Current Issues Affecting Indiana Tax Policy

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I. Introduction

According to Justice Holmes, "[t]axes are what we pay for civilized society."[1] This statement would lead one to expect a certain civilized rationality in the procedures by which taxes are determined and assessed. Unfortunately, a close examination of most taxing statutes and regulations thoroughly dissipates any such expectation.

This Article focuses upon policy issues affecting three Indiana taxes. Of most immediate interest is the general reassessment of all real property in Indiana, which is currently underway.[2] Secondly, a recent revision of the Indiana Department of Revenue's regulations signifies an abrupt reversal of tax policy in the area of sales and use taxes.[3] Finally, an Indiana Supreme Court decision and its impact on Indiana's death tax scheme is critiqued.[4]

II. General Reassessment of Real Property for Property Tax Purposes

A. *Effects of the General Reassessment*

A general reassessment of all real property in Indiana began[5] on July 1, 1987, and is scheduled to be completed by March 1, 1989.

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1. Compania General de Tabacos v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting).

2. *See infra* notes 5-104 and accompanying text.

3. *See infra* notes 105-77 and accompanying text.

4. *See infra* notes 178-239 and accompanying text.

5. The Indiana General Assembly has ordered nine general assessments of real property since the comprehensive revision of the state's property tax laws enacted in 1919. The 1919 Act provided for general reassessments in 1919, 1922, and every four years thereafter. Act approved March 11, 1919, ch. 59, § 152, 1919 Ind. Acts 198, 281. A general reassessment was conducted in 1922. *See* Hasse v. Bielefeld, 197 Ind. 498, 150 N.E. 413 (1926). An amendment to the statute provided for the next general reassessment in 1925. Act approved February 27, 1925, ch. 27, 1925 Ind. Acts 67. *See* Postlewaite v. Hasse, 205 Ind. 396, 186 N.E. 761 (1933). A 1927 amendment provided for general

The valuations produced by the reassessment will be the basis for property tax assessments effective March 1, 1989, and the resulting taxes due in May and November, 1990.[6] The new valuations will remain in effect until a subsequent general reassessment, which is scheduled to be completed by March 1, 1997.[7] More than twenty bills were introduced in the 1989 session of the General Assembly to delay, phase in, or otherwise minimize the impact of the reassessment on various classes of taxpayers[8] In any event, if history is any guide the current general reassessment will prove to be a time of controversy and testing of the administrative and legal underpinnings of Indiana's property tax system.[9]

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reassessments in 1928 and 1932. Act approved March 7, 1927, ch. 91, 1927 Ind. Acts 233. After the 1932 reassessment, the General Assembly temporarily abandoned the scheme of compulsory quadrennial assessments and delegated to the State Board of Tax Commissioners the duty to decide whether statewide or local reassessments were necessary. Act approved February 24, 1937, ch. 19, 1937 Ind. Acts 58. *See* County Bd. of Review v. Kranz, 224 Ind. 358, 66 N.E.2d 896 (1946). Statutorily-mandated general reassessments were resumed with the 1950 reassessment. Act approved March 9, 1949, ch. 225, 1949 Ind. Acts 722. Since 1950, general reassessments have been ordered for 1962 (Act approved March 10, 1961, ch. 319, § 701, 1961 Ind. Acts 893, 903), 1969 (Act approved March 14, 1963, ch. 338, 1963 Ind. Acts 847), and 1979 (1978 Ind. Acts 806). A plan was adopted in 1969 to reassess real property annually in one-sixth of the state's counties so that all property would be reassessed within the six-year cycle. Act approved March 11, 1969, ch. 112, 1969 Ind. Acts 254. The plan was repealed before it was implemented. Act of February 22, 1972, *Pub. L. No. 49*, 1972 Ind. Acts 455. *See also* Op. Att'y Gen. 104 (1971).

6. Ind. Code § 6-1.1-4-4 (1988).

7. *Id.*

8. *Lawmakers Hope To Soften Tax Blow*, Indianapolis News, Feb. 14, 1989, at A4, col. 4-5.

9. Among the cases arising in connection with the 1979 general reassessment were Lubbenhusen v. State Bd. of Tax Comm'r, 496 N.E.2d 139 (Ind. Ct. App. 1986) *cert. denied*, 107 S. Ct. 1605 (1987); State Bd. of Tax Comm'r v. Vermillion County Property Owners Association, 490 N.E.2d 341 (Ind. Ct. App. 1986); State Bd. of Tax Comm'r v. Smith, 463 N.E.2d 493 (Ind. Ct. App. 1984); Indiana State Bd. of Tax Comm'r v. Ropp, 446 N.E.2d 20 (Ind. Ct. App. 1983) (state board's equalization order was upheld); Indiana State Bd. of Tax Comm'r v. Brown, 410 N.E.2d 1205 (Ind. Ct. App. 1980) (state board could not be enjoined from completing equalization proceedings); Governours Square v. State Bd. of Tax Comm'r, 528 N.E.2d 864 (Ind. T. C. 1987) (application of income method of valuation allowed in determining economic obsolescence of an apartment complex); Meridian Hills Country Club v. State Bd. of Tax Comm'r, 512 N.E.2d 911 (Ind. T. C. 1987) (golf course assessment upheld in part and invalidated in part); Cambridge Square North v. Indiana State Bd. of Tax Comm'r, Cause No. S582-0753 (Marion Superior Court, June 3, 1983) (state board erred in failing to apply the income method in determining the assessed value of an apartment complex, in disallowing an allowance for economic obsolescence, and in applying a formula for determining land values); McCloskey v. State Bd. of Tax Comm'r, Cause No. 37,226 (Hancock Circuit Court, October 24, 1977) (state board was enjoined from enforcing a regulation which applied a 30% inflation adjustment factor in arriving at the true cash value of real property).

Although the general reassessment can be expected to raise the overall assessed value of taxable property in most, if not all, taxing jurisdictions in the state, it should not, by itself, cause an increase in the actual amount of property taxes collected to fund local government. In this connection, the property tax levy is the product of the assessed value of taxable property in the taxing jurisdiction multiplied by the applicable tax rate. The property tax rate is mathematically adjusted in relationship to the total assessed value to produce the tax levy required to fund the local government budget.[10] The growth in the budget is subject to various statutory controls[11] which in turn govern the growth in the overall property tax burden. Rather than increase taxes, the intended and expected effect of general reassessment is to reallocate the property tax burden among different classes of taxpayers as their relative shares of the assessed value base change. It has been estimated that on average homeowners may experience an increase in property taxes of 14% from the 1989 reassessment. Farmers may enjoy an average reduction in taxes of 15%, and businesses may receive an average reduction of 5%. In absolute terms, it has been projected that $99 million in property taxes will be shifted from farmers and businesses to homeowners.[12]

Much of this shift in the tax burden can be explained by the fact that business personal property and utility property are self-assessed annually and thus more closely reflect current values.[13] On the other hand, the increase in real property values resulting from price-level inflation is largely excluded from the assessment base between general reassessments.[14] During the interim, business personal property and

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10. Ind. Code § 6-1.1-17-1 to -19 (1988).

11. Ind. Code §§ 6-1.1-18-1 to -11 & 6-1.1-19-1 to -8 (1988). In addition, the state board of tax commissioners has been given special authority to adjust post-1988 tax rates in the case of certain tax levies—such as cumulative building funds—that are applied at fixed rates to the outstanding assessed value. Act approved May 4, 1987, Pub. L. No. 74, § 25, 1987 Ind. Acts 1394, 1411. Absent such adjustment, the actual tax paid would rise solely as a result of the general reassessment.

12. Memorandum from the Legislative Services Agency to the Commission on Tax and Financing Impact Policy (Aug. 24, 1988). *See also* L. DeBoer, Projecting the Impact of the 1990 Reassessment on Indiana County Assessment (June 1987) (available from Purdue University); L. DeBoer, The Indiana Property Tax Assessment System: Simulations of Four Policy Alternatives (1987) (available from Purdue University Cooperative Extension Service) [hereinafter DeBoer, Tax Assessment System]. The specific impact on individual taxpayers could vary dramatically from these averages depending on the specific taxing jurisdiction, the type of property involved, and various other factors.

13. Ind. Code §§ 6-1.1-2-2 & 6-1.1-8-25 (1988).

14. Consumer prices rose 100.3% between January 1975, and January 1985. *Consumer Price Index* (Rev. CPI-W Urban Wage Earners and Clerical Workers (All items (1967) = 100)). Construction costs as of January 1975, and January 1985, were used,

utility property assume a gradually increasing share of the property tax burden. General reassessment restores a rough parity between real property and personal property in terms of the prevailing price levels used to determine assessed values. However, this realignment occurs through a sudden, discrete adjustment.[15] This phenomenon is disconcerting to taxpayers and is typically accompanied by calls for legislative and administrative strategies to blunt, or at least delay, the impact on certain classes of taxpayers, such as homeowners.

As in past years, the general reassessment can be expected to increase the incidence of controversy and litigation regarding property taxes, as well as competition among classes of taxpayers for preferential treatment. These forces are likely to place considerable pressure on the state's property tax system and highlight the weaknesses in its legal and administrative structure.

B. Indiana's Approach to Property Tax Valuation

A first step in understanding a state's property tax system is to identify the prevailing valuation standard and the allowable methods for estimating value. At least conceptually, if not always in practice, most states tie the assessment of property to market value or some uniform fraction thereof.[16] Terms such as "actual value," "fair cash value," or "true and actual value" are typically used in state statutes to denote market value,[17] defined generally as the price at which property can be sold by a willing seller to a willing buyer when both operate with knowledge of the facts and without duress.[18] The methodology applied to determine market value is by no means uniform. However, generally accepted appraisal principles recognize three basic methods for valuing property:[19] the market approach,[20] the income

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respectively, to determine reproduction cost schedules for purposes of the 1979 and 1989 general reassessments. *See* Indiana State Board of Tax Commissioners, *Foreword* to Real Property Appraisal Manual (1976); Indiana State Board of Tax Commissioners, *Foreword* to Real Property Assessment Manual (1986).

15. DeBoer, Tax Assessment System, *supra* note 12.

16. International Association of Assessing Officers, Improving Real Property Assessment: Reference Manual 2 (1978). *See also* Institute of Property Taxation, Property Taxation § 2.01[1] (1987).

17. Note, *The Road to Uniformity in Real Estate Taxation: Valuation and Appeal*, 124 U. Pa. L. Rev. 1418, 1420 n.21 (1976).

18. Institute of Property Taxation, *supra* note 16, at § 2.01[1]; and International Association of Assessing Officers, Property Assessment Valuation 21 (1977).

19. Allison & Brown, *Appraisal Theory and Practice in the Computerized Age*, in Encyclopedia of Real Estate Appraising 9-10 (3d ed. 1978).

20. "The market approach, known also as the market data or sales comparison

approach,[21] and the cost approach.[22] Standard appraisal practice typically employs all three methods whenever possible to determine a final estimate of value.[23] As discussed below, it appears that the General Assembly and State Board of Tax Commissioners ("State Board") have departed from many of these familiar principles in the design and administration of Indiana's property tax system. Whether their approach can be sustained by the Indiana courts remains to be seen.

Professor Wade Newhouse, in his study of state constitutional requirements for uniformity and equality in taxation, has identified twelve categories of constitutional clauses and ranked them according to their strictness or permissiveness on the scales of universality and uniformity, *i.e.*, the extent to which all property must be included within the tax base and the degree to which all property must be uniformly taxed without classification as to effective rates.[24]

The cornerstone of Indiana's property tax system is Article X, section 1, of the Indiana Constitution, which provides:

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approach, results in a market value estimate derived from the analysis of recent sales of property similar to the property appraised." W. Shenkle, Modern Real Estate Appraisal 133 (1978). "The comparative sales approach rests on the principle of substitution, which states that no commodity has a value greater than that for which a similar commodity—offering similar uses, similar utility and similar function—can be purchased within the reasonable time limits that the buyers' market demands." International Association of Assessing Officers, *supra* note 18, at 105.

