DEPARTMENT OF STATE REVENUE

18-20070682.LOF

Letter of Findings: 07-0682
Financial Institutions Tax
For the Years 2002, 2003, 2004, 2005

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ISSUES

I. Financial Institutions Tax – Imposition.

Authority: IC § 6-5.5-2-1; IC § 6-5.5-3-1; IC § 6-5.5-1-12; IC § 6-5.5-1-13; IC § 6-5.5-1-17; IC § 6-5.5-3-1; IC § 6-5.5-3-8; IC § 6-5.5-4-8; IC § 6-8.1-5-1; 45 IAC 17-2-1; 45 IAC 17-2-4; 15 U.S.C. § 381; *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the assessment of FIT arguing that it does not do business in Indiana.

II. Financial Institutions Tax – Combined Returns.

Authority: IC § 6-8.1-5-1; 45 IAC 17-3-2; 45 IAC 17-3-5; *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests that the Department erred in forcing its combination with a related entity.

III. Financial Institutions Tax – Computation.

Authority: IC § 6-5.5-2; IC § 6-8.1-5-1; *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer challenges the calculation of FIT on the ground that the Department made computational errors resulting in an over-assessment of the amount of tax due.

IV. Tax Administration – Ten Percent Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the proposed assessment of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a wholly-owned subsidiary of a retailer (Parent) incorporated out of state. Parent operates retail stores in Indiana. Taxpayer - through two tax disregarded entities filing under Taxpayer (Trust A and Trust B) - financed and securitized retail charge card receivables generated under revolving charge accounts through sales of merchandise in Parent's stores. The receivables originated through the use of Parent's retail charge cards issued, during most of the audit years, by another related entity (Bank).

Bank was wholly-owned by an investment company which itself was wholly-owned by Parent. Bank is a credit card bank under the Competitive Equality Act of 1987. Bank issued all proprietary credit cards for customers who shop at Parent's retail stores and extended credit to Parent's customers.

Several years before the years at issue, Bank began selling its revolving credit card account receivables, without recourse and at face value, on a daily basis to a related entity, Trust A, which then transferred the assets to yet another related entity, Trust B, in exchange for certificates representing undivided interests in the receivables.

Trust B securitized the accounts receivable generated by Bank's credit card accounts for corporate borrowings. Trust B issued "certificates" to its investors representing the investors' undivided ownership in the underlying credit card loans.

During most of the protest years Bank retained ownership of the accounts and serviced the receivables for which it was paid servicing fees. However, Bank's credit card business was acquired by an unrelated party (Company) in recent years. At that time, substantially all of the credit card receivables were sold to Company. As a result of the transaction, and pursuant to a marketing and servicing agreement, Company establishes and owns the proprietary credit card accounts for customers of Parent, retains the benefits and risks associated with the ownership of credit accounts, provides key customer service functions, receives the finance charge income and incurs the bad debts associated with those accounts. Pursuant to this agreement, Parent receives ongoing cash compensation from Company.

Both Trust A and Trust B, as stated above, are disregarded entities and file under Taxpayer. According to Taxpayer at hearing, Trust A and Trust B merely exist on paper and all their activity takes place with Taxpayer.

As the result of an audit of the years 2002 through 2005, the Indiana Department of Revenue (Department) determined that Trust A, Trust B, and Taxpayer were subject to Indiana Financial Institutions Tax (FIT). All three were non-filers for FIT. The Department assessed FIT against Taxpayer (since Trust A and Trust B were disregarded for tax purposes). Taxpayer protested the assessment. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Financial Institutions Tax – Imposition.

DISCUSSION

The Department concluded that Taxpayer is subject to the FIT pursuant to IC § 6-5.5-3-1 and 45 IAC 17-2-1 because it was transacting the business of a financial institution as defined in IC § 6-5.5-3-1(4) and (6). The Department's audit stated that Trust A and Trust B held the credit card receivables of persons in Indiana, generated from sales in Indiana, and received interest payments from these persons in Indiana. These two entities were non-filers for FIT purposes and are subject to FIT. As disregarded entities for tax purposes, the tax consequences to these entities flowed through to Taxpayer.

Taxpayer argued that while indeed it was a financial institution, it was not one doing business in Indiana, and, therefore, was not subject to Indiana FIT.

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), (c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Within Indiana, "There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana." IC § 6-5.5-2-1(a).

The FIT is imposed on both "nonresident taxpayers" and "resident taxpayers" transacting business within this state. IC § 6-5.5-1-12,13. The statute defines a "nonresident taxpayer" as "a taxpayer that (1) is transacting business within Indiana as provided in IC § 6-5.5-3; and (2) has its commercial domicile outside Indiana." IC § 6-5.5-1-12.

