DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0261
Indiana Corporate Income Tax
For the Tax Years 1995, 1996, and 1997

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ISSUES

I. Sale of Wood Products to Out-of-State Customers – Gross Income Tax.

Authority: IC 6-2.1-2-2; IC 6-2.1-3-3; 45 IAC 1-1-119(1)(a); 45 IAC 1-1-119(2)(b).

Taxpayer argues that the Department of Revenue (Department) erred when it concluded that the receipt of money from the sale of wood products to out-of-state customers was subject to gross income tax.

II. Classification & Computational Errors.

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

Taxpayer maintains that the audit erred in categorizing exempt and non-exempt sales of wood products; as a result, the amount of the gross income tax assessment is purportedly incorrect.

III. Abatement of the Ten-Percent Negligence Penalty.

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

Taxpayer requests that the Department exercise its discretion to abate the ten-percent negligence penalty because no reason was ever provided taxpayer for imposition of the penalty.

STATEMENT OF FACTS

Taxpayer is in the business of selling specialized wood products. Taxpayer has both foreign and domestic customers. Some of taxpayer's out-of-state customers place an order for a particular type or grade of wood product, taxpayer chooses which of its products conforms to the customer's requirements, and the item is then shipped to that out-of-state customer. Other out-of-state customers send a representative to taxpayer's Indiana location, the representative selects a particular item of wood, and that particular item is set aside and later delivered to the out-of-state customer by means of common carrier.

The Department conducted an audit of taxpayer's records. The audit concluded that money taxpayer received from certain transactions with out-of-state customers was subject to the state's gross income tax. Taxpayer disagreed, submitted a protest, an administrative hearing was held, and this Letter of Findings results.

FINDINGS

I. Sale of Wood Products to Out-of-State Customers – Gross Income Tax.

Taxpayer maintains that receipts derived from sales made to certain of its out-of-state customers are not subject to the gross income tax. The transactions at issue are those in which an out-of-state customer travels to Indiana, chooses a particular item, arranges for taxpayer to ship that item, and thereafter awaits receipt of the selected wood product at the foreign destination. The audit determined that these transactions were intra-state, and the money received was subject to gross income tax. Taxpayer characterizes these particular transactions as inter-state and the receipts not subject to gross income tax.

Indiana imposes a tax on "the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana." IC 6-2.1-2-2. However, not all income is not subject to the tax. IC 6-2.1-3-3 provides that, "Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution."

Pursuant to IC 6-2.1-3-3, the Department has promulgated rules which distinguish between "nontaxable outshipments" and "taxable outshipments." In particular, taxpayer cites to 45 IAC 1-1-119(1)(a) which defines certain sales as exempt. The regulation – in effect at the time of the subject transactions – states that "nontaxable outshipments" include:

> Sales to nonresidents where the seller, upon receipt of a prior order and as part of the contract, ships the goods from a point within or without Indiana to an out-of-state destination. Such sales are exempt from taxation whether shipment is made by the seller in his own conveyance, by his contract carrier or by common carrier, and whether the shipment is made on bills of lading showing the seller, buyer or a third party as the shipper of record.

In the transactions here at issue, the out-of-state customer sends a representative to taxpayer's location before placing an order. The representative selects a particular item it wishes to purchase. That item is labeled and segregated. Taxpayer and out-of-state customer sign a sales agreement for the item in which the taxpayer is required to ship the item to the customer's location. Taxpayer then sends a bill to the out-of-state customer.

Taxpayer maintains that – for purposes of the gross income tax – these particular transactions are not complete until the out-of-state customer physically takes delivery of the selected item at the customer's out-of-state location. Thus, although the customer's representative has chosen the item it wishes to purchase and has signed an agreement to that effect, the transaction is not

complete until the item has traveled to taxpayer's site and has been accepted by the customer. In support, taxpayer points out that under basic principles of commercial law, the customer – under certain circumstances – is entitled to refuse delivery of the item and require taxpayer to accept return of that item. Taxpayer asserts that the audit's conclusion "mischaracterizes the facts and mistakes principles of commercial law."