21. The income approach is intended to determine the present value of the expected future earnings from the property in question. "In the *income approach*, the appraiser takes the net annual income and capitalizes it at an appropriate capitalization rate." W. Shenkle, *supra* note 20, at 54 (emphasis in original). "The capitalization process restates market value by converting the future benefits of property ownership into an expression of present worth." International Association of Assessing Officers, *supra* note 18, at 203.

22. The cost approach estimates value by considering the cost of the property less depreciation. International Association of Assessing Officers, *supra* note 18, at 131; W. Shenkle, *supra* note 20, at 157-58. The cost figure employed may be either actual cost, replacement cost, or reproduction cost depending on the circumstances. 1 J. Bonbright, The Valuation of Property at 140-50 (1937).

23. Allison & Brown, *supra* note 19, at 9-10. It has been suggested that under ideal circumstances in a purely competitive market, these three methods would produce identical valuations. However, in the real world markets are not perfect, and actual data may be unavailable for purposes of computation under the market comparison or income approach. Thus, in arriving at a single value the appraiser may have to harmonize different estimates produced by the three methods or may have to rely on less than all three. Note, *Tax Assessments of Real Property: A Proposal for Legislative Reform*, 68 Yale L.J. 335, 344-45 (1958) [hereinafter Note, *Tax Assessments*].

24. W. Newhouse, Constitutional Uniformity and Equality in State Taxation (2d ed. 1984).

> The General Assembly shall provide, by law, for a uniform and equal rate of property assessment and taxation and shall prescribe regulations to secure a just valuation for taxation of all property, both real and personal.[25]

On the basis of its constitution, Indiana is ranked among the fourteen most restrictive states in this study, and it appears that it is only the specific authorization to the General Assembly to exempt intangible property that prevents Indiana's Constitution from being assigned to the most restrictive end of the scale.[26] With a few exceptions,[27] the Indiana courts have applied the uniformity clause of the Indiana Constitution as strictly as Professor Newhouse's study predicts. Over the years, several statutes,[28] regulations,[29] and informal assessment policies[30] have been struck down as violating the constitution's requirement for uniformity, equality, and just valuation.

The General Assembly has chosen to implement the constitutional mandate to prescribe regulations for the just valuation of property by

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25. Ind. Const. art. X, §1. This section also permits the Indiana General Assembly to exempt the following classes of property:

> (1) Property being used for municipal, educational, literary, scientific, religious or charitable purposes;
> (2) Tangible personal property other than property being held for sale in the ordinary course of a trade or business, property being held, used, or consumed in connection with the production of income, or property being held as an investment;
> (3) Intangible personal property.

Id. Motor vehicles, mobile homes, airplanes, boats, trailers, and similar property may also be exempted if an excise tax is imposed on such property instead. *Id.*

26. W. Newhouse, *supra* note 24, at 475-504, 1902 (1984).

27. *See, e.g.*, Lutz v. Arnold, 208 Ind. 480, 512-20, 193 N.E. 840 (1935) (Treanor, C. J., concurring) (the concurring opinion was filed later and appears in a different volume of the North Eastern Reporter at 196 N.E. 702 (1935)).

28. *See* Huie v. Private Truck Council, Inc., 466 N.E.2d 435 (Ind. 1984) (taxation of indefinite situs property of interstate motor carriers); Wright v. Steers, 242 Ind. 582, 179 N.E.2d 721 (1962) (exemption for motor vehicles); Finney v. Johnson, 242 Ind. 465, 179 N.E.2d 718 (1962) (formula method for valuing household goods).

29. State Bd. of Tax Comm'rs v. Polygram Records, Inc., 487 N.E.2d 444 (Ind. Ct. App. 1985) (treatment of accrued royalties in valuation of musical recording inventory of record distributor); State Bd. of Tax Comm'rs v. Pioneer Hi-Bred Int'l, Inc., 477 N.E.2d 939 (Ind. Ct. App. 1985) (grain inventory held at different levels of trade); McCloskey v. State Bd. of Tax Comm'rs, Cause No. 37226 (Hancock Circuit Court, October 24, 1977).

30. Harrington v. State Bd. of Tax Comm'rs, 525 N.E.2d 360 (Ind. T.C. 1988) (boat marina assessment); Meridian Hills Country Club v. State Bd. of Tax Comm'rs, 512 N.E.2d 911 (Ind. T.C. 1987) (golf course assessment); Indiana State Bd. of Tax Comm'rs v. Lyon & Greenleaf Co., 172 Ind. App. 272, 359 N.E.2d 931 (1977) (fungible grain inventory taxed at different values depending on identity of owner).

directing the state board to promulgate its own administrative regulations for classifying property and determining values.[31] These regulations are the basis for determining "true tax value," the statutory valuation standard.[32] The local tax rates are applied to the property's "assessed value," which is 33 1/3% of its true tax value.[33] The statutes require that the state board's regulations base true tax value on certain enumerated factors and "any other factor the board determines by rule is just and proper."[34]

The regulations issued by the State Board for assessment of real property are sometimes referred to as Regulation 17 or as the "Real Property Assessment Manual."[35] Under Regulation 17, the true tax value of land (other than farm land) is based on market values using the sales comparison method of appraisal.[36] Farm land valuations are

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31. IND. CODE §§ 6-1.1-31-5, 6-1.1-31-6, & 6-1.1-31-7 (1988).

32. *Id.* § 6-1.1-31-5(a).

33. *Id.* § 6-1.1-1-3.

34. *Id.* § 6-1.1-1-3. In the case of real property, the enumerated factors are:

(1) the proper classification of real property;
(2) the size of real property;
(3) the effects that location and use have on the value of real property;
(4) the depreciation, including physical deterioration and obsolescence, of real property;
(5) the cost of reproducing improvements;
(6) the productivity or earning capacity of land; and
(7) the true tax value of real property based on the factors listed in this subsection and any other factor that the board determines by rule is just and proper.

Id. §6-1.1-31-6(b).

In the case of personal property, the enumerated factors are:

(1) the proper classification of personal property;
(2) the effect that location has on the value of personal property;
(3) the cost of reproducing personal property;
(4) the depreciation, including physical deterioration and obsolescence, of personal property; and
(5) the true tax value of personal property based on the factors listed in this subsection and any other factor that the board determines by rule is just and proper.

Id. § 6-1.1-31-7(b).

The assessed value of public utility property is based on its "just value," which is determined by the state board based on several enumerated factors which the board "may" consider. *Id.* §6-1.1-8-26. The total "unit value" of the utility, which is to be determined by the state board, is then allocated between "distributable property" and "fixed property" and assigned to the applicable taxing jurisdiction according to prescribed rules. *Id.* §6-1.1-8-25.

35. The current regulations can be found in IND. ADMIN. CODE tit. 50, r. 2.1-1 to 2.1-6 (1988). The regulations issued for the 1969 and 1979 general reassessment were known as the *Indiana Real Property Appraisal Manual*. The 1979 regulations are set forth at IND. ADMIN. CODE tit. 50, r. 2-1 to 2-13 (1988).

36. IND. ADMIN. CODE tit. 50, r. 2.1-2-1(c) (1988). Alternatively, the "abstraction

derived by using the "productivity method." The regulations assign all farm land a base rate of $495 per acre, which is adjusted by productivity factors supplied by the state board.[37] Real estate improvements are generally assessed on the basis of replacement cost, which is adjusted, in the case of residential property, for physical depreciation and "neighborhood desirability"[38] and, in the case of commercial and industrial property, for physical depreciation and obsolescence.[39]

The valuation of tangible personal property of a business is governed by separate regulations commonly known as Regulation 16.[40] Depreciable property assessments are based largely on historical book costs[41] with depreciation adjustments allowed under prescribed tables based on the property's actual age in relationship to the applicable cost recovery or useful life period for federal income tax purposes.[42] Inventory is also generally valued on the basis of actual book costs[43] subject to a flat downward 35% valuation adjustment.[44]

Public utility property is assessed under what is commonly known as Regulation 19.[45] Personal property owned by a public utility is generally valued using adjusted basis figures for federal income tax purposes (with some exceptions).[46] Real property values are based on Regulation 17.[47]

Even as Indiana's latest general reassessment nears its scheduled completion, the standard of value which these valuation techniques are intended to measure remains unclear. The statute does not define "value" as such but merely refers to the state board's regulations as the basis for determining taxable value.[48] The state board's regulations have been the statutory basis for real property valuations since 1950[49]

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method" can be used to calculate the value of improved land in a situation in the absence of sufficient samplings of vacant land sales. *Id.* tit. 50, r. 2.1-2-1(d).

37. *Id.* r. 2.1-2-2.

38. *Id.* r. 2.1-3-2 and 2.1-3-3.

39. *Id.* r. 2.1-5-1.

40. *Id.* r. 4.1-1-1 to 4.1-8-5 (for recent amendments, see 12 Ind. Reg. 818 (1989)).

41. Ind. Admin. Code tit. 50, r. 4.1-2-2 (1988).

42. *Id.* r. 4.1-2-6.

43. *Id.* r. 4.1-3-2.

44. *Id.* r. 4.1-3-8.

45. *Id.* r. 5-1-1 to 5-9-1 (for recent amendments, see 12 Ind. Reg. 527-30 (1988)).

46. Ind. Admin. Code tit. 50, r. 5-4-3 (1988). This section has been recently amended, and amendments can be found at 12 Ind. Reg. 528-30 (1988).

47. 12 Ind. Reg. 528 (1988) (to be codified at Ind. Admin. Code tit. 50, r. 5-4-2.5).

48. Ind. Code §§ 6-1.1-31-5(a), 6-1.1-31-6(b)(7), & 6-1.1-31-7(b)(5) (1988).

49. *See* Act approved March 9, 1949, ch. 225, 1949 Ind. Acts 722; Act approved March 13, 1959, ch. 316, 1959 Ind. Acts 819; Act approved March 10, 1961, ch. 319, 1961 Ind. Acts 893; Act approved March 18, 1975, Pub. L. No. 47, 1975 Ind. Acts 247.

and for personal property valuations since 1961.[50] The statutes contain a list of factors on which the state board's regulations are supposed to be based.[51] However, a 1984 amendment added the following statement after this list of factors:

> With respect to the assessment of real property, true cash value does not mean fair market value. True cash value is the value determined under the rules of the state board of tax commissioners.[52]

A similar statement was added in connection with personal property valuation.[53] In addition, the amendments deleted from the list of factors the productivity or earning capacity of personal property and the capitalization of income from the use of personal property.[54] The amendments also eliminated capitalization of income from real property use.[55] The apparent purpose of these amendments was to sever Indiana's definition of value from any concept of market value determined by reference to either the market approach or the income approach.[56] Moreover, because of the statement that true cash value means "the value determined under the rules of the state board of tax commissioners,"[57] the statute might be read as a legislative declaration that taxable values should be divorced entirely from market value considerations however determined. That inference is reinforced by a 1986 amendment in which the term "true cash value"—which had been the

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Prior to 1950, the assessing officials were directed to consider several enumerated statutory factors in arriving at property tax values. Ind. Code Ann. §§ 64-103, 64-601, & 64-1019(b) (Burns 1951 Replacement). Thus, prior to 1950 local assessors appear to have had the discretion to use their own judgment in applying the statutory factors and not to have been bound by the State Board's interpretation of such factors as embodied in its regulations.

50. Act approved March 10, 1961, ch. 319, 1961 Ind. Acts 893; 1975 Ind. Acts 247.

51. *See supra* note 34 and accompanying text.

52. Ind. Code § 6-1.1-31-6(c) (1988).

53. *Id.* § 6-1.1-31-7(d).

54. Act approved March 2, 1984, Pub. L. No. 42, § 2, 1984 Ind. Acts 552, 554.

55. *Id.*

56. It is possible that Pub. L. No. 42-1984 was enacted in reaction to the decision in Cambridge Square North v. Indiana Bd. of State Tax Comm'rs, Cause No. 37226 (Marion County Sup. Ct., June 3, 1983) in which the court held that the state board could not deny the use of the income method in valuing real estate because Ind. Code § 6-1.1-31-6(b) (1982) expressly referred to earning capacity and capitalization of income. In addition, Regulation 17 apparently sanctioned the income method, although it never explained how valuations under the income and cost methods should be reconciled. Ind. Admin. Code tit. 50, r. 2-1-9 (1985) (repealed 9 Ind. Reg. 706 (1986)).

