DEPARTMENT OF STATE REVENUE

40-20100653.LOF

Letter of Findings: 40-20100653
Utility Receipts Tax
For the Years 2006, 2007, 2008

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ISSUE

I. Utility Receipts Tax – Imposition – "Connection Fees" and SDCs.

Authority: IC § 6-2.3-1-4; IC § 6-2.3-1-6; IC § 6-2.3-1-9; IC § 6-2.3-1-14; IC § 6-2.3-2-1; IC § 6-2.3-3-2; IC § 6-2.3-3-5; IC § 6-2.3-3-10; IC § 6-2.3-4-1; IC § 6-2.3-4-2; IC § 6-2.3-4-3; IC § 6-2.3-4-4; IC § 6-2.3-4-5; IC § 6-2.3-4-6; IC § 6-2.3-4-7; IC § 6-2.3-5-1; IC § 6-2.3-5-2; IC § 6-2.3-5-3; IC § 6-2.3-5-4; IC § 6-2.3-5-5; IC § 6-2.3-5-6; IC § 6-8.1-5-1; 170 IAC 1-6-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Economy Oil Corp. v. Ind. Dep't of State Revenue, 321 N.E.2d 215 (1974); Fell v. West, 73 N.E.2d 719 (Ind. App. 1905); http://www.in.gov/iurc/files/Complete_Toolkit.pdf; IURC's 2010 Report to the Regulatory Flexibility Committee of the General Assembly; Wholesale Sewer Agreement (1989) - fourth amendment (June 8, 1994).

STATEMENT OF FACTS

The taxpayer is an Indiana for-profit utility company ("Utility") that offers sanitation and sewer services to both residential and commercial customers in Indiana. Utility is taxed as an S-corporation and has been incorporated since the 1980s.

The Indiana Department of Revenue ("Department") conducted an Indiana Utility Receipts Tax ("URT") audit of Utility for the years 2006, 2007, and 2008. The Department's audit found that Utility had remitted URT for the years at issue on sewer service user fees it collected from its customers. However, the audit's review of Utility's general ledger revenue accounts revealed that Utility had not remitted URT on certain receipts from other accounts the Department's auditor believed were subject to URT. As a result, the Department's audit assessed Utility additional URT and interest for the years at issue. Utility protested the proposed assessments. A hearing was held on Utility's protest and this Letter of Findings ensues. Additional information will be provided as needed.

I. Utility Receipts Tax – Imposition – "Connection Fees" and SDCs.

DISCUSSION

All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

As of January 1, 2003, taxpayers that provide utility services are subject to the URT. URT is an income tax imposed on the gross receipts of a taxpayer that is a resident or domiciliary of Indiana and also on the gross receipts derived from activities or sources within Indiana by a non-resident taxpayer. IC § 6-2.3-2-1 states:

> An income tax, known as the utility receipts tax, is imposed upon the receipt of:
> (1) the entire taxable gross receipts of a taxpayer that is a resident or a domiciliary of Indiana; and
> (2) the taxable gross receipts derived from activities or businesses or any other sources within Indiana by a taxpayer that is not a resident or a domiciliary of Indiana. (Emphasis added).

"Gross receipts" for purposes of the URT is defined at IC § 6-2.3-1-4 as follows:

> "Gross receipts" refers to anything of value, including cash or other tangible or intangible property[,] that a taxpayer receives in consideration for the retail sale of utility services for consumption before deducting any costs incurred in providing the utility services. (Emphasis added).

" Taxable gross receipts" are clearly defined under IC § 6-2.3-1-9 as follows:

> "Taxable gross receipts" means the remainder of:
> (1) all gross receipts that are not exempt from tax under IC 6-2.3-4; less
> (2) all deductions that are allowed under IC 6-2.3-5. (Emphasis added).

