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The Indiana Gross Income Tax

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INDIANA GROSS INCOME TAX†

ARTHUR H. NORTHRUP*

ADOPTION

The general property tax has been the great beast of burden of local public financing in Indiana as in other states. From 1830 to 1933 the Indiana general property tax remained basically unaltered.¹ The reforms in 1919 were limited to increasing the efficiency, productivity, and equity of the tax,² and the greater uniformity of assessments gave the "Indiana Plan" deserved fame. Because of the success of the reforms, however, the state and local governments relied heavily upon the property tax as a source of revenue.³ The burden on property nearly doubled in the early days of the depression and delinquencies became so prevalent that the General Assembly, in 1932, provided for installment payments and placed limitations on property tax rates.⁴ While the limitations could be circumvented to some extent because of constitutional loopholes, even substantial compliance, in the face of the great reduction in assessed valuations resulting from the 1932 reassessment, would have thrust most cities into large deficits. But the limitations did indicate a necessity for relief of the tax burden on property and emphasized the need for a new source of revenue. One possibility might have been deficit financing, but the legislators of the thirties did not view the crisis as a temporary condition, and the Indiana Constitution precluded any long-range program of borrowing such as the federal government undertook.⁵ The feeling was pre-

† This article is confined to a discussion of the nature, basis, rates, exemptions, incidence and effects of the tax. Although some writers on interstate commerce have erroneously treated the tax as one based on occupation, the subject of interstate commerce cannot be discussed within the scope of this article.

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1. Hall, *The Inception of the Indiana Gross Income Tax*, 33 BULL. NAT. TAX ASS'N 17 (1947).

2. IND. STAT. ANN. (Burns 1943 Repl.) §§ 64-1301 to 64-1344. The State Board of Tax Commissioners was given more effective power to review local assessments, budgets, levies, and bond issues.

3. At one time the rate was forty cents per hundred dollars and as recently as 1931 it was twenty-nine cents. Between 1926 and 1932, over eighty per cent of total taxes levied by governmental units within Indiana came from property. Tax Facts Review, Indiana Gross Income Tax Division (1940), pp. 5, 6.

4. IND. STAT. ANN. (Burns 1943 Repl.) §§ 64-307, 64-309. State revenue was limited to fifteen cents upon each one hundred dollars of taxable property. Municipal corporations were limited to one and one-half dollars per each one thousand dollar valuation. Immediately thereafter, the General Assembly imposed a one dollar limit per one hundred dollar property value upon revenue received by local governments on property outside the municipalities.

5. IND. CONST. Art. 10, § 5:

No law shall authorize any debt to be contracted on behalf of the State,

valent that any immediate revenues would have to come from a new state tax, such as a sales or an income tax. Because of widespread objection to excise taxes, a state income tax was the logical choice. Three factors, other than the objections of wealthy citizens, led to the preference of a gross income tax over one on net income. First, the new tax had to yield sufficient revenue to balance the budget without impairing the relief given by the property tax limitations. Second, the closing of some schools demanded that the new tax yield revenue promptly. Third, the new tax should be unquestionably constitutional.

To realize the revenue raised during the thirties by the gross income tax would have required a retail sales tax with a rate three times as high as the average rate for gross income.⁶ For comparable revenue from a net income tax, the rates would have to have been seventy-three per cent of the prevailing federal rates.⁷ While retailers themselves have advocated a retail tax at higher rates, the farm and labor groups have rallied to support the gross income tax whenever a sales tax has been proposed. Although these latter groups would have preferred a net income tax, there was strong feeling that the state and federal governments ought not tax the same thing and that the federal government had already preempted the field.

Interest in a state income tax antedated the thirties, but it was felt that such a tax would require an amendment to the Indiana Constitution which provides for equal rates on any direct tax.⁸ An enabling amendment was passed by two consecutive sessions of the General Assembly and was referred to the people in 1921. The proposed amendment was approved in 1926 and 1932 by a majority of those voting on the proposal, but not a majority of those voting in the election. It was not until 1935, however, that the Indiana Supreme Court overruled earlier cases and held that an amendment could be effected by a majority of those voting on the proposal.⁹

The 1932 campaign for a gross income tax was led by a bi-partisan group

except in the following cases: To meet casual deficits in the revenue; to pay the interest on the State Debt; to repel invasion, suppress insurrection, or, if hostilities be threatened, provide for the public defense.

See Bates, *The Borrowing Power Under the Casual Deficit Proviso of the Indiana Constitution*, 8 IND. L. J. 341 (1933).

A further constitutional provision prohibits local government units from incurring indebtedness beyond two per cent of their assessed property valuation. IND. CONST. Art. 13. This provision, however, has been ineffective, having been construed to allow the legislative creation of co-terminous taxing districts, each of which is permitted to incur the constitutional indebtedness. See, however, Rappaport v. Indianapolis, 87 N. E.2d 77 (Ind. 1949) (dissenting opinion) 88 N. E.2d 150 (Ind. 1949).

6. HALL, *THE INDIANA GROSS INCOME TAX* (unpublished thesis in University of Wisconsin Library, 1945) pp. 248, 249.

7. *Id.* at 246, 247.

8. IND. CONST. Art. 10, § 1 requires "a uniform and equal rate . . ." See Miles v. Department of Treasury, 209 Ind. 172, 199 N. E. 172 (1935).

