

**Letter of Findings Number: 07-0620**  
**Financial Institutions Tax**  
**For Tax Years 2003-2005**

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**ISSUE**

**I. Financial Institutions Tax—Apportionment.**

**Authority:** IC § 6-5.5-2-4; IC § 6-5.5-4-2; IC § 6-5.5-5-1; IC § 6-8.1-5-1; I.R.C. § 61; I.R.C. § 243.

Taxpayer protests the exclusion of certain dividends from Taxpayer's receipts denominator for Financial Institutions Tax purposes.

**STATEMENT OF FACTS**

Taxpayer is a corporation which filed combined Indiana Financial Institutions Tax returns for the years at issue. Taxpayer and the other entities in the combined return are domiciled in Indiana. For 2003 and 2004, Taxpayer's returns did not include certain dividends in Taxpayer's receipts denominator. For 2005, Taxpayer's return included all dividends in Taxpayer's receipts denominator but not in Taxpayer's receipts numerator.

Taxpayer filed amended returns for 2003 and 2004. The amended returns included the previously-excluded dividends in Taxpayer's receipts denominator. This addition reduced Taxpayer's apportionment factor, which resulted in a refund claim.

The Department conducted an investigation for 2003, 2004, and 2005. As a result of the investigation, the Department denied Taxpayer's 2003 and 2004 refunds. The Department also issued an assessment. Taxpayer protested both the refund denials and the assessment. The Department conducted an administrative hearing, and this Letter of Findings results.

**I. Financial Institutions Tax—Apportionment.**

**DISCUSSION**

Taxpayer argues that three separate categories of dividends are required to be included in full in Taxpayer's receipts denominator, but not in its receipts numerator. The first category of receipts is intercompany dividends from subsidiaries located in Indiana. The second category is receipts from unrelated corporations that qualify for a partial dividend deduction under I.R.C. § 243. The third category is dividends received from an out-of-state subsidiary not included in Taxpayer's Indiana return.

Taxpayer asserts that the dividends constitute gross income within the meaning of I.R.C. § 61. Therefore, under the terms of IC § 6-5.5-4-2(a), the dividends must be included in the receipts factor for determining Taxpayer's apportionment ratio for Financial Institutions Tax. The Department argues that the dividends—at least between members of Taxpayer's federal consolidated group—are eliminated in determining Taxpayer's taxable income for federal purposes; therefore, the dividends are not included in Taxpayer's receipts denominator.

Taxpayer further argues that only the receipts attributable to Indiana under the specifically enumerated provisions of IC § 6-5.5-4 are includible in Taxpayer's receipts numerator. However, Taxpayer argues that IC § 6-5.5-2-4 requires that all of Taxpayer's receipts (other than receipts from sources outside the United States) be included in the denominator.

Under IC § 6-5.5-2-4, in a combined return, a taxpayer's numerator consists of all receipts attributable to transacting business in Indiana. A taxpayer's denominator consists of all receipts attributable to transacting business in all jurisdictions.

Taxpayer's argument can best be explained by an example. Two banks—Bank 1 and Bank 2—file a combined return. Bank 1 has \$100 of Indiana receipts and \$400 of everywhere receipts (except for dividends). Bank 2 has \$200 of Indiana receipts and \$500 of everywhere receipts. Bank 2 also pays \$100 in dividends to Bank 1. Bank 1 and Bank 2 do business in the same states, and all states have financial institutions tax laws similar to Indiana's laws.

Prior to the inclusion of the dividends, the combined group had an apportionment factor of 33.33 percent in Indiana  $[(\$100+\$200)/(\$400+\$500)]$ , and an apportionment factor of 66.67 percent in all states other than Indiana.

However, with the inclusion of the dividends, Taxpayer's argument is that Indiana would have an apportionment factor of thirty percent  $[(\$100+\$200)/(\$400+\$500+\$100)]$ . Assuming that the laws of other states are consistent with Indiana's laws, Taxpayer would have an apportionment factor of sixty percent in the other states  $[(\$300+\$300)/(\$400+\$500+\$100)]$ . The dividends appear in *no* state's numerator, but *every* state's denominator.

However, Taxpayer does not note that two, rather than one, predicates exist for a particular receipt to be included in Taxpayer's receipts denominator. The first predicate is that the particular receipt constitute gross income within the meaning of I.R.C. § 61. For purposes of this discussion, the inclusion of the dividends in

question within the meaning of I.R.C. § 61 gross income will be assumed; however, the Department does not necessarily concede this issue. The second predicate is that the receipts must be attributable to transacting business in a state.

If the dividends are not attributable to transacting business in Indiana, the receipts must be attributable to transacting business in some other state. Taxpayer does not note (with the possible exception of dividends from an affiliated corporation conducting business in a state other than Indiana) a state in which Taxpayer's dividends are "attributable to transacting business." Thus, the dividends in question would be neither includible in Taxpayer's numerator nor denominator under this approach.

In the alternative, if the receipts are attributable to transacting business, then the receipts must be attributable to some state. The statute is silent on this point. However, prior to 1999, resident financial institutions effectively included their dividends in both the receipts numerator and denominator, while nonresident shareholders included the dividends in their receipts denominator. Requiring resident financial institutions to apportion their income does not lead to the result contemplated by Taxpayer, namely that dividends are *never* Indiana-source receipts. As such, the dividends are Indiana-source receipts for purposes of the receipts numerator.

The Department also asserts that the income was not "fairly reflected" by the inclusion of dividends paid to Taxpayer only in Taxpayer's receipts denominator. Under IC § 6-5.5-5-1(b),

If the department or taxpayer determines that the result of applying this section or article do not fairly represent the taxpayer's income within Indiana or the taxpayer's income within Indiana may be more fairly represented by a separate return, the taxpayer may petition for and the department may allow, or the department may require, in respect to all or a part of the taxpayer's business activity any of the following:

- (1) Separate accounting.
- (2) The filing of a separate return for the taxpayer.
- (3) A reallocation of tax items between a taxpayer and a member of the taxpayer's unitary group.

In Taxpayer's case, a reallocation of the dividends to the company that paid the dividends (i.e., effectively treating the dividends as if they had never been paid) would fairly reflect Taxpayer's Indiana income. For one thing, it would prevent the dilution of Taxpayer's Indiana income by excluding receipts attributable to nowhere. In addition, it would fairly apportion Taxpayer's income by taking into account Taxpayer's activities as a financial institution rather than as a passive shareholder.

To summarize, the dividends in question are gross income for federal income tax purposes. However, the dividends should also be included in Taxpayer's receipts numerator. Taxpayer's apportionment method did not fairly reflect its Indiana source income, and thus the exclusion of dividends from both the receipts numerator and the denominator was a proper means of fairly reflecting Taxpayer's Indiana-source income. Taxpayer has not met its burden of demonstrating that the assessment was incorrect pursuant to IC § 6-8.1-5-1(b) (now (c)).

#### **FINDING**

Taxpayer's protest is denied.

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