

XIII. Taxation

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A. Introduction

This Survey Article is concerned with recent developments in the area of Indiana state taxation. Included in this Article are the most important cases concerning corporate gross income tax, inheritance tax, sales tax, and property tax. Of particular importance is a decision by the Supreme Court of Indiana concerning the exemption from sales tax for the purchase of equipment to be *directly* used in *direct* production. Also included in this Article are recent statutory developments concerning individual adjusted gross income tax, corporate partnerships, small business corporations, and the county option income tax. The discussion also includes an important administrative announcement pertaining to Indiana's position as it applies to the principles of unitary taxation to corporations doing business in Indiana. This issue arose after a United States Supreme Court decision which enhanced the authority of the states to tax the income of foreign affiliates of corporations doing business in their state.

B. Gross Income Taxation

In *Indiana Department of State Revenue v. Kroger Co.*,¹ Kroger claimed that trading stamps given to customers at the time of purchase reduced its gross receipts and thereby subjected only the price paid by the customer less Kroger's cost for the trading stamps to the gross income tax. The Indiana Gross Income Tax Act² provides that gross income, except as otherwise provided, includes the "gross receipts of the taxpayer received from trades, businesses, or commerce."³ The statute

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¹453 N.E.2d 1175 (Ind. Ct. App. 1983).

²IND. CODE §§ 6-2-1-1 to 36 (1976) (recodified at IND. CODE §§ 6-2.1-1-1 to 6-2.1-8-10 (1982)). Many of the cases in this Survey Article were decided under the 1976 version of the Indiana Code. Although much of the tax code was recodified in the 1982 version, the changes, except where noted, were not substantial, and the current version is cited parenthetically where the applicable code section has been replaced.

³IND. CODE § 6-2-1-1(m) (1976) (recodified at IND. CODE § 6-2.1-1-2(a)(1) (Supp. 1984)).

also provides a specific exclusion for the amount of "cash discounts allowed and taken on sales."⁴ Kroger argued that giving Top Value Trading Stamps to its customers who could redeem the stamps for merchandise or, pursuant to state law, receive cash based on their cash redemption value from Kroger or Top Value⁵ reduced Kroger's "gross receipts."

The Department of Revenue claimed that the issuance of the trading stamps was not a cash discount but a "cost of doing business."⁶ The Department found the distribution of trading stamps to be more in the nature of an "advertising ploy," not a cash discount to Kroger customers.⁷ The court stated it had not previously addressed this precise issue and found most closely analogous to it the case of *Indiana Department of State Revenue v. Marsh Supermarkets, Inc.*⁸ Although *Marsh* involved a question under sales tax law, the central issue was whether or not the distribution of coupons to customers, entitling them to discounts on certain Marsh items, reduced the amount of the sale subject to sales tax to the price less the discount distributed to the customer. The court stated that in *Marsh* it had found in favor of the taxpayer because the coupons' "effect was to lower the price paid by customers."⁹ The court noted that it also had held that supplier discounts were exempt from sales tax because they lowered the price paid by the taxpayer to its supplier and therefore did not contribute to Marsh's gross income.¹⁰ In *Kroger*, the court recognized that *Marsh* was distinguishable in that it was a sales tax case, the discounts were "received" by Marsh and not its customers, and the discounts clearly reduced the price paid to Marsh.¹¹

In reviewing similar cases of other jurisdictions, the court noted a crucial distinction with respect to these cases and Indiana law which requires that the trading stamps of Kroger must be redeemable for cash.¹² This caused the court to conclude that the issuance by Kroger of the Top Value Trading Stamps was a "cash discount."¹³ The court concluded that even without the existence of the specific statute requiring that the stamps be redeemable for cash it would have, nevertheless, held that the stamps represented a cash discount.¹⁴

⁴IND. CODE § 6-2-1-1(m) (1976) (recodified at IND. CODE § 6-2.1-1-2(c)(11) (Supp. 1984)).

⁵IND. CODE § 24-4-2-3 (1982).

⁶453 N.E.2d at 1177.

⁷*Id.*

⁸412 N.E.2d 261 (Ind. Ct. App. 1980).

⁹453 N.E.2d at 1177.

¹⁰*Id.*

¹¹*Id.* at 1178.

¹²*Id.* (citing IND. CODE § 24-4-2-2 (1982)).

¹³453 N.E.2d at 1178.

¹⁴*Id.* (citing Eisenberg's White House, Inc. v. State Bd. of Equalization, 72 Cal.

The court recognized that both parties made compelling arguments for their position.¹⁵ Based upon its analysis of the “economic effect of the trading stamps,” the court concluded that they were “cash discounts” because they were redeemable in cash and because they had a cash value.¹⁶ Kroger customers purchasing items and receiving trading stamps were deemed to have received something of value in return for their purchase which ultimately reduced the net proceeds to Kroger, even though Kroger received the collateral benefit of the advertising.¹⁷

In *Kroger*, the Indiana Court of Appeals provided sound reasoning for its holding that the gross income of a retail grocer does not include the value of trading stamps. Nevertheless, the court’s approach in determining the reduction to the grocer’s gross income is not entirely consistent with the applicable statutes. The court, apparently at the request of Kroger, permitted Kroger to reduce its gross income by the value of its payment to Top Value Trading Stamps for Kroger’s purchase of these trading stamps. The court did not indicate whether it considered the payments by Kroger to Top Value as equivalent to that value which the customers received by way of the trading stamps upon their purchases from Kroger. The focus of the opinion is that customers pay Kroger in cash for their purchases and receive the purchased items plus certain trading stamps which are considered to reduce the cash received by Kroger upon the purchase. It would seem, therefore, that the reduction for gross income tax purposes should be the actual value of the trading stamps issued to customers throughout the year in question.

The premise that the payment by Kroger to Top Value was equivalent to the value paid by Kroger to its customers presents at least two problems. First, the payments by Kroger to Top Value would not necessarily occur in the same tax year and in the same amount as the actual distribution of stamps to Kroger’s customers. In fact, it would seem that in order for Kroger to have the stamps available for distribution to customers, the purchase of these stamps would occur at a time prior to the actual sale of goods and distribution of stamps to the customers.

The second problem with using the price paid by the grocer to the trading stamp issuer is that there is no assurance that the price paid to the trading stamp company will necessarily equal or exceed the value of the trading stamps to receiving customers. It is conceivable that trading stamp companies require some sort of a premium from the grocer purchasing trading stamps in order to obtain a profit on the transaction. If this is so, then the reduction to the grocer’s gross income under *Kroger* will be greater than the value of the stamps distributed.

App. 2d 8, 164 P.2d 57 (1945)).

¹⁵453 N.E.2d at 1177.

¹⁶*Id.* at 1179.

¹⁷*Id.*

In any event, it would appear that the reduction against gross income for the payment of trading stamps to customers should be a value based upon the number of stamps distributed in the tax year to customers of the taxpayer. A logical value for reduction of the grocer's gross income amount would be based upon the redeemable face value of the trading stamps actually issued. This requirement might be more burdensome upon the taxpayer, but it is he who desires the reduction of his gross income tax liability. Furthermore, to permit a reduction based upon the taxpayer's payment to a trading stamp company ignores that the basis of this reduction is grounded in the fact that the stamps, when given to the customers, reduce "both the ultimate price paid by their recipients and the net proceeds received by [the taxpayer]." ¹⁸

In *United Artists Theatre Circuit, Inc. v. Indiana Department of State Revenue*,¹⁹ United Artists claimed that the portion of its receipts from film viewers which was paid to the film distributors was not subject to gross income tax because it had received this portion of the payments either on behalf of the distributor, or as a special agent merely collecting for the distributor. The Indiana Court of Appeals held that United Artists was subject to gross income tax on the entire amount of its receipts from movie patrons.²⁰

United Artists owns various theaters throughout Indiana at which it shows films to the general public. The rights to show these films during the years in question were acquired from third party film distributors under two types of licenses. In the first type of agreement, which was seldom used, United Artists paid a fixed charge to the distributor for the right to show a movie. The second and most common type of agreement provided that United Artists pay the film distributor a percentage of the gross receipts from admissions. United Artists was permitted under these agreements to reduce the payments to distributors for a "house allowance."²¹ The house allowance was usually based on a fixed dollar amount and was to compensate United Artists for its operating expenses.²² In those cases where no house allowance was deducted, a lesser percentage was paid to the film distributor for the right to show the film. The United Artists agreements which were based on percentage amounts sometimes contained trust clauses which stated that the percentage of the admissions payable to the distributor was held by United Artists in trust for the distributor.²³

At the outset, the court found that United Artists' argument was

¹⁸*Id.*

¹⁹459 N.E.2d 754 (Ind. Ct. App. 1984).

²⁰*Id.* at 758-59.

²¹*Id.* at 755-56.

²²*Id.* at 757.