57. Ind. Code § 6-1.1-31-6(c) (1988).

statutory valuation standard since at least 1919[58]—was replaced by the term "true tax value."[59]

In connection with its "sunset review" of the State Board, the Indiana Legislative Services Agency characterized the State Board as advocating the position that market values are not the basis for property tax assessments in Indiana.[60] The State Board's administrative actions over the years have generally been consistent with this position.[61] More recently, in response to the 1984 statutory amendments, the State Board amended existing Regulation 17 to delete the principal reference to the income method of valuation[62] and eliminated the method entirely from the version of Regulation 17 issued for the 1989 general reassessment.[63] In addition, the state board has not attempted to apply even the cost approach as a true proxy for market values. As it did in the 1979 version of Regulation 17,[64] the State Board has applied an across-the-board 15% "discount" to actual replacement costs (determined by a state-wide study) in establishing the schedules in the 1989 version of Regulation 17.[65] Similarly, the State Board's regulations for assessing farmland, business personal property, and utility property also contain features that tend to produce true tax values below market values derived according to accepted appraisal principles.[66]

C. *Critique of the "True Tax Value" System*

The goals of a property tax system that bases assessment values on rules divorced from market values appear to be related primarily to improving the ease and cost of administration. Under such a regime,

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58. Act approved March 11, 1919, ch. 59, 1919 Ind. Acts 198.

59. Act approved March 11, 1986, Pub. L. No. 24, 1986 Ind. Acts 617 (codified as amended at Ind. Code § 6-1.1-1-3 (1988)).

60. Indiana Legislative Services Agency, Performance Audit of State Board of Tax Commissioners, State Board of Accounts, Treasurer of State's Office, Board of Depositories, Department of Revenue, Indiana Revenue Board, Common School Fund, Land Division, Office of Auditor of State 1 (May 1985) [hereinafter Performance Audit].

61. Note, *Suggested Adjustments to Indiana Condominium and Property Tax Laws*, 10 Ind. L. Rev. 693, 725 (1977).

62. Ind. Admin. Code tit. 50, r. 2-1-9 (1985) (repealed 9 Ind. Reg. 706 (1986)).

63. Ind. Admin. Code tit. 50, r. 2.1-1-1 to 2.1-6-1 (1988).

64. Performance Audit, *supra* note 60, at 4.

65. *See Reassessment Guidelines Ok'd*, Indianapolis News, May 27, 1986, at 11, col. 1; *Senator Says Property Tax May Leap 20%*, Indianapolis News, June 21, 1986, at 17, col. 5; and *Assessing Will Hit Home—Literally*, Indianapolis Star, June 25, 1986, at 1, col. 1. The study showed that construction costs had risen 100% between 1975 and 1985, but the state board increased the cost schedules by only 85%.

66. *See supra* notes 37, 41-47 and accompanying text. *See also* Performance Audit, *supra* note 60, at 7.

the often intractable problems of ordinary appraisal practice would ideally fall away as the process of valuing property was reduced to the application of a set of mechanical rules and formulas that could be applied even by those with relatively minimal training. In addition, controversy and litigation would be reduced, with the ultimate issue being whether the applicable regulations were properly applied. The typically conflicting testimony of appraisal experts would not have to be weighed and reconciled. Finally, the discretion of local assessors would be greatly confined under such a system, and the conformity of their valuations with the requirements of the regulations would be subject to relatively easy verification by taxpayers and reviewing administrative boards or courts.[67]

However, even if it was assumed that comprehensive and consistent regulations could be developed to achieve such objectives, there are serious drawbacks to a system that rejects market value as the ultimate standard for assessment valuation. In general, assessing officials and taxpayers alike are left without any conceptual guideposts in developing the assessment regulations or in determining or evaluating actual assessments of individual properties.

First, under such a scheme, "value" comes to resemble "taxable income" under the Internal Revenue Code.[68] "Taxable income" is whatever Congress defines it to be (subject to some relatively non-obtrusive constitutional limitations). If "true tax value" is whatever the State Board's regulations define it to be, the State Board is thrust into the role of a legislative body, potentially subject to all the political forces typically directed at a legislature.[69]

Second, although even a market-value based assessment system can be criticized on various policy grounds,[70] the results can at least be

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67. *Cf.* Note, *Tax Assessments*, *supra* note 23, at 375.

68. *Id.* at 370.

69. A serious legal question also arises concerning whether the legislature can constitutionally delegate to the State Board the authority to define the taxable value standard. *Cf.* Welsh v. Sells, 244 Ind. 423, 435, 192 N.E.2d 753, 760 (1963) (the court held that a section of House Enrolled Act Number 1226 (1963) that authorized the Department of Revenue to modify the tax rate brackets set by law was an unconstitutional delegation of authority). *But cf.* Taxpayers Lobby v. Orr, 262 Ind. 92, 101, 311 N.E.2d 814, 818 (1974) ("The mere fact that the Act may require some interpretation . . . does [not] mean that the Act requires an unconstitutional exercise of legislative power by the Department of Revenue . . . [T]he Supreme Court has recognized that some discretion must be conferred upon an administrative body in the enforcement of tax laws."). *Id.* at 818-19. *See also* Note, *supra* note 61, at 731.

70. Ture, *Shortcomings of the Property Tax* in PROPERTY TAX REFORM: THE ROLE OF THE PROPERTY TAX IN THE NATION'S REVENUE SYSTEM 92 (1973) [hereinafter PROPERTY TAX REFORM] and Woodruff, *Strengths and Weaknesses of the Property Tax*, in PROPERTY TAX REFORM, *supra*, 99 & 105-09.

rationalized as distributing the burdens of taxation in rough proportion to what the underlying property is worth. Results under a system divorced from the market value standard are difficult to rationalize except by reference to political compromise.

Third, it becomes very difficult for taxpayers to evaluate the equity of their assessments *vis-a-vis* other taxpayers when market values are not the conceptual basis for assessment, especially when all or most valuations are fixed below prevailing market levels. A taxpayer typically can be expected to have some general notion of the market value of the taxpayer's own property. Thus, he or she can proceed with some degree of confidence in the uniformity of assessment practice in general if the taxpayer's property, as well as the property of others, is assessed at close to fair market value.[71] However, when most property, including his or hers, is assessed at less than fair market value, the taxpayer has no readily available means of gauging the uniformity of assessments relative to market values unless he or she knows the precise fraction of full value generally used to determine assessed value. If this fraction cannot be determined or if there is no uniform fraction, the taxpayer may have to resort to a sales/assessment ratio study, a statistical analysis intended to establish the average ratio of market value to assessed value. Very few taxpayers have the resources to undertake such a study.[72]

Aside from the weight of the policy arguments, a "true tax value" system not based on a fair market value standard must also be scrutinized under the Indiana Constitution.[73] It is on this score that the most serious doubts about the viability of such a system arise.[74]

The Indiana courts have not yet been required to state explicitly whether Indiana's constitutional mandate for uniform and equal assessment and just valuation requires property to be assessed at full fair market value or some uniform fraction thereof. However, in *Walter*

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71. Pajcic, Weber, & Francis, *Truth or Consequences: Florida Opts for Truth in Millage in Response to the Proposition 13 Syndrome*, 8 FLA. ST. U.L. REV. 593, 608 (1980); and Note, *supra* note 17, at 1426.

72. Note, *supra* note 17, at 1440-43. *See also* Note, *Inequality in Property Tax Assessments: New Cures for an Old Ill*, 75 HARV. L. REV. 1374 (1962). Fractional value assessment may also diminish the taxpayer's propensity to appeal even an unequal assessment of which he is aware simply because the variation from the norm appears to be less. Thus, a taxpayer might be willing to accept an assessment at 24% of fair market value when the average assessment fraction of all property is 20%. He would seem less likely, however, to accept an assessment at 120% of fair market value if full value was the standard. However, the inequality is the same in both cases. Pajcic, Weber & Francis, *supra* note 71, at 608.

73. IND. CONST. art. X, § 1. *See supra* note 25 and accompanying text.

74. *Cf.* Note, *Tax Assessments*, *supra* note 23, at 382; Note, *supra* note 61, at 726.

v. Schuler,[75] the Florida Supreme Court, after construing almost identical language in Florida's Constitution,[76] concluded that the constitutionally required "just valuation" of property was to be determined by the property's fair market value.[77] In that case, the court found it necessary to define the term "just valuation," which it referred to as "X," before it could rule on whether wide-spread assessment of property at varying fractions of market value violated the state's constitution:

> "[F]air market value" and "just valuation" should be declared "legally synonymous" and that such is the best way to arrive at the definition of "X." The former term is a familiar one and it, in turn may be established by the classic formula that it is the amount a "purchaser willing but not obliged to buy would pay to one willing but not obliged to sell."[78]

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75. 176 So. 2d 81 (Fla. 1965).

76. At the time of the decision in Walter v. Schuler, Florida's constitution provided: "The legislature shall provide for a uniform and equal rate of taxation . . . and shall prescribe such regulations as shall secure a just valuation of all property, both real and personal." FLA. CONST. art. IX, § 1.

This language was present in the Florida Constitution between 1885 and 1968. A similar provision had existed in the 1868 constitution. W. NEWHOUSE, *supra* note 24, at 179. The "just valuation" requirement was also carried over into the 1968 constitution. FLA. CONST. art. VI § 4. Indiana and Florida provide an interesting comparison of two states in which property tax systems have developed under almost identical constitutional provisions but differing statutory schemes, administrative structures, and political and economic conditions. Coeppel & Fanchel, *Challenging Ad Valorem Real Property Assessments in Florida*, 3 J. ST. TAX'N 113 (1984); Hudson, *Florida's Property Appraisers*, 7 NOVA L.J. 477 (1983); Pajcic, Weber & Francis, *supra* note 71; Wershow, *Agricultural Zoning in Florida—Its Implications and Problems*, 13 U. FLA. L. REV. 479 (1960); Wershow, *Ad Valorem Taxation and Its Relationship to Agricultrual Land Tax Problems in Florida*, 16 U. FLA. L. REV. 521 (1964); Wershow, *Ad Valorem Assessments in Florida—Whither Now?*, 18 U. FLA. L. REV. 9 (1965); Wershow, *Recent Developments in Ad Valorem Taxation*, 20 U. FLA. L. REV. 1 (1967); Wershow, *Regional Valuation Board—A British Answer to Ad Valorem Assessment Problems in Florida*, 21 U. FLA. L. REV. 324 (1969); Wershow, *Ad Valorem Assessments in Florida—The Demand for a Viable Solution*, 25 U. FLA. L. REV. 49 (1972); Wershow & Schwartz, *Ad Valorem Assessments in Florida—Recent Developments*, 36 U. MIAMI L. REV. 67 (1981); Note, *Ad Valorem Taxation—Agricultural Classifications—The Continuing Preferential Tax Treatment Accorded the Florida Land Speculator*, 7 FLA. ST. U.L. REV. 571 (1979); Note, *The Florida Constitution and Legislative Classification for Tax Assessment Purposes*, 17 U. FLA. L. REV. 609 (1965); Note, *"Fogg" Lingers Over the Supreme Court of Florida*, 39 U. MIAMI L. REV. 549 (1985).

77. 176 So. 2d at 85-86.

78. *Id.* (citation omitted). The Arkansas Supreme Court has also held that fair market value assessment was necessary to satisfy a constitutional requirement that "[a]ll property subject to taxation shall be taxed according to its value" as well as the requirement that the values be "equal and uniform throughout the State." Arkansas Pub. Serv. Co. v. Pulaski County Bd. of Equalization, 266 Ark. 64, 582 S.W.2d 942 (1979). *See also*

Although the Indiana courts have not yet faced this issue squarely, it is nonetheless clear that in prior decisions the Indiana courts have not permitted either the Indiana General Assembly or the state board to define value for tax purposes as the mechanical end product of formulas adopted primarily for the sake of administrative convenience.

