DEPARTMENT OF STATE REVENUE

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LETTER OF FINDINGS: 07-0618
Financial Institutions Tax
For the Years 2003, 2004, 2005

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ISSUES

I. Financial Institutions Tax – Apportionment of Partnership Income.

Authority: IC § 6-5.5-1-18; IC § 6-5.5-2-1; IC § 6-5.5-2-3; IC § 6-5.5-2-4; IC § 6-5.5-2-8; IC § 6-5.5-5-1; IC § 6-5.5-5-2; IC § 6-8.1-5-1; 45 IAC 17-2-1; P.L. 68-1991; Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629 (Ind. Tax Ct. 1999); State ex rel. Hatcher v. Lake Super. Ct., Room Three, 500 N.E.2d 737 (Ind. 1986).

Taxpayer protests the method of calculating the income of one if its subsidiary partnerships on its combined return.

II. Tax Administration – Underpayment Penalty.

Authority: IC § 6-5.5-7-1; IC § 6-8.1-10-2.1.

Taxpayer protests the assessment of the underpayment penalty.

STATEMENT OF FACTS

Taxpayer is a resident financial services company that provides comprehensive services to businesses and individuals. Taxpayer's unitary group includes several subsidiaries among which is a Delaware limited liability company (LLC). According to Taxpayer and the Department, LLC has two members - an Indiana bank (IN Bank) which is also a subsidiary of Taxpayer that owns one-percent of LLC and another Delaware limited liability company (LLC2) that owns ninety-nine-percent of LLC. IN Bank is the sole owner of LLC2. As a single-member limited liability company, LLC2 has elected to file its federal returns as a corporation.

The Indiana Department of Revenue ("Department") conducted a Financial Institutions Tax (FIT) audit of Taxpayer for the years 2003, 2004, and 2005. Taxpayer had filed combined FIT returns with its subsidiaries for the years at issue. Taxpayer's combined returns included the apportioned income, rather than the adjusted gross income, of LLC. The Department's audit adjusted Taxpayer's combined return to include the adjusted gross income of the LLC, rather than the apportioned income, to calculate the tax due. As a result, additional FIT was assessed against Taxpayer. Taxpayer protested the assessment. A hearing was held and this Letter of Findings results. Additional facts will be presented as necessary.

I. Financial Institutions Tax – Apportionment of Partnership Income.

DISCUSSION

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).

The FIT is imposed on taxpayers transacting the business of a financial institution within this state. IC § 6-5.5-2-1. 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."

IC 6-5.5-2-1 states in part:

(a) 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. The amount of the tax for a taxable year shall be determined by multiplying eight and one-half percent (8.5%) times the remainder of:

(1) the taxpayer's apportioned income; minus

(2) the taxpayer's deductible Indiana net operating losses as determined under this section; minus

(3) the taxpayer's net capital losses minus the taxpayer's net capital gains computed under the Internal Revenue Code for each taxable year or part of a taxable year beginning after December 31, 1989, multiplied by the apportionment percentage applicable to the taxpayer under IC 6-5.5-2 for the taxable year of the loss.

IC 6-5.5-2-3 deals with the apportioned income of a taxpayer not filing a combined return:

For a taxpayer that is not filing a combined return, the taxpayer's apportioned income consists of the taxpayer's adjusted gross income for that year multiplied by the quotient of:

(1) the taxpayer's total receipts attributable to transacting business in Indiana, as determined under IC 6-5.5-4; divided by

(2) the taxpayer's total receipts from transacting business in all taxing jurisdictions, as determined under IC 6-5.5-4.

IC 6-5.5-2-4 deals with the apportioned income of a taxpayer filing a combined return for its unitary group:

> For a taxpayer filing a combined return for its unitary group, the group's apportioned income for a taxable year consists of:
> (1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by
> (2) the quotient of:
> (A) all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by
> (B) the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions.
> (Emphasis added).