²³*Id.*

“tantamount to claiming an exemption.”²⁴ Thus, the court held that the tax statutes would be strictly construed against the taxpayer since it was claiming an exemption.²⁵

The court agreed with United Artists’ first argument that receipts received on behalf of a third person do not subject the persons receiving such payments to the gross income tax.²⁶ However, United Artists was unsuccessful in convincing the appellate court that the trial court had erred in finding that United Artists was the owner of the entire admissions upon receipt. The court reviewed the trial court’s finding that the film agreements, while entitling the distributor to a percentage of the admissions, were more in the nature of a rental agreement which were business expenses of United Artists and unavailable for deduction from its gross income. The trial court had concluded that the provisions in the agreements ensuring its collection of the distributor’s percentage of admissions were merely a means of securing payment, and that these payments were expenses of United Artists in doing business.²⁷

The *United Artists* court referred to the Indiana Supreme Court case of *Gross Income Tax Division v. Warner Brothers*,²⁸ which concerned the question of whether or not Warner Brothers was engaged in interstate commerce and thus exempt from gross income tax. In *Warner Brothers*, the Indiana Supreme Court held that Warner Brothers was not engaged in interstate commerce: “[N]or can we see that the license agreement, providing for a percentage of the exhibitor’s admission price as the license fee, changes the character of the transaction.”²⁹ The *United Artists* court recognized that this was not a binding argument against United Artists, but it also recognized that this holding was valid as to the logic that a percentage of the exhibitor’s admission fee does not change the character of the transaction.³⁰

Reviewing the facts, the court indicated that the agreement’s provision entitling United Artists to a “house allowance” indicated that the parties

²⁴*Id.* at 756.

²⁵*Id.* (citing *Indiana Dep’t of State Revenue v. Boswell Oil Co.*, 148 Ind. App. 569, 268 N.E.2d 303 (1971)).

²⁶459 N.E.2d at 756-57 (citing *Indiana Dep’t of Revenue v. Waterfiled [sic] Mtg. Co.*, 400 N.E.2d 212 (Ind. Ct. App. 1980); *Department of Treasury v. Ice Serv., Inc.*, 220 Ind. 64, 41 N.E.2d 201 (1942)).

²⁷459 N.E.2d at 757.

²⁸233 Ind. 345, 118 N.E.2d 117 (1954).

²⁹*Id.* at 348, 118 N.E.2d at 119.

³⁰459 N.E.2d at 757 n.2. The court in this footnote revealed that United Artists had contended that the Department of Revenue should not be allowed to rely on *Warner Brothers* because this case had been repudiated by later Department of Revenue regulations. The court conceded this was correct; however, the fact that this holding was now contrary to Department of Revenue regulations did not supersede the reasoning of *Warner Brothers*, at least to the extent that it commented upon a percentage of license agreement and its change upon the character of the transaction.

treated the entire admission fees as gross income, since all calculations were made on the total admissions after deduction for "the house allowance."³¹ Moreover, United Artists had not segregated that percentage of fees which was payable to the distributors into a separate banking account, but rather paid it from its own accounts.³² The court made no mention of what effect segregation of funds might have had upon the outcome of this case.

United Artists also claimed that the portion of admissions received and eventually paid to the movie distributors had been received as a special agent for the distributor.³³ United Artists argued it was merely a collection agent for the distributors due to the requirement that special prenumbered tickets be utilized and because the distributor had a right to audit records of United Artists and monitor theater premises.³⁴ The distributor also retained many rights regarding the actual showing of the films and almost total control of advertising related to the films. The trial court, however, found nothing in the licensing agreements indicating that United Artists was an agent for the distributors for any purpose and that any allegations of agency were uncorroborated.³⁵

The court of appeals found *United Artists* distinguishable from *Indiana Department of Revenue v. Waterfiled [sic] Mortgage Co.*,³⁶ where it was held that a mortgage company collecting mortgage payments and transferring those amounts, which included interest, to the appropriate bank was merely a conduit and not subject to gross income tax. Furthermore, the court denied United Artists' claim that it was a special agent, because the real nature of the agreements revealed that they were rental agreements which based the payment to the film distributor upon a percentage of the receipts from admission.³⁷

The final issue in *United Artists* was whether or not the trial court's scope of review was limited to the facts presented to the Department of Revenue in administrative hearings. The trial court had held that the scope of its review was limited to facts presented to the Department and that the facts found by the Department were presumed to be valid.³⁸ United Artists argued, and the appellate court agreed, that a taxpayer's claim for gross income tax refunds was to be held *de novo* upon trial.³⁹ However, since United Artists failed to show any evidence was excluded by the trial court nor did it offer to prove evidence which had been

³¹*Id.* at 758.

³²*Id.*

³³*Id.*

³⁴*Id.*

³⁵*Id.*

³⁶400 N.E.2d 212 (Ind. Ct. App. 1980).

³⁷459 N.E.2d at 759.

³⁸*Id.*

³⁹*Id.*

excluded, the court concluded that the trial court's finding constituted harmless error.⁴⁰

C. Inheritance Tax

The issue in *In re Estate of Pfeiffer v. Henry*⁴¹ was the manner in which the estate was permitted to allocate inheritance tax deductions. The decedent's will provided that expenses were to be paid from the residuary assets of the estate. The estate's expenses consumed assets so as to leave no residual properties and no abatement⁴² of a portion of specific devises.⁴³ For purposes of inheritance tax, the estate proportionately allocated the estate's expenses⁴⁴ among all the assets of the estate. The Department of Revenue objected, claiming that the expenses should be directly allocated to those assets which were reduced pursuant to the provisions of the decedent's will.⁴⁵

The court held that the estate's method of apportionment was incorrect because "[l]ogic dictates that a deduction must be attributed only to the party which expends the resources which constitute the deduction."⁴⁶ In so holding, the court found that a deduction should be treated under the same standard as an exemption, which is to construe any ambiguity in the law against the party claiming the exemption.⁴⁷

In *Indiana Department of State Revenue v. Estate of Broyles*,⁴⁸ the estate did not pay the inheritance tax within the required eighteen month time period from the date of the decedent's death. This resulted in the imposition of a ten percent interest penalty on the delinquent portion of the inheritance tax from the date of death until the time of payment.⁴⁹ The probate court's final determination of the inheritance tax in the amended Order Determining Value of Estate and Amount of Tax added ten percent

⁴⁰*Id.* at 759-60.

⁴¹452 N.E.2d 448 (Ind. Ct. App. 1983)

⁴²The abatement of the decedent's residual bequest and specific devise was made pursuant to Indiana Code section 29-1-17-3. There was no controversy as to whether the abatement had been made pursuant to statutory requirements.

⁴³452 N.E.2d at 450.

⁴⁴Indiana Code section 6-4.1-3-13(b) provides the applicable language for the deduction of estate expenses for inheritance tax purposes: "The following items, and no others, may be deducted from the value of property interests transferred by a resident decedent under his will, under the laws of intestate succession, or under a trust . . ." IND. CODE § 6-4.1-3-13(G) (1982).

⁴⁵452 N.E.2d at 451.

⁴⁶*Id.*

⁴⁷*Id.* at 452.

⁴⁸457 N.E.2d 250 (Ind. Ct. App. 1983).

⁴⁹*Id.* at 252. Interest on the tax runs from the date of death until payment is actually made.

interest charge⁵⁰ to the delinquent tax due.⁵¹ Ten months following the amended order, the estate petitioned for a reduction of the penalty interest from ten percent to ten percent pursuant to Indiana Code section 6-4.1-9-1(b),⁵² which permits the probate court to grant a reduction if an unavoidable delay prevented the determination of the amount of the inheritance tax due.

The probate court granted the estate's request for reduction.⁵³ The Department of Revenue objected to this reduction in interest on one ground; it claimed that the petition requesting the reduction in interest rate was not filed within the ninety day period required by statute⁵⁴ for filing a petition for rehearing with a probate court after the determination of an inheritance tax has been made.⁵⁵

The court of appeals held that a petition for reduction of interest is within the ambit of the ninety day requirement for filing and that failure to file within the statutory period deprived the probate court of subject matter jurisdiction over the reduction in interest.⁵⁶ The court addressed the issue of whether or not the statute containing the ninety day restriction for objecting to an "inheritance tax determination" includes a petition for the reduction of interest.⁵⁷ The term "determination" was held to mean consideration by the court of any factor relating to

⁵⁰Indiana Code section 6-4.1-9-1(a) provides that if the tax remains unpaid eighteen months after the decedent's death, then a 10% interest rate is imposed on the delinquent portion of the tax from the date of death until the payment is made. IND. CODE § 6-4.1-9-1 (1982).

⁵¹457 N.E.2d at 251.