In a 1961 statutory amendment,[79] the Indiana General Assembly dealt with the difficulty of accurately valuing household goods by providing that such goods would have an assessed value equal to 5% of the assessed value of the improvements on the real estate on which the household goods were kept and maintained.[80] However, in *Finney v. Johnson*[81] the Indiana Supreme Court held that such provision, although simplifying and increasing the effectiveness of assessment and taxation of household goods, nonetheless violated the just valuation requirements of article X, section 1, of the Indiana Constitution.[82]

In *Indiana State Board of Tax Commissioners v. Lyon and Greenleaf Co.*,[83] the state board's regulations provided that raw wheat belonging to farmers should be taxed at sixty cents per bushel while raw wheat inventory held by a dealer or manufacturer was valued at the lower of actual cost or current replacement cost. Consequently, commingled wheat could be taxed at two different values depending on the identity of the owner. The court recognized that the constitutional requirements for uniformity, equality, and a just valuation were interdependent; uniformity and equality result when property is assessed at a just valuation. It further recognized that the authority granted to the Indiana General Assembly to "prescribe regulations to secure a just valuation" allowed it to establish the "mode by which the valuation of all property shall be ascertained."[84] Although actual cost was one of the statutory factors on which the state board was allowed to base its regulations, the court concluded that cost and "value" are not necessarily equivalent within the meaning of article X, section 1, of the Indiana Constitution:

> While it is true that the relevant statutes recognize cost as a factor to consider in arriving at a just valuation, such factor

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Rocky Mountain Oil & Gas Ass'n v. State Bd. of Equalization, 749 P.2d 221, 232 (Wyo. 1987).

79. Act of March 11, 1961, ch. 325, 1961 Ind. Acts 959.

80. Household goods were subject to taxation until a constitutional amendment was approved by the general assembly in 1963 and 1965. *See* Act of April 20, 1963, ch. 48 (Spec. Sess.), 1963 Ind. Acts Spec. Sess. 228; Act approved March 9, 1965, ch. 482, 1965 Ind. Acts 1452. The amendment was approved by the electorate in 1966.

81. 242 Ind. 465, 179 N.E.2d 718 (1962).

82. *Id.* at 466, 179 N.E.2d at 719.

83. 172 Ind. App. 272, 359 N.E.2d 931 (1977).

84. *Id.* at 276, 359 N.E.2d at 934.

> is not a sufficient condition to satisfy the constitutional requirements. Thus, a method of cost valuation which does not move towards the goal of securing a just valuation of all property on the principles of uniformity and equality cannot withstand constitutional attack.[85]

As these cases illustrate, the courts not only did not equate taxable value with the value determined by statute or the state board's regulations, but they obviously perceived just valuation as an objective standard against which such statutes and regulations are to be measured.

D. *Elements of a "Just Valuation" Property Tax System*

An efficient property tax system—at least one that can function under a constitutional uniformity provision such as Indiana's—must necessarily adopt a standard of value tied to the generally recognized principle that value "is the ability of a commodity to command another commodity (money) in exchange."[86] Known as exchange value, this amount represents, in principle, an objective value assigned to property by the marketplace.[87]

In estimating exchange value, orthodox appraisal practice requires application of the three standard methods of valuation, with each result operating as a check on the other in arriving at a final valuation.[88] Reproduction cost (or replacement cost) less depreciation is often suggested as a ceiling on valuation on the ground that property should not be valued at an amount in excess of what it would cost to replace the property with an effective substitute.[89] In some cases, property assessments have been approved on the ground that they reflect "use value," *i.e.*, a value that exceeds exchange value because it reflects the subjective value afforded to property based on a specific use or user. Use value may not be fully reflected in the property's market price (or exchange value) because prospective purchasers would not derive the same utility from the property as the current owner.[90] Usually

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85. *Id.* (footnote omitted). *See also* State Bd. of Tax Comm'rs v. Pioneer Hi-Bred Int'l, Inc., 477 N.E.2d 939 (Ind. Ct. App. 1985), and State Bd. of Tax Comm'rs v. Polygram Records, Inc., 487 N.E.2d 444 (Ind. Ct. App. 1985).

86. International Association of Assessing Officers, *supra* note 18, at 16.

87. Hazen & Janata, *Value Concepts in Property Taxation and Cost Approach as Applied to Real Estate, Machinery & Equipment and Unitary Value Concepts* in N.Y.U. 2d Ann. Inst. on St. & Local Tax'n and Conf. on Prop. Tax'n § 16.02[2][a] (1984) [hereinafter *Value Concepts*].

88. *See supra* notes 19-23 and accompanying text.

89. *See* Note, *supra* note 17, at 1432-33; 1 J. Bonbright, *supra* note 22, at 156.

90. *Value Concepts*, *supra* note 87, at § 16.02[2][c]. *See also* 1 J. Bonbright, *supra* note 22, at 14-16; Hazen, *The Pure Property Tax as Applied to Industrial Property* in N.Y.U. 3d Ann. Inst. on St. & Local Tax'n and Conf. on Prop. Tax'n § 18.05[1] (1985) [hereinafter *Pure Property Tax*].

these cases involve specialized property, in which instance an assessment based on use value may justify application of the reproduction cost approach even though an income or market value approach would result in a lower valuation.[91]

However, the important point is that the standard of value concept—whether exchange value or use value—should not be confused with the different issue of the appropriate valuation technique or techniques to be used in estimating such value. As suggested by the court in *Lyon & Greenleaf*, a property tax system which elevates the cost method of valuation to the position of a standard of value in its own right will fail to meet the mandates of the Indiana Constitution in given situations.[92] Conversely, an attempt to exclude entirely the income method or the market comparison method of appraisal will also likely contravene the constitution in situations where they provide clear, probative evidence of market value and where reproduction cost cannot be supported as the single best indication of value, as is sometimes advocated in the case of highly specialized property.[93] These observations draw into question the constitutional validity of the recent changes in the property tax statutes and Regulation 17, which attempt to abolish all consideration of market values or the income method of valuation.[94]

The appropriate standard of value for tax assessments should also not be confused with the standards applicable to judicial review of administrative determinations. In articulating the standards for judicial review, the courts have held that decisions of the State Board should be upheld unless they are arbitrary, capricious, an abuse of discretion, unsupported by substantial evidence, or in excess of statutory authority.[95] In *State Board of Tax Commissioners v. Chicago, Milwaukee,*

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91. *Value Concepts*, *supra* note 87, at § 16.02[2][c].

92. Indiana State Bd. of Tax Comm'rs v. Lyon and Greenleaf Co., 172 Ind. App. 272, 275, 359 N.E.2d 931, 933 (1977).

93. *Cf. Value Concepts*, *supra* note 87; *Pure Property Tax*, *supra* note 90.

94. *See supra* notes 55-63 and accompanying text. There are also serious questions about the constitutionality of the numerous exemptions and deductions provided under Indiana's property tax laws. *See* Note, *Uniform Property Taxation in Indiana—The Need for a Constitutional Amendment*, 38 Ind.L.J. 72 (1962). *See also* W. Newhouse, *supra* note 26, at 501-02. Ranging from deductions for the blind and disabled [Ind. Code §6-1.1-12-11 (1982)] to tax credits for inventory in an enterprise zone [Ind. Code §6-1.1-20.8-1 (Supp. 1988)], the adjustments for specific classes of taxpayers have not been reviewed by the courts. *Cf.* State *ex rel.* Tieman v. Indianapolis, 69 Ind. 375 (1879) (property tax deduction for widows and orphans was unconstitutional).

95. *See, e.g.*, State Bd. of Tax Comm'rs v. Gatling Gun Club, Inc., 420 N.E.2d 1324 (Ind. Ct. App. 1981); American Juice, Inc. v. State Board of Tax Comm'rs, 527 N.E.2d 1169 (Ind. T.C. 1988); Indiana Ass'n of Seventh Day Adventists v. State Bd. of Tax Comm'rs, 512 N.E.2d 936 (Ind. T.C. 1987); Meridian Hill Country Club v. State Bd. of Tax Comm'rs, 512 N.E.2d 911 (Ind. T.C. 1987).

St. Paul & Pacific Railroad,[96] a 1951 case, the Indiana Supreme Court declared that a taxpayer is not entitled to judicial relief even if the taxpayer can show that a valuation method different from that used by the State Board would have produced a lower assessment. The court stated that the State Board is not required to use any particular valuation method in fixing assessments so long as the result is not "fraudulent, capricious, or arbitrary."[97] Thus, the court granted the State Board a measure of discretion in determining property tax values although it did not spell out the standards to be used in deciding whether a given valuation would be treated as arbitrary and capricious.[98]

Given the imprecision of the appraisal process and the well-established limits on judicial review of administrative decisions, the State Board must be allowed flexibility in setting assessed values or prescribing valuation regulations to be used by lower level assessors. However, as the cases demonstrate,[99] that flexibility is not unlimited, and the assessment results must be evaluated according to some identifiable standard. Although no Indiana court has yet so held, one approach would be to uphold an assessment if the methodology upon which it is based is within the broad range of generally accepted appraisal principles. The fact that a certain appraiser might have reached a different result would not invalidate the assessment as long as it could be established that the state board's valuation was within the reasonable range supportable under sound appraisal principles. This standard of review would further the goal of requiring accurate market value assessments but would avoid unrestrained judicial second guessing of the state board's valuation determinations.

Adoption of a market value-based valuation standard, coupled with the requirement that assessments be supportable under generally accepted appraisal principles, would appear to further the constitutional goals of uniformity, equality, and just valuation. The burden of the property tax would be spread more closely in accordance with the value of the underlying property. To the extent available, prevailing market values would serve as a guide in evaluating assessments and would permit adjustments in the assessments as needed to sustain uniformity.

Although a fully-realized property tax system based on this model might not be feasible in practice, it appears likely that even a reasonable approximation would contribute substantially to the improvement of

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96. 121 Ind. App. 302, 96 N.E.2d 279 (1951).

97. *Id.* at 310, 96 N.E.2d at 283. *See also* Indiana State Bd. of Tax Comm'rs v. Traylor, 141 Ind. App. 324, 229 N.E.2d 46 (1967). *Cf.* State Bd. of Tax Comm'rs v. Valparaiso Golf Club, Inc., 164 Ind. App. 687, 330 N.E.2d 394 (1975).

98. 121 Ind. App. at 310, 96 N.E.2d at 283.

99. *See supra* notes 28-30.

uniformity. However, the costs of implementing such a sophisticated system—both in the commitment of resources and the restructuring of administrative procedures—cannot be ignored.

To perform its duty of administering a mass appraisal system, the State Board must be allowed to prescribe regulations that rely to a degree on short-hand formulas, rules of thumb, and uniform cost schedules. However, to approximate market values, such regulations need to be relatively faithful to recognized appraisal concepts. Thus, the regulations should allow the use of the income method of valuation for certain types of properties, allow consideration of actual sales prices of comparable properties, recognize the distinction between the actual age and the effective age of property,[100] permit indexation of cost figures to reflect inflation, and set forth guidelines for estimating functional and economic obsolescence.[101] How far the State Board should be required to go in incorporating sophisticated appraisal techniques in its regulations is admittedly a difficult issue. Moreover, to the extent that the regulations prescribe such appraisal techniques, local assessors would undoubtedly require increased training and resources, and the amount of their discretion in determining values would inevitably grow. Greater local discretion could arguably open up the possibility of abuse, which then could require a greater commitment of resources at the state level to monitor local assessment practices. In addition, application of the market comparison method, which appears to be officially sanctioned under current Regulation 17 only in the area of residential and commercial land values,[102] is seriously hampered by the absence of any requirement that accurate sales price data be set forth on deeds, a common requirement in many states.[103] Thus, an effective property tax system might also require adoption of a law requiring disclosure of this information.[104] Finally, because of

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100. *Cf.* PERFORMANCE AUDIT, *supra* note 60, at 4 (Legislative Services Agency criticized the 1979 version of Regulation 17 for basing depreciation on actual age).

101. Regulation 17, governing real property assessments, presently allows an adjustment for economic and functional obsolescence but gives little guidance concerning how such obsolescence should be measured or whether a capitalized earnings approach could be used for this method. IND. ADMIN. CODE tit. 50, r. 2.1-5-1 (1988). Thus, having officially banished the income method from Regulation 17, the State Board may have permitted it to re-enter through the back door as a means of quantifying obsolescence.