Taxpayer protested the Department's "pre-apportionment" method of determining its Indiana income subject to the FIT. Taxpayer contended that LLC's income, because it files as a partnership, should have been first apportioned between Indiana receipts and its total receipts - using a factor apportionment calculation - with only the resulting Indiana apportioned receipts then included in the combined factor apportionment calculation on Taxpayer's Indiana combined return. Taxpayer bases its "post apportionment" methodology on the phrase "adjusted or apportioned income" in IC § 6-5.5-2-8, which states:

> If a corporation is:
> (1) transacting the business of a financial institution (as defined in IC 6-5.5-1-17(d); and
> (2) is a partner in a partnership or the grantor and beneficiary of a trust transacting business in Indiana and the partnership or trust is conducting in Indiana an activity or activities that would constitute the business of a financial institution if transacted by a corporation;
> the corporation is a taxpayer under this article and shall, in calculating the corporation's tax liability include in the corporation's adjusted or apportioned income the corporation's percentage of the partnership or trust adjusted gross income or apportioned income.
> (Emphasis added).

The Department's audit report states that since Taxpayer is filing a combined return on behalf of its unitary group and LLC is a member of the unitary group, IC § 6-5.5-2-4 clearly requires that LLC's adjusted gross income must be included on the combined return - "the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group" - with a combined apportionment percentage then applied to the entire unitary group. IC § 6-5.5-2-4 provides no exceptions or qualifications.

Taxpayer points to IC § 6-5.5-2-8 which, as cited above, states that Taxpayer is to use either the adjusted or apportioned income. Taxpayer's interpretation of the statute is that the corporate partner must include the apportioned, never the adjusted gross, income in the combined return. Taxpayer's position is that the distinction between entities that must use the adjusted gross and those that must apportion first was based on the differing treatment in old FIT law of resident and non-resident entities. Prior to amendment in 1999, FIT law required a resident entity to report all of its adjusted gross income on the return regardless of source, whereas it only required a non-resident entity to report its apportioned income on the return. Taxpayer argues that FIT law was amended to treat residents and non-residents equally, therefore, all taxpayers must use the apportioned income to report their partnership income.

The statute on its face may appear unclear on how Taxpayer and the Department are to determine which method of apportionment to use. To determine the correct statutory construction, one must consider the intent of the legislature. Mynsberge v. Dep't of State Revenue, 716 N.E.2d 629, 631 (Ind. Tax Ct. 1999). To do this, one must look at the entire statutory scheme since the Indiana legislature does not maintain a legislative record. Finally, one must assume that the statutory scheme is logical and the interpretation will not bring about an absurd result. State ex rel. Hatcher v. Lake Super. Ct., Room Three, 500 N.E.2d 737, 739 (Ind. 1986). Effectuation of the entire statutory scheme in a logical fashion prevails over a strict and literal reading of any one provision. Id.

The statutory scheme that applied to Taxpayer during the years at issue states the following clearly. The members of the unitary group include any and all entities engaged in the unitary financial institution's business. IC § 6-5.5-1-18. The unitary group must file a combined return that covers all the operations of the unitary business and covers all the members of the unitary group. IC § 6-5.5-5-1. Each combined return must include the adjusted gross income of all the members of the unitary group, even if some of the members would not otherwise be subject to taxation under this article. IC § 6-5.5-5-2. The apportioned income for the entire unitary group is the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group multiplied by the Indiana apportionment percentage. IC § 6-5.5-2-4. This last statute was specifically amended by P.L. 68-1991 (effective January 1, 1992) to make clear that the adjusted gross income rather than the apportioned income of both resident and non-resident taxpayers was to be included in the combined return if taxpayer was a member of a unitary group.

IC § 6-5.5-2-8 is part of this scheme. Since partnerships are pass through entities, IC § 6-5.5-2-8 specifically addresses when a corporate partner in a partnership is subject to FIT and how it is to calculate its FIT liability. The statute's reference to "adjusted gross or apportioned" income merely reflects the requirements of IC § 6-5.5-2-3 and IC § 6-5.5-2-4; i.e., whether the entity is filing separately or is included in a combined return.