IC § 6-2.3-4 lists seven categories of gross receipts that are exempt from URT: gross receipts from transactions with the United States government (IC § 6-2.3-4-1); gross receipts from commerce between Indiana and another state or foreign jurisdictions (IC § 6-2.3-4-2); gross receipts received by conservancy districts, regional water, sewage, or solid waste districts, nonprofits formed solely to provide water to the public, etc. (IC § 6-2.3-4-3); gross receipts from occasional sales of utility services by an entity that is not regularly engaged in selling utility services (IC § 6-2.3-4-4); gross receipts from the sale of utility services by owners or operators of commercial hotels, campgrounds, mobile home parks, and marinas (IC § 6-2.3-4-5); gross receipts from sales of utility services between members of an affiliated or controlled group (IC § 6-2.3-4-6); and lastly, gross receipts received by a taxpayer from an electricity supplier as payment for severance damages or compensation resulting from a change in assigned service area boundaries (IC § 6-2.3-4-7).

IC § 6-2.3-5 lists all the deductions allowed under URT. The deductions allowed are for a standard annual deduction (IC § 6-2.3-5-1), bad debts (IC § 6-2.3-5-2), resource recovery systems if the taxpayer is allowed to take a federal depreciation deduction with respect to the resource recovery system and it processes solid or hazardous waste (IC § 6-2.3-5-3), amounts received for the return of empty containers (IC § 6-2.3-5-4), gross receipts exempted as interstate mobile telecommunications under other statutes (IC § 6-2.3-5-5), and lastly, a deduction is allowed for retail sales of bottled water or gas to the extent that the purchases were treated as retail transactions (IC § 6-2.3-5-6).

IC § 6-2.3-3-10 specifies the taxability of certain receipts:

> Gross receipts include receipts received for installation, maintenance, repair, equipment, or leasing services provided to a commercial or domestic consumer that are directly related to the delivery of utility services to the commercial or domestic consumer or the removal of equipment from a commercial or domestic consumer upon the termination of service.

IC § 6-2.3-1-14 defines "utility service:"

> "Utility service" means furnishing any of the following:
>
> (1) Electrical energy.
>
> (2) Natural gas, either mixed with another substance or pure, used for heat, light, cooling, or power.
>
> (3) Water.
>
> (4) Steam.
>
> (5) Sewage (as defined in IC 13-11-2-200).
>
> (6) Telecommunication services.

In the course of the Department's URT audit, Utility provided URT returns for the years at issue. According to the Department's audit summary, the returns showed that Utility had remitted URT on sewer service user fees it received from its residential and commercial customers. However, a review of Utility's revenue accounts in its general ledger showed that there were receipts from other ledger accounts that should have been included in the URT returns. The additional taxable receipts fell into two categories, as determined by Utility: "Connection Fees," and "Contributions in Aid of Construction" ("CIAC").

It should be noted that the Department's audit stated that Utility had several revenue accounts the receipts of which were not subject to URT because the receipts did not directly related to the delivery of a utility service. The accounts that were not subject to URT were: interest income; residential and commercial penalties; unbilled user fees (because billing is in arrears and therefore the receipts are subject to URT when billed); rent/lease income from renting to space at Utility's headquarter location to other tenants; and revenue from application fees and preliminary planning fees from developers. The Department's audit states that credit was given to Utility for tax previously remitted on some of these receipts.

Utility points out that in construing tax statutes relating to assessment and collection:

> [I]t is a well established rule of statutory construction that the statutes levying or imposing taxes are not to be extended by implication beyond the clear import of the language of the statute in order to enlarge their operation. Instead, they are to be construed more strictly against the state and in favor of the taxpayer. Gross Income Tax Division v. Surface Combustion Corp., 111 N.E.2d 50 (1953); Ralph L. Shirmeyer, Inc. v. Ind. Revenue Bd., 99 N.E.2d 847 (1951); Dept. of Treasury Ind. v. Muessel, 32 N.E.2d 596 (1941).