⁵²Indiana Code section 6-4.1-9-1(b) provides:

If an unavoidable delay, such as necessary litigation, prevents a determination of the amount of inheritance due, the appropriate probate court, in the case of a resident decedent, or the department of state revenue, in the case of a non-resident decedent, may reduce the rate of interest imposed under this section, for the time period beginning on the date of the decedent's death and ending when the cause of delay is removed, to six percent (6%) per year.

IND. CODE § 6-4.1-9-1(b) (1982).

⁵³457 N.E.2d at 252.

⁵⁴Indiana Code section § 6-4.1-7-1 provides:

A person who is dissatisfied with an inheritance tax determination made by a probate court with respect to a resident decedent's estate may obtain a rehearing on the determination. To obtain the rehearing, the person must file a petition for rehearing with the probate court within ninety (90) days after the determination is made. In the petition, the person must state the grounds for the rehearing. The probate court shall base the rehearing on evidence presented at the original hearing plus any additional evidence which the court elects to hear.

IND. CODE § 6-4.1-7-1 (1982).

⁵⁵457 N.E.2d at 252.

⁵⁶*Id.* at 253.

⁵⁷*Id.* at 252.

the manner of which the amount of tax is ultimately computed, including an interest reduction.⁵⁸

The court observed that the order of the probate court granting the reduction in interest was not restricted to that period prior to the final determination of the tax.⁵⁹ While the court noted this conclusion was incorrect because the statutory language⁶⁰ permits reduction in interest for only that period prior to the determination of the tax and not for the period after the determination of tax and before payment, it indicated that this error alone was not fatal and could have been modified upon appeal.⁶¹

In *Indiana Department of State Revenue v. Estate of Rogers*,⁶² the inheritance tax had been paid within one year of the decedent's death but additional inheritance taxes, along with interest at the statutory rate of ten percent per annum, were later determined after a federal estate tax audit.⁶³ The estate immediately paid an amount equal to the additional inheritance tax determined to be due. The estate also filed a petition to determine the interest due on this additional inheritance tax and for a reduction of the interest rate from ten percent to six percent.⁶⁴ The probate court ordered the estate to pay interest on the additional inheritance tax at a rate of ten percent from the date of the decedent's death until the tax was finally paid.⁶⁵ Based upon this order, the estate computed and paid the interest. In computing interest due, the estate assumed that its first additional payment was applied first against the principal of the tax due and any remainder constituted interest on the tax.⁶⁶

The probate court ultimately determined that the estate had properly calculated the application of the payment to principal and interest. Further, it found that the Department of Revenue, having failed to file objections to the court's later order which confirmed the estate's calculations, had waived its right to file objections because of the statutory ninety day limitation⁶⁷ on filing petitions for the redetermination of tax.⁶⁸

⁵⁸*Id.* at 253 (citing *In re Estate of Hogg*, 150 Ind. App. 650, 276 N.E.2d 898 (1971)). The court noted that the *Hogg* decision was based upon the pertinent statute prior to its current amendment; however, the court found the *Hogg* analysis retained its applicability in the setting of the existing case. 457 N.E.2d at 252-53.

⁵⁹457 N.E.2d at 252.

⁶⁰The pertinent portion of Indiana Code section § 6-4.1-9-1(b) provides: "[T]he appropriate probate court . . . may reduce the rate of interest imposed under this section, for the time period beginning on the date of the decedent's death and ending when the cause of delay is removed" IND. CODE § 6-4.1-9-1(a) (1982) (emphasis added).

⁶¹457 N.E.2d at 252.

⁶²459 N.E.2d 69 (Ind. Ct. App. 1984).

⁶³*Id.* at 70.

⁶⁴*Id.*

⁶⁵*Id.*

⁶⁶*Id.*

⁶⁷See *supra* note 54.

⁶⁸459 N.E.2d at 70.

On appeal, the Department of Revenue contended that the later payments of tax should have been first applied to interest due at the time of payment and that any remainder should have been applied to the principal of the inheritance tax due. It also claimed that since its motion was in the nature of a motion to compel compliance with the court's original determination of tax, its failure to file within the ninety day period did not deprive the court of subject matter jurisdiction. It argued that the motion was not within the realm of the statute limiting the time for filing a petition for rehearing and redetermination of inheritance tax.⁶⁹

The court agreed with the Department of Revenue that payments made when both inheritance tax and interest are due must be applied first to the interest due, and then only after full payment of the interest is applied, to the principal of the tax due.⁷⁰ The Department of Revenue's interpretation followed the laws of Indiana and the United States, which generally require payments made without an agreement or statute to the contrary be first applied to interest; then, if any remains, to the reduction of principal.⁷¹

The court also held that the Department of Revenue's motion to compel compliance with the court's original redetermination of additional inheritance tax did not come within the ninety day requirement for filing. This was so because the statute is limited in its application to those cases where the Department of Revenue is "*dissatisfied* with the inheritance tax determination."⁷²

The court also quickly disposed of the estate's argument that an oral agreement estopped the Department. The court held that since there was no evidence of an oral agreement in the record there was no need to consider whether an estoppel could even be asserted against the Department.⁷³

Whether or not the mailing of an inheritance tax payment by United States certified mail, return receipt requested, two days prior to the due date constituted a timely payment of inheritance tax was the question posed to the court in *Nell v. Tracy*.⁷⁴ The facts in *Nell* were undisputed. Two days prior to the due date of the inheritance tax, the estate's attorney sent a check by certified mail, return receipt requested, in the correct amount of tax due and payable, to the Indiana Department of

⁶⁹*Id.*

⁷⁰*Id.* at 70-71 (citing 45 IND. ADMIN. CODE 4-6-6 (1984); 1962 Op. Att'y Gen. No. 73, 79).

⁷¹459 N.E.2d at 71 (citing *Jacobs v. Ballenger*, 130 Ind. 231, 29 N.E. 782 (1892) among many other authorities).

⁷²459 N.E.2d at 71.

⁷³*Id.* at 72.

⁷⁴459 N.E.2d 432 (Ind. Ct. App. 1984).

State Revenue at its proper address and to the proper person.⁷⁵ The check was mailed from the United States Post Office in Vincennes, Indiana. According to the testimony of the postmaster of the Vincennes Post Office, a letter mailed in such a manner would normally be delivered overnight to the proper address in Indianapolis. The check was not received until four days past the due date.⁷⁶ The Department of Revenue contended payment was not timely, causing interest charges to accrue from the date of decedent's death until the time of payment.⁷⁷

The Inheritance Tax Division argued that the post office was the agent of the sender because it could withdraw the letter prior to delivery and, therefore, it was not until delivery that the payment was made.⁷⁸ The evidence in *Nell* did establish that the estate could have withdrawn the payment from the mail but, nonetheless, the court held that payment was made upon mailing.

The court relied upon decisions from other jurisdictions⁷⁹ for the proposition that the purpose of penalties upon late payment of tax was to penalize those who were careless in their payment of tax and that the penalty should not be imposed where persons mailed taxes in a manner which would normally result in a timely payment.⁸⁰ The estate had done what any reasonable person in normal business practice would have done, which was to make timely payment of the tax on or before the due date.⁸¹ The court concluded that the Department of Revenue's position was grossly unfair and wrong, dictating a finding in favor of the estate.⁸² The holding in *Nell* prevents an unjust result to a taxpayer which, as the court noted, could have done little more to ensure timely payment short of personal delivery.

Another Indiana appellate court, in considering whether the filing

⁷⁵*Id.* at 433.

⁷⁶*Id.*

⁷⁷*Id.* at 433 n.4. The Department of Revenue contended that based upon the holding in *Estate of Rogers*, see *supra* notes 62-73 and accompanying text, the payment would be applied first against interest due and the remaining against principal. Application of the *Rogers* decision would have resulted in a sizeable sum of unpaid principal of inheritance tax which would have drawn interest pending the outcome of the ultimate determination of the timeliness of the payment.

⁷⁸459 N.E.2d at 434 (citing *Guardian Nat'l Bank v. Huntington County State Bank*, 206 Ind. 185, 187 N.E. 388 (1933)).

⁷⁹459 N.E.2d at 434. The court first cited *Hills Materials Co., Inc. v. Van Johnson*, 316 N.W.2d 646 (S.D. 1982), which permitted a taxpayer to go unpenalized when he was able to establish he had mailed his tax payment three days prior to the due date. The second case cited by the court for this proposition was *General Petroleum Corp. v. Smith*, 62 Ariz. 239, 157 P.2d 356 (1945).

⁸⁰459 N.E.2d at 434.

