DEPARTMENT OF STATE REVENUE

18-20080718.LOF

Letter of Findings: 08-0718
Financial Institutions Tax
For the Years 2004, 2005, and 2006

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ISSUES

I. Substantial Nexus – Financial Institutions Tax.

Authority: U.S. Const. art. I, § 8, cl. 3; IC § 6-8.1-5-1(c); IC § 6-5.5-3-1(6); IC § 6-5.5-2-4; IC § 6-5.5-2-3; IC § 6-5.5-1-17(a); IC § 6-5.5-1-12; IC § 6-5.5-1-12, 13; Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977); MBNA America Bank, N.A. & Affiliates v. Indiana Dept. of State Revenue, 895 N.E.2d 140 (Ind. Tax. Ct. 2008); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer argues that five of its affiliates did not have a "substantial nexus" with Indiana and should not have been included as members of its unitary group subject to Indiana's Financial Institutions Tax.

II. Loan Portfolios – Financial Institutions Tax.

Authority: IC § 6-8.1-5-1(c); IC § 6-5.5 et seq.; IC § 6-5.5-3-1(6); IC § 6-5.5-3-1; IC § 6-5.5-2-4; IC § 6-5.5-2-3; IC § 6-5.5-1-12, 13; IC § 6-5.5-1-12.

Taxpayer maintains that two of its affiliates are not subject to tax because they did not conduct business with Indiana customers but merely held portfolios containing loans made to Indiana customers.

III. Calculation Errors – Financial Institutions Tax.

Authority: IC § 6-8.1-5-1(c).

Taxpayer maintains that the Department of Revenue's audit contained calculation errors which warrant correction.

IV. Ten-Percent Penalties.

Authority: IC § 6-8.1-10-2.1; IC § 6-8.1-10-2.1(b); IC § 6-8.1-10-2.1(d); IC 6-5.5-7-1(a); IC § 6-5.5-6-3; IC § 6-5.5-6-3(a); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that it is entitled to abatement of both the ten-percent negligence penalty and underpayment penalty.

STATEMENT OF FACTS

Taxpayer consists of an affiliated group of corporations. The relevant affiliates include a federally charted bank, a state chartered bank, two out-of-state companies that make automobile loans, and two subsidiaries that subsequently hold loans originating from the automobile loans. The Department of Revenue (Department) conducted an audit review of taxpayer's returns and business records for the years 2004 through 2006. As a result of that audit, the Department issued Notices of Proposed Assessment. Taxpayer disagreed and filed a protest to that effect. The matter was assigned to the Hearing Officer. An administrative hearing was conducted during which taxpayer explained the basis for its protest. This Letter of Findings Results.

I. Substantial Nexus – Financial Institutions Tax.

DISCUSSION

Taxpayer argues that its federally chartered bank and its state chartered bank were not "transacting business within Indiana" because they do not have "any presence within Indiana." Taxpayer concludes that the two banks were not required to report or pay Indiana Financial Institutions Tax (FIT).

The audit report found that none of the "corporations included in [the] audit report have an office or any physical location in Indiana." In addition, the report noted that neither the federally chartered bank nor the state chartered bank had any Indiana employees.

A. Economic Nexus.

Taxpayer states that because the two banks did not have a physical presence in Indiana and did not have any Indiana employees, the proposed assessment attributable to those two banking entities should be abated. The audit found that because the two banks earned interest and fees from loaning money to Indiana customers and from conducting business with Indiana customers, the two banks were subject to the FIT. The issue is whether the two banks' mere economic presence within the Indiana is sufficient to justify the proposed assessments.

For purposes of the FIT, a "'[t]axpayer' means a corporation that is transacting the business of a financial institution, including any of the following:

(1) A holding company.
(2) A regulated financial corporation.
(3) A subsidiary of a holding company or regulated financial corporation.
(4) Any other corporation organized under the laws of the United States, this state, another taxing jurisdiction,

or a foreign government that is carrying on the business of a financial institution." IC § 6-5.5-1-17(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. A taxpayer, not filing a combined return, determines its FIT liability based on the taxpayer's adjusted gross income "multiplied by the quotient of... the taxpayer's total receipts attributable to transacting business in Indiana, as determined under IC 6-5.5-4; divided by... the taxpayer's total receipts attributable to transacting business in all taxing jurisdictions as determined under IC 6-5.5-4." IC § 6-5.5-2-3. In contrast, a taxpayer filing a combined return determines its FIT liability based on its apportioned income consisting of the taxpayer's "(1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by... the quotient of... all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by... the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions." IC § 6-5.5-2-4.

The FIT definition of "transacting business" within this state includes the activities of a company which "regularly engages in transactions with customers in Indiana that involve intangible property, including loans... [that] result in receipts flowing to the taxpayer from within Indiana." IC § 6-5.5-3-1(6).

Taxpayer objects to the assessment on the ground that the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, precludes Indiana from imposing the FIