Kentucky state income tax reciprocity agreement,[30] these taxpayers did not pay Indiana adjusted gross income tax. Therefore, they could not avail themselves of the credit provision but instead were obligated to pay the local occupation tax.

Based on the authority of *Austin v. New Hampshire*,[31] the Indiana Supreme Court declared[32] that the Indiana Occupation Income Tax law, by effectively taxing only nonresidents, was an unconstitutional violation of the privileges and immunities clause of the United States Constitution.[33] In light of *Austin*, the court's decision in *Lee* on the constitutional issue could have been anticipated, but its collateral ruling on the class action question was surely a surprise to most followers of Indiana taxation.

The Kentucky plaintiffs had brought their action for a refund of the unlawfully collected occupation income tax on behalf of themselves and "all persons being nonresidents of, or domiciled without the State of Indiana, while principally employed within the State of Indiana."[34] Each of the named taxpayer plaintiffs had followed the express statutory procedures required for instituting a court action for a tax refund.[35] The trial court had ruled that under Indiana Trial Rule 23(A)[36] and subsection 2 of Indiana Trial Rule 23(B),[37] the named plaintiffs were proper and adequate representatives of the class of nonresident taxpayers who had been obliged to pay the occupation income tax and that the case was properly maintainable as a class action.[38]

On appeal, the state contended that the trial court had erred in ordering the case maintainable as a class action because there had

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[30]*See id.* § 6-3-5-1, -2; KY. REV. STAT. § 141.070(2) (1970 & Supp. 1980).

[31]420 U.S. 656 (1975). *Austin* was also a taxpayer class action challenging a similar tax on the income of nonresidents, the New Hampshire commuters' income tax. See N.H. REV. STAT. ANN. § 77-B:1 to -B:28 (1970 and Supp. 1973). The Supreme Court held that the tax violated the privileges and immunities clause, U.S. CONST. art. IV, § 2, cl. 1. 420 U.S. at 668. The Supreme Court made no mention of the propriety of the class action.

[32]406 N.E.2d at 652.

[33]U.S. CONST. art IV, § 2, cl. 1. provides: "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States."

[34]406 N.E.2d at 648.

[35]*Id.* at 649. The administrative procedures were provided in IND. CODE §§ 6-3-6-2, -4, -3.5-3-11.5(4) to -11.5(7) (1976). *Id.* §§ 6-3-6-2, -4 were repealed by Act of Mar. 3, 1980, Pub. L. No. 61, § 15, 1980 Ind. Acts 660, effective Jan. 1, 1981. For the current provisions, *see* IND. CODE §§ 6-8.1-9-1 to -3 (Supp. 1980).

[36]IND. R. TR. P. 23(A).

[37]IND. R. TR. P. 23(B)(2).

[38]406 N.E.2d at 648.

been no showing to the trial court that all the members of the putative class, that is, all nonresident workers who had paid the occupation income tax, had exhausted their statutory administrative remedies.[39] Although acknowledging that a trial court is without jurisdiction to determine the legality of the imposition of a tax unless the plaintiff has exhausted administrative remedies, the supreme court answered the state's contention thusly:

> In the situation with which we are confronted, the named plaintiffs personally satisfied the jurisdictional requirements of the statute by exhausting their administrative remedies before bringing their action. In so doing they afforded the state government the opportunity of reckoning with their claim. The claim itself was constitutional in nature and sought to void the statute because it discriminated against a class to which plaintiffs belonged, namely, non-residents. It was by its nature a claim which would, if successfuly prosecuted by a lone plaintiff, provide a basis for classwide relief in the absence of certification. We, therefore, conclude that the certification of this action as a class action does not vitiate or evade the jurisdictional requirements of the statute and is not contrary to the case law cited. The action satisfied all of the requirements of Trial Rule 23(A) and the requirement of subsection 2 of Trial Rule 23(B), and therefore the trial court did not err in ordering the case maintainable as a class action.[40]

On the surface, the supreme court's conclusion that the case was maintainable as a class action seems inherently fair and appropriate. As the court observed, the state had been afforded its day in court to respond to the singular legal issue affecting all members of the class.[41]

While seemingly fair and appropriate, the court's decision may produce a number of problems yet to be identified. For example, how is the three-year statute of limitations for the filing of refund claims[42] to be applied to class actions? This statutory requirement serves two crucial functions: First, it cuts off claims against the state after the elapse of three years, and second, it serves as notice

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[39]In support of this contention, the state cited three cases: State *ex rel.* Indiana Dep't of State Revenue v. Marion Circuit Court, 255 Ind. 501, 265 N.E.2d 241 (1971); Marhoefer Packing Co. v. Indiana Dep't of State Revenue, 157 Ind. App. 505, 301 N.E.2d 209 (1974); Cooper v. County Bd. of Review, 150 Ind. App. 232, 276 N.E.2d 533 (1972).

[40]406 N.E.2d at 649.

[41]*Id.*

[42]IND. CODE § 6-8.1-9-1 (Supp. 1980).

to the state of the dollar amount of revenues which may have to be refunded. Obviously, the state must be able to project its revenue requirements with some degree of certainty. The added exposure to taxpayer class action refund recoveries may prove to be a serious complicating factor.

Another possible problem could concern the handling of refund claims awarded pursuant to a class action judgment in instances where an individual member of the class is in fact a delinquent taxpayer. Perhaps the courts, in awarding class action judgments, should specify that any refund awarded to an individual member of the class shall be first applied to any tax liability then delinquently due and owing by such class member.[43]

While the sheer massiveness of a taxpayer class might create awesome procedural problems, perhaps the fundamental requirements of Indiana Trial Rule 23 will afford the most satisfactory basis for resolving issues affecting large numbers of taxpayers. Trial Rule 23 provides a means to handle problems relating to manageability of large groups, adequacy of the class representatives, and the necessity for notice.

Finally, it should be noted that the supreme court in *Lee* also sustained the trial court's award of attorney fees to the named plaintiffs' attorneys.[44] As the supreme court observed, the trial court's award was entirely consistent with its finding that the action was properly maintainable as a class action.[45]

Although *Lee* certainly suggests the establishment of a new horizon for state tax litigation, one note of caution is necessary. The court, in holding that the case was maintainable as a class action, did emphasize that the "claim itself was constitutional in nature and sought to void the statute."[46] While it does not appear from the balance of the court's opinion that its holding was intended to be restricted to the maintenance of class actions raising constitutional issues, there is a strong implication that the courts will look to the nature of the issue when determining whether a taxpayer action is maintainable as a class action. To be sure, it presents a fertile field for tax litigation.

D. Other Significant Gross Income Tax Decisions

In *Indiana Department of State Revenue v. Food Marketing*

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[43]*See id.* § 6-8.1-9-2.

[44]406 N.E.2d at 649.

[45]*Id. See* IND. R. TR. P. 23(D)(5).

[46]406 N.E.2d 649.

Corp.,[47] the court of appeals was faced with the question of the proper computation of a wholesale grocer's gross earnings for imposition of the gross income tax. This question specifically involved a special gross income tax rate classification[48] which permits "wholesale grocers who are engaged in the business of selling stocks of groceries, tobacco products and expendable household supplies" to report and pay gross income tax based on their "gross earnings . . . derived from wholesale sales of stocks of groceries, tobacco products and expendable household supplies to retail food establishments."[49] "Gross earnings" is defined in the statute as the taxpayer's gross receipts from such wholesale sales "less the cost of the stock of groceries, tobacco products and expendable household supplies sold."[50]

The precise issue in *Food Marketing* was whether a wholesale grocer was entitled to deduct its warehousing costs, buying costs, turnover costs, and building expenses in computing its gross earnings. The Revenue Department argued that the statutory deduction for the wholesale grocer's "cost of stock sold" only permitted a deduction for initial acquisition expense and freight-in expense.

In a split decision, the majority of the court held that the statutory term "cost of the stock . . . sold"[51] was broader than the concept argued by the Revenue Department.[52] The majority pointed out that if the legislature had intended to limit the deduction to initial acquisition costs, as urged by the state, it could have employed such appropriate language as "invoice cost," "original acquisitional cost," or "purchase cost."[53] The majority stated: "Instead, the Legislature used the term 'cost of the stock . . . *sold*' which logically includes those items necessary to prepare the products for resale as argued by Food Marketing."[54]

The majority also emphasized that because the wholesale grocer's provision was a tax imposition provision, it should be construed against the state and in favor of the taxpayer. The court accordingly ruled that the grocer was entitled to deduct the additional preparation costs in computing its gross earnings.[55]

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[47]403 N.E.2d 1093 (Ind. Ct. App. 1980).

[48]IND. CODE § 6-2-1-1(s) (Supp. 1980).

[49]*Id.*

[50]*Id.*

[51]*Id.*

[52]403 N.E.2d at 1097.

[53]*Id.* at 1096.

[54]*Id.*

[55]*Id.* at 1097. Judge Staton, in his lengthy dissent, took vigorous issue with the majority's application of the plain meaning rule and the majority's determination that deduction provisions are to be construed against the state. *Id.* at 1097-1103 (Staton, J., dissenting).

In *Indiana Department of State Revenue v. Northern Indiana Steel Supply Co.*,[56] the plaintiff brought suit for a refund of gross income tax paid in connection with its sale of certain heavy equipment in 1971. The issue before the court was whether Northern Indiana Steel could, in computing gross income tax liability, deduct from the purchase price the amount which it owed on the equipment at the time of sale. Under the terms of sale, the indebtedness had been assumed by the purchaser.

The gross purchase price for the equipment was $405,319.80; the amount owed on such equipment was $383,163.50, a portion of which was payable pursuant to a conditional sale contract with the balance being subject to various security agreements. At the closing, the purchaser had assumed the outstanding indebtedness on the equipment and had made a cash payment of $22,156.30, for the balance of the $405,319.80 purchase price.

Following an audit the Revenue Department assessed gross income tax on the total purchase price of $405,319.80.[57] In its refund claim Northern Indiana Steel contended that it was not taxable on the amount of indebtedness ($383,163.50) which its purchaser had assumed. The court of appeals sustained Northern Indiana Steel's contention and held it was not subject to gross income tax on the amount of the indebtedness assumed by the purchaser.[58]

The court's holding is entirely consistent with the supreme court's earlier decisions in *Indiana Department of State Revenue v. Colpaert Realty Corp.*[59] and *Department of State Revenue v. Crown Development Co.*[60] The supreme court recognized in each case that, in the sale of real estate subject to a mortgage encumbrance, the purchaser's assumption of the mortgage debt, and his agreement to pay off that debt, was not a taxable constructive receipt to the seller.[61]

As in the *Colpaert Realty* and *Crown Development* decisions, the court in *Northern Indiana Steel* reasoned that the purchaser's

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[56]388 N.E.2d 596 (Ind. Ct. App. 1979).

[57]The Revenue Department based its assessment on IND. CODE § 6-2-1-1(m) (Supp. 1980) which provides that gross income includes "gross receipts received from the sale, transfer, or exchange of property, tangible or intangible, real or personal, including the sale of capital assets." *Id.* § 6-2-1-1(h) defines "receipt" as "the gross income in cash, notes, credits or other property which is received by the taxpayer or is received by a third person for his benefit." Finally, *id.* § 6-2-1-1(i) defines "receive" or "received" as "the actual coming into possession of, or the crediting to, the taxpayer of gross income . . ., or the payment of his expenses, debts, or other obligations by a third party for his direct benefit."

[58]388 N.E.2d at 600.

[59]231 Ind. 463, 109 N.E.2d 415 (1952).

[60]231 Ind. 449, 109 N.E.2d 426 (1952).

[61]231 Ind. at 472, 109 N.E.2d at 419; 231 Ind. at 459-60, 109 N.E.2d at 430.

assumption of the debt was not taxable as a constructive receipt because, under the express language of the statute,[62] an assumption of indebtedness would be a taxable gross receipt *only* if the assumption were for the "direct benefit" of the former debtor-taxpayer. The court quoted from *Colpaert Realty* as follows:

> Considering the relative advantages flowing to the respective parties, it seems to us that where a purchaser assumes and agrees to pay a debt secured by mortgage, the *direct* benefit to be derived from the subsequent payment of it must be said to flow to the purchaser, and the benefit flowing to the grantor-mortgagor is secondary, incidental, consequential and remote, and therefore indirect within the meaning of the statute.[63]

Another gross income issue arose in *Indiana Department of Revenue v. Waterfiled* [*sic*] *Mortgage Co.*[64] Waterfield was engaged in the mortgage banking business. Waterfield originated mortgage loans which would be assembled into a block of mortgage loans for sale to a third-party investor. The transaction, known as "warehousing," would begin with a number of banks advancing funds to Waterfield. After closing, each mortgage would be assigned to a particular bank, and Waterfield would continue to service the mortgages, for a fee, by collecting mortgage payments from the mortgagors and transferring these payments, including interest, to the mortgagee banks. Waterfield would not send the mortgagors' checks directly to the banks. Rather, Waterfield would deposit the funds in a custodial account and, at the end of each billing period, Waterfield would send one of its own checks for the amount due to each bank. The Revenue Department contended that the interest portions of the mortgage payments constituted gross income to Waterfield.

After reviewing the evidence presented to the trial court, the court of appeals affirmed the trial court's ruling that Waterfield was serving in an agency capacity for the various banks it represented.[65] Therefore, the interest payments on the mortgage loans which Waterfield received in servicing the mortgages were not taxable gross receipts to Waterfield.

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[62]IND. CODE § 6-2-1-1(i) (Supp. 1980).

[63]388 N.E.2d at 598 (quoting 231 Ind. at 478, 109 N.E.2d at 421-22).

[64]400 N.E.2d 212 (Ind. Ct. App. 1980).

[65]*Id.* at 215. *See also* 45 IND. AD. CODE § 1-1-54 (1979) which provides that "[t]axpayers are not subject to gross income tax on income they receive in an agency capacity."

E. Indiana Sales and Use Tax

In *Indiana Department of State Revenue v. Harrison Steel Castings Co.*,[66] the court of appeals considered the issue of sales tax exemptions in a manufacturing context. The company purchased safety equipment which it provided to its employees in its steel casting business. The company then asserted that the equipment qualified for exemption from the Indiana sales tax as "[s]ales of manufacturing machinery, tools and equipment to be *directly used* by the purchaser in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of tangible personal property . . . ."[67] The Revenue Department, after an audit, assessed the company for excluding the items in computing its sales and use tax. The company paid the amounts and brought suit for a refund. The trial court held the property exempt.

The court of appeals, however, reversed the decision.[68] The court reviewed its prior decisions on the same exemption provision, *Indiana Department of State Revenue v. RCA Corp.*[69] and *Indiana Department of State Revenue v. American Dairy, Inc.*,[70] as well as the Revenue Department's sales tax regulation.[71] The court concluded:

> We observe that the Department's interpretation of direct use involves a "positive effect" and an "active causal relationship" to the production process. Our holdings in *American Dairy* and *RCA* certainly seem to follow this strict interpretation. We, thus, determine that the use of safety equipment in the production process is not a "direct use" as it does not have a positive effect and active causal relationship to the production of a product.[72]

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[66]402 N.E.2d 1276 (Ind. Ct. App. 1980).

[67]IND. CODE § 6-2-1-39(b)(6) (1976) (emphasis added) (repealed 1980) (currently codified at IND. CODE § 6-2.5-5-3 (Supp. 1980)).

[68]402 N.E.2d at 1278.

[69]160 Ind. App. 55, 310 N.E.2d 96 (1974).

[70]167 Ind. App. 367, 338 N.E.2d 698 (1975).

[71]IND. AD. RULES AND REGS. (6-2-1-39) -15 (Burns Code ed. 1972) (currently codified at 45 IND. AD. CODE § 2-3-15 (II) (1979)) provides an explanation of direct use:

> In determining whether property is directly used, consideration must be given to the following factors:
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> (A) The physical proximity of the property in question to the production process in which it is used;
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> (B) The proximity of time of use of the property in question to the time of use of other property used before and after it in the production process;
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> (C) The active causal relationship between the use of the property in question and the production of a product.

[72]402 N.E.2d at 1278.

This holding is certainly consistent with *American Dairy* and *RCA*. It is also clear that the court was influenced by "the well-settled principal that in construing an ambiguity in a taxation exemption statute, the statute must be strictly construed against the taxpayer."[73] However, it is submitted that in *Harrison Steel* the court has perpetuated an unwarranted emphasis on the double use of the word "direct" in the tax exemption provision and simultaneously ignored the fact that this statutory sales tax exemption expressly applies to "machinery, tools *and equipment*."[74]

Adopting the reasoning of *RCA*, the court accepted without challenge the Revenue Department's interpretation that the test for the statutory exemption required that the article "have a 'positive effect' and an 'active causal relationship' to the production process."[75] What the court continues to overlook is that the Revenue Department itself has contradictorily disregarded its own test when it recognizes that conveyor systems, lift trucks, cranes, and other kinds of hoists used in the production cycle, but which have no "active causal relationship" to the product, are exempt under this statutory provision.

It is submitted that the court's emphasis in *RCA*, *American Dairy*, and *Harrison Steel* on the "double direct" test reflects a misplaced zeal to obtain a literal statutory interpretation. It is agreed that "direct" means "direct," whether stated once, twice, or three times. Unfortunately, in attempting to make some sense out of the double use of the word "direct," the courts have ignored the fact that the Indiana sales tax exemption for production materials expressly encompasses more than raw input or machinery. The Indiana statute includes an exemption for "equipment."[76] In construing the Indiana gross income tax, the court of appeals has recognized that the term "equipment" includes "[w]hatever is needed in equipping; . . . the articles comprised in an outfit; . . . equipage."[77] Consequently, when the manufacturing exemption literally includes "equipment," that is, that which is necessary to comprise the production output, it logically follows that the safety equipment, as well as the humidity and temperature control equipment, should be deemed exempt. While an exemption provision is to be construed

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[73]*Id.* at 1277.

[74]IND. CODE § 6-2-1-39(b)(6) (1976) (emphasis added) (currently codified at IND. CODE § 6-2.5-5-3 (Supp. 1980)).

[75]402 N.E.2d at 1278.

[76]IND. CODE § 6-2-1-39(b)(6) (1976) (currently codified at IND. CODE § 6-2.5-5-3 (Supp. 1980)).

[77]Department of Treasury v. Ranger-Cook, Inc., 114 Ind. App. 107, 113, 49 N.E.2d 548, 550 (1943) (citing WEBSTER'S NEW INT'L DICTIONARY 865 (2d ed. 1937)).

strictly against the taxpayer,[78] this rule of statutory construction only applies in the case of an ambiguity[79] and the inclusion of "equipment" in the Indiana exemption is sufficient to dispel the existence of an ambiguity which would justify the court's narrow focus on the term "direct."

The second issue in *Harrison Steel* concerned the trial court's rejection of the Revenue Department's attempt to impose a penalty[80] against Harrison Steel. The Department argued that the taxpayer was subject to a penalty for its failure to timely pay the tax, even though the trial court had found the taxpayer had a reasonable basis for not paying the tax. The court of appeals examined the "negligent or intentional disregard" standard set forth in the applicable penalty statute,[81] and concluded that Harrison Steel had acted in good faith and had paid all taxes that it reasonably thought were owed. Therefore, the trial court's refusal to impose a penalty was affirmed.[82]

In *State Department of Revenue v. Calcar Quarries, Inc.*,[83] the taxpayer was engaged in a stone quarry, concrete and asphalt business. In connection with its quarry business, Calcar often delivered crushed stone in Calcar trucks operated under certificates of public convenience and necessity issued by the Indiana Public Service Commission. Calcar claimed that in delivering crushed stone it was engaged in public transportation and that its purchases of trucks and supplies for such transportation were exempt from the Indiana sales tax under the public transportation sales tax exemption provision.[84]

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[78]402 N.E.2d at 1277.

[79]*Id.*

[80]IND. CODE § 6-2-1-16(f) (Supp. 1980) (repealed effective Jan. 1, 1981). *See id.* §§ 6-8.1-1-1 to -11-1 (new tax administration provisions effective Jan. 1, 1981). *Id.* § 6-8.1-11-1 defines the transitional retroactivity.

[81]*Id.* § 6-2-1-16(d) (repealed effective Jan. 1, 1981).

[82]402 N.E.2d at 1282. *See* IND. CODE § 6-8.1-10-2 (Supp. 1980) sets out the penalty provisions effective January 1, 1981. *Id.* § 6-8.1-10-2(d) provides:

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

(Emphasis added.) *Id.* § 6-8.1-10-2(e) provides the procedural method for substantiation of the taxpayer's reasons to avoid a penalty. *Id.* § 6-8.1-10-2(f) expressly enables the Department of Revenue to adopt its own regulations to define terms used such as "negligence" and "reasonable cause." It remains to be seen what role "good faith" or reasonable conduct will play in future tax cases.

[83]394 N.E.2d 939 (Ind. Ct. App. 1979).

[84]IND. CODE § 6-2-1-39(b)(4) (1976) (currently codified at IND. CODE § 6-2.5-5-27 (Supp. 1980)).

The court of appeals upheld the trial court's ruling that Calcar was eligible to claim the public transportation exemption for its trucks, because Calcar had operated the trucks pursuant to certificated authority received from the Public Service Commission and the activity involved constituted public transportation.[85]

The second issue in *Calcar Quarries* involved the same sales tax manufacturing exemption provision applied in *Harrison Steel.*[86] The court again reviewed its earlier holding in *RCA*. However, the court concluded that items such as supplies and repairs of bins, parts for stock trucks, and a tractor-loader which transferred crushed stone from the quarry to the bins for the production of asphalt or concrete, were all "directly used in direct . . . production"[87] of the asphalt or concrete and therefore were exempt from the sales tax.[88] The court of appeals stressed that the trial court, in its findings of fact, had expressly found that Calcar was engaged in one continuous flow of production from its quarry operations to its concrete or asphalt manufacturing activities.[89]

Calcar Quarries may become a useful precedent for taxpayers with integrated production operations. It may also begin to erode the hypertechnical test announced in *RCA* that exempt machinery, tools, and equipment must have a "causal effect" on the product being manufactured.[90] In *Calcar Quarries*, the court retarded the

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[85]394 N.E.2d at 941. *See* 45 IND. AD. CODE § 2-3-13 (1979).