45 IAC 17-2-1 elaborates that the FIT "is intended to tax both traditional financial institutions that are transacting business within Indiana, as well as other types of businesses that are deemed to be transacting the business of a financial institution in Indiana."

For purposes of the FIT, a corporation that is transacting the business of a financial institution, includes a regulated financial corporation, IC § 6-5.5-1-17(a)(2), any other corporation that is carrying on the business of a financial institution, IC § 6-5.5-1-17(a)(4), and specifically includes "[o]perating a credit card, debit card, charge card, or similar business." IC § 6-5.5-1-17(d)(2)(C).

45 IAC 17-2-4(b), in relevant part, elaborates on "other corporations" subject to FIT:

(b) The corporation is deemed to be conducting the business of a financial institution and therefore subject to the FIT if eighty percent (80 [percent]) or more of the corporation's gross income during the taxable year is derived from the following activities:

(1) Extending credit. (Refer to subsection (e) below.)

...

(3) Credit card operations.

(c) As used in this section, "gross income" includes the income derived from activities which are performed by corporations primarily (as defined by the eighty percent (80 [percent]) test) engaged in the business of extending credit. Gross income includes income from the following:

(1) Interest.

(2) Fees.

(3) Penalties.

(4) A market discount or other type of discount.

...

(e) For purposes of satisfying the eighty percent (80 [percent]) test, corporations which are in the business of a financial institution must be conducting the activities of extending credit,..., or credit card operations, as follows:

(1) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include secured or unsecured consumer loans;...; credit card loans;...; loans arising in factoring; and any other transactions with a comparable economic effect.

...

(3) Operating a credit card, debit card, charge card, or similar business. If eighty percent (80[percent]) of a corporation's total gross income is derived from:

(A) extending credit;

(B) leasing; or

(C) credit card operations;

the corporation is subject to the FIT.

Therefore, based on the above facts and law, Taxpayer is clearly conducting the business of a financial institution. Taxpayer does not dispute this determination and states as much in a letter dated March 30, 2007. The letter responded to the Department's proposed Audit Summary and raised other issues which are the subject of this protest.

The next and determinative question, then, is whether Taxpayer is conducting the business of a financial institution in Indiana.

Pursuant to IC § 6-5.5-3-1, a financial institution is transacting business within Indiana if it:

(1) maintains an office in Indiana;

(2) has an employee, representative, or independent contractor conducting business in Indiana;
(3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
(4) regularly solicits business from potential customers in Indiana;
(5) regularly performs services outside Indiana that are consumed within Indiana;
(6) *regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana*;
(7) owns or leases tangible personal or real property located in Indiana; or
(8) regularly solicits and receives deposits from customers in Indiana.
(*Emphasis added*).

IC § 6-5.5-4 deals with the attribution of financial institution receipts. Specifically, the statutory provision for attributing credit card receipts derived from customers both inside and outside Indiana is set out at IC § 6-5.5-4-8 which states as follows:

Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertaining credit card receivables and credit card holders' fees *must be attributed to the state to which the card charges and fees are regularly billed*.
(*Emphasis added*).

Based on the above, Taxpayer transacted the business of a financial institution in Indiana. Taxpayer held the credit card receivables of Indiana customers. Taxpayer regularly billed Indiana customers for payments, interest, and fees on the receivables. The receipts from these billings are attributed to Indiana. IC § 6-5.5-4. Receipts therefore did flow to Taxpayer from within Indiana. The conditions of IC § 6-5.5-3-1(6) have been met.

Taxpayer argues that while receipts do flow to it from Indiana, it, however, does not itself "engage in transactions with customers in Indiana that involve intangible property, including loans." In other words, Taxpayer argues that while the transactions result in receipts flowing to it from within Indiana, it does not engage in the transactions that generate the receivables.

Taxpayer is mistaken. As stated above, Taxpayer regularly engages in transactions with Indiana customers when it regularly bills them for payments, interest and fees on the receivables it holds. Furthermore, the transfer of receivables that flow to Taxpayer are, per agreement with Bank, based on certain revolving credit card accounts which represent ongoing extension of credit to people in Indiana, the receivables of which automatically flow to Taxpayer. Parent's original Pooling and Servicing Agreement states that the conveyance of receivables includes "the [r]eceivables existing as of the Cut-Off Date *and thereafter created and arising in connection with the Accounts* (other than Additional Accounts)" - the "Cut-Off Date" being the date of the transfer of specific receivables. (*Emphasis added*). Taxpayer is therefore regularly engaged in these transactions with its Parent's Indiana customers. The stream of receivables that make their way to Trust A and then to Trust B where they are securitized, relies on a constant, daily, replenishment by means of newly generated receivables, the credit for which is extended by Bank to Parent's customers. This constant stream of receivables affords Trust B the steady flow of income without which Trust B could not earn the ratings that allow it to market its existing securitized receivables favorably to third-party institutional investors thus generating the corporate borrowings that are its "raison d'etre."