102. *See supra* note 36 and accompanying text.

103. Benshoof & Gibson, *Trial of Tax Discrimination Case Under the 4-R Act*, N.Y.U. 2D ANN. INST. ON ST. & LOCAL TAX'N AND CONF. ON PROP. TAX'N § 20.06[4] (1984).

104. *Cf.* MODEL REAL PROPERTY TRANSFER INFORMATION ACT, art. 2, § 2.1(a)(11) (American Bar Association Legislative Recommendation No. 1987-1, approved Aug. 1988).

shifting values of individual properties as well as general price level changes, the cycle for the general reassessment of real estate should be more frequent than once every eight to ten years.[105]

The price of achieving genuine fairness and equity in property taxation may not be cheap. However, Indiana's constitutional provisions for uniformity, equality, and just valuation may yet require either that this price be paid or that the constitution be amended to provide the Indiana General Assembly more latitude in defining "value" and in distinguishing among different classes of taxpayers.

III. New Sales Tax Regulations Interpreting the Sales Tax Manufacturing Exemption

The year's most significant development in the sales tax area was the promulgation by the Indiana Department of Revenue of revised sales tax regulations on September 1, 1987.[106] The promulgation of the new regulations, together with two decisions of the court of appeals, effectively ended a long standing dispute between taxpayers and the department about the precise contours of several sales and use tax exemption statutes. The new regulations largely adopt the taxpayers' position, and in issuing the new regulations the department has conceded defeat for its prior interpretation.

A. The Manufacturing Exemption

When enacted in 1963,[107] Indiana's sales and use tax statutes provided an exemption for the sale 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."[108] Additional exemptions were provided for agricultural equipment,[109] property used to produce manufacturing or agricultural equipment,[110] and materials consumed in production of food and commodities for sale.[111]

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105. *Cf.* DeBoer, Tax Assessment System, *supra* note 12.

106. 10 Ind. Reg. 2610 (1987).

107. Act approved April 20, 1963, ch. 30 (Spec. Sess.), 1963 Ind. Acts (Spec. Sess.) 60.

108. Ind. Code Ann. § 64-2654(b)(6) (Burns Supp. 1964) (current amended version at Ind. Code § 6-2.5-5-3(b) (1988)).

109. Ind. Code Ann. § 64-2543(b)(6) (Burns Supp. 1964) (current amended version at Ind. Code § 6-2.5-5-2 (1988)).

110. Ind. Code Ann. § 64-2654(b)(6) (Burns Supp. 1964) (current amended version at Ind. Code § 6-2.5-5-4 (1988)).

111. Ind. Code Ann. § 64-2654(b)(1) (Burns Supp. 1964) (current amended version at Ind. Code § 6-2.5-5-1 (1988)).

The policy rationale for such exemptions, sometimes termed the "producer's goods exemptions,"[112] is that a sales tax is designed to tax consumer expenditures. "If goods used in production are taxed as well as the final products, an element of multiple taxation of the same consumer expenditures is introduced."[113] The difficulty arises in determining whether an item acquired by a producer should be taxed as a consumer good or exempted as a mere instrumentality of an intermediate production stage. The more narrowly the producer's goods exemption is construed, the greater the opportunity for the pyramiding of sales taxes into the final cost of the finished product. At the other extreme, if the producer's goods exemption is interpreted too broadly, the integrity of the tax base is threatened.

In Indiana, as in most states which provide the producer's goods exemption, the statutory language exempts goods used in "direct production."[114] This language has been the subject of differing interpretations since its enactment in 1963. The department historically has sought to dissect the specific parts of the production process, analyze the effect of each item of equipment on the work in process, and allow the exemption only if the effect is "immediate." Based on this analysis, the department has argued that such a relationship exists only when the equipment makes physical contact with the work in process or, by itself, transforms the work during production. Equipment which merely supported the process of production, or which produced effects only indirectly through intermediary equipment or substances, was not granted exemption by the department.[115]

Taxpayers, on the other hand, have urged the department and Indiana courts to interpret the language as providing exemptions for equipment that forms an essential and integral part of an integrated production process. Under this so-called "integrated plant" theory, it is the integrated manufacturing process which causes production to occur, and any item of equipment that is an integral part of the manufacturing process should be exempt from sales and use tax. One of the earliest judicial articulations of the integrated plant theory was made in *Niagara Mohawk Corporation v. Wanamaker*.[116] In its evaluation the court stated

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112. J. Due and J. Mikesell, Sales Taxation 41 (1983).

113. *Id.* at 50.

114. Ind. Code § 6-2.5-5-3(b) (1988). The term "direct production" has always been an element of the manufacturing exemption in Indiana. *See* Ind. Code Ann. § 64-2654(b)(6) (Burns Supp. 1964).

115. *See infra* notes 117-62 and accompanying text.

116. 286 App. Div. 446, 144 N.Y.S.2d 458 (1955), *aff'd* 2 N.Y.2d 764, 139 N.E.2d 150, 157 N.Y.S.2d 972 (1956). *See also* Duval Sierrita Corp. v. Arizona Dep't of Revenue,

> [i]t is not practical to divide a generating plant into "distinct" stages. It was not built that way, and it does not operate that way. The words "directly and exclusively" should not be construed to require the division into theoretically distinct stages of what is in fact continuous and indivisible.[117]

Because of some early detours in the course of interpreting its exemption statute, Indiana failed to accept the integrated plant doctrine until some twenty years after the enactment of its sales and use tax.

B. Administrative and Judicial Interpretation

In its earliest interpretations contained in administrative circulars,[118] the department sought to limit the exemption to equipment which "acted upon" and had a "positive effect on" the goods under production.[119] Generally, the department required that the specific equipment effect some "transformation" or conversion of the product before exemption would be allowed.[120] The department's first official regulations interpreting the manufacturing exemption, adopted in 1972, followed the restrictive interpretations contained in the earlier circulars.[121]

In a series of cases in the 1970's, the Indiana Courts of Appeals had the opportunity to interpret the manufacturing exemption. Unfortunately, the first decision, *Indiana Department of State Revenue v. RCA Corp.*,[122] started the court down a path that seemed to magnify

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116 Ariz. 200, 568 P.2d 1098 (Ariz. App. 1977); Arkansas Beverage Co. v. Heath, 257 Ark. 991, 521 S.W.2d 835 (1975); Richardson v. State Tax Comm'n, 100 Idaho 705, 604 P.2d 719 (1979); Ames v. State Tax Comm'n, 246 Iowa 1016, 71 N.W.2d 15 (1955); Ross v. Greene & Webb Lumber Co., 567 S.W.2d 302 (Ky. 1978); Courier Citizen Co. v. Commissioner of Corp. & Taxation, 358 Mass. 563, 266 N.E.2d 284 (1971); Floyd Charcoal Co. v. Director of Revenue, 599 S.W.2d 173 (Mo. 1980); Manitowoc Co. v. Sturgeon Bay, 122 Wis. 2d 406, 362 N.W.2d 432 (Wis. Ct. App. 1984).

117. 286 App. Div. at 449, 144 N.Y.S.2d at 461-62.

118. The Indiana Department of Revenue initially issued circular ST-16 on February 3, 1964, describing and defining the tests to be satisfied to exempt certain property from application of sales tax. IND. DEP'T OF REVENUE, CIRCULAR ST-16 (REVISED) (Feb. 3, 1964). A revised, but substantially identical, circular was issued a year later. IND. DEP'T OF REVENUE, CIRCULAR ST-16 (REVISED) (April 5, 1965). In 1967, however, a substantially revised circular was issued, citing several pages of exemption examples that reflected a more liberal scope of exemptions and included previously non-exempt items. IND. DEP'T OF REVENUE, CIRCULAR ST-16 (REVISED) (Jan. 1, 1967). Two years later, the Dept. retreated to its pre-1967 position in its revised Circular ST-16. IND. DEP'T OF REVENUE, CIRCULAR ST-16 (REVISED) (July 1, 1969).

119. IND. DEP'T OF REVENUE, CIRCULAR ST-16 (REVISED) 2 (July 1, 1969).

120. IND. ADMIN. RULES & REGS. 15(IV) (Burns 1976).

121. IND. ADMIN. RULES & REGS. 15 to 17 (Burns 1976).

122. 160 Ind. App. 55, 310 N.E.2d 96 (1974).

the controversy and uncertainty surrounding the exemption and would eventually be rejected fourteen years later. At issue was the status of air conditioning equipment that was used to control the temperature, humidity, and presence of foreign particles in the air and to avoid contamination in the process of manufacturing color television picture tubes. The court observed that the manufacturing exemption contained the requirement that exempt equipment be "'*directly* used' in the '*direct* production' of tangible personal property."[123] It interpreted the reiteration of the "direct" requirement in the phrase "directly used. . . in the direct production"[124] as a sign that the legislature intended the exemption to be narrowly construed and, therefore, required an extremely close connection between the equipment and the items being produced.[125] This "double direct" interpretation was not only logically questionable, it proved to be very difficult to apply in a consistent and common sense fashion, as later cases illustrate.

The problem with the court's analysis was that, by the convenient use of an ellipsis, it omitted the critical phrase "by the purchaser" from the exemption statute. When that phrase is reinserted, it appears that the legislative intent was to insure that the exemption applied to equipment "*directly used by the purchase*r" and not by some other entity.[126] When correctly read in its entirety, the statute requires only that the equipment be used in direct production. There is no second "direct" in the statute relating to the way equipment is used within the production process.

In *Indiana Department of State Revenue v. Indianapolis Transit System, Inc.*,[127] the court of appeals dealt with the "public transportation" exemption.[128] The court acknowledged and apparently accepted the "double directness" interpretation of *RCA* but distinguished it from the instant case on two grounds.[129] The court, however, relied

123. *Id.* at 56, 310 N.E.2d at 97 (quoting Ind. Code § 6-2-1-39(b)(6) (1971)) (emphasis in original).

124. The statute exempted "[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." Ind. Code §6-2-1-39(b)(6) (1971).

125. 160 Ind. App. at 62, 310 N.E.2d at 100.

126. *See e.g.*, Harold MacQuin, Inc. v. Halperin, 415 A.2d 818 (Me. 1980) (examption refused for loaned equipment). *See also* Indiana Department of Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 525 (Ind. 1983).

127. 171 Ind. App. 299, 356 N.E.2d 1204 (1976).

128. The "public transportation exemption" precludes application of state gross retail tax to "the sale . . . storage, use or other consumption . . . of tangible personal property or service which is directly used or consumed in the hindering of public transportation of persons or property." Ind. Code § 6-2-1-39(b)(4) (1971).

129. 171 Ind. App. at 305-06, 356 N.E.2d at 1208-09.

on *RCA* to afford a broader judicial construction of the "single directness requirement" of this specific exemption and allowed the exemption.[130]

In *State Department of Revenue v. Calcar Quarries, Inc.*,[131] the taxpayer operated a stone quarry, an asphalt plant, and a concrete plant. The trial court found these operations to be integrated.[132] The primary issue was whether trucks and tractors were exempt since they were used to transport stone from the quarry to a crusher, from the crusher to stockpiles, and from the stockpiles to the asphalt or concrete plants. Because the transportation equipment was used as part of this integrated operation, transportation of the stone was held to be exempt.[133] The court found evidence to the contrary and stated that "[t]he concept of an integrated operation makes inappropriate the State's references to 'pre-production' and 'post-production' activities."[134] The most important result of *Calcar* was the recognition of the importance of the equipment's role in an integrated plant or an integrated production process.