[86]IND. CODE § 6-2-1-39(b)(6) (1976) (repealed 1980) (currently codified at IND. CODE § 6-2.5-5-3 (Supp. 1980)). *See* text accompanying notes 66-79 *supra*.

[87]394 N.E.2d at 943.

[88]*Id.*

[89]*Id.* During the final editing of this Article, the Second District of the Indiana Court of Appeals decided Indiana Dep't of State Revenue v. Cave Stone, Inc., 409 N.E.2d 690 (Ind. Ct. App. 1980), which almost directly contradicts *Calcar Quarries*. In *Cave Stone*, the court held that transportation equipment used to transport crude stone from the quarry to a stone crusher and transportation equipment used to transport the crushed stone from the crusher to stockpiles were taxable as not being "directly used in direct processing." *Id.* at 696. The court said:

> Transportation equipment which merely serves as a means for a product to go from one step to another does not have a positive effect and causal relationship to the production of the graded stone. We hold "directly used in direct processing" requires the transportation equipment be an integral part of a process which is ongoing during the transportation. Here the stone, while being transported, remains unaffected by processing.

Id. At the time of this writing, a petition for rehearing has been filed in *Cave Stone* pointing out to the court the inconsistency of its holding with that of *Calcar Quarries*. Carried to its logical extreme, *Cave Stone* would deny exemption to all kinds of conveying equipment (overhead cranes, hoists, fork lift trucks, and conveyor belts) used to convey actual work in process between production points. The future of *Cave Stone* could be very significant.

[90]*See* text accompanying note 72 *supra*.

Revenue Department's persistent effort to restrict the sales tax exemption for production machinery to an artificially narrow concept. Hopefully, there will be some further developments to restore a more practical and common sense construction to the manufacturing exemption.

In *Indiana Department of State Revenue v. Martin Marietta Corp.*,[91] the issue arose whether freight charges advanced by Martin Marietta to its customers were subject to the Indiana sales tax as part of the sales price of the goods sold.[92] The freight charges were separately invoiced and no profit was realized upon reimbursement. The court of appeals held that the freight charges were the liability of Martin Marietta's customers.[93] The court accordingly concluded that the reimbursements of such freight charges to Martin Marietta were not part of the sales price and therefore were not subject to the sales tax.[94]

F. Adjusted Gross Income Tax

The decision in *Indiana Department of State Revenue v. Continental Steel Corp.*[95] is a sequel to *Indiana Department of Revenue v. Kimberly-Clark Corp.*[96] handed down during the last survey year. *Continental Steel* also involved the question whether the activities of Continental's sales personnel in seventeen foreign states exceeded mere solicitation so as to subject Continental to income tax liability in those states notwithstanding the protection of Public Law 86-272.[97] Continental Steel is an Indiana corporation, but if Continental's out-of-state salesmen were engaged in selling activities involving more than mere solicitation, then its sales delivered into those states from Indiana points of origin would not become a part of Continental's adjusted gross income taxable by Indiana under the state's "sales factor" tax apportionment formula.[98]

The court observed that the Continental salesmen in the seven-

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[91]398 N.E.2d 1309 (Ind. Ct. App. 1979).

[92]IND. CODE § 6-2-1-1(k) (Supp. 1980).

[93]398 N.E.2d at 1313 (citing IND. CODE §§ 26-1-2-308, -401(2)(a) (1976)).

[94]398 N.E.2d at 1313. *See* 1972 Op. Ind. Att'y Gen. 10-12.

[95]399 N.E.2d 754 (Ind. Ct. App. 1980).

[96]375 N.E.2d 1146 (Ind. Ct. App. 1978) *discussed in* Weinstein, *Foreword: Indiana Taxation, 1979 Survey of Recent Developments in Indiana Law*, 13 IND. L. REV. 1, 28 (1980).

[97]15 U.S.C. § 381 (1976) (providing that income derived from interstate commerce is not subject to taxation by a state in which the taxpayer's activity amounts to mere solicitation).

[98]IND. CODE § 6-3-2-2(e) (1976). The "sales factor" (total sales attributed to Indiana divided by total sales everywhere) is used to determine the portion of income taxable by Indiana.

teen states engaged in various selling activities: they adjusted customers' complaints, helped customers design special orders, gave technical help to customers, helped customers assemble catalogs, checked inventories, and occasionally made collections. The court concluded that these kinds of activities constituted "solicitation plus" activities and, that, under *Kimberly-Clark*, Continental's sales into such states from Indiana origins were not to be added to the Indiana numerator of the sales factor under the so-called "throwback rule."[99]

Two observations are worthwhile about *Continental Steel*. First, the court affirmatively acknowledged that the application of the "throwback rule" depended only upon a determination whether the taxpayer was engaged in activities which made the taxpayer liable for taxation by the foreign state of destination. It made no difference whether the taxpayer was *in fact paying taxes* to that state.[100] The question is whether the taxpayer is *taxable* in the foreign state and not whether the taxpayer has in fact been *taxed* by the foreign state.