The Department also points to the following cases in construing tax statutes relating to assessment and collection: "A liberal rule of construction must be indulged in order to secure their uniform implementation;" Economy Oil Corp. v. Ind. Dep't of State Revenue, 162 Ind. App. 658, 665, 321 N.E.2d 215, 218 (1974); "[t]he statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers." Fell v. West, 73 N.E.2d 719, 722 (Ind. App. 1905).

Therefore, the URT is imposed on a utility's entire taxable gross receipts as defined above with clearly stated exemptions and deductions, also as defined above. The definition of "gross receipts" under URT encompasses anything of value that a taxpayer receives that is related to the provision of utility services and is not exempt or deductible. IC § 6-2.3-2-1 and IC § 6-2.3-1-9. As evidenced by IC § 6-2.3-3-10, the receipts must be directly related to the delivery or removal of utility services, including installation, maintenance, repair, equipment or leasing services.

A. "Connection Fees."

The particular "connection fees" at issue in this protest are fees that Utility collects from housing developers. Utility is responsible for providing access to sewer lines so that individual and commercial residents have sewer services at their locations. Developers actually install those lines. For the years at issue, Utility collected $305 from developers for each residential or commercial location to cover the cost of a sewer permit and the fee Utility paid to an engineering firm to inspect and approve the sewer pipes (installed by developers) that run from the locations where the sewer services will be used to the main sewer line. The engineering firm was responsible for ensuring the pipes were connected correctly according to Utility's specifications.

The Department's audit subjected these fees to URT under IC § 6-2.3-1-4, the URT definition of "gross receipts." The Department's audit also noted that, pursuant to IC § 6-2.3-3-2, the entire balance in this account is subject to URT even if there are other nontaxable charges included in the account because nontaxable receipts

are subject to URT if the nontaxable receipts are not separated from the taxable receipts on the taxpayer's records or returns. Utility did not provide a breakdown of taxable versus nontaxable receipts.

IC 6-2.3-3-2 states:

> Notwithstanding any other provisions of this article, receipts that would otherwise not be taxable under this article are taxable gross receipts under this article to the extent that the amount of the nontaxable receipts are not separated from the taxable receipts on the records or returns of the taxpayer.

In reference to IC § 6-2.3-3-10, the statute that discusses the taxability of certain utility receipts, Utility argues that these "connection fees" are typically paid by the developer in exchange for inspection services only, and that no part of the fee is used for consumption of utility services by customers. Utility further argues that the installation, pursuant to IC § 6-2.3-3-10, must be directly related to the delivery of utility services actually consumed by the customer. Utility's reading of the URT statutes appears to assume that no receipts are taxable until a utility customer actually consumes the utility – all other receipts directly related to the provision of utility services appear to be excluded under Utility's analysis.

The Department points out that the language of IC § 6-2.3-1-4 does not say that gross receipts includes anything of value received by a taxpayer in consideration for the retail sales of "utility services consumed" but rather says "utility services for consumption." In other words, while the receipts from services have to be directly related to the delivery of the utility services for consumption, the consumption need not have already taken place.

The Department takes a different view of these "connection fees." The "connection fees" protested here are "in consideration" for the permitting and inspection of tangible personal property installed to directly provide utility services to existing, specific, individual delivery points; i.e., the existing locations at which the retail sale by Utility of the utility services will occur. IC § 6-2.3-1-4; IC § 6-2.3-3-10. These "connection fees" are therefore "in consideration of the retail sale of utility services consumed." In other words, but-for the Utility's inspection and approval of these lines there could be no provision of utility services to the customers at those locations.

Another way to consider this issue is to remove the developer from the picture. If an individual built a residence and wished to connect that residence to a main sewer line, the individual would pay that same fee to Utility. There would be no question in that instance that the fee paid to Utility was "in consideration of the retail sale of utility services for consumption."

Even if, for the sake of argument, these "connection fees" were not in and of themselves subject to URT, under IC § 6-2.3-3-2 they would be taxable because Utility did not separate taxable receipts from non-taxable receipts in its records or returns.

Therefore, the protested "connection fees" were properly subjected to URT.