9. *In re Todd*, 208 Ind. 168, 193 N. E. 865 (1935).

of political leaders. Although this group left no reports of its meetings, there is evidence that much of its attention was directed toward an investigation of the Mississippi sales tax as well as other state taxes. It was this group which drafted the administration's original tax measure, which was very similar to the Mississippi statute.¹⁰ The proposal underwent substantial modification after being presented to the legislature in 1933. Licensing all businesses, customary in Mississippi, was politically undesirable in Indiana. Confronted with strong competition by the Farm Bureau's net income tax bill, the original administration proposal was completely redrafted, the unpopular sales tax features being minimized, and was renamed the "gross income tax bill." There were two rates: $\frac{1}{4}$ of 1% applied to wholesaling, manufacturing, and agriculture; and 1% applied to other business and individual gross receipts. A basic exemption of one thousand dollars was allowed each taxpayer. Thus modified, the bill was enacted.¹¹

The success of the gross income tax as an emergency measure is indicated by its production of revenue within two months after enactment.¹² The number of returns and the amount of collections have steadily increased in subsequent years, except in 1939 following the recession and in 1942 when business was converting to war work.¹³ By the end of the thirties the gross income tax was second only to the gasoline tax as a source of state revenue, and eighty-one of Indiana's ninety-two counties were receiving more in financial support from the state than their citizens were paying in gross income taxes.¹⁴ From 1933 to 1939 the gross income tax supplied approxi-

10. Hall, *supra* note 1, at 22.

11. IND. STAT. ANN. (Burns 1933) §§ 64-2601 *et seq.*

12. HALL thesis, *op. cit. supra* note 6, at 99.

13. The following table is set out in a news release, April 1, 1948, (Information Bulletin 649), supplied by Walter L. Sturdevant, past Chief Deputy, Indiana Gross Income Tax Division:

<i>Year Ending March 31</i>	<i>Collections</i>	<i>No. Returns</i>
1934	\$ 7,860,307.93	534,770
1935	13,220,933.28	533,431
1936	16,012,773.69	575,708
1937	19,942,597.10	625,287
1938	22,958,724.08	723,381
1939	19,880,152.93	656,551
1940	23,179,713.66	766,080
1941	25,229,101.45	809,823
1942	34,043,863.20	1,038,484
1943	33,336,742.10	1,145,845
1944	40,488,792.06	1,266,478
1945	45,580,012.35	1,286,029
1946	45,606,556.71	1,250,054
1947	52,317,538.89	1,367,754
1948	63,224,293.51	1,472,000
1949	69-70 million (oral estimate by Mr. Sturdevant)	

14. INDIANA YEAR BOOK (1940), pp. 223, 224.

mately one-quarter of the state's revenue.¹⁵ The tax fluctuates markedly with business activity, and now produces over three times the revenue it did in 1939—nearly seventy million dollars.¹⁶ The costs of administration have been low. Between 1935 and 1947 revenues nearly quadrupled, while costs have only doubled and are now only two per cent of the collections. The basic rate of 1% has produced nearly twice as much revenue as have the wholesale and the subsequently enacted retail rates combined. It is the broad application of the basic rate which gives the act its distinctive scope.

ADMINISTRATION

Rather than entrust the administration of the new tax to the State Board of Tax Commissioners, the administration created the Gross Income Tax Division as a part of the newly organized Department of Treasury, reorganized in 1945 as the Department of Revenue. This move was prompted by a desire for administration by personnel loyal to the new tax and by the opportunity to combine enforcement of the new tax and the 1929 chain-store tax so as to provide economical and thorough enforcement of the tax against retailers.

Returns are mailed to taxpayers filing returns for the previous year, or to those requesting them. After the returns are filed, the taxpayer is notified of any errors or omissions in his income report. Upon receipt of the subsequent Notice of Proposed Assessment, the taxpayer is allowed thirty days to protest, and to state the facts and authorities upon which he relies. This entitles him to a hearing at a time and date set by the Division. The hearing is conducted by an examiner who will receive additional memoranda on the facts and law, and who may request from the Division Director or Chief-Deputy a subpoena *duces tecum* on any record pertaining to the question. The hearing is required to be conducted "consistent with the usual and ordinary rules of procedure and insofar as practicable, . . . in an informal manner."¹⁷ This right to protest is the only administrative remedy offered the taxpayer by the gross income tax act itself, but the rules of the Administrative Adjudication Act of 1947¹⁸ give an additional right to a formal hearing. If the protest is neglected or is overruled, a Notice and Demand is issued, allowing the taxpayer ten days to pay before a warrant is issued to the county sheriff who records the warrant as a judgment lien.

15. Tax Facts Review, Indiana Gross Income Tax Division (1940), pp. 8, 9.

16. Oral estimate by Walter L. Sturdevant, past Chief Deputy, Indiana Gross Income Tax Division.

17. Indiana Gross Income Tax Regulations, Series VII, Approved April 27, 1946, § 4402. §§ 4400-4410 provide the rules on hearing. Contrast §§ 800 and 4401 on refund hearings at discretion or of right.

18. Ind. Acts 1947, c. 365, p. 1451.

Taxpayers have endeavored to carry their cases to the courts by several methods. The statutory procedure requires payment of the tax and application to the Division for a refund within three years.¹⁹ Upon written denial of the refund, or six months after application, the taxpayer may bring action against the Division in the superior or circuit court of his residence or business location, or, if he has neither, in the Marion Circuit or Superior Court. But other procedures have been successfully undertaken. The use of an injunction to restrain tax collection was available before a 1937 prohibitory amendment.²⁰ The Indiana Supreme Court has approved the use of declaratory judgments to determine the constitutionality of the tax on interstate commerce and other sources of income.²¹ But a more recent trial court decision has denied this device for determining constitutionality, saying it is available only when there is no remedy at equity or law.²² Consequently, in most cases the taxpayer is reduced to two remedies: (1) to pay the disputed tax and sue for a refund or (2) to refuse to pay and to protest the Notice of Proposed Assessment. The latter requires payment of interest and penalty, should the Division prevail.

The Division has powerful collection methods at its disposal. If the taxpayer is preparing to remove or conceal himself or his property, the Division may make a jeopardy assessment and demand immediate payment, issuing a warrant to the sheriff for immediate levy. This levy has the same effect as a judgment execution or an attachment proceeding, and either garnishment or proceedings supplementary may apply. If the warrant is returned unsatisfied, the sheriff must attach a schedule of the taxpayer's property, and failure to levy on any available property so listed constitutes misfeasance. Other collection powers allow the Division to sue to collect the

19. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2614.

20. The use of an injunction was expressly held proper in *Department of Treasury v. Ridgely*, 211 Ind. 9, 4 N. E.2d 557 (1936). IND. STAT. ANN. (Burns 1943 Repl.) §64-2614 (d) prohibited injunctions and provided that the remedy for illegal taxation was an action to recover payments. The constitutionality of this amendment was upheld by the Marion Superior Court in *Department of Treasury v. Smoketeria Importing Co.*, INDIANA YEAR BOOK (1940), p. 226.