The second observation is actually a belated protest to the tide of decisions[101] being handed down throughout the country applying the "solicitation plus" test in determining the applicability of Public Law 86-272. It is not possible within this survey to elucidate a total rebuttal to the unfortunate development of this case law. However, it is this writer's observation that the "solicitation plus" test is a wholly artificial and unrealistic concept. It is difficult to believe that Congress intended to restrict the protections of federal law to corporations whose salesmen engaged only in mere solicitation. Surely Congress understood that the ordinary and habitual practice of salesmen in 1959, and for many years prior thereto, included such routine selling functions as listening to customers' complaints, looking at customers' inventories, accepting customer payments from time to time, and rendering technical assistance to a customer's personnel. The strict "solicitation plus" test naively restricts the activities of a salesman to a sterile, unnatural environment never intended by the Congress. Nevertheless, *Continental Steel* is consistent with the majority of state court decisions now available on this point.

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[99]399 N.E.2d at 759. Application of a "throwback rule" would allow the Indiana Department of Revenue to add back the sales which the corporation, in computing its tax, had allocated elsewhere. IND. CODE § 6-3-2-2(n) (1976) provides two instances where an Indiana taxpayer may properly allocate sales and income to another state.

[100]399 N.E.2d at 758.

[101]*See, e.g.*, Miles Laboratories, Inc. v. Department of Revenue, 274 Or. 395, 546 P.2d 1081 (1976); Deseret Pharmaceutical Co. v. State Tax Comm'n, 579 P.2d 1322 (Utah 1978).

G. Ad Valorem Property Tax Decisions

In *State Board of Tax Commissioners v. Aluminum Co. of America,*[102] Alcoa brought an action challenging the Board's reassessment of its manufacturing inventories. The basic question presented was whether Alcoa was required to value aluminum ingots at their full manufactured value including overhead costs attributable to their production. The ingots had been manufactured at one plant and delivered to another plant for fabrication. Under the applicable regulation,[103] the Tax Board had allowed manufacturers to value their work in process and finished goods inventories pursuant to an alternative valuation procedure based on the raw material costs and direct labor expense incurred in the production of such inventories. However, the Tax Board contended that products manufactured at one plant of a taxpayer and shipped to another plant for further fabrication were to be valued at full manufactured cost, the regular valuation method, rather than at a valuation based only on direct labor and material costs as permitted by the alternative method for work in process and finished goods inventories. Alcoa charged that the Board's refusal to allow Alcoa to use the alternative method for valuing ingots produced at one plant and delivered to another plant for fabrication was contradictory to the Tax Board's own regulation. Alcoa argued that its Indiana plants were collectively engaged in one integrated operation and that consequently it should be permitted to value its inventories, wherever located, on the alternative direct labor and materials basis.

The court of appeals noted that, under the Tax Board's contention, ingots manufactured at one plant site and shipped to another plant for fabrication would be taxed at substantially different values than ingots which had, in fact, been manufactured at the second plant site even though the first class of ingots, those shipped to the fabricating plant site, were in all other respects comparable to the second class of ingots.[104] The court concluded that the Tax Board's regulation did not provide for a different valuation method for ingots produced at one plant and shipped to another plant for further processing.[105] Consequently, the court held that Alcoa's reporting of its inventory was correct and consistent with the Tax Board's regulation.[106] The court, in reaching this conclusion, observed that a taxing authority may not abandon its own regulations.

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[102]402 N.E.2d 1316 (Ind. Ct. App. 1980).

[103]50 IND. AD. CODE §§ 4-3-1 to -10 (1979).

[104]402 N.E.2d at 1321.

[105]*Id.*

[106]*Id.*

The second issue in *Alcoa* involved the timeliness of the Tax Board's assessment for the 1974 returns. The court once again criticized the Tax Board's efforts to characterize its audit procedures as constituting a "hearing"[107] within the requirement of the statute[108] which mandates a hearing before the issuance of a final Notice of Assessment. The court said, "Due process requires that a hearing must encompass more than a mere audit or . . . investigation."[109] The court concluded that Alcoa had not been accorded a timely hearing by the Tax Board[110] and, accordingly, the Board's issuance of an assessment for 1974 occurred after the appropriate limitation period[111] had run.