Approximately a year after the Indiana First District Court of Appeals' decision in *Calcar*, the second district issued its opinion in *Indiana Department of State Revenue v. Cave Stone, Inc.*,[135] a case involving similar facts. Cave Stone's operation included removing crude stone from quarries, transporting it to crushers, crushing and screening stone into grades of aggregate, and ultimately hauling this stone to various stock piles.[136] Without referring to *Calcar*, the court held that equipment used to transport stone from a quarry to a crusher and then to stockpiles was taxable because it was not "directly used in the direct mining and processing of the stone."[137] Thus, the Indiana Second District Court of Appeals accepted the department's ultimate audit and litigating position: the effect of equipment on work in process had to be considered separately from all other equipment used in production. Each item would be exempt only if its effect, disregarding its role in the overall production process, caused some transformation or change in the product undergoing processing. The production process itself had to be fractured into many individual parts, as if a production plant consisted of various separately identifiable production processes.

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130. *Id.* at 306, 356 N.E.2d at 1208.
131. 182 Ind. App. 84, 394 N.E.2d 939 (1979).
132. *Id.* at 89, 394 N.E.2d at 942.
133. *Id.* at 90, 394 N.E.2d at 943.
134. *Id.*
135. 409 N.E.2d 690 (Ind. Ct. App. 1980), *rev'd*, 457 N.E.2d 520 (Ind. 1983).
136. *Id.* at 692.
137. *Id.* at 696.

The relationship between each item of production equipment and the work in process was analyzed. Only those which were so closely connected with work in process that they physically transformed the product would qualify.[138] In a strong dissent, Chief Judge Buchanan refused to accept the line-drawing approach of the department and the majority and endorsed the integrated plant theory.[139]

On transfer, the majority opinion of the court of appeals was reversed.[140] The Indiana Supreme Court agreed with the dissent of Chief Judge Buchanan, stating that "[t]he issue, then, is whether the transportation is an integral part of the production or processing of the stone."[141] Finding that the equipment was both necessary to the production of the finished product and an integral part in the ongoing process of processing the stone into a finished product,[142] the court rejected the overly narrow analysis of the second district and approved the analysis of the first district in *Calcar*.[143]

Despite the judicial setback to its litigating position,[144] the department continued to hold fast to its restrictive interpretation. In its administrative rulings during the post-*Cave Stone* period, the department found the following to be taxable: electrical distribution systems located beyond the final control switch of certain equipment;[145] air compressors used to drive production machinery;[146] coolant and lubricating fluid circulation systems;[147] gloves necessary to avoid burns and cuts;[148] quality control equipment located away from the immediate production area;[149] scales used to weigh raw materials;[150] and work benches.[151] The inconsistency between the *Cave Stone* formulation of the test for ex-

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138. *Id.* at 695-97.

139. *Id.* at 698-99 (Buchanan, C.J., dissenting).

140. Indiana Dep't of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983).

141. *Id.* at 524.

142. *Id.*

143. *Id.* at 525. The Court concluded that the first district, in *Calcar*, strictly construed the statute and that the court of appeals in the instant case "took such strict construction one step further and narrowed it to a breadth that we cannot accept." *Id.*

144. In the interim between the two *Cave Stone* decisions, the Fourth District Court of Appeals in Department of Revenue v. United States Steel Corp., 425 N.E.2d 659 (Ind. Ct. App. 1981), expressly rejected the "positive effect" and "causal relationship" test of the Department's regulations in upholding the exemption for safety equipment.

145. Rev. Rul. 83-5988-ST (1984), 8 Ind. Reg. 949 (1985).

146. Rev. Rul. 84-6671-ST (1984), 8 Ind. Reg. 950 (1985).

147. Rev. Rul. 84-6953-ST (1985), 10 Ind. Reg. 960 (1987).

148. Rev. Rul. 83-6091-ST (1984), 8 Ind. Reg. 944 (1985).

149. Rev. Rul. 83-6091-ST (1984), 8 Ind. Reg. 945 (1985).

150. Rev. Rul. 83-5899-ST (1984), 8 Ind. Reg. 947 (1985).

151. Rev. Rul. 83-6091-ST (1984), 8 Ind. Reg. 944 (1985).

emption and the department's administrative position ensured that conflict would continue. Three more decisions by the Indiana Court of Appeals in a four-year span resolved this conflict against the department.

In *Indiana Department of State Revenue v. Indiana Harbor Belt Railroad Co.*,[152] the court of appeals found that the *Cave Stone* analysis could be applied by analogy to the scope of the exemption for equipment used in public transportation, even though the public transportation exemption used the word "direct" only once instead of twice as in the case of the manufacturing exemption.[153] The court cited the *Cave Stone* concept "of direct use or consumption in the integrated operation of providing public transportation"[154] to affirm the trial court's finding that certain items were exempt even without a specific finding that these items were "directly" used or consumed in the provision of public transportation services.[155]

Another case required the court to determine whether haulage rock and haulage road graders were an integral part of production or processing of a coal mining operation. In *Indiana Department of State Revenue v. AMAX, Inc.*,[156] the Indiana First District Court of Appeals found that since the rock and road graders were essential to the building and maintenance of haulage roads, without which marketable coal could not be produced from AMAX's surface mines,[157] they were "directly used or consumed by AMAX in the direct production of personal property so as to be exempt."[158]

Most recently, the court decided *Department of Revenue v. Kimball International, Inc.*,[159] in which spray booths and air make up units used in a wood finishing plant were held to be exempt. The disputed items were necessary to create a suitable environment for the application of a finish to the products.[160] The court finally recognized that the Department's narrow reading of *RCA* could not be squared with *Cave Stone*,[161] and that the former should essentially be confined to its specific facts:

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152. 460 N.E.2d 170 (Ind. Ct. App. 1984).

153. *Id.* at 175.

154. *Id.* at 176.

155. *Id.* at 175.

156. 513 N.E.2d 1260 (Ind. Ct. App. 1987).

157. *Id.* at 1261. The haul roads would lengthen as the open pit coal mine walls would recede from the coal processing plant. The heavy traffic of coal transport trucks required constant maintenance of the haul roads.

158. *Id.* at 1263. The court relied on the *Cave Stone* analysis to reach its conclusion.

159. 520 N.E.2d 454 (Ind. Ct. App. 1988).

160. *Id.* at 455.

161. The court found that the department had interpreted *RCA* to "support the proposition that environmental control equipment is never exempt . . . and that exempt equipment must have a positive effect on the product." *Id.* at 456.

> The Department also finds in *RCA* a requirement that to be exempt equipment must have a positive effect on the product. This is clearly inconsistent with the Supreme Court's holding that the focus *is* on the whole process, and that the product does not have to be transformed by the equipment in question. . . . Accordingly, it is necessary to make clear that [to] the extent that it stands for any point inconsistent with the controlling precedent of *Cave Stone*, *supra*, then *Ind. Dept. Rev. v. RCA*, *supra*, is hereby expressly overruled.[162]

C. *The New Regulations*

On April 1, 1987, the department proposed new regulations,[163] which were published as final rules on September 1, 1987.[164] The new regulations closely track the *Cave Stone* decision. The most important change is the department's adoption of the integrated plant theory:

> The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. *Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.*[165]

An identical test is applied to determine exemptions for agriculture,[166] mining and extraction,[167] processing or refining,[168] production of manufacturing or agricultural equipment,[169] and for property consumed in production process or mining,[170] or consumed in agriculture.[171]

The regulations contain numerous examples apparently designed to reverse prior rulings. For example, the following items are specifically identified as exempt:

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162. *Id.* at 456-57 (emphasis in original).

163. 10 Ind. Reg. 1396 (1987).

164. 10 Ind. Reg. 2610 (1987) (codified at Ind. Admin. Code tit. 45, r. 2.2-5-1 to r. 2.2-5-70 (1988)).

165. Ind. Admin. Code tit. 45, r. 2.2-5-8(c) (1988) (emphasis added).

166. *Id.* r. 2.2-5-1(a).

167. *Id.* r. 2.2-5-9(c).

168. *Id.* r. 2.2-5-10(c).

169. *Id.* r. 2.2-5-11(c).

170. *Id.* r. 2.2-5-12(c).

171. *Id.* r. 2.2-5-13(b).

— "[a]ir compressors used as a power source for exempt tools and machinery;"[172]
— "[e]lectrical distribution system, including generators, transformers, electrical switchgear, cables inside or outside the plant, and related equipment used to produce and/or supply electricity to exempt manufacturing equipment;"[173]
— "[a] workbench used in conjunction with a work station or which supports production machinery;"[174]
— "[s]afety clothing or equipment which is required to allow a worker to participate in the production process;"[175]
— "[a]n automated scale process which measures quantities of raw aluminum for use in the next production step of the casting process in the foundry;"[176]
— "[p]umping and filtering equipment and related tanks and tubing used to supply lubricating and coolant fluids to exempt drilling and cutting machinery."[177]

This short list of examples demonstrates the fundamental change wrought by the new regulations. None of the former cited equipment would have been exempt under the former "positive effect" and "causal relationship" interpretation urged by the department in prior years.

With the adoption of the new regulations, Indiana has joined the majority of states in accepting the "integrated plant" doctrine as the controlling principle under which the manufacturing exemption will be construed. While the new test will not resolve all potential issues which may arise from the myriad variations of the production process, it at least provides a sound conceptual basis upon which controversies will be decided.

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172. *Id.* r. 2.2-5-8(c)(2)(A). *Cf.* Rev. Rul. 84-6671-ST (1984), 8 Ind. Reg. 950 (1985) ("The air compressor does not directly, immediately effect the product, but directly, immediately effects [sic] air and production machines.").

173. Ind. Admin. Code tit. 45, r. 2.2-5-8(c)(7)(B) (1988). *Cf.* Rev. Rul. 83-5988-ST (1984), 8 Ind. Reg. 949-50 (1985) (all electrical equipment existing before the final control switch of an exempt machine is taxable).

174. Ind. Admin. Code tit. 45, r. 2.2-5-8(c)(2)(E) (1988). *Cf.* Rev. Rul. 83-6091-ST (1984), 8 Ind. Reg. 944 (1984) (work benches taxable).

175. Ind. Admin. Code tit. 45, r. 2.2-5-8(c)(2)(F) (1988). *Cf.* Rev. Rul. 83-6091-ST (1984), 8 Ind. Reg. 944 (1985) (work gloves necessary to avoid burns and cuts are not exempt).

176. Ind. Admin. Code tit. 45, r. 2.2-5-8(c)(2)(G) (1988). *Cf.* Rev. Rul. 83-5899-ST (1984), 8 Ind. Reg. 947 (1985) (weighing is a pre-production activity and, therefore, taxable).

177. Ind. Admin. Code tit. 45, r. 2.2-5-8(c)(3)(A) (1988). *Cf.* Rev. Rul. 84-6953-ST (1985), 10 Ind. Reg. 960 (1987) (such items are taxable as not having a direct effect on product).

IV. Death Taxes: The *Pearson* Case

A review of recent developments affecting Indiana tax policy would be incomplete without addressing the issue of death taxes. Prior to an analysis of *Indiana Department of State Revenue v. Estate of Pearson*,[178] and overview of the statutory scheme of Indiana's inheritance and estate taxes is essential. Although the court of appeals decided *Pearson* in 1986, the Indiana Supreme Court adopted and affirmed that decision in April 1988.[179]

A. Indiana's Statutory Scheme

Indiana imposes death taxes in two levels.[180] The inheritance tax is a first level tax imposed on transfers of property interests made by a decedent at the time of his death.[181] The inheritance tax on resident decedents is based on Indiana real property, personal property not having an out-of-state situs, and all intangible property owned by the decedent.[182] A nonresident decedent is taxed only on his Indiana real estate and personal property with an Indiana situs.[183] The inheritance tax is imposed at graduated rates based on the amount of property transferred and the classification of the recipient.[184] This tax applies to all death transfers of persons either residing or having property in Indiana.[185] It has no connection with the federal estate tax.

In contrast to the inheritance tax, the Indiana estate tax is directly based on provisions of federal estate tax law.[186] It is a second level tax designed to "pick up" unused portions of the federal death tax credit.[187]

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178. 498 N.E.2d 990 (Ind. Ct. App. 1986).

179. 521 N.E.2d 350 (Ind. 1988), *adopting and aff'g* 498 N.E.2d 990 (Ind. Ct. App. 1986).