21. This was the remedy sought in both *Storen v. J. D. Adams Mfg. Co.*, 212 Ind. 343, 7 N. E.2d 941 (1937) and *Department of Treasury v. J. P. Michael Co.*, 105 Ind. App. 255, 11 N. E.2d 512 (1938).

22. *Heiny and Redding et al. v. Department of Treasury (DeKalb County Superior Court)*, INDIANA YEAR BOOK (1942), p. 297. Great reliance was placed on *Smoketeria Importing Co. v. Department of Treasury*, where Judge Wood said:

The Court has given long consideration to the defendant's contention that the proper remedy for the plaintiff to pursue in this case is to appeal under the provisions of the gross income tax law itself and not to attempt to obtain redress by means of a declaratory judgment. It strikes the Court that it is well settled in Indiana in the case of *Brindley v. Meara*, 209 Ind. 144, 198 N. E. 301, that the declaratory judgment act may not be used where a ready remedy is available to the party either in law or equity.

tax, including an additional ten per cent penalty and an extra two per cent per month; to request that criminal penalties be prosecuted; and to request that the Attorney General seek to enjoin the recalcitrant taxpayer from continuing in business. After one hundred and twenty days of delinquency, the State may have a receiver appointed for the taxpayer. Both at common law and under the statute unpaid taxes are regarded as preferred claims.²³

The gross income tax has not been uniformly enforced. In the early years, retailers were the principal targets of enforcement, and crews from the Division would unexpectedly move into a town and inspect every store. Not until 1937 was a serious attempt made to enforce the tax against farmers. An amendment then required the following interrogatory to be included within the personal property blanks for the next year: "Did you pay any gross income tax to the State of Indiana with respect to your gross income for the preceding calendar year?" Failure to answer the question was made a misdemeanor, and in 1938 six thousand new farm accounts were added to the Division's files. To some extent the tax is more easily enforced against wage earners than professional groups because individual bills or fees may be difficult to prove. The regulations require each person to file an information return showing all payments to any person who received over one thousand dollars a year except suppliers and professional men. Information returns are likewise required of those paying over three hundred dollars in interest or dividends to Indiana residents, and of brokers and others having custody of the funds. As a result of the improved procedures for reporting and enforcement, the number of taxpayers has steadily grown. In 1933 there was one taxpayer for every eleven residents;²⁴ in 1943, one for every three.²⁵ This would seem to justify the settlement that "Low Rate, Many Payers is Gross Income Theory."²⁶

RATE DISTINCTIONS

Retailers' Amendments

Since the enactment of the tax, the only changes in its basic structure have been the retailers' amendments. The legislature, in 1937, granted retailers a special deduction of three thousand dollars a year on the proceeds from retail sales.²⁷ The deduction is in place of, not in addition to, the general one thousand dollar annual deduction, and was enacted primarily for the

23. Department of Treasury v. Reinking, Receiver, 109 Ind. App. 63, 32 N. E.2d 741 (1941).

24. INDIANA YEAR BOOK (1941), p. 101.

25. INDIANA YEAR BOOK (1944), p. 193.

26. Title of an article by Clarence A. Jackson in the Report of the December 1936 Conference of the National Association of Tax Administrators, p. 57.

27. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2605.

benefit of the small retailer. In 1942 another amendment created a special $\frac{1}{2}$ of 1% rate applicable to retail merchants, dry cleaners, and launderers.²⁸ Large retailers were the greatest beneficiaries of this amendment and the Division opposed the amendment for that reason and because it greatly reduced revenue.²⁹

Recently, all rates have been temporarily increased to pay the Indiana World War II veterans' bonus.³⁰ The increases are neither equal on all three rates nor proportional. The $\frac{1}{4}$ of 1% manufacturing and wholesaling rate was doubled and is now $\frac{1}{2}$ of 1%. The 1% basic rate was increased one-quarter and is now $1\frac{1}{4}$ %. And the retailers' rate, $\frac{1}{2}$ of 1%, was also increased one-quarter, and is now only $\frac{5}{8}$ of 1%, making it very little higher than the wholesalers' new rate! While the termination of the bonus rates may provide an occasion for a permanent rate readjustment, discussion of the rate differential cases can best be cast in terms of the presumably permanent rates.

To grant relief to retailers,³¹ the 1937 General Assembly proceeded directly contrary to its general clarification of the tax as one based on the nature of the transaction taxed rather than on the taxpayer's occupation, and made a special case of retail merchants. A retail merchant was defined as "only a person regularly and occupationally engaged in purchasing tangible personal property and selling the same at retail at a fixed and established place of business."³² The statute defined selling at retail to include:

. . . only a transaction by a 'retail merchant' by which the ownership of tangible personal property is transferred, . . . for a consideration, when such a transfer is made in the ordinary course of the transferor's regularly conducted business and at a fixed and established place of business, and is acquired by the transferee for any other purposes than those designated by subsection (a) of sec. 3 of this act."³³

As stated in subsequent regulations, the new rate was "strictly occupational."

28. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2603 (c) and (d).

29. Gross Income Tax 1942 Statistical Review, Indiana Gross Income Tax Division. The Division pointed out that 133 large retailers would save a quarter of a million dollars, or an average saving of \$10,000, while 25,000 retailers grossing under \$10,000 each would save only \$567,000, an average of \$23 each.

30. Ind. Acts 1949, c. 277.

31. The gross income tax paid by the following industries, in terms of 1936 net income, was: 16.78% for auto dealers, 12.22% for ice and fuel, 10.28% for combined retail, 7.54% for restaurants, 6.11% for wholesalers, 1.72% for manufacturers, and .80% for agriculture. The Report of The Indiana Tax Study Commission. January 1, 1939, p. 7.

32. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2601 (j). See also Regulations, *op. cit. supra* note 17, § 1400.

33. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2601 (k). See also Regulations, *op. cit. supra* note 17, § 1401.