Taxpayer further argued during the Department's audit that it was exempt from Indiana FIT pursuant IC § 6-5.5-3-8, which states "events not considered doing business in Indiana." Specifically, Taxpayer cites to IC § 6-5.5-3-8(5)(B) which states:

Notwithstanding any other provision of this chapter, a taxpayer, except for a trust company formed under IC 28-1-4, is not considered to be transacting business in Indiana if the only activities of the taxpayer in Indiana are or are in connection with any of the following:
...
(5) Owning an interest in the following types of property, including those activities within Indiana that are reasonably required to evaluate and complete the acquisition or disposition of the property, the servicing of the property or the income from the property, the collection of income from the property, or the acquisition or liquidation of collateral relating to the property:
...
(B) An interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest that provide for payments in relation to payments or reasonable projections of payments on the notes or certificates.

Taxpayer misreads the above referenced statute as it applies to both Trust A and Trust B and thus to Taxpayer.

While Trust A did end up owning "certificates of interest" in Trust B "that provide for payments in relation to payments or reasonable projections of payments on the certificates," that, however, was not Trust A's *only* activity in Indiana as also required by the statute Taxpayer cites. Trust A actually purchased the receivables from Bank and sold them to Trust B in exchange for certificates of interest in the assets that Trust B then securitized. Trust A

does not merely "*complete* the acquisition... of the property," it *initiates* the process when it acquires the receivables from Bank which it then transfers to Trust B in exchange for certificates of interest when the assets are securitized. In other words, Trust A is the prime mover in the series of activities undertaken by the related parties that result in the securitization of the receivables. This is evidenced, for example, by the fact that Trust A's interest in the underlying credit card receivables is subordinate to the interests of other investors in Trust B, the unrelated institutional investors. Trust A's activities encompass more than simple ownership of the certificates of interest and the attendant activities that go with acquisition and disposition of ownership of property contemplated in the statute Taxpayer cites.

As for Trust B, it does not come under the statute Taxpayer cites. Trust B issues the certificates to investors, it collects payments on the receivables from Indiana customers, it acquires on a daily basis additional receivables which it securitizes, and makes payments to the institutional investors as a return on their certificates of interest. Trust B's activities also go beyond the activities contemplated in the exemption statute.

Therefore, both Trust A and Trust B come under Indiana FIT. As disregarded entities, Trust A and Trust B are treated as divisions of Taxpayer, therefore subjecting Taxpayer to Indiana FIT. The Department's initial proposed assessment was correct.

Taxpayer also argues that the Department already assessed FIT against Bank to which Bank agreed and paid the tax, which, therefore, precludes the Department from assessing FIT on Taxpayer. The fact that one entity among a series of related entities comes under FIT does not mean that the other related entities are somehow relieved of FIT liability if they are statutorily subject to FIT. Bank paid Indiana FIT on Indiana's percentage of the loan origination fees Bank received. Bank's receipts are not the same as the receipts for which Taxpayer is subject to FIT.

Taxpayer has not met its necessary burden to show that it is not subject to Indiana FIT.

FINDING

Taxpayer's protest is respectfully denied.

II. Financial Institutions Tax – Combined Returns.

DISCUSSION

Apart from protesting that it is subject to Indiana FIT, Taxpayer argues that it is not a member of a unitary group as defined in IC § 6-5.5-5. It states in its December 14, 2007, letter protesting the assessment:

> The business activities of [Taxpayer] are not of mutual benefit, dependent upon, or contributory to another entity, in transacting the business of a financial institution in Indiana. [Taxpayer] is only investing in a block of receivables that were acquired because of federal banking regulations... and does not participate in transacting the business of a financial institution.

The Department found that Taxpayer must file a combined return with Bank pursuant to 45 IAC 17-3-2 because Taxpayer and Bank have unity of ownership and unity of business activities.

Again, 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), (c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

45 IAC 17-3-2(a) states that separate or combined reporting are the only reporting methods permitted under FIT. 45 IAC 17-3-2(b) states that if a taxpayer is a member of a unitary group, as defined in 45 IAC 17-3-5, then combined reporting is mandatory.

45 IAC 17-3-5 states in relevant part:

> (a) A designated taxpayer who is a member of a unitary group shall file a combined return covering all the operations of the unitary business and including all taxpayer members of the unitary group.
>
> (b) A corporation must be a taxpayer as defined under 45 IAC 17-2 in order to be a member of a unitary group for purposes of the FIT.
>
> (c) A "unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually, or as a group, in transacting the business of a financial institution. Unity of ownership exists when a corporation is a member of a group of two (2) or more entities and more than fifty percent (50%) of the voting stock of each member of the group is directly or indirectly owned by:
>
> (1) a common owner or common owners, either corporate or noncorporate; or
>
> (2) one (1) or more of the member corporations of the group....