B. "Contributions in Aid of Construction"/"System Development Charges."

The Department's audit imposed URT on fees the audit called "Contributions in Aid of Construction" ("CIAC") and which Utility referred to as "System Development Charges" ("SDC"). The Indiana Utilities Regulatory Commission ("IURC") refers to these fees as "System Development Charges" as well. Because the IURC defines and approves these charges, this Letter of Findings will refer to these fees as SDCs.

According to Utility, the SDC implicated in this protest was a $2,400 fee that Utility collected from developers for each household that was provided or was to be provided sewer service. Utility explained that of that amount, $1,050 was remitted to the local municipality (hereinafter referred to as the "Town") to cover the additional sewer capacity needed to accommodate the anticipated additional households that would be included in the Town's sewage system as the Town grew. In its letter to the Department dated November 11, 2010, Utility refers to this amount as the "Town Portion" and states that it "is collected on behalf of and as an agent for the Town pursuant to a Wholesale Sewer Agreement between [Utility] and the Town...." The remaining portion of the fee, Utility explains, was money Utility itself used, or would use, in its own plant to upgrade sewer pumps and to expand its own sewer capacity to accommodate residential growth and the resulting additional demand placed on its infrastructure.

The Department's audit subjected these receipts to URT also pursuant to IC § 6-2.3-1-6 which states that payment of a taxpayer's expenses, debts, or other obligations by a third party for the taxpayer's direct benefit is subject to URT.

Utility stated that it used the SDCs for capital projects including off-site sewer main extensions, force mains, lift stations, etc. and that these projects impact future growth. Utility explained that a developer typically pays the SDC when the development has passed preliminary planning and review and before the property is conveyed to the customer; i.e., the customer does not consume utility services. According to Utility, ordinarily the customers do not pay the SDC fee, the developers do, and no portion of the SDC provides utility service to the developer. In other words, Utility argues that this fee is not in exchange for utility services for consumption by existing customers. IC 6-2.3-1-4. In addition, Utility argues that these transfers are not retail sales but are wholesale sales.

Because the utility industry is heavily regulated, the Department looks to how the government body tasked with regulating this industry in Indiana, the Indiana Utilities Regulatory Commission ("IURC"), defines certain specialized industry terms. Utility is regulated by the IURC. Indeed, Utility stated that the IURC approved its SDC after hearing testimony as to what the SDC would fund.

The regulations governing the IURC define SDCs as follows in 170 IAC 1-6-2(11):

"System development charge" or "SDC" means a one (1) time fee **assessed to new customers** of water or sewer utilities to help finance development of utility systems, mainly those dealing with facilities for production, treatment, or storage necessary to serve those new customers. The term includes the following:

(A) Impact fee.

(B) Availability fee.

(C) Capacity fee.

(Emphasis added).

The IURC definition of SDC is relevant in determining the taxability of these charges under URT because the SDC rate and use are approved by the IURC (for those utilities regulated by the IURC). The IURC definition of SDC quoted above clarifies the description provided by Utility establishing who pays the SDC. According to 170 IAC 1-6-2(11), quoted above, the SDC is a one-time fee assessed to new customers of water or sewer utilities. The IURC's website describes SDC as follows in relevant part:

SDCs are utility fees **paid by property owners** who connect their properties to the utility's system for the first time. These fees are primarily intended to recover a utility's cost to provide new customers with source of supply, treatment and storage facilities.... **(Emphasis added).**

http://www.in.gov/iurc/files/Complete_Toolkit.pdf (page 40).