The difficulties inherent in such definitions were foreseen in the Divisions' pointed comment:

Since the amendment is now law it would seem logical for the . . . Division to adhere closely to the strict definition. If this is done it will eliminate all who are not 'occupationally engaged' as a 'retail merchant.' This virtually gives the tax division arbitrary power to classify persons for the $\frac{1}{2}$ of 1% rate.³⁴

Rates on "Wholesale Sales"

Because the rate for selling at retail is the general rate of 1%, while proceeds of wholesale sales are taxed at $\frac{1}{4}$ of 1%, manufacturers and merchants have struggled to qualify their transactions as wholesale sales, especially prior to the 1942 amendment establishing a special retail rate. The Indiana Supreme Court has concluded that the "basic tax on taxpayers generally is one per cent," and that a manufacturer who sells at retail enjoys a competitive advantage over retail merchants because the manufacturer avoids the tax on middlemen, and he is not entitled to a further advantage in tax rates.³⁵ Thus the courts have recognized that the rate is based on transactions rather than occupations. Four-fifths of the litigation under the statute involves a determination of the proper rate.³⁶

The original 1933 act had a manufacturers' rate of $\frac{1}{4}$ of 1% "Upon the entire gross income of every person engaged in the business of manufacturing, compounding, or preparing for sale, profit or use an article. . . ."³⁷ The scope of the manufacturer's rate was severely restricted by judicial interpretation. Accordingly, a retail druggist's income derived from compounding and filling prescriptions was subjected to the basic rate, the court holding that the word "compounding" was colored by the preceding word "manufacturing" and was not applicable to retail merchants.³⁸ Dry cleaning was held to be a personal service subject to the basic rate rather than a preparation of garments for use so as to fall within the manufacturers' rate.³⁹ Similarly, the pasteurizing and bottling processes carried on by a dairy which delivered milk directly to its customers' doors were held not sufficient to qualify under the manufacturers' rate.⁴⁰

34. Gross Income Tax 1942 Statistical Review, Indiana Gross Income Tax Division, p. 8.

35. *Storen v. J. D. Adams Mfg. Co.*, 212 Ind. 343, 348, 7 N. E.2d 941, 943 (1937).

36. HALL thesis, *op. cit. supra* note 6, at 291.

37. Ind. Acts 1933, c. 50, § 3 (a).

38. *Department of Treasury v. Ridgely*, 211 Ind. 9, 4 N. E.2d 557 (1936).

39. *Clark's Laundry & Dry Cleaning Co. v. Department of Treasury*, 103 Ind. App. 359, 5 N. E.2d 683 (1937).

40. *Suabedissen-Wittner Dairy, Inc. v. Department of Treasury*, 105 Ind. App. 626, 16 N. E.2d 964 (1938).

In 1937 the statute was recast in terms of "wholesale sales" rather than "manufacturing."⁴¹ Since that time, taxpayers have sought to bring their transactions within the statutory definition of "wholesale sales," which includes only the following seven categories.

1. *Sales of tangible personalty for resale in the same form (except capital assets of the seller).*

This language was analyzed by the court when a bottle manufacturer sought to recover taxes paid at the basic rate on sales to brewers who sold beer in the bottles subject to a refund of the cost of the bottles when returned. The Treasury department contended that the extensive reuse of the bottles by the brewer and the absence of any resale of the bottles by the brewers proved the brewer to be the ultimate consumer of the bottles. But the court held that the brewer's agreements were essentially resale agreements rather than for the mere use of the bottles, and that the filling, capping, and labelling of the bottle did not preclude resale of the bottle in the same form.⁴²

2. *Sales of tangible personalty as a material "to be directly consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, repairing, mining, agriculture or horticulture.*

The statute defines "consumed" to mean only "the immediate disipation or expenditure by combustion, use or application and shall not mean or include, the obsolescence, discarding, disuse, depreciation, damage, wear, or breakage of tools, dies, equipment, rolling stock or its accessories, machinery or furnishings."⁴³ Much attention has been given the word "immediate" in litigation under this section. The United States Court of Appeals for the Seventh Circuit upheld an Indiana circuit court construction that "immediate consumption" may involve a lapse of time.⁴⁴ However, the federal court felt that steel rolls usually discarded within a year or less and actually used as scrap steel were not "consumed," regardless of immediacy.

Two recent Indiana Appellate Court decisions have shed further light on this problem. The sale of silica refractory materials used to line an open hearth furnace was held to be within the above provision on the theory that the materials were immediately expended even though they did not become useless in some instances until six months of peak operation. "Immediate"

41. IND. STAT. ANN. (Burns 1947 Supp.) § 64-2603 (a). Compare the provision in the original act, IND. STAT. ANN. (Burns 1933) § 64-2603 (a). The definition of "wholesale sales" in the amendment, however, includes certain manufacturing processes.

42. Department of Treasury v. Fairmount Glass Works, 113 Ind. App. 684, 49 N. E.2d 1 (1943).

43. IND. STAT. ANN. (Burns 1947 Supp.) § 64-2603 (a).

44. Continental Roll and Steel Foundry Co. v. Department of Treasury, 117 F.2d 196 (7th Cir. 1941).

was held to refer to causation as well as to time.⁴⁵ In the other case, slugs of printers' type were sold to publishers and were custom-made for jobs requiring few impressions. The court concluded that the slugs were "material" rather than "equipment" and said ". . . if they are susceptible to both definitions, we must adopt the one most favorable to the taxpayer."⁴⁶

3. *Sales of tangible personalty "incorporated by the purchaser as a material or integral part into tangible property produced."*

Attorneys for the Ingram Richardson Mfg. Co. argued for the application of this provision in the enamelled parts case discussed under the next category, but the decision rested on the absence of any sale of the parts.

4. *Receipts from the business of industrial processing, enameling, plating or servicing of any tangible personalty which is to be sold by the person for whom such processing is done as a material, part, or whole article produced by such person or for sale.*

Cases holding that industrial processing is a service to which the basic rate is applicable led to an amendment of the statute in 1941 which created this fourth category under the wholesalers' rate. By this amendment, the form of the transaction becomes manufacturing for resale. Prior to this amendment, the Indiana Supreme Court had held that creosoting railroad ties was not manufacturing, since it was merely a preservative process, like painting.⁴⁷ The Court of Appeals for the Seventh Circuit had also held that enameling for stove and refrigerator parts manufacturers was a service rather than a sale of the enameling material, or a purchase and resale of the parts.⁴⁸

In a subsequent case, however, the Indiana Supreme Court held that making ladies' coats at a contract price was manufacturing when the cloth, but not the findings, was furnished to the maker.⁴⁹ This case was decided under the original 1933 statute. The enameling case, which arose after the 1937 amendments, was distinguished by determining the making of coats to be neither a professional nor a personal service and by looking to the 1941 amendment to give legislative meaning to the earlier provision so as to restrict the basic tax to such services. The Court also held that a sale was not indispensable to the business of manufacturing, and that manufacturing for "profit or use" came within the lower rate.