180. "State death taxes" refers to all taxes imposed by a state upon death transfers regardless of the measure of the tax or the subject upon which it is imposed. "Inheritance tax" refers to a state tax imposed upon an heir for the privilege of receiving property from a decedent. "Estate tax" refers to a tax, whether state or federal, imposed upon a decedent's estate for the privilege of making death transfers. A "first" or "second level" tax refers to death taxes of a state that imposes both an inheritance (first-level) tax on all estate and an estate (second-level) tax on estates of a certain magnitude.

181. Ind. Code § 6-4.1-2-1(a) (1988). The inheritance tax is assessed upon the property which is transferred by the decedent and is to be paid by the estate's personal representative prior to distribution. *Id.* §§ 6-4.1-8-1, -2.

182. *Id.* § 6-4.1-2-2.

183. *Id.* § 6-4.1-2-3.

184. *Id.* § 6-4.1-5-1.

185. *Id.* § 6-4.1-2-1.

186. *Id.* §§ 6-4.1-11-1 to -6.

187. In this article, the term "pickup tax" is used to refer to a state death tax

The Indiana estate tax for resident decedents is computed by reducing the federal death tax credit by the total state death taxes paid by the estate. The remainder is then assessed as the estate tax.[188] For nonresidents, the amount of the federal death tax credit is also reduced by total state death taxes. The remainder is then multiplied by a fraction representing the percentage of the total federal gross estate located in Indiana.[189] In determining the actual death taxes paid for purposes of reducing the federal death tax credit, the term "state death tax" does not include the Indiana estate tax "or any tax which is similar in purpose and character to the Indiana estate tax."[190]

B. The Pearson *Case: Background and Issue*

In *Pearson*, the decedent was an Indiana resident with property in both Indiana and Florida. His estate was subject to the federal estate tax and was entitled to a federal death tax credit of $14,632.02. His estate paid an Indiana inheritance tax of $7,052.55 and a Florida death tax of $1,311.81.[191] The sole issue was whether the Florida tax was "similar in purpose and character to the Indiana estate tax" and, therefore, nondeductible in computing the Indiana estate tax.[192]

Florida imposes a single death tax, which is the product of the federal death tax credit and a fraction representing the portion of a decedent's total estate located in Florida.[193]

C. The Court of Appeals' Opinion

As a threshold matter, the court of appeals determined that its construction of Indiana Code section 6-4.1-1-12, specifically the words "similar in purpose and character," should be based upon prior in-

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measured by reference to the federal death tax credit. The "federal death tax credit" refers to the credit against a decedent's federal estate tax for state death taxes. I.R.C. §§ 2011, 2102 (1986) provide a credit against the federal estate tax for state death taxes that is not to exceed a certain scheduled amount. Unless the decedent actually pays the state death taxes, there is no credit. This provides an incentive for states to impose "pickup" taxes, which effectively transfer funds from federal to state coffers without increasing the tax burdens of individual decedents. Note that pickup taxes do not apply to persons whose taxable estates are not subject to the federal estate tax (generally estates below $600,000 under current law).

188. Ind. Code § 6-4.1-11-2(a) (1988).

189. *Id.* § 6-4.1-11-2(b).

190. *Id.* § 6-4.1-1-12.

191. 498 N.E.2d 990 (Ind. Ct. App. 1986).

192. *Id.* at 990. *See* Ind. Code § 6-4.1-1-12 (1988). In this case the actual tax in controversy was $1,311.81, the Florida tax.

193. *Id.* at 992. Relevant portions of Florida Statutes section 198.03 are quoted in the court's opinion.

terpretation of the predecessor statute.[194] The only appellate opinion addressing the prior statute was *State v. Purdue National Bank*.[195] The court relied on the factual similarity of *Purdue National Bank* and its holding that "pickup taxes paid other states are not to be subtracted when computing the Indiana estate tax"[196] to dismiss the estate's argument that the *Purdue National Bank* holding was limited to the second level pickup taxes of Tennessee and Kentucky, and therefore not applicable to the single Florida tax.[197] The *Pearson* court seized upon the following language in *Purdue National Bank*: "'It is our opinion that pickup taxes paid other states are not to be deducted when computing the pickup tax imposed by paragraph (a) of the above statute [I.C.6-4-1-37].'"[198]

The court concluded that the Florida tax was a pickup tax and, solely because of that label, was "similar in character and purpose" to the Indiana estate tax.[199] It found further that the essential character of a pickup tax was *not* its second level nature nor its subject but

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194. *Id.* at 991-92. In 1976, the Indiana General Assembly recodified the Indiana inheritance tax and estate tax laws. Act approved February 18, 1976, Pub. L. No. 18, 1976 Ind. Acts 69. Section 6-4.1-1-12 was the successor statute to prior Ind. Code § 6-4-1-37 (1971) which provided:

> (a) In the event that a federal estate tax is payable to the United States on the estate of a decedent who was a resident of the state of Indiana at the time of his death and the inheritance tax, if any, paid to the state of Indiana, disregarding interest, plus the death taxes (not including any credit for state death taxes allowed by the federal estate tax law) paid to other states or territories in respect to the property of the decedent is less than the maximum credit for state taxes allowed by the federal estate tax law, a tax equal to such difference is hereby imposed.
>
> (b) A tax is levied against the estate of every decedent not domiciled in this state upon the transfer of the portion of the decedent's gross estate in the state of Indiana equal in amount to that proportion of the amount by which the death tax credit exceeds the amount of state death taxes, exclusive of taxes imposed by other states of the character and purpose of the tax levied by paragraph (a) of this section which the value of the portion of the decedent's gross estate in the state of Indiana bears [to] the value of decedent's entire gross estate.

Ind. Code § 6-4-1-37 (1971).

195. 171 Ind. App. 76, 355 N.E.2d 414 (1976).

196. 498 N.E.2d 990, 991 (Ind. Ct. App. 1986).

197. *Id.*

198. *Id.* (quoting *Purdue National Bank*, 171 Ind. App. at 78, 355 N.E.2d at 416). In *Purdue National Bank*, the meaning of the parenthetical words, "not including any credit for state death taxes allowed by the federal estate tax law," was construed to refer to pickup taxes, defined as "additional tax[es] in an amount equal to the amount by which the allowed credit exceeds the state tax." 171 Ind. App. at 76, 77 n.1, 355 N.E.2d at 415 n.1.

199. 498 N.E.2d at 994.

rather its nature as "a tax levied by the state in order to take advantage of the federal death tax credit."[200]

The court then addressed the estate's argument that the taxes were not similar in nature because the Florida tax was assessed solely on the property located in Florida, while Indiana's estate tax was not so limited. This was dismissed as merely a jurisdictional requirement rather than a distinction in purpose or character.[201] The estate also argued that the Florida tax scheme prevented total death taxes from exceeding the federal death tax credit. Even if this was so, the court responded, it has nothing to do with the purpose and character of the tax.[202] The court also dismissed various other arguments advanced by the estate for the reason that they did not specifically demonstrate that the purpose and character of the two taxes were different.[203] Specifically the court found:

> All of the distinctions which the Estate would draw are distinctions collateral to the essential purpose and character of the taxes themselves. Both taxes are, undeniably, pickup taxes. The purpose of both the Florida estate tax and the Indiana estate tax is to take advantage of the federal estate tax credit for state death taxes paid.[204]

To portray the essential similarity of the character of the two taxes, the court then set out the mathamatical formulas for computing Indiana and Florida estate taxes:

$$\text{Indiana Estate Tax} = \frac{\text{Indiana Estate}}{\text{Gross Estate}} \times \begin{array}{l}(\text{Federal tax credit -} \\ \text{State death taxes})\end{array}$$

$$\text{Florida Estate Tax} = \frac{\text{Florida Estate}}{\text{Gross Estate}} \times \text{Federal tax credit.}^{205}$$

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200. *Id.* at 991 (citing 42 Am. Jur. 2d *Inheritance, Estate, and Gift Taxes* § 7 (1969)).

201. *Id.* at 992. The court also noted that if a reference to property within the taxing state is sufficient to render another state's death tax different in purpose and character, no tax levied by another state would be excluded by Ind. Code § 6-4.1-1-12 (1988), and the statute would be superfluous. *Id.*

202. *Id.* at 993.

203. *Id.* The arguments were that the Florida tax did not reduce its tax base by other states' death taxes while Indiana did and that Indiana had a two level inheritance-estate tax while Florida imposed but a singe death tax.

204. *Id.*

205. *Id.* at 994.

The court further noted:

> The similarity in character between the two taxes is demonstrated by the means each tax employs to achieve its purpose. Both taxes refer to the federal tax credit in order to determine the estate tax owed. In fact, the only difference between the formula employed by Indiana to determine the estate tax of a non-resident decedent and the formula used by Florida is that the Indiana formula takes into account the state death taxes paid.[206]

D. Analysis

The court of appeals' opinion correctly identified the purpose of pickup taxes as diverting funds to state treasuries which otherwise would be destined for federal use.[207] However, the sketchy analysis by the court of the *character* of the two taxes missed the point.

As a general rule, the character of a tax must be determined by reference to its classification, its subject, and its measure.[208] Death taxes are classified as excise taxes; that is, taxes imposed on the exercise of a specific right in property.[209] The subject of a death tax is either the privilege of inheriting property (inheritance tax) or the privilege of transferring property at death (estate tax). The measure is the method used to determine the tax due. For inheritance taxes, the measure is generally a progressive rate structure; for estate taxes, the measure is generally a portion or the whole of the federal death tax credit.

Prior to determining whether another state's death tax is similar in character to the Indiana estate tax, a determination of the character of the Indiana tax is necessary. Indiana's estate tax imposed on resident decedents differs from that imposed on nonresidents.[210]

Resident Estate Tax = Federal Death Tax Credit - State Death Taxes Actually Paid [211]

$$\text{Nonresident Estate Tax} = \frac{\text{Indiana Estate}}{\text{Gross Estate}} \times \begin{array}{c}\text{Federal Death Tax Credit} \\ \text{- State Death Taxes} \\ \text{Actually Paid}\end{array}$$ [212]

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206. *Id.* at 993-94.

207. *See* Estate of Fasken, 19 Cal.3d 412, 417-20, 563 P.2d 832, 834-36, 138 Cal. Rptr. 276, 278-80 (1977) for a cogent history and analysis of the purpose of a pickup tax.

208. J. Hellerstein & W. Hellerstein, State and Local Taxation 27 (1978); *see generally* 71 Am. Jur. 2d *State and Local Taxation* § 22 (1973).

209. J. Hellerstein & W. Hellerstein, *supra* note 208, at 29.

210. *Compare* Ind. Code §6-4.1-11-2(a) (1988) *with id.* §6-4.1-11-2(b).

211. *Id.* § 6-4.1-11-2(a).

212. *Id.* § 6-4.1-11-2(b).

The character of the resident estate tax is that of an excise on the death transfer of a decedent's total estate, measured by the *total* federal death tax credit reduced by death taxes paid to all states.[213] This measure will be referred to as the "excess federal death tax credit."[214]

The character of Indiana's nonresident estate tax, on the other hand, is that of an excise on the death transfer of a decedent's apportioned estate, measured by the *apportioned* excess federal death tax credit. The excess federal death tax credit is apportioned by Indiana, which asserts a claim to only that portion of the excess federal death tax credit which is proportionate to the size of the decedent's Indiana estate.[215]

Although the taxes on residents and nonresidents are excise taxes on death transfers, it is readily apparent that the taxes differ in both the property that is being taxed and in the measure of the tax. Indiana asserts entitlement to the entire excess federal death tax credit of its resident decedents, and it asserts a proportionate entitlement to the excess federal death tax credit of nonresident decedents.[216] Each of these taxes must be regarded separately. Because they tax different interests and use different measures, they must be regarded as having distinctly different characters.

The next question is the meaning of Indiana's exclusion from the computation of the excess federal death tax credit of state death taxes "similar in purpose and *character* to the Indiana estate tax."[217] Which of Indiana's estate taxes—resident or nonresident—is referred to by this statutory command? It is clear from prior law that the reference is to the resident estate tax.[218] In the former statute imposing the nonresident

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213. At this point in the analysis, it is not important to determine whether another state's death tax should be subtracted from the federal death tax credit. The crucial fact to be recognized is that the measure of the tax on Indiana residents is the entire federal death tax credit, unapportioned by the location of the estate's property.