However, the question raised is not one of commercial law or whether or not the out-of-state customer may or may not justifiably renege on the deal it struck with taxpayer in Indiana. For purposes of determining the applicability of the gross income tax, the regulation is squarely on point. 45 IAC 1-1-119(2)(b) states that taxable outshipments include "Sales to nonresidents where the goods are accepted by the buyer or he takes actual delivery within the state. Sales will also be taxable if the goods are shipped out of state on bills of lading showing the seller, buyer or a third party as shipper if the goods were *inspected and accepted*, or when any other evidence shows that the sales were completed prior to shipment in interstate commerce." (*Emphasis added*).

Presumably the out-of-state customer could – justifiably or unjustifiably – eventually refuse to accept delivery of the item. The out-of-state customer could determine that the item shipped was not identical to the item chosen in Indiana; the customer could determine that the item was damaged in transit; the customer could determine it no longer had a need for the item; the customer could simply arbitrarily decide it no longer wanted the item, decline acceptance, and refuse to pay the bill. All of these possibilities raise various questions of commercial, contract, and insurance law, but all of these consequent legal issues are irrelevant to the gross income tax question. Customer came to Indiana, customer inspected and selected a particular item it wanted to purchase, and customer agreed to purchase that item. The transaction was completed in Indiana, and the proceeds from the transactions are subject to the state's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Classification & Computational Errors.

Given the conclusion that receipts from "inspection sales" are subject to gross income tax, taxpayer maintains that the audit erred in categorizing taxable and nontaxable sales to out-of-state customers. As a result, taxpayer argues that it is entitled to have the Department reexamine the records of its transactions and reclassify a number those transactions.

At the time of the audit, the Department determined the money taxpayer received from "inspection sales" customers was subject to gross income tax. The audit was initially informed that it was not possible to determine which of its transactions were or were not "inspection sales." Subsequently, one of taxpayer's representatives – its export manager – reviewed a listing of all of taxpayer's customers and specified which of the customers did and which did not participate in "inspection sales" of taxpayer's goods. Taxpayer later indicated that this classification was incorrect. Thereafter, taxpayer solicited, received, and supplied "certification letters" from a limited number of its customers indicating that these customers did not – in all

cases – enter into "inspection sales." The audit determined that this customer information was inconclusive, one-sided, and did not reasonably or accurately distinguish between those customers which conducted "inspection sales" and those customers which did not. The taxpayer was asked if there was additional information which would assist in distinguishing "inspection sales" customers and "non-inspection sales" customers. Taxpayer responded that that there was no further information which would be of assistance. The audit report was completed based on the information initially supplied by the taxpayer's export manager.

Taxpayer argues that it is entitled to further consideration of the matter. It argues that – upon reexamination of the customers lists – it can now more precisely distinguish between "inspection sales" customers and "non-inspection sales" customers.

The taxpayer was provided with a notice of proposed adjustment indicating that it was liable for additional gross income tax on the money it received from "inspection sales" customers. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b).

Taxpayer has provided extensive documentation by which it proposes to demonstrate that a number of sales to out-of-state customers were not entered into based upon an in-state inspection and acceptance of the taxpayer's wood products. However, there is nothing in this lengthy documentation which specifically refutes the audit's original determination. Having relied upon the taxpayer's initial information and having been provided with considerable opportunity to refute or supplement that information, it would appear that little can be gained from yet another go-around of the same records available at the time the audit report was prepared. Taxpayer's suggestion that the audit report is flawed does not meet taxpayer's burden of proving the initial assessment is wrong.

FINDING

Taxpayer's protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer requests that the Department exercise its discretion to abate the ten-percent negligence penalty.

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

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer

must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer's protest was based upon the additional assessment of gross income tax on receipts from sales to out-of-state customers in which the out-of-state customer sent its representatives into the state to inspect and acquire taxpayer's wood products. Taxpayer may have initially been under the impression that these were inter-state transactions and that the receipts were not subject to gross income tax. However, this same issue was addressed during a previous audit, and gross income tax was assessed on virtually identical transactions upon completion of that prior audit. Taxpayer is protesting an issue which had been addressed and resolved during one of its previous state audits. Nonetheless, taxpayer chose not to pay gross income tax on the receipts from similar transactions. Its decision to do so was not indicative of the "reasonable care, caution, or diligence . . . expected of an ordinary reasonable taxpayer" that would warrant abatement of the ten-percent penalty.

FINDING

Taxpayer's protest is respectfully denied.

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