The decision in *Stokely-Van Camp, Inc. v. State Board of Tax Commissioners*[112] presented the opportunity for a comprehensive judicial review of the statutory assessing procedure for inventories of taxpayers described as "first processer[s] of perishable horticultural products."[113] However, the court of appeals summarily disposed of the appeal by holding that the Tax Board's reassessment of Stokely was invalid because the Board had failed to enter written findings in support of its order.[114] The court of appeals remanded the case to the trial court with instructions to set aside the final assessment and to remand the case to the Board for written findings in support of any reassessment of Stokely.[115] *Stokely-Van Camp* is a significant decision because the court specifically held that although the State Tax Board had been explicitly excluded from the hearing requirements of the Administrative Adjudication Act,[116] the Board should nevertheless have made written findings in support of its reassessment order.[117] In reaching that conclusion, the court stated:

> The practical reasons for requiring administrative findings are so powerful that the requirement has been imposed with remarkable uniformity by virtually all federal and state courts, irrespective of a statutory requirement. The reasons have to do with facilitating judicial review, avoiding judicial usurpation of administrative consideration, helping parties

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[107]*See* Whirlpool Corp. v. State Bd. of Tax Comm'rs, 167 Ind. App. 216, 338 N.E.2d 501 (1975).

[108]Ind. Code § 6-1.1-14-11 (1976).

[109]402 N.E.2d at 1323.

[110]*Id.*

[111]Ind. Code § 6-1.1-16-1 (1976).

[112]394 N.E.2d 209 (Ind. Ct. App. 1979).

[113]*Id.* at 210. *See* Ind. Code § 6-1.1-3-13 (1976).

[114]394 N.E.2d at 211.

[115]*Id.*

[116]*See* Ind. Code § 4-22-1-2 (1976).

[117]394 N.E.2d at 210-11.

plan their cases for rehearings and judicial review, and keeping agencies within their jurisdiction.[118]

H. Indiana Intangibles Tax

One of the most important Indiana state tax decisions handed down during the 1979-1980 survey period was *Meridian Mortgage Co. v. State*.[119] This case not only involves a significant intangibles tax question but the court of appeals, in reaching its specific holding, also emphasized the principle that in state tax matters the taxing authorities must look to the substance of the transaction and not be blinded by the formalities or "form" of the transaction.[120]

The specific issue before the court was whether Meridian Mortgage, a mortgage broker which originated and serviced home mortgage loans for banks, title insurance companies and permanent investors, was the owner or the person controlling such mortgage loans so as to be liable for intangibles tax thereon.[121] Basically, Meridian Mortgage would find and assist prospective home buyers in need of mortgage financing to obtain loans. Pursuant to financing agreements with various banks and insurance companies, Meridian Mortgage would make the necessary arrangements for executing the mortgage loans, disbursing the mortgage loan proceeds, and servicing the mortgage indebtedness. Under the formal financing agreements with the banks and title companies, the clear legal implication was that Meridian Mortgage was actually borrowing funds from these institutions and then in turn was lending the funds to the home buyers. For example, as the court observed, the title to the home mortgage loans formally remained in the name of Meridian Mortgage until sold to a permanent investor. However, after observing the various formalities of the transactions, the court of appeals stated:

> The verbiage of these "loan" agreements does not accurately describe the actual transaction which occurs. They recite that the Bank "loans" the money to Meridian, but Meridian never receives any such loan. Meridian, in fact, is not even a conduit; the money goes directly from the Bank to the title company for disbursement to the Seller.[122]

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[118]*Id.* at 211 (quoting K. DAVIS, ADMINISTRATIVE LAW TEXT § 16.03 (3d ed. 1972)).

[119]395 N.E.2d 433 (Ind. Ct. App. 1979).

[120]*Id.* at 441.

[121]*See* IND. CODE § 6-5.1-2-1 (Supp. 1980). The court of appeals in *Meridian Mortgage* was actually applying the predecessor statute, IND. CODE § 6-5-1-2 (1976) (repealed 1977). The court disclaimed any application of its opinion to the statute's new form because the repealed statute explicitly demanded ownership or control. 395 N.E.2d at 438 n.6.

[122]395 N.E.2d at 435.

The court concluded after thorough analysis that, in light of the real substance of the transaction, Meridian Mortgage did not own or control the mortgage loans and consequently had no intangibles tax liability in respect thereto.[123] And in so holding the court stated: "It would be folly for us to hold that form triumphs over substance under these conditions. To fit these transactions into 'ownership' or 'control' on the part of Meridian would seem very much like trying to make a crab into a lobster without altering its shell."[124]

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[123] *Id.* at 440.
[124] *Id.* at 441.