⁸¹*Id.*

⁸²*Id.* at 435.

of an appeal of property tax assessment was timely, has recently reached a different conclusion about the effect of filing by mail.⁸³ This may indicate that a decision from the Indiana Supreme Court would be appropriate to resolve this conflict between the appellate courts, or that the imposition of a penalty deserves a special exception in the law. In either case, the interests of Indiana taxpayers would be best served by a statutory enactment. A more favorable solution would be a statute which prescribes that the mailing of these items would be effective at the date of the postmark. This would comport with an endless list of statutes and trial rules which permit federal and state tax payments and pleadings regarding tax matters to be effective upon proper mailing with the United States Post Office. Moreover, effectiveness upon mailing offers a desirable certainty which is not otherwise practically obtainable.

In *Indiana Department of State Revenue v. Estate of Smith*,⁸⁴ the question was whether or not the survivor of the decedent was entitled to a deduction, for inheritance tax purposes, for payment of the decedent's funeral expenses and the estate's administrative expenses.⁸⁵ The survivor and the decedent were joint tenants with full rights of survivorship to a bank account. Indiana's statute⁸⁶ does not permit deductions for payment by a survivor of a joint bank account if the assets of the decedent's estate are sufficient to pay the debts or funeral expenses. The value of the assets in the estate were sufficient to pay these expenses, but were not used because the assets were not readily convertible into an acceptable form of payment for these expenses.⁸⁷

The court held that the payments by the holder of a joint survivor account could not be claimed as deductions simply because the estate lacked the liquidity to make the payments eventually made by the joint survivor. Because the statute was clear and unambiguous, the court could not substitute language which it felt the legislature may have intended.⁸⁸

D. Property Tax

In *Margrat, Inc. v. Indiana State Board of Tax Commissioners*,⁸⁹

⁸³See *Margrat, Inc. v. Indiana State Bd. of Tax Comm'rs*, 448 N.E.2d 684 (Ind. Ct. App. 1982). See *infra* notes 89-99 and accompanying text.

⁸⁴460 N.E.2d 1263 (Ind. Ct. App. 1984).

⁸⁵*Id.* at 1264.

⁸⁶Indiana Code section 6-4.1-3-14 provides in pertinent part: "[T]he amount of the decedent's debts or funeral expenses paid by a surviving joint owner of property held jointly with the decedent may be deducted from the value of the jointly held property if the assets of decedent's estate are insufficient to pay the debts or funeral expenses." IND. CODE § 6-4.1-3-14 (1982).

⁸⁷460 N.E.2d at 1265.

⁸⁸*Id.* (citing *State ex rel. Southern Hills Mental Health Center, Inc. v. Dubois County*, 446 N.E.2d 996 (Ind. Ct. App. 1983)).

⁸⁹448 N.E.2d 684 (Ind. Ct. App. 1982).

a taxpayer received an adverse determination by the State Board of Tax Commissioners regarding the assessed value of the taxpayer's property. The taxpayer mailed its notice of appeal by registered mail, return receipt requested, exactly thirty days following the date of the adverse determination. Three days later the State Board received the notice of intent to appeal.⁹⁰ The State Board moved to dismiss this appeal on the ground that the notice had not been filed within the thirty day statutory requirement for filing.⁹¹

An appeal from the State Board of Tax Commissioners is permitted by statute⁹² if written notice is made within thirty days after the board gives notice of its final determination to the taxpayer.⁹³ The statute also expressly provides that notice is effected upon the taxpayer on the day on which the notice is deposited in the United States mail.⁹⁴

In *Margrat*, the court rejected the taxpayer's argument that the Indiana Trial Rules should be applied to make a filing effective upon mailing by registered or certified mail and to add three days to a prescribed period when notice is mailed to a party.⁹⁵ Instead, the court found *Weatherhead Co. v. State Board of Tax Commissioners*⁹⁶ controlling which interpreted the predecessor statute to the current provision for the filing of written notice with the Board.⁹⁷ In *Weatherhead*, the court found that the term "filing" meant the actual delivery of the document to the proper office and its receipt by the proper official.⁹⁸ Since the language of the existing statute had not been changed in meaning from that interpreted in *Weatherhead*, the court held that notice of an appeal of a determination by the Board must be received within the thirty day period in order to be an effective notice of an appeal.⁹⁹

⁹⁰*Id.* at 685.

⁹¹*Id.*

⁹²Indiana Code section 6-1.1-15-5 provides in pertinent part:

(b) If a person desires to initiate an appeal of the state of board of tax commissioners' final determination, he shall:

(1) file a written notice with the state board of tax commissioners informing the board of his intention to appeal . . . ;

. . . .

(c) To initiate an appeal under this section a person must take the action required by subsection (b) of this section within thirty (30) days after the board gives him notice of its final determination.

IND. CODE § 6-1.1-15-5 (1982).

⁹³448 N.E.2d at 685.

⁹⁴IND. CODE § 6-1.1-36-1 (1982).

⁹⁵448 N.E.2d at 685.

⁹⁶151 Ind. App. 680, 281 N.E.2d 547 (1972).

⁹⁷448 N.E.2d at 685.

⁹⁸*Id.* at 686 (citing *Weatherhead*, 151 Ind. App. at 684, 281 N.E.2d at 550).

⁹⁹448 N.E.2d at 686.

E. Sales Tax

The Supreme Court of Indiana settled much of the confusion surrounding the interpretation of the "double direct" language contained within the sales tax exemption in its decisions in *Indiana Department of State Revenue v. Cave Stone, Inc.* and *Indiana Department of State Revenue v. Meshberger Stone, Inc.*¹⁰⁰ This language provides for a sales tax exemption for the purchase of certain equipment "to be *directly* used by the purchaser in the *direct* production . . . of . . . tangible personal property."¹⁰¹ In *Cave Stone*, the court considered the purchase of equipment which was used to transport stone from quarry to crusher and from crusher to stockpiles. The supreme court held that this equipment was "directly used" in the "direct production" of the companies' stone product and was thereby exempt from the gross retail tax, or sales tax. The supreme court accepted transfer of these cases in order to resolve the conflict in interpretation of the statute.¹⁰²

The case arose upon separate complaints filed by Cave Stone, Inc. and Meshberger Stone, Inc. (the "Companies"). The supreme court found the issues in both cases to be identical and having been treated as such in one appeal, it considered them together in its single decision. Only one issue¹⁰³ was considered and resolved by the supreme court: whether or not the machinery, parts, and related items used by the Companies in hauling crude stone were directly used by the Companies in the direct production, manufacture, mining, processing, or finishing of tangible personal property.¹⁰⁴

The Companies were in the business of selling sized, aggregate stone after its removal from their quarries. The preparation of the stone for sale involved several processes. The crude stone was stripped, drilled, blasted, and then loaded onto trucks which hauled it to a primary crusher. The stone was then crushed, separated, washed, and screened into various grades of aggregate stone. The stone was next taken by conveyor to a loader for loading onto trucks for transport to separate stockpiles, referred to as "stock out," from which it was eventually sold. The stockpiling not only preserved the grading of the stone and prevented commingling, but also allowed moisture to drain from the

¹⁰⁰457 N.E.2d 520 (Ind. 1983). Because these two cases were combined by the Indiana Supreme Court and decided upon the basis of the same issue, both are referred to when the case name "*Cave Stone*" is used.

¹⁰¹IND. CODE § 6-2-1-39(b)(6) (1976) (recodified at IND. CODE § 6-2.5-5-3 (1982) (emphasis added)).

¹⁰²For a more complete discussion of this controversy, see King, *Taxation, 1981 Survey of Recent Developments in Indiana Law*, 15 IND. L. REV. 409, 413 (1982).

¹⁰³A second issue presented for determination was whether or not the Companies were subject to penalties. Due to the ultimate disposition of this case, it was not necessary to decide this issue. 457 N.E.2d at 527.

¹⁰⁴*Id.* at 521.

washed stone to obtain a moisture level at a standard generally acceptable to stone purchasers.¹⁰⁵ The trial court found that the transportation of the materials prior to their final disposition in stock out was prior to the stone being in its “final, most marketable form” because the stock out step also constituted a part of the production, the necessary drainage of the stockpiles.¹⁰⁶ The trial court also concluded the stock out step constituted transportation of unfinished work, a part of the continuous flow of the production of the stone.¹⁰⁷

Section 6-2-1-39(b)(6) of the Indiana Code which was the pertinent statute for the years in controversy provided in part: “Nor shall the state gross retail tax [sales tax] apply to any of the following transactions: Sales 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 The court of appeals, in arriving at its decision against the taxpayer, had concluded that the various categories contained in the above statute were exclusive of one another and that “to the extent a particular procedure falls within a definite exemption category that category is exclusive. . . .”¹⁰⁹ The majority of the appellate court then found that the appropriate category in the case at bar was the term “processing,” which requires an operation placing the product in a different form, composition, or character. Next, the majority found that because the hauling of the crude stone and the stock out were steps which did not alter the form, composition, or character of the stone, these were steps not directly used in the direct processing of the stone.¹¹⁰ Upon rehearing, the court of appeals also determined that the equipment was not used in the direct “production” of stone. Further, to be exempt from the sales tax the manufacture and equipment would have to have a transformational effect as opposed to a translational effect.¹¹¹

In *Cave Stone*, the supreme court recognized that exemption statutes were to be strictly construed against the taxpayer,¹¹² but found that the

¹⁰⁵*Id.*

¹⁰⁶*Id.* at 523.