45. *Gross Income Tax Dept. v. Harbison-Walker Refractories Co.*, 113 Ind. App. 695, 48 N. E.2d 834 (1943).

46. *Department of Treasury v. Ranger-Cook, Inc.*, 114 Ind. App. 107, 113, 49 N. E.2d 548, 550 (1943).

47. *Indiana Creosoting Co. v. McNutt*, 210 Ind. 656, 5 N. E.2d 310 (1936).

48. *Ingram-Richardson Mfg. Co. v. Department of Treasury*, 114 F.2d 889 (7th Cir. 1940), *rev'd as to an interstate commerce immunity*, 313 U. S. 252 (1941).

49. *Oster v. Department of Treasury*, 219 Ind. 313, 37 N. E.2d 528 (1941).

5. "Sales of drugs, medical, and dental preparations, and similar materials to be directly consumed in professional use by doctors, hospitals, embalmers and tonsorial parlors."

Where hair tonics were sold by a manufacturer primarily for use in a barber shop, but the barbers sometimes resold the tonics and preparations to customers, the Appellate Court imposed the basic rate.⁵⁰ Although the regulations now apply the lower wholesale sales rate where resale by the barber is contemplated,⁵¹ this case still stands to require taxpayers to segregate receipts or be subject to the highest rate applicable.⁵²

6. Sales of tangible personal property to be directly consumed by the purchaser in the business of industrial cleaning;⁵³

7. Sales of any tangible personal property to be directly consumed by the purchaser directly in the business of rendering public utility service.

The seven above classifications are subject to the following provisions: (1) no sale to a governmental unit or agency is to be included; (2) price and quantity are not to be considered; (3) it is not material whether the sale is from stock or upon order, or whether the seller produced the property sold.

From these provisions and the decisions under them the courts have effected a theoretically clear-cut line between wholesale and retail sales. This demarcation was set out by the Indiana Supreme Court in *Storen v. Adams*:

The rate does not depend upon the business in which the taxpayer is engaged, but upon the activity from which each item of his gross income is received. Sales to ultimate consumers or users must be regarded as retail sales, whether made by the producer of the article sold or another.⁵⁴

Adams had sold road building and repair machinery to dealers or to ultimate users, and argued that such sales were incidental to manufacturing because no store was maintained for wholesaling or retailing.

The Attorney General contended: (1) sales to ultimate users are not the usual business of a manufacturer; (2) a dealer's gain is realized from such sales which call for taxation at the rate applicable to such dealers; (3) the rates fixed by the statute are not upon the business in which the taxpayer is engaged, but upon the source of the income, whether derived from manufacturing, wholesaling or retailing; (4) one person may be subject to different rates since he must segregate his income; (5) a sale to an ultimate

50. Department of Treasury v. Jackson, 105 Ind. App. 702, 11 N. E.2d 514 (1937).

51. Regulations, *op. cit. supra* note 17, § 1505.

52. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2604.

53. The same sequence of events which produced category 4 explains the background for the amendment adding this provision. See Clark's Laundry & Dry Cleaning Co. v. Department of Treasury, 103 Ind. App. 359, 5 N. E.2d 683 (1937).

54. 212 Ind. 343, 348, 7 N. E.2d 941, 943 (1937).

customer is a retail sale. The court sustained these contentions, reasoning that under any other result "manufacturers, who operate exclusively through retail stores . . . and compete with retailers in the ordinary sense, have a discriminatory advantage by reason of the fact of manufacturing their own product."⁵⁵ The court was unanimous in applying the retail sales tax rate. In the same year the Appellate Court applied the retail rate to sales of groceries in large quantities to state, city and private charitable institutions for consumption by the inmates.⁵⁶

It is clear, then, that transactions rather than the nature of the taxpayer's business determine the application of the wholesalers' tax rate. While the decisions illustrate the equity of this solution, its practicality may be questioned. Classification of sources of income is more difficult than occupational classification. A major difficulty is that the disposition of the article sold determines the applicable rate.⁵⁷ Fortunately, most sellers do have accurate ideas as to the use to which buyers will put their purchases.

THE BASE OF THE TAX

Taxes may be classified according to the subject on which they are imposed. Real property taxes are *in rem* while income taxes are *in personam*. This traditional dichotomy is confused by a third type, excises, which are not strictly levies against the person, but against certain activities or privileges. The Indiana Gross Income Tax has been sustained on the ground that it is an excise tax on the privilege of domicile or of doing business in Indiana, and not a property tax.⁵⁸ This decision does not affect the conclusion earlier reached that the rate of tax depends upon each transaction rather than upon the occupation of the taxpayer.

55. *Id.* at 347, 7 N. E.2d at 943.

56. Department of Treasury v. J. P. Michael Co., 105 Ind. App. 255, 11 N. E.2d 512 (1938).

57. Regulations, *op. cit.* *supra* note 17, § 900:

In many instances where income is derived from sales of tangible personal property it will be necessary for the seller to know the occupation of the purchaser and his intended use or disposal of the property in order to apply the proper rate.

For example, in the auto sales and repair business, auto parts may be sold at retail to customers, or they may be incorporated into customers' automobiles as part of the repair service. In such cases the Division has said:

The fact that such operators are duly qualified retail merchants does not entitle them to segregate their gross receipts in such a manner as to report income from the sales of material at one-half of one per cent when such material is required in the performance of automotive repair service. INDIANA YEAR BOOK (1947), p. 386.

58. Miles v. Department of Treasury, 209 Ind. 172, 199 N. E. 372 (1935), *dismissed*, 298 U. S. 640 (1935). The Indiana Supreme Court, at 187, declared:

It cannot logically be said that one who engages in large enterprises . . . has not enjoyed a privilege and a protection, and put a burden upon the machinery of government . . . merely because his activities did not yield him a net profit in any given period.