Taxpayer's reading of IC § 6-5.5-2-8 renders all reference to "adjusted gross income" in the statute a nullity. Further, Taxpayer's reading of IC § 6-5.5-2-8 in isolation from the rest of the FIT statutory scheme contravenes the legislature's intent expressed clearly in the overarching statutory scheme as evidenced by, but not limited to, the following statutes: (1) IC § 6-5.5-1-18 defines the unitary group to include any entity engaged in a unitary business transacted wholly or partially within Indiana. Specifically included by reference is any entity, regardless of form, that conducts activities that would constitute the business of a financial institution if the activities were conducted by a corporation; (2) IC § 6-5.5-5-1 which requires a unitary group to file a combined return that covers all operations of the unitary business and includes all members of the unitary group; (3) IC § 6-5.5-5-2 which provides that a combined return must include the adjusted gross income of all members of the unitary group, even if some of the members would not otherwise be subject to taxation under the FIT article; and (4) as discussed above, IC § 6-5.5-2-4 which defines the apportioned income for a unitary group as the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group multiplied by the Indiana apportionment percentage.

Lastly, the FIT statutory scheme does not, nor has it ever, allowed the inclusion of the apportioned income of a member of a unitary group in the combined return irrespective of whether the member was a resident or non-resident, or whether the entity was a partnership or some other corporate form.

The statutory scheme requires that the adjusted gross income and receipts of LLC are added to Taxpayer's adjusted gross income and receipts. After this addition, the Taxpayer's adjusted gross income tax figure is multiplied by the appropriate percentage to determine Taxpayer's Indiana adjusted gross income to be included in Taxpayer's combined return. This is the pre-apportionment method used by the Department in determining Taxpayer's proper financial institutions tax liability.

The Department properly used the pre-apportionment method in determining the partnership's Indiana adjusted gross income to be included in Taxpayer's combined FIT return.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Underpayment Penalty.

DISCUSSION

Taxpayer protests the imposition of the ten percent penalty for underpayment of estimated tax for the 2004 and 2005 tax years as prescribed under IC § 6-5.5-7-1 which incorporates IC § 6-8.1-10-2.1(b).

IC § 6-5.5-7-1 states:

(a) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on a taxpayer who fails to make payments as required in IC 6-5.5-6. However, no penalty shall be assessed for a quarterly payment if the payment equals or exceeds:

(1) twenty percent (20[percent]) of the final tax liability for the taxable year; or

(2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.

(b) The penalty for an underpayment of tax on a quarterly return shall only be assessed on the difference between the actual amount paid by the taxpayer on the quarterly return and the lesser of:

(1) twenty percent (20[percent]) of the taxpayer's final tax liability for the taxable year; or

(2) twenty-five percent (25[percent]) of the taxpayer's final tax liability for the taxpayer's previous taxable year.

IC § 6-8.1-10-2.1(b) states:

Except as provided in subsection (g), the penalty described in subsection (a) is ten percent (10[percent]) of:

(1) the full amount of the tax due if the person failed to file the return;

(2) the amount of the tax not paid, if the person filed the return but failed to pay the full amount of the tax shown on the return;

(3) the amount of the tax held in trust that is not timely remitted;

(4) the amount of deficiency as finally determined by the department; or

(5) the amount of tax due if a person failed to make payment by electronic funds transfer, overnight courier, or personal delivery by the due date.

(Emphasis added).

In this case, the amount of deficiency as finally determined by the department resulted in Taxpayer's underpayment of estimated tax. IC § 6-8.1-10-2.1(b)(4). Taxpayer, therefore, was subject to the underpayment penalty under IC § 6-5.5-7-1, unless Taxpayer's estimated payments were either twenty percent of the final tax liability in each of the years in question or twenty-five percent of the final tax liability for Taxpayer's previous taxable year. IC § 6-5.5-7-1 also incorporates by reference IC § 6-8.1-10-2.1(d) which states:

If a person subject to the penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

In this instance the Department's audit waived the negligence penalty imposed under IC § 6-8.1-10-2.1 against Taxpayer. Since the Department's authority to waive the penalty under IC § 6-8.1-10-2.1(d) is tied to a

showing that Taxpayer's negligence was due to "reasonable cause and not willful neglect," the same standard for waiver is incorporated by reference to IC § 6-5.5-7-1. Given the Department's waiver of the negligence penalty, it stands to reason, without additional statement of willful neglect, that Taxpayer has demonstrated that its underpayment of tax was due to reasonable cause.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest is denied on Issue I and denied on Issue II.

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