¹⁰⁷*Id.*

¹⁰⁸IND. CODE § 6-2-1-39(b)(6) (1976) (recodified at IND. CODE § 6-2.5-5-3 (1982)).

¹⁰⁹457 N.E.2d at 524 (quoting *Indiana Dep't of State Revenue v. Cave Stone, Inc.*; *Indiana Dep't of State Revenue v. Meshberger Stone, Inc.*, 409 N.E.2d 690, 695 (Ind. Ct. App. 1980), *vacated*, 457 N.E.2d 520 (Ind. 1983)).

¹¹⁰*Id.*

¹¹¹*Id.*

¹¹²*Id.* (citing *Gross Income Tax Div. v. National Bank & Trust Co.*, 226 Ind. 293, 298, 79 N.E.2d 651, 653 (1948); *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

court of appeals had too narrowly construed this statute against the taxpayer. Specifically, the supreme court found that the exemption provisions were not mutually exclusive but provided a comprehensive description of various means of "production."¹¹³ The supreme court cited with approval Judge Buchanan's dissent in the appellate court decision in which he provided two definitions of "production."¹¹⁴ The supreme court concluded that the statute envisioned all of the operations or processes by which the finished product was derived. Thus, the supreme court reasoned that the production or processing of stone begins at the time of the initial stripping, drilling, and blasting at the quarry and ends at the time the stone is stockpiled. Further, the production process was continuous and indivisible.¹¹⁵

The supreme court found that the transportation in question was "essential to the achievement of a transformation of the crude stone into aggregate stone" and that it "played an integral part in the ongoing process of transformation."¹¹⁶ Therefore, the supreme court held that the equipment was directly used by the Companies in direct production, manufacturing, mining, processing, or finishing of tangible personal property within the meaning of the exemption.¹¹⁷

In the course of explaining its reasoning, the supreme court defined the term "direct" production: "direct" production turned on whether or not the transportation was an integral element in the production or processing of the aggregate stone. It did not matter whether any transformation occurred during the transportation of the stone; rather, because the trucks were "essential to the achievement of a transformation of the crude stone into aggregate stone," the equipment was used in the direct production.¹¹⁸

¹¹³457 N.E.2d at 524.

¹¹⁴*Id.* The definitions of the word production cited by Chief Judge Buchanan and incorporated in *Cave Stone* were the following:

"In an economic sense, production includes all activity directed to increasing the number of scarce economic goods. It is not simply the manual, physical labor involved in changing the form or utility of a tangible article. . . . Production: something that is produced naturally or as a result of labor and effort; the act or process of producing, bringing forth or making; the creation of utility, the making of goods available for human wants."

Id. (quoting *Indiana Dep't of State Revenue v. Cave Stone, Inc.*; *Indiana Dep't of State Revenue v. Meshberger Stone, Inc.*, 409 N.E.2d 690, 698 (Ind. Ct. App. 1980) (Buchanan, C.J., concurring in part and dissenting in part) (quoting *Borden Co. v. Borella*, 325 U.S. 679, 683 (1945); WEBSTER'S THIRD LAW INT'L DICTIONARY 1810 (unabridged ed. 1971), *Cave Stone vacated*, 457 N.E.2d 520 (Ind. 1983)).

¹¹⁵457 N.E.2d at 527.

¹¹⁶*Id.*

¹¹⁷*Id.*

¹¹⁸*Id.*

While the supreme court spent much time defining and explaining the term “direct production,” it gave only a cursory review to the phrase “directly used by the purchasers”:

The statute provides that the manufacturing machinery, tools and equipment, in order to be exempt, must (1) be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of tangible personal property. *In the present case, the transportation equipment in question was directly used by the purchaser, not some other entity, and it was used in the direct production and processing of crude stone into aggregate stone.*¹¹⁹

The supreme court appears to have changed the “double direct” test to a single direct test by defining “directly used by the purchaser” as used by the purchaser and “not some other entity.”

The court followed its conclusion with a review of the various Indiana appellate court decisions which have interpreted this exemption.¹²⁰ A look at each of these cases reviewed by the Indiana Supreme Court is instructive because it indicates the supreme court’s analysis in other factual settings.

One case discussed in *Cave Stone* was *Department of Revenue v. United States Steel Corp.*¹²¹ The court found the *United States Steel* analysis was correct in interpreting that “direct” production requires the equipment in question to have an “immediate link with the product being produced.”¹²² The supreme court also noted that the *United States Steel* analysis correctly concluded that the focus should be on whether the equipment was an “integral part of manufacturing and operates directly on the product during production.”¹²³ The supreme court stated that it had been held in *United States Steel* that safety equipment was essential, integral, and in direct production, for the employees could not complete the production process without the equipment.¹²⁴

The court in *Cave Stone* also affirmed the analysis in *Indiana Department of State Revenue v. American Dairy of Evansville, Inc.*¹²⁵ In *American Dairy* it was held that milk cans used to hold, measure, and convey raw materials were available for exemption from the sales

¹¹⁹*Id.* at 525 (emphasis added).

¹²⁰*Id.* at 525-26

¹²¹425 N.E.2d 659 (Ind. Ct. App. 1981).

¹²²457 N.E.2d at 525 (quoting *Department of Revenue v. United States Steel Corp.*, 425 N.E.2d 659, 662 (Ind. Ct. App. 1981)).

¹²³457 N.E.2d at 525 (quoting *Department of Revenue v. United States Steel Corp.*, 425 N.E.2d 659, 664 (Ind. Ct. App. 1981)).

¹²⁴457 N.E.2d at 525.

¹²⁵167 Ind. App. 367, 338 N.E.2d 698 (1975), *transfer denied*, July 14, 1976.

tax.¹²⁶ In *Cave Stone*, the supreme court stated that the majority of the appellate court had incorrectly distinguished *American Dairy* on the ground that the processing of the milk occurred while the milk was in the cans while no processing of the stone occurred during transport in *Cave Stone*.¹²⁷ The supreme court noted that the trial court in *American Dairy* had found that the containers were used only to "hold, measure and convey."¹²⁸ It was further noted that the court of appeals in *American Dairy* had permitted the exemption for the milk containers without requiring any transformation in the milk while stored in the containers.¹²⁹

The holding in *Indiana Department of State Revenue v. RCA Corp.*¹³⁰ was also found to be consistent with the holding in *Cave Stone*. The court in *RCA* held that air conditioning equipment in an RCA plant was not directly used in direct production of color television picture tubes. The court recognized the importance of the air conditioning to the production, but found that the production could continue without the air conditioning even though it would be done in a less economic manner. This was found to be distinguishable from *Cave Stone* in which the equipment to transport the stone to the crusher and to the stockpiles was essential to the production of the aggregate stone.¹³¹ The supreme court did not address the fact that in *RCA* the Department of Revenue had conceded that the controlled environment was "integral and essential" to RCA,¹³² which suggests that *RCA* may have been closer to an exemption than the supreme court admitted.

The supreme court also concluded that its instant opinion was consistent with the holding in *Indiana Department of State Revenue v. Harrison Steel Castings Co.*¹³³ In *Harrison*, safety equipment was found not to be eligible for the sales tax exemption because, according to the supreme court, it was not so essential to the production that its removal would have halted production.¹³⁴

In *Cave Stone*, the court also addressed the effect of the Department's regulations. The Department of Revenue argued that a different result might have occurred had this case been brought under the later, and now existing, regulations. The supreme court, however, clearly stated that

¹²⁶*Id.* at 375, 338 N.E.2d at 702.

¹²⁷457 N.E.2d at 526.

¹²⁸*Id.*

¹²⁹*Id.*

¹³⁰160 Ind. App. 55, 310 N.E.2d 96 (1974), *transfer denied*, Oct. 13, 1976.

¹³¹457 N.E.2d at 526.

¹³²160 Ind. App. at 58, 310 N.E.2d at 98.

¹³³402 N.E.2d 1276 (Ind. Ct. App. 1980).

¹³⁴457 N.E.2d at 526.

to the extent any regulation was inconsistent with the holding in *Cave Stone*, it would be contrary to the enabling statute and invalid to that extent.¹³⁵ Therefore, it appears quite clear that *Cave Stone* is, and will continue to be, the seminal case in the field of exemption from sales tax for the purchase of equipment to be directly used by the purchaser in the direct production of tangible personal property in Indiana.