In selecting gross receipts as evidence of ability to pay, Indiana has at least returned to the standards of the faculty taxes imposed during the American Revolution.⁵⁹ The advantage of gross receipts over property as a measure of ability to pay is that the former seizes on wealth that is possessed. Several types of taxes may be distinguished on the basis of their relationship to gross receipts. (1) A gross receipts tax includes all material values acquired from certain sources defined by the statute. (2) Other taxes may be based on gross receipts, but allow exemptions either in terms of certain amounts or certain sources. (3) Gross profits taxes include gross receipts less the cost of the goods sold. (4) And a net income tax is measured by gross receipts less all business expenses. To highlight these different types by a study of the gross receipts aspect of the Indiana tax requires a discussion of the impact of the tax on business, in which area the tax is quite distinctive.

Taxable and Exempt Income

The statutory definition of gross income is ". . . the gross receipts of the taxpayer. . . ."⁶⁰ This broad definition has led some persons to regard the tax in some aspects as a simple gross receipts tax.⁶¹ But the Act provides for a general exemption, provides special tax bases for some transactions, and excludes certain sources of income from the tax, so the gross income tax falls clearly within the second type discussed above.

Exempted from the tax is income received by the taxpayer in the capacity of tax collection agent under either the Federal or Indiana statutes.⁶²

Derivative immunities as a result of selling to the federal government are recognized by the statute only to the extent required by the Federal Constitution. The Attorney General's opinion is that receipts from sales to federal agencies are taxable.⁶³ And the regulations include money received under federal contracts and professional fees received from the Federal Government.

The regulations have also provided that the immunity of national banks from the tax shall not apply to individual income from ownership of stock in these banks. Nor does the exemption apply to interest on tax exempt Indiana municipal bonds. The Indiana Supreme Court has held that an

59. The 1777 Constitutions of Vermont and Pennsylvania provide for combined poll, occupation and property taxes based on gross earning ability. Eventually property became the only measure of this tax.

60. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2601 (m).

61. In *Freeman v. Hewitt*, 329 U. S. 249 (1946), Mr. Justice Rutledge properly considered the tax a gross receipts tax as applied to the taxpayer in that case. The majority regarded the tax equivalent to a sales tax.

62. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2606, especially subsection (b) which was intended to avoid a tax on a tax. See Regulations, *op. cit. supra* note 17, §§ 1900-1906.

63. OPS. IND. ATT'Y GEN. (1936) p. 205; (1935) p. 297.

excise upon the transfer of tax exempt property does not impair the obligation of contract within the meaning of the Federal Constitution.⁶⁴

Corporate reorganizations and liquidations have raised another problem in the scope of gross income taxation. The definition of gross income excludes exchanges between stockholders of stock for stock or bonds or similar securities of the same corporation, or such exchanges of securities of corporations or associations participating in a consolidation, merger or reorganization. Accordingly, it was held that a holding company dissolution did not result in taxable income to stockholders who surrendered all the holding company stock and received in exchange the stock of the two subsidiary companies.⁶⁵ An Attorney General's Opinion in 1936 found no tax liability when a foreign corporation, in order to withdraw from the state, transferred its Indiana assets to satisfy its debts.⁶⁶ Nevertheless, cash or property received by a shareholder in a partial or complete liquidation of a corporation is taxable as gross income.⁶⁷ The value of property is presumed to be the book value except in the case of listed stocks and bonds, for which market value is used. The legal basis for this Regulation is that the statutory phrase "all receipts by reason of the investment of capital" means not only profits, but also payments for capital. Since the dissolved corporation and its shareholder are distinct entities, liquidation payments to the shareholder are part of his gross receipts.

In the application of the tax the definition of "receipt" is most important. By statute "receipts" include cash, notes, credit, and other property received. "Received" is defined as coming into the possession of, or crediting to, the taxpayer of gross income, or the payment of his expenses, debts or obligations by a third party for his definite benefit. Constructive receipts include ". . . items of income from any source . . . becoming due a taxpayer but not actually reduced to possession . . . and which may be withdrawn by him at his own election at any time. . . ." But any substantial limitation or condition upon the power of withdrawal will defer tax liability.

This broad definition of gross receipts has led to criticism of the tax as a turnover tax, encouraging business integration.⁶⁸ A broader attack is that

64. *Storen v. J. D. Adams Mfg. Co.*, 212 Ind. 343, 7 N. E.2d 941 (1937).

65. *Department of Treasury v. Muessel*, 218 Ind. 250, 32 N. E.2d 596 (1941).

66. *Ops. Ind. Att'y Gen.* (1936), p. 317.

67. Regulations, *op. cit. supra* note 17, § 2405.

68. Blakey and Blakey, *Sales Taxes and Other Excises*, Public Administration Service (1945), p. 10:

The burden of the sales tax in Indiana is heavier, however, than some might infer from the low rate because that State has a very comprehensive gross income tax on income from almost every source; in fact, it comes nearer to a general turnover tax than that of any state.

And GROVES, *POSTWAR TAXATION AND ECONOMIC PROGRESS* 107 (1946):

Gross income is usually defined to include all receipts without any deduc-

the tax is aimed at business, and that the trend is away from taxing property and receipts and is toward taxing persons on the income they enjoy. Logically this trend would sweep away all business taxation. But not even the Federal Government has yet raised personal income taxes to the point where business taxation may be eliminated.⁶⁹ The facility of collection and political expediency render business taxation seemingly inevitable.

Taxable and Exempt Entities

The word "taxpayer" is broadly defined in the statute to mean any person or firm. A discussion of only the more interesting and troublesome aspects of taxable or exempt entities will be undertaken here.

The fiction of incorporation has complicated the taxation of subsidiaries. Upon securing the Division's permission, a corporation may file a consolidated return for an affiliated group of corporations and thus eliminate gross income taxes on transfers between members of the group.⁷⁰ The rate imposed is that which is applicable to the last transaction of a member of the group. But to qualify under this exemption, the affiliates must be incorporated in Indiana or authorized to do business here, and there must be two or more corporations having ninety-five per cent of their voting stock owned by the same third corporation. While the offer of the exemption encourages integration to some extent, it is not likely that ninety-five per cent of the stock of a corporation will be acquired merely for the purpose of obtaining a lower tax rate.