214. The amount of the excess federal death tax credit will vary according to the death tax rates imposed by states in which the decedent's property is located. As a practical matter, most states imposing inheritance taxes will not entirely utilize their proportionate share of the estate death tax credit.

215. The constitutional difficulties inherent in such an apportionment are addressed *infra* at text accompanying notes 224-39.

216. IND. CODE § 6-4.1-11-2(a), (b) (1988). From a federal point of view, such a position is indefensible. For example, if each state asserted such a right, all decedents having property in more than one state would be subjected to multiple taxation in the name of picking up the estate death tax credit. For example, a decedent having an estate death tax credit of $100,000 with property equally divided between States A and B would be assessed taxes by State A (his state of residence) in the amount of $100,000 and by State B in the amount of $50,000 (assuming no inheritance or first level taxes).

217. IND. CODE § 6-4.1-1-12 (1988) (emphasis added).

218. *Id.* § 6-4-1-37 (1971) (repealed 1976). Subsections from this section of the statute are quoted *supra* note 194.

estate tax, the legislature provided for an apportioned tax on the excess estate death tax credit "exclusive of taxes imposed by other states of *the character and purpose* of the tax levied by paragraph (a) of this section."[219] Paragraph (a) describes the resident estate tax and includes the words interpreted by *Purdue National Bank* as referring to state pickup taxes.[220] Because the current statutes are merely a "codification or restatement of applicable or corresponding provisions" of prior law,[221] the proper test in determining whether a state's death taxes should reduce the federal death tax credit is whether the questioned tax is similar in purpose and character to Indiana's estate tax imposed upon *resident* decedent's estates, that is, a pickup tax arrogating to the taxing state *all* of the excess federal death tax credit, regardless of the location of the estate's property.

The court of appeals' comparison of the Florida estate tax with the Indiana estate tax for *nonresident* decedents to demonstrate the similar character of the two taxes was erroneous.[222] The proper test is to compare the Indiana resident tax, which imposes a tax on the total death transfers of a decedent, with the Florida estate tax, which imposes a tax on only the portion of the decedent's estate apportioned to Florida. The result of such a test should be a determination that the Florida tax is not similar in character to the Indiana tax and, therefore, the federal death tax credit should be reduced by the Florida tax prior to the calculation of the Indiana tax. The result of such a determination would have been the allocation of the federal death tax credit between Indiana and Florida according to each state's respective portion of Pearson's estate.

This interpretation of the statute would require Indiana to disregard only those state death taxes which, like Indiana's resident estate tax, assert entitlement to the full unapportioned federal death tax credit.[223] This would permit Indiana to collect its estate tax despite the heavy-handedness of other states' legislatures, but would require it to respect other states' claims to a proportionate amount of the federal death tax credit.

E. The Constitutionality of Indiana's Estate Tax As Construed in Pearson

Neither the court of appeals nor the supreme court in affirming *Pearson* addressed the constitutionality of the Indiana estate tax.[224] For

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219. IND. CODE § 6-4-1-37(b) (1971) (repealed 1976) (emphasis added).

220. *See supra* text accompanying notes 199-200.

221. Act approved February 18, 1976, Pub. L. No. 18, § 3, 1976 Ind. Acts. 69, 104.

222. *See supra* text accompanying note 206.

223. *See supra* text accompanying note 188.

224. 498 N.E.2d 990 (Ind. Ct. App. 1986), *adopted and aff'd*, 521 N.E.2d 350 (Ind. 1988).

several reasons, the tax as construed in *Pearson* may be constitutionally defective.

The source of the potential defect is that the estate tax imposes a direct tax on tangible property located out of state. It does this by asserting an entitlement to the excess federal death tax credit, which, in the case of estates with multi-jurisdictional property, must be based upon property located in another state. This concept can best be illustrated by the following examples:

> *Example 1*: *A* died a resident of Indiana leaving an estate equally divided between Indiana and State *X*. *A*'s estate has a federal death tax credit of $100,000. Indiana levies an inheritance tax of $25,000. State *X* levies an inheritance tax of $20,000. Indiana then assesses an estate tax of $55,000, computed as follows:

Federal death tax credit	$100,000
less state death taxes	
($25,000 + $20,000)	(45,000)
Indiana resident estate tax	$ 55,000

In this example, Indiana would collect a total of $80,000 in death taxes. The $25,000 inheritance tax is clearly imposed with reference to Indiana property. The pickup tax, on the other hand, is measured by the total federal death tax credit, which is computed under federal law with reference to the total estate located both in Indiana and in State *X*.[225]

In *Frick v. Pennsylvania*,[226] the United States Supreme Court declared unconstitutional a state death tax imposed upon out-of-state tangible property. The court stated that "[w]hile a State may so shape its tax laws as to reach every object which is under its jurisdiction it cannot give them any extraterritorial operation."[227]

The Court reached the same decision in *Treichler v. Wisconsin*.[228] In *Treichler*, Wisconsin had a pickup tax virtually indistinguishable from that of Indiana.[229] However, what was at issue was the constitutionality of the statutorily imposed, third-level emergency excise of 30% of the total Wisconsin death taxes.[230] The *Treichler* Court did not specifically address the constitutionality of the pickup tax, but instead examined whether the tax, to the extent it was measured by tangible property

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225. I.R.C. §§ 2031, 2103 (1986).

226. 268 U.S. 473 (1925).

227. *Id.* at 489.

228. 338 U.S. 251 (1949).

229. Wis. Stat. § 72.50 (1947) (repealed and recreated at Wis. Stat. § 72.61 (1988)).

230. Wis. Stat. § 72.74(2) (1947) (repealed and recreated at Wis. Stat. § 72.18 (1988)).

located outside of Wisconsin, was in violation of the Due Process Clause of the fourteenth amendment.[231] The Court first noted that Wisconsin claimed the entire excess federal death tax credit without apportionment according to the location of the estate's property. The deduction allowed for other states' death taxes did not effect an apportionment because those taxes "have no necessary relation to the proportion of property outside Wisconsin."[232] Therefore, because the second local pickup tax was "a tax on property rated and measured in part by tangible property, the situs of which was outside Wisconsin," the tax was an unconstitutional deprivation of property without due process.[233]

Treichler was cited by the California Supreme Court in its decision that a California tax regulation was unconstitutional. In *Estate of Fasken*,[234] *Treichler* was interpreted to mean "that because the federal credit for state death taxes is 'rated and measured by the entire estate, regardless of situs,' no state can assert a claim to *all* of that credit when some taxable portion of the estate is located in another state."[235]

The regulation declared unconstitutional in *Fasken* was somewhat less intrusive than the tax imposed by Indiana on its residents. The regulation required California taxing authorities to compute the pickup tax for decedents' estates with property both in California and other states (regardless of the decedent's residence) by multiplying the excess federal death tax credit by a fraction representing the California portion of the estate.[236] In essence, this regulation adopted for both residents and nonresidents a pickup tax computation identical to that imposed upon nonresidents by Indiana.[237] This type of tax was held to be unconstitutional by the California court:

> [T]he allowable pick-up tax which may be levied by one state in a situation where there is multi-state property in a decedent's estate, is not dependent upon the death taxes levied by another state exercising jurisdiction over any of the property involved. Each state according to the *Treichler* formula may properly levy a pick-up tax which is calculated by first apportioning the federal state death tax credit according to the ratio of property which lies within its borders, and then reducing that apportioned credit

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231. 338 U.S. at 256.
232. 338 U.S. at 255.
233. *Id.* (citing Frick v. Pennsylvania, 268 U.S. 473 (1925)).
234. 19 Cal. 3d 412, 563 P.2d 832, 138 Cal. Rptr. 276 (1977).
235. *Id.* at 424, 563 P.2d at 839, 138 Cal. Rptr. at 283 (quoting Treichler v. Wisconsin, 338 U.S. 251, 254 (1949) (emphasis in original)).
236. *Id.* at 416 n.1, 563 P.2d at 833 n.1, 138 Cal. Rptr. at 277 n.1.
237. *See* Ind. Code § 6-4.1-11-2(1) (1988).

> by its inheritance tax. The balance of the apportioned credit constitutes the pick-up tax.[238]

The defect in the California regulation was that it could result in a tax on the death transfer of property in another state, despite its allocation of the excess federal death tax credit according to location of the estate's property. For example, if the estate was divided equally between California and Arizona and Arizona had no inheritance tax, the regulation would permit California to claim both its inheritance tax and half of the remaining federal death tax credit. This increased California's share of the federal death tax credit beyond the permissible constitutional limits.

Indiana's nonresident pickup tax is indistinguishable from that declared unconstitutional in *Fasken*. The resident pickup tax is even more apparent in its taxation of property located in other states. *Treichler* flatly prohibits such exactions. A pickup tax should have no reference to other states' death taxes. The federal death tax credit should be proportionately allocated to the states in which the estate's property is located. Then each state may levy a pickup tax on its allocated portion of the credit as exceeds its inheritance or other first-level tax—if any.

> *Example 2*: An Indiana resident decedent's estate is entitled to a federal death tax credit of $100,000. His property is evenly divided between Indiana and State *X*. Indiana imposed inheritance taxes of $25,000 and State *X* imposed inheritance taxes of $15,000.

In *Example 2*, Indiana can impose a tax on property located in Indiana. Because the federal death tax credit is calculated by reference to the decedent's *total* estate, only half of which is in Indiana, the maximum pickup tax would be $50,000 (50% of the federal death tax credit of $100,000). Because Indiana has already collected $25,000 of inheritance tax, the estate tax should properly be $25,000 ($50,000 - $25,000). The formula for such a tax would be as follows:

$$\text{Indiana Pickup Tax} = \frac{\text{Indiana estate}}{\text{Total estate}} \times \begin{array}{c}\text{Federal state}\\ \text{eath tax credit}\end{array} - \begin{array}{c}\text{Indiana}\\ \text{inheritance}\\ \text{tax}\end{array}$$

This formula should not, and constitutionally cannot, vary between resident and nonresidents.[239]

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238. 19 Cal. 3d at 428, 563 P.2d at 841-42, 138 Cal. Rptr. at 285-86.

239. As this Article goes to press, House Bill 1654, providing for a single estate tax applicable to both residents and nonresidents and using this formula, has been introduced in the General Assembly.

F. Policy and The Pearson *Rule*

Even if the Indiana estate tax suffered no constitutional defect, the policy implications of *Pearson* cry out for legislative amendment. The court stated:

> We acknowledge that the imposition of state death taxes in excess of the federal tax credit undermines the policy supporting a state pickup tax. However, as the *Purdue* court noted, such a result is not necessarily outside the intent of the legislature. Absent some clear mandate from the state or federal legislatures, we cannot say that the imposition of these taxes in excess of the federal credit is prohibited.[240]

The potential effect of the estate tax as construed in *Pearson* is to drive taxpayers from Indiana. The type of taxpayer who is adversely affected by the estate tax (a person subject to federal estate taxation, which begins actually to tax estates aggregating in excess of $600,000) is precisely the type of person most likely to have substantial amounts of property in Florida or other states. The impact of Indiana death taxes may be a component in estate planning, including the selection of domicile. Depending upon the class of beneficiaries[241] and the proportion and type of assets located outside of Indiana, Indiana residents could save substantial death taxes simply by altering their domiciles to another state. Such a change in domicile may be costly to Indiana because of lost income tax revenue, but it relieves the expatriate of the inheritance taxation of his intangible assets and the unapportioned pickup tax imposed by Indiana on its residents. For Mr. Pearson, the cost was only $1,311.81; for many other persons the cost may prove to be substantially greater.

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240. 498 N.E.2d 990, 994 (Ind. Ct. App. 1986), *adopted and aff'd*, 521 N.E.2d 350 (Ind. 1988) (citation omitted).

241. There is no federal estate tax assessed upon transfers to a person's spouse. I. R. C. § 2056 (1986). Such transfers are also exempt from Indiana's Inheritance tax. Ind. Code § 6-4.1-3-7 (1988). The policy problem raised by the Indiana estate tax typically arises upon the death of a widow or widower.