Nevertheless, *Cave Stone* will not end the search for a test which will clearly identify equipment used in “direct” production, as there will continue to be an endless need for application of whether an item constitutes “an integral and essential part of production.” Rather, the great importance of *Cave Stone* is that it has decisively put to rest the Department’s argument that to qualify for the sales tax exemption an item must actually touch or have a direct positive effect upon the item produced.

In *Indiana Department of State Revenue v. Hertz Corp.*,¹³⁶ Hertz sought an exemption from the sales tax for its gasoline purchases. Hertz claimed that the purchase of that portion of its gasoline which it sold to its customers was not subject to sales tax because its purchase was a wholesale purchase for resale to its customers,¹³⁷ and because it was a purchase for the purpose of reselling the same goods in the form in which they were purchased.¹³⁸

Hertz established that it generally entered into two types of rental agreements. The first type of agreement was a “wet rental” agreement in which all the fuel was provided by Hertz and a higher charge was paid by the customer because the fuel was provided. Under the “wet rental” agreements, the entire price of the rental was subjected to sales

¹³⁵*Id.* at 527.

¹³⁶457 N.E.2d 246 (Ind. Ct. App. 1983).

¹³⁷The previous code section provided: “The term ‘wholesale sales’ means and includes only the following: (1) Sales of any tangible personal property . . . to a purchaser who purchases the same for the purpose of reselling it in the form in which it is sold to him” IND. CODE § 6-2-1-3(a) (1976) (recodified at IND. CODE § 6-2.5-4-2(b) (1982)). This provision is now found at Indiana Code section 6-2.5-4-2(b) which provides, for purposes of this discussion, that a person is making wholesale sales when he “(1) sells tangible personal property, other than capital assets or depreciable property, to a person who purchases the property for the purpose of reselling it without changing its form.” IND. CODE § 6-2.5-4-2(b) (1982)

¹³⁸The previous code section provided: “(b) Nor shall the state gross retail tax [sales tax] apply to . . . (9) Sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling in the regular course of the purchaser’s business such tangible personal property in the form in which it is sold to such purchaser.” IND. CODE § 6-2-1-39(b)(9) (1976) (recodified in IND. CODE § 6-2.5-5-8 (1982)). This provision is now included at Indiana Code section 6-2.5-5-8: “Transactions involving tangible personal property are exempt from the state gross retail tax [sales tax] if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of his business without changing the form of the property.” IND. CODE § 6-2.5-5-8 (1982).

tax which was collected and remitted to the Department of Revenue.¹³⁹ The second type of rental agreement used by Hertz was a "dry rental" agreement, in which the customer was required to pay Hertz if the vehicle were returned to Hertz with less than a full tank of gasoline. In the case of these "dry rental" agreements, the bill to the customer would segregate his charge into two separate categories: the additional charge for the fact that the car had been returned with less than a full tank of gasoline, and the normal rental charge based upon the mileage and time of the rental of the vehicle. Sales tax was collected on both categories of the customer's bill and timely remitted to the Department of Revenue.¹⁴⁰

Hertz objected only to the collection of sales tax upon its bulk purchases of fuel which in turn were used by its customers under both the dry and wet rental agreements. The court agreed with Hertz that its customers had separately paid for the gasoline supplied by Hertz by either the higher charge placed on them in the case of "wet rental" agreements or by a separate charge in the case of "dry rental" agreements.¹⁴¹ This qualified the bulk purchase of gasoline by Hertz as an exempt purchase under the statutory exemption of purchases for resales.¹⁴² Although Hertz suggested several alternatives to support its argument, the court relied solely upon this exemption and did not consider the adequacy of other arguments.¹⁴³

In *Indiana Department of State Revenue v. Indiana Harbor Belt Railroad*,¹⁴⁴ the court of appeals interpreted the sales tax exemption containing the so-called "single-direct" standard.¹⁴⁵ In *Harbor Belt*, the railroad argued that the purchase of the following items were exempt from the sales tax by virtue of being directly used or consumed for the rendering of public transportation: tools and equipment used to repair and maintain rolling stock and track; items used for repair and maintenance of the railroad's buildings; vehicles (other than locomotives or rolling stock) used primarily for transportation of track maintenance crews; items used for repairs and maintenance of those vehicles; and

¹³⁹457 N.E.2d at 247.

¹⁴⁰*Id.*

¹⁴¹*Id.* at 249-50.

¹⁴²IND. CODE § 6-2-1-39(b)(9) (1976) (recodified at IND. CODE § 6-2.5-5-8 (1982)). See *supra* note 138.

¹⁴³457 N.E.2d at 247.

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

¹⁴⁵The former relevant Indiana Code section provided the following exception from sales tax: "The sale, storage, use or other consumption in this state of tangible personal property or service which is directly used or consumed in the rendering of public transportation of persons or property." IND. CODE § 6-2-1-39(b)(4) (1976) (recodified at IND. CODE § 6-2.5-5-27 (1982)). The current code provides the following exemption: "Transactions involving tangible personal property and services are exempt from the state gross retail tax [sales tax], if the person acquiring the property or service directly uses or

items used in general administrative and managerial operations such as office equipment, uniforms, and locks and keys.¹⁴⁶

While the court recognized the literal distinction between the “single-direct” standard contained in the law in issue, it indicated that the holding by the Indiana Supreme Court in *Cave Stone*¹⁴⁷ adopted a test which did not require a reference to the single or double directness language of the statutes. The court in *Harbor Belt* interpreted *Cave Stone* as necessitating an examination of the integrated process of manufacturing and establishing an “immediate link with the product being produced.”¹⁴⁸ Further, the holding in *Cave Stone* was found applicable to the statute containing the “single-direct” standard by analogy.¹⁴⁹ The court stated that the test to be applied, based on *Cave Stone*, is to consider the “particular item’s relation to full, continuous and indivisible production process, not whether an item . . . has a transformational effect on the end product.”¹⁵⁰

The only previous Indiana case interpreting the “single-direct” requirement in controversy was *Indiana Department of State Revenue v. Indianapolis Transit System, Inc.*¹⁵¹ In *Indianapolis Transit*, the court applied the test of whether the purchased items had a “necessity towards operations.”¹⁵² The court in *Harbor Belt* felt that this approach by the court in *Indianapolis Transit* did not vary much, if at all, from the approach adopted in *Cave Stone*.¹⁵³ The only difference the court noted between the cases was the distinction between what is an integral part of manufacturing as compared to what is an integral part of rendering transportation. The court noted that the latter concept, “an integral part of rendering transportation,” was a broader concept.¹⁵⁴

The *Harbor Belt* court went on to find that all of the contested items were exempt from the sales tax under the reasoning enunciated in *Cave Stone*.¹⁵⁵ These were found to be within the concept of a “direct use or consumption in the integrated operation of providing public transportation.”¹⁵⁶

consumes it in providing public transportation for persons or property.” IND. CODE § 6-2.5-5-27 (1982).

¹⁴⁶460 N.E.2d at 176.

¹⁴⁷457 N.E.2d 520 (Ind. 1983).

¹⁴⁸460 N.E.2d at 174 (quoting *Department of Revenue v. United States Steel Corp.*, 425 N.E.2d 659, 662 (Ind. Ct. App. 1981)).

¹⁴⁹460 N.E.2d at 175.

¹⁵⁰*Id.* (citing *Cave Stone*, 457 N.E.2d at 524).

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

¹⁵²*Id.* at 306, 356 N.E.2d at 1209.

¹⁵³460 N.E.2d at 175.

¹⁵⁴*Id.*

¹⁵⁵*Id.* at 176-77.

¹⁵⁶*Id.*

The court in *Harbor Belt*, while reviewing the standard set forth in *Cave Stone*, did not apply the test to each of the specific items claimed to be exempt by the railroad. Although the court claimed that each of these items was within the holding of *Cave Stone*, it appears that the court relied on its "broader concept" in interpreting what was "directly used or consumed for the rendering of public transportation" in order to find that purchases such as "repair and maintenance of buildings and general administrative and managerial operations" were exempt. Otherwise, it is impossible to imagine that such items would be exempt under a *Cave Stone* analysis.

F. 1984 Statutory Developments in Indiana Tax Law

Several provisions of particular importance were adopted by the 1984 General Assembly. The four most significant statutory changes are included in this Article.