But corporations are not invariably regarded as taxable entities. Under some circumstances a corporation may be regarded as an agent, taxable only on its commissions and not on its gross income. This agency concept was applied where four ice manufacturing companies organized a corporation as a selling and distributing agency. The corporation paid all of its net income to the ice companies in proportion to the quantity of ice they delivered to it for sale. The Indiana Supreme Court held that the corporation was the manufacturers' agent and ordered a refund of the payments it had made.⁷¹ The logic of the decision seems sound, but the result is that these companies have achieved a greater immunity from turnover taxation than an affiliated

tions. The objection to this base is that as goods move from one processor to another, values are recounted at successive transfers. The amount of tax paid on goods by the time they reach the consumer will depend on the number of transfers involved in their preparation. Some of this tax can be avoided by the integration of industry, which eliminates transfers in the processing and distribution of goods.

69. PAUL, *TAXATION FOR PROSPERITY* c. 45 (1947).

70. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2609. Regulations, *op. cit. supra* note 17, § 2403, rules 1-11.

71. Department of Treasury v. Ice Service, Inc., 220 Ind. 64, 41 N. E.2d 201 (1942).

group enjoys, for they paid only on the net income of the selling agent whereas the affiliated group's gross income would include the selling and administrative expenses of the retail affiliate. In another case three out-of-state telephone corporations created an Indiana corporation which acted as an agent in operating a standard billing system. The agent paid all expenses until the shares could be computed, when the telephone companies shared the expenses. The Ice Service case was relied upon by the Indiana Supreme Court in holding that the receipt of these shares by the Indiana agent as trustee did not constitute taxable income.⁷² Trusteeship is not grounds for an exemption, but agency is. The case reaffirms the fact that agency presents greater possibilities for tax savings than does integration through affiliated groups.

Agency and consignment are treated quite differently under the gross income tax. The regulations provide that ". . . in the case of consignment sales 'gross income' shall include the gross receipts from the sale of goods sold on consignment and the tax shall be paid thereon by the consignee." Where a consignor had paid the tax and had been reimbursed by the consignee in accordance with their contract, the Indiana Supreme Court held that the purpose of the provision was to insure collection of the tax upon the sale of goods at retail within the state, and that it in no way relieved a consignee of the additional liability to pay gross income tax upon the commissions he received as a result of the sale.⁷³

The taxability of the activities of Indiana municipalities is a complex problem. Included with the definition of taxable entities are municipal corporations as well as "any other political subdivision of the state engaged in private or proprietary activities or business." The distinction between proprietary and governmental functions of government agencies is not a new one. Since this distinction is sufficiently valid to allow federal penetration of the Constitutional immunity of states, it is doubly valid in state taxation of municipalities, which do not possess the attributes of sovereignty. The Indiana Supreme Court has held municipal ownership of water, gas, and electric utilities to be a proprietary function and the income derived therefrom taxable.⁷⁴ The same result has attained where municipalities operate markets, wharves, golf courses, airports, cemeteries,⁷⁵ and swimming pools⁷⁶ and tennis associations.⁷⁷ The Attorney General has given an opinion that receipts from municipal sewage disposal plants from the sale of by-products

72. *Gross Income Tax Division v. Indiana Associated Telephone Corp.*, 118 Ind. App. 669, 82 N. E.2d 539 (1948).

73. *Department of Treasury v. Spindler Co.*, 222 Ind. 53, 51 N. E.2d 363 (1943). IND. STAT. ANN. (Burns 1943 Repl.) § 64-2601 (m), provision on consignment.

74. *Department of Treasury v. Linton*, 223 Ind. 363, 60 N. E.2d 948 (1945).

75. *Department of Treasury v. Evansville*, 223 Ind. 435, 60 N. E.2d 952 (1945).

76. *Department of Treasury v. Tipton*, 223 Ind. 373, 60 N. E.2d 957 (1945).

77. *Department of Treasury v. Michigan City*, 223 Ind. 432, 60 N. E.2d 947 (1945).

are taxable; that sewage levies and billings to water users are not; and that the operation of parking meters is a governmental function not subject to the tax.⁷⁸ By regulation, municipalities are also exempt from taxation on receipts from hospitals, bond issues, sales and earnings on intangibles, public libraries and schools.⁷⁹

Contrasts With Net Income Taxes

The Indiana Gross Income Tax is very little different from the federal net income tax in its application to personal income not derived from business profits. The main difference noted by individual earners is that the Indiana tax is strictly proportional to income while the federal rates are sharply progressive.

A surprising and steadily growing number of Indiana businesses are taxed upon gross earnings rather than gross receipts.⁸⁰ Though gross earnings are not the same as net income their use is a move away from the gross receipts base. Gross earnings differ from net income only in that: (1) if gross earnings are computed on each transaction, losses are not deductible, (2) in any case, gross earnings include selling and administrative expenses of the business, while net earnings do not. Nevertheless, the growing use of the gross earnings base illustrates a tendency of the gross income tax to break down into separate types of taxes. A further increasing similarity to net income taxation has been the consistent and rapid rise in the importance of deductions.⁸¹ Factors contributing to this increase are the retailers' amendment in 1937, the increased use of the interstate commerce exemption, and the extension of the gross earnings basis of taxation.

78. OPS. IND. ATT'Y GEN. (1940), p. 50.

79. Regulations, *op. cit. supra* note 17, § 2502. IND. STAT. ANN. (Burns 1943 Repl.) §§ 2601 (m) and 2606 (i).

80. Included within this category are banks, trust companies, building and loan associations, all types of brokers, dealers in securities, finance companies, dealers in commercial paper, and persons engaged in the business of lending money and credit. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2601 (n). By a 1941 amendment the same provision is made for domestic casualty and fire insurance carriers, except that they are wholly exempt on income used to maintain legally required reserves or other policy liabilities. IND. STAT. ANN. (Burns 1943 Repl.) § 64-2601 (p) and (o). A special public grain dealers' base is provided by IND. STAT. ANN. (Burns 1947 Supp.) § 64-2603 (h) and (i).