Taxpayer and Bank are both owned by Parent, thus establishing unity of ownership. Bank's and Taxpayer's activities and operations are "of mutual benefit, dependent upon, [and] contributory to one another, individually, or as a group, in transacting the business of a financial institution" because Bank establishes and services the credit card accounts while Taxpayer holds the receivables and payments generated as a result. Bank and Taxpayer both perform functions that as a whole allow Parent to offer credit card accounts to its Taxpayers. None of these activities could exist without the others and are thus mutually dependent and beneficial. Therefore the Department's initial determination is correct; Taxpayer must file a combined return with Bank.

Taxpayer also argues that since Bank was assessed, and paid, FIT for the same years as the audit being protested here, the Department cannot now attempt to combine Bank and Taxpayer as a unitary group thus making an assessment for the same periods that were previously audited, assessed, and closed for Bank.

Taxpayer argues the following in its December 14, 2007, letter:

> Federal Revenue Procedure 2005-32, Section 5 states "The Service will not reopen a case closed after examination to make an adjustment to liability unfavorable to the taxpayer unless: (1) there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of material fact; (2) the closed case involved a clearly-defined, substantial error based on an established Service position existing at the time of the examination; or (3) other circumstances exist indicating that a failure to reopen the case would be a serious administrative omission." Where no guidance relating to this issue is found in specific state statutes or state specific cases (as in the case of Indiana), the courts routinely follow the federal guidelines.

As a preliminary matter, Taxpayer's argument is on behalf of Bank which technically is not part of this protest. Furthermore, Bank was repeatedly asked, over a period of several months beginning in September 2006 through April 2007, for Taxpayer's information for the purpose of combination under FIT. Bank repeatedly argued that Taxpayer would not be subject to FIT and did not provide the requisite information determining if a combination was appropriate even after the Department extended the audit period to allow time for the production of the information it had repeatedly requested.

As for Taxpayer's argument stated above, the Department is not bound by the federal revenue procedure guidelines. Even if the Department were bound by the guidelines, they involve Bank and not the subject of this protest, which is Taxpayer.

The Department's audit report states the calculation of liability as follows:

> While [T]axpayer must file a combined return the [T]axpayer did not provide information for [Taxpayer] in a timely fashion to complete an audit report with Bank and Taxpayer on a combined basis.
>
> The audit of [Bank] was completed [separately].
>
> The audit of [Taxpayer] has been calculated for the fiscal years ended 2/1/2003, 1/31/2004, and 1/31/2005 as if it, [Taxpayer], had been in the combined return with [Bank]. A combined denominator consisting of the total receipts of both entities, with [Taxpayer]'s Indiana receipts as the numerator, will be used to compute the apportionment percentage that will be applied to the combined income of both entities.
>
> The [T]axpayer did not provide information for [Bank] for the fiscal year ended 2/2/2002 so this period has been calculated based only on [Taxpayer].
>
> As stated above, Taxpayer is correctly combined with Bank in calculation of the FIT assessment.

FINDING

Taxpayer's protest is respectfully denied.

III. Financial Institutions Tax – Computation.

DISCUSSION

Taxpayer challenges the calculation of FIT on the ground that the Department made computational errors resulting in an over-assessment of the amount of tax due. FIT is computed under IC § 6-5.5-2. Taxpayer states in its December 14, 2007, letter:

> The State's computation does not consider elimination of intercompany transactions and does not adjust for interest expense that is shown on the parent company but which is actually interest expense on the debt of [Taxpayer] since the receivable balances are securitized. Therefore, the net income of [Taxpayer] has been significantly overstated.

At hearing, Taxpayer stated the debt was incorrectly reflected on Parent's return which was actually interest expense for Taxpayer. Taxpayer consequently did not take the interest deduction itself. When asked at hearing if Taxpayer had amended its federal return(s) to correct this occurrence, it stated that it had not. Furthermore, Taxpayer did not provide any documentation for the computation issues it stated in its letter cited above.

Again, 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), (c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Taxpayer has not provided documentation to support its protest of the Department's computation of FIT.

FINDING

Taxpayer's protest is respectfully denied.

IV. Tax Administration – Ten Percent Penalty.

DISCUSSION

Taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Additionally 45 IAC 15-11-2(c) states:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. 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 under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and, thus, will be dealt with according to the particular facts and circumstances of each case. In this case, Taxpayer has not affirmatively established that its failure to remit Indiana FIT was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

Taxpayer is subject to Indiana FIT and is correctly combined with Bank. The FIT calculations made by the Department stand.

Taxpayer is not relieved of the negligence penalty assessment.

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