1. *Changes in Indiana Adjusted Gross Income Tax.*—Section 6-3-1-3.5 of the Indiana Code defines the term "adjusted gross income" to mean the adjusted gross income as defined in the Internal Revenue Code, as modified by other provisions in that section.¹⁵⁷ One effect of this is that changes made in the federal tax structure which affect an individual's federal adjusted gross income will cause a corresponding change in the individual's Indiana adjusted gross income.¹⁵⁸ Such a change was brought about in federal income tax law, and consequently in Indiana law, by the Social Security Amendments of 1983.¹⁵⁹

This change is contained in the Internal Revenue Code at section 86, which generally provides that beginning in 1984, individuals receiving social security benefits and certain railroad retirement benefits may be taxed for federal income tax purposes on a portion of those benefits, depending upon their other income and tax return filing status.¹⁶⁰ As indicated, since the Indiana adjusted gross income follows the federal

¹⁵⁷IND. CODE § 6-3-1-3.5 (Supp. 1984). This code section provides that "the term 'adjusted gross income' shall mean: (a) In the case of all individuals, 'adjusted gross income' as defined in Section 62 of the Internal Revenue Code" *Id.*

¹⁵⁸Act of Feb. 24, 1984, Pub. L. No. 49-1984, Sec. 2, 1984 Ind. Acts 621, 623 (codified at IND. CODE § 6-3-1-11 (Supp. 1984)) defined the term "Internal Revenue Code" to mean the United States Internal Revenue Code of 1954 as amended and in effect on January 1, 1984.

¹⁵⁹Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65. (1983).

¹⁶⁰I.R.C. § 86(b) (West Supp. 1984). This section causes an inclusion of a portion of the social security benefits based upon the taxpayer's federal adjusted gross income, with certain modifications, but only to the extent these benefits exceed a "base amount." Lower income taxpayers should not be affected by this provision because the "base amount" provided in I.R.C. § 86(c) is \$25,000, except in the case of taxpayers filing a joint return, in which case the "base amount" is \$32,000, and \$-0- for taxpayers married at the close of a taxable year not filing a joint return and not living apart from their spouse at all times during the taxable year. *Id.*

adjusted gross income, those taxpayers subjected to federal income tax on social security benefits would also include this amount in their Indiana adjusted gross income if it were not for Public Law 49.¹⁶¹ This provision adds Indiana Code section 6-3-1-3.5(a)(12), a reduction of Indiana adjusted gross income for that amount equal to the social security and railroad retirement benefits included in the taxpayer's federal gross income by reason of section 86 of the Internal Revenue Code. Thus, even those selected taxpayers who will be subject to federal income tax due to social security and railroad retirement benefits will not be subjected to Indiana adjusted gross income tax on those amounts.

2. *Exemption from the Indiana Gross Income Tax and Filing Requirements for Certain Corporations.*—With Public Law 78,¹⁶² the 1983 Indiana General Assembly made a major change by exempting certain corporations from the Indiana gross income tax. This law is a significant departure from the longstanding Indiana rule that all corporations, except those qualifying as a federal S corporation,¹⁶³ were subject to tax on their gross income. For those qualifying corporations that are not federal S corporations, this exemption only applies to gross income tax and does not affect the corporation's requirement to pay Indiana adjusted gross income and Indiana supplemental net income taxes.

The significance of this provision is that it will no longer be desirable or necessary for corporations doing business in Indiana to elect to be treated as federal S corporations solely in order to avoid paying the gross income tax. Qualifying corporations may choose to revoke their election to be treated as S corporations in order to gain the benefits of income tax splitting between the corporate entity and the shareholders, who would otherwise be taxed on the corporation's income if the S corporation election were to be continued. In certain cases, the current federal income tax savings of such income splitting may more than offset the additional Indiana adjusted gross and supplemental net income taxes imposed on the corporation. Furthermore, this gross income tax exemption will remove one major tax disincentive for the incorporation of partnerships and sole proprietorships, thereby subjecting the resulting corporation to Indiana tax on its gross income.¹⁶⁴

The requirements to qualify under this exemption are nearly identical

¹⁶¹Act of Feb. 24, 1984, Pub. L. No. 49-1984, Sec. 1, 1984 Ind. Acts 621, 622 (codified at IND. CODE § 6-3-1-3.5 (Supp. 1984)).

¹⁶²Act of Mar. 23, 1983, Pub. L. No. 78-1983, 1983 Ind. Acts 662 (codified at IND. CODE § 6-2.1-3-24.5 (Supp. 1984)).

¹⁶³See IND. CODE § 6-2.1-3-24 (1982); IND. CODE § 6-3-2-3 (1982) (exempting corporations qualifying as federal S corporations from tax under the Indiana gross income tax and Indiana adjusted gross income tax, respectively).

¹⁶⁴A more complete discussion of the effects of this Act is contained at Smith & Hetzner, *To incorporate or not to incorporate—after 'Indiana SBC Act'—*, 27 RES GESTAE 270 (1983).

to the requirements for a corporation eligible to elect federal S corporation treatment. In fact, the statute incorporates the term "small business corporation" as having the same definition as that contained in the Internal Revenue Code at section 1361. Generally, section 1361(b) requires that, to be eligible as a "small business corporation," a corporation must: (1) be a domestic corporation; (2) not be a member of an affiliated group as defined therein, with one exception for inactive subsidiaries; (3) have only one class of stock, with certain exceptions; (4) have not more than thirty-five shareholders with husband and wife being treated as one shareholder; and (5) have only shareholders that are United States citizens or certain estates or trusts.¹⁶⁵

An additional requirement to be eligible to qualify as an Indiana small business corporation is included in section 6-2.1-3-24.5(c) of the Indiana Code. This section requires a small business corporation to have less than 25% of the corporation's gross income consist of passive investment income in a taxable year.¹⁶⁶ Generally, passive investment income is defined to include royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities.¹⁶⁷

Public Law 47¹⁶⁸ amended section 6-2.1-3-24.5(d) of the Indiana Code to specify when a corporation desiring to be exempt from Indiana gross income tax must file proof with the Department of Revenue. The statute now clearly provides that the corporation claiming the exemption must annually provide proof to the Department of its eligibility for the exemption. This proof must be filed on or before the due date of the corporation's gross income tax return, including any extensions granted by the Department of Revenue therefor. Both the exemption and the proof requirement are effective for taxable years that begin after December 31, 1983.¹⁶⁹

3. Exclusion of Corporate Partnerships from Liability for the Indiana Gross Income Tax.—Public Law 47¹⁷⁰ also contains provisions which eliminate corporate partnerships from liability for Indiana gross income tax. Prior to amendment, the exemption for partnerships from gross income tax specifically excluded a partnership which had one or more partners that were corporations.¹⁷¹ Under the previous provisions of the law, several questions had arisen and were litigated concerning the exact

¹⁶⁵I.R.C. § 1361(b) (West Supp. 1984).

¹⁶⁶The term "passive investment income" is, by incorporation, defined to have the same meaning as contained at I.R.C. § 1362(d)(3)(D) (West Supp. 1984).

¹⁶⁷*See id.*

¹⁶⁸Acts of Mar. 5, 1984, Pub. L. No. 47-1984, 1984 Ind. Acts 617 (codified at IND. CODE § 6-2.1-3-24.5(d) (Supp. 1984)).

¹⁶⁹*See id.*, Sec. 8, at 619.

¹⁷⁰IND. CODE §§ 6-2.1-3-25, 6-3.1-3-1 (Supp. 1984).

¹⁷¹Repealed were portions of Indiana Code section 6-2.1-3-25 (1982).

application of the term "corporate partnership" and its result when an otherwise exempt corporation was the corporate partner, and when multi-tiered partnerships existed.¹⁷²

The effect of this new law is particularly dramatic to limited partnerships formed and sold to the public as tax shelter investments. Almost always, it is desirable for the general partner of the limited partnership to be a corporation for two reasons: (1) to limit the liability of the general partner to the corporate assets; and (2) to provide continuity to the partnership since it would be dissolved under state law in the event of the death, insanity, or bankruptcy of an individual general partner. Indiana law prior to the decisions of *Indiana Department of State Revenue v. Glendale-Glenbrook Associates*¹⁷³ and *Park 100 Development Co. v. Indiana Department of State Revenue*,¹⁷⁴ which imposed the gross income tax on *each* partner of a "corporate partnership," made it generally unacceptable to have a corporate general partner, thus forcing an individual to be the general partner and accept the associated liabilities. After the *Glendale* and *Park 100* decisions, it was possible to have an S corporation be the general partner without the imposition of gross income tax on the partnership's income. The change in the law likely will result in more general partners in limited partnerships being regular corporations.¹⁷⁵ All practitioners will still need to be careful in forming these limited partnerships to respect the possibility of the Internal Revenue

¹⁷²See *Indiana Dep't of Revenue v. Glendale-Glenbrook Assocs.*, 429 N.E.2d 217 (Ind. 1981); *Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981). A discussion of these cases is contained at Boyd, *Taxation, 1982 Survey of Recent Developments in Indiana Law*, 16 IND. L. REV. 355, 364-66 (1983).

¹⁷³429 N.E.2d 217 (Ind. 1981).

¹⁷⁴429 N.E.2d 220 (Ind. 1981).