81. HALL thesis, *op. cit. supra* note 6, at 242, shows the following figures based on the Statistical Analysis of Indiana Gross Income Tax Returns, Indiana Gross Income Tax Division:

<i>Year</i>	<i>Deductions in Thousands</i>	<i>Percentage of Reported Receipts</i>
1933	\$ 261.0	20.3
1934	397.5	20.3
1935	594.1	24.6
1936	817.1	26.8
1937	1,225.3	43.3
1938	1,429.5	39.7

INCIDENCE AND EFFECTS

The incidence, or final burden, of a tax is determined by the availability of means of allocating the reduction in real income resulting from the payment of taxes. If the taxpayer absorbs the tax, the incidence is upon him. If the tax cost is shifted forward, the incidence falls upon the consumer; if backward, upon the wholesaler, manufacturer, or supplier. Presumably, the great difference between net income and gross income taxation is that net income taxes are not as readily shifted. This view presumes a truly competitive market in which prices afford highest cost producers very little net income, so that a net income tax has no effect upon the price of the product. At any rate, the incidence cannot be shifted if price changes will so reduce demand that profits seriously decline. Supposedly a gross income tax is more easily shifted because the tax varies directly with the price. But, again, the seller's ability to shift the burden depends upon the elasticity, the price sensitivity, of demand for the product. If prices are rigid, net income taxes are easier to shift, because an increase in sales at the same price will shift the incidence, whereas a price increase is more likely to be necessary to shift the incidence of a gross income tax.

Following the enactment of the gross income tax statute, many Indiana department stores raised their prices one per cent to shift the tax to consumers. Small retailers felt competition prevented a mark-up. A movement for mandatory shifting failed to influence the legislature, and the regulations indicate a neutral attitude toward shifting. Since the Indiana tax rate is low, shifting is more easily achieved. The absorption of the gross income tax, even at low rates, however, is disastrous to any business operating on a small profit margin. Consequently, the purpose of the low rates—to avoid affecting any group adversely—may be thwarted by shifting.

However there are certain institutional factors discouraging shifting. (1) Some small retailers, especially after the increased exemption, absorbed the tax in the hope of increasing sales volume. (2) Manufacturers' policies may enforce a fixed price on certain items, but this may be partially compensated for by double-shifting on non-competitive products. (3) Out-of-state competition may prevent shifting. The sales taxes in Ohio, Michigan, and Illinois, however, have substantially removed this threat for most Indiana retailers.

As a general matter wage earners probably absorb the Indiana gross income tax; the professional groups tend to shift it forward; and farmers, though largely avoiding the tax, are the victims of a backward shift as sellers and probably a forward shift as consumers.

As distinguished from incidence, the effects of a tax concern the adjustments which citizens would not have made in the absence of the tax. Thus,

a net income tax might encourage wastefulness in a highly profitable business. Because of the low rate and the extensive scope of the gross income tax, its effects are less substantial. The most obvious effect is the tendency to encourage integration. If the tax were heavy or the rate nearly as high for wholesalers as for retailers (as it is under the temporary bonus rates) this would be a serious objection. The normal $\frac{1}{4}$ of 1%, however, is not high enough to encourage integration, particularly in view of the requirement of ninety-five per cent ownership to qualify for a consolidated return.

EVALUATION OF THE TAX

The advantages of the gross income tax over a sales or net income tax are many. (1) Computation of tax liability is simple. The multiplication of distinctions has made this less and less true for business, but the requirement of keeping such books as are necessary to determine gross income tax liability is met by any firm or individual keeping reasonably good records.⁸² By contrast, federal income taxation may necessitate a separate system of accounting. (2) The cost of administration of the gross income tax is low. Although administrative costs have risen annually in amount, they have declined steadily in relation to the revenues and are now less than two per cent of the collections. Unlike sales taxes, the gross income tax places no collection burden on businessmen, except the duty to report annually payments exceeding one thousand dollars to persons other than suppliers or professional men. This provides an effective cross check on evasion. (3) Low rates and wide coverage prevent the tax from being a great burden on anyone. The tax is shiftable, so the burden does not rest entirely on business. Sellers might defeat the wide coverage by putting most of the burden on consumers, but the tax is not so easily shifted as a sales tax. (4) The yield of the tax is large and stable. This proposition was an important factor in the adoption of the gross rather than the net income tax. But it bears examination in view of the repeated statements of the Division that receipts from the tax are a barometer of business activity. Net income may vary more, over the business cycle, than the real volume of business activity. In view of price fluctuations, however, it is not at all clear that net income varies as much as the dollar volume of business activity. Consequently gross income tax receipts may decrease more in times of depression than net income receipts. One element increasing the amount of revenue produced by the gross income tax, as well as its stability, is the number of persons taxed. Like a sales tax, it reaches more people than the net income tax because it reaches poorer people. (5) The tax is a partial substitute for a property or sales tax, a single tax instead of a list of nuisance taxes. Admittedly the

82. Regulations, *op. cit. supra* note 17, § 400.

tax is better than a sales tax, but it has not kept Indiana free of excises, as the cigarette tax illustrates. As for implimenting property tax relief, the motor fuel tax has produced more revenue than the gross income tax. Further, property relief was in part due to a reduction of total taxes during the thirties. At any rate, property taxes are not appreciably lower in the cities.

The disadvantages of the tax come largely from its broad scope. The probability that the tax can be shifted produces several bad results. (1) It means that the tax is blind because its incidence and effects are not controlled by the state for socially desirable purposes. Furthermore, citizens who pay hidden taxes fail to see the extent of their interest in governmental expenditures. (2) Since shifting usually takes the form of shifting forward to the consumer, the tax falls heavily upon the poor. Sales taxation is worse in this respect since it is more easily shifted, but a net income tax is sometimes more equitable. (3) Ability to pay is another standard by which net income taxes are usually considered superior to gross income taxes. But if ability to pay means cash on hand—liquidity—then gross income taxes are probably superior. (4) Gross income taxation is particularly vulnerable to attack on the ground that it is turnover taxation, resulting in higher prices and encouraging integration of business. But low rates and strict requirements for consolidation greatly reduce this danger.

Advocates of the Indiana Gross Income Tax generally have a Messianic faith, reminiscent of Henry George's single taxers, that one tax can be applied to gross income from all sources. The tax, however, has had a constant tendency toward increased distinctions. It now has three rates instead of the original two; two basic deduction rather than one; and three tax bases rather than one for gross and net income alike. Time corrodes any tax structure, but better results might be achieved by separate taxes on business and personal income, as was repeatedly proposed in 1932.