Also, the IURC's 2010 Report to the Regulatory Flexibility Committee of the General Assembly describes SDCs on page 96 as follows:

Another way to finance infrastructure investments and minimize the effect on existing customers is through system development charges (SDCs) or **utility fees paid by property owners who connect their properties to the utility's system for the first time.** These fees are primarily meant to recover a utility's cost to provide new customers with a source of supply, treatment, and storage facilities; SDCs can be more than $1,400 for water connections and $3,000 for wastewater connections. **(Emphasis added).**

The Department also points to the Wholesale Sewer Agreement between Utility and the Town for further clarification of the nature of the SDCs and the "Town Portion" of this fee. The fourth amendment to that 1989 agreement, dated June 8, 1994, discusses Utility's purchase of sewage treatment capacity from the Town. The amendment clarifies that the $1,050 portion Utility collects from the developer is directly related to specific sewage treatment capacity that Utility purchases from the Town and is directly related to specific customers. The fee actually compensates Utility for Utility's payment to the Town of that very fee which becomes due to the Town when the Town issues the building permit to or for the benefit of the customer. The amendment states in relevant part:

As [Utility] requests, [the Town] shall sell to [Utility] wastewater treatment capacity.... The wastewater treatment capacity shall be purchased as "equivalent dwelling units" ("EDUs"), each EDU being equal to that amount of wastewater treatment plant capacity necessary to treat 300 gallons of treatable effluent per day.

For purposes of planning and forecasting the amount of wastewater treatment plant capacity..., [the Town] shall maintain records of EDUs reserved, EDUs available and EDUs in use....

If the EDU capacity does not exist at the time it is purchased and paid for by [Utility], [the Town] shall supply such capacity to [Utility] by constructing additional, or expanding existing, wastewater treatment facilities or allowing [Utility] to do the same, as provided for below; provided, however, [Utility] shall not be required to construct wastewater treatment facilities at its expense when it has purchased capacity which has not yet been provided by [the Town].

For each EDU purchased by [Utility], it shall pay $1,050 ("EDU Charge"). Any adjustment to the EDU Charge shall be by mutual agreement....

Payment for EDUs shall become due when [the Town] issues the building permit to or for the benefit of the customer for whose use such EDUs are requested and shall be paid at such intervals as shall be agreed upon by the parties. All payments of EDU Charges by [Utility] to [the Town] shall be accounted for and used by [the Town] only for sewer utility purposes.

(Emphasis added).

The above quoted text demonstrates that (1) Utility is not collecting the Town Portion of the SDC on behalf of the Town and as an agent of the Town, but rather (2) it is collecting the Town Portion of the fee from developers for Utility's purchase of EDUs from the Town, the EDUs being "for the benefit of the customer for whose use such EDU's are requested."

Utility itself suggests in its own letter to the Department, that the developer may invoice its customers for these fees. Utility, however, argues that the developer itself does not receive utility services. In other words, Utility is arguing that the SDC fee it receives from Developer is therefore not directly connected to Utility directly providing utility services in a retail sale to a customer.

Utility is mistaken in its interpretation of the statute. In addition to the analysis under subsection (A), the Department points out that the "in consideration" language in IC § 6-2.3-1-4 is not limited to the consideration between customers and Utility. If the language was so limited, then third party payments, pursuant to IC § 6-2.3-1, would never be received "in consideration," let alone "in consideration for the retail sale of utility services for consumption."

Again, in light of the Indiana legislature's imposition of URT on a broad definition of taxable gross receipts and the fact that the legislature clearly stated exemptions and deductions from URT that did not include the sort of exclusion Utility proposes, the Department takes a different view of these SDCs. The SDCs are "in consideration" for the permitting and inspection of tangible personal property installed to directly provide utility services to new specific, individual delivery points; i.e., the existing locations at which the retail sale by Utility of the utility services will occur. IC § 6-2.3-1-4; IC § 6-2.3-3-10. These SDCs are therefore "in consideration of the retail sale of utility services for consumption."

Utility further argues that these are not retail but wholesale transactions. IC § 6-2.3-3-5 is the only URT statute that references "wholesale" sales and the reference to wholesale sales is to those sales that take place between two utilities. This is not the case in this instances. All of the protested transactions are connected to the retail sale of utility services.

Based on all of the above, the SDCs were properly subjected to URT.

FINDING

Taxpayer's protest of the imposition of URT on "connection fees" and "SDCs" is respectfully denied.

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