¹⁷⁵The new law establishes that a corporate partnership will not be subject to gross income tax; however, it does not explain how the gross income tax will be applied to corporations which are partners of a corporate partnership. Under the "aggregate" theory of partnerships where the partnership is not considered a separate entity, but merely an aggregation of separate individuals or entities, the corporate partner would be treated as receiving its proportionate amount of the gross receipts of the partnership. This would impose a substantial accounting and reporting requirement upon corporate partnerships and may lead to avoidance of corporate partnership structures similar to that experienced under the repealed law. In many partnerships, it may be impossible to determine the proportionate share of gross income of any partner, particularly partnership agreements with special allocation provisions.

Alternatively, under the "entity" theory of partnerships where the partnership is considered a separate entity, only actual distributions by the partnership to the corporate partner would result in gross income tax liability. This would seem to reach a conclusion which is appropriate given the concept of "gross income" contained in Indiana Code section 6-2.1-1-2(a) which imposes gross income tax on the "gross receipts of a taxpayer." IND. CODE § 6-2.1-1-2(a) (Supp. 1984). The largest and most obvious advantage to this interpretation is that the corporate partner would be taxed on the "net" proceeds of the partnership after tax deductions, a result which would not be permitted if the corporate partner had directly received its share of the "gross receipts" of the business carried on

Service reclassifying these partnerships as "associations" taxable as corporations not as partnerships.¹⁷⁶

4. *Enactment of a County Option Income Tax.*—As of July 1, 1984, Public Law 44¹⁷⁷ permits Indiana counties to have the option of adopting either the County Adjusted Gross Income Tax ("CAGIT") or the County Option Income Tax ("COIT"), but not both. COIT was introduced by

by the partnership. This is precisely the type of avoidance of the gross income tax that the repealed provision relating to corporate partnerships was designed to avert.

If actual distributions to the corporate partner are determinative as its gross receipts subject to the gross income tax, this will provide a substantial opportunity for tax planning. Arranging partnership distributions to fall in particular years would enable corporations to delay gross income tax payments and diminish them to the extent distributions are switched away from years where the gross income tax liability exceeds the adjusted gross income tax liability. Further, the actual distributions may have no relationship to the income of the partnership for the same taxable year. Finally, the partnership may choose not to make any distributions at all, even though it is generating large amounts of income. The most flagrant abuses of any of these advantages may lead to attacks by the Indiana Department of Revenue based on the "substance over form" argument.

Another approach to this problem is to have the corporation report as gross income its portion of the partnership net income just as it is reported for adjusted gross income tax purposes. This would be the simplest answer to the aforementioned accounting and timing difficulties because the same information is already required for reporting to the corporate partner. This approach would also minimize the opportunity for tax avoidance since the income would be taxed in the same year that it was generated. Unfortunately, this approach completely ignores the wording and intent of the Gross Income Tax Act unless a strained interpretation of the term "gross receipts" is accepted.

Further complicating this matter, and of no less importance, is the fact that the receipt of gross income by a corporation is taxed at two substantially different rates for the purpose of the gross income tax. The initial question which arises is whether the nature of the activity for purposes of the applicable tax rate will be set at the partnership or corporate level, which may again involve the application of the "aggregate" or "entity" theory of partnerships. Presumably, whichever theory is followed will be the same theory that is followed for purposes of determining at what level the gross receipts will be treated as received by the corporation. An application of the statute would again seem to require that actual receipt of distributions will control, which will make it nearly impossible to define whether a distribution to a partner should be taxed at the higher or lower rate of gross income tax. See IND. CODE §§ 6-2.1-2-4, -5 (1982). Since partnership gross receipts will likely not be in the same amount and the same year as any actual distributions to the corporate partner, there may be a requirement to establish a "tracing" of the nature of any distributions. In most cases, this would be an accounting nightmare.

The lack of segregation of gross income between the separate rates may subject the taxpayer to the provisions of Indiana Code section 6-2.1-2-7(c) which provides that a taxpayer who fails to separate his gross income as required will have his "entire gross income" subject to the higher rates. IND. CODE § 6-2.1-1-7(c) (1982).

The Indiana Department of Revenue, in Information Bulletin Number 31, dated March, 1984, has acknowledged the elimination of the gross income tax on corporate partnerships. It does not undertake to establish its interpretation of the proper application of gross income tax to corporate partners. Hopefully, additional guidance will be forthcoming on this question.

¹⁷⁶See Treas. Reg. § 301.7701-2 (1983); see also Rev. Proc. 74-17, 1974-1 C.B. 438, as modified for the requirements for obtaining an advance Private Letter Ruling.

¹⁷⁷Act of Mar. 7, 1984, Pub. L. No. 44-1984, 1984 Ind. Acts 563.

this new law and permits adopting counties to initially tax county taxpayers at a rate of .2% on their Indiana adjusted gross income. A "county taxpayer" includes a resident of that county on January 1 of the applicable calendar year or a person maintaining his principal place of business or employment in that county on January 1 of the applicable year and not residing on that same date in a county in which COIT or CAGIT is in effect.¹⁷⁸

COIT may be initially adopted at a rate of .2% on resident county taxpayers, automatically rising .1% each year until it reaches a maximum of .6%.¹⁷⁹ After the rate has reached the .6% level, the county may act to increase COIT by no more than .1% each year until it reaches a maximum of 1%.¹⁸⁰ When COIT applies to nonresident taxpayers of a county, the rate will at all times be one-fourth of the tax rate imposed upon the resident county taxpayers.¹⁸¹

G. Unitary Taxation

Last year's Survey Article on Taxation¹⁸² reported the United States Supreme Court decision in *Container Corp. of America v. Franchise Tax Board*.¹⁸³ In *Container*, the Supreme Court gave state courts broad authority to determine whether or not the income of corporations related to a corporation doing business in their state was part of a "unitary business" and thus subject to taxation in their state based on the state's apportionment laws. The State of Indiana's application of *Container* was set forth in Commissioner's Directive #10.¹⁸⁴ Directive Number 10 indicates that the Department of Revenue will not use combined income tax reporting under the "unitary business" concept as a means to assess additional tax, but will only use this for the fair reporting and reflection of income attributable to Indiana when the standard three factor formula clearly does not fairly reflect income. A special point is made that Indiana should not be characterized as a "unitary state." In support of this contention, the Department of Revenue indicates that approximately eighty taxpayers are filing combined Indiana adjusted gross income tax and supplemental net income tax returns as unitary business entities. It is indicated that many of these are filing as unitary businesses due

¹⁷⁸IND. CODE § 6-3.5-6-1 (Supp. 1984).

¹⁷⁹*Id.* § 6-3.5-6-8(b), (d).

¹⁸⁰*Id.* § 6-3.5-6-9(a).

¹⁸¹*Id.* § 6-3.5-6-8(e).

¹⁸²King & Bennett, *Taxation, 1983 Survey of Recent Developments in Indiana Law*, 17 IND. L. REV. 319, 319 (1984).

¹⁸³103 S. Ct. 2933 (1983). For an extensive discussion of this case, see Stuart & Williams, *Constitutional Considerations of State Taxation of Multinational Corporate Income: Before and After Container Corporation of America v. Franchise Tax Board*, 16 IND. L. REV. 783 (1983).

¹⁸⁴Commissioner's Directive Number 10, February, 1984 (Indiana's position on the United States Supreme Court decision in *Container Corp. of America v. Franchise Tax Board*).

to the request of the corporations and not due to Department requirements.

In a related announcement,¹⁸⁵ Governor Orr stated that the only time combined reporting will be required for taxpayers conducting unitary businesses will be when there is evidence of a blatant attempt to avoid Indiana taxes. He further stated that there were only about fifteen returns being required and that those were the result of the standard three factor formula not fairly reflecting income of the taxpayers. He also indicated that Indiana will not adopt unitary reporting as a general policy because of the potential adverse effect to Indiana's future economic growth.¹⁸⁶

Apparently, one inducement in the publication of the Commissioner's Directive and the Governor's letter was the hope that the Sony Corporation might locate a new plant in Terre Haute, Indiana.¹⁸⁷ This report indicated that prior to Sony agreeing to place a large plant near Terre Haute, Sony officials obtained commitments from Governor Orr and bipartisan political support for an agreement to abolish the unitary tax.

If these reports are correct, it appears that legislation to abolish the unitary tax in Indiana will be a prime goal of the General Assembly in its next session. Lacking this, the Commissioner's Directive and the Governor's letter should reassure most taxpayers that they will not be required to file unitary reports in Indiana. Nevertheless, the right of Indiana to impose combined reporting when the three factor formula does not "fairly reflect income" is clearly reserved. What constitutes a fair reflection of income is something which could likely have a different meaning to the Department of Revenue and to taxpayers with potential liability under the unitary business concept.

¹⁸⁵Letter from Robert D. Orr, Governor of the State of Indiana (February 23, 1984).

¹⁸⁶*Id.*

¹⁸⁷INDIANAPOLIS BUSINESS JOURNAL, June 18-24, 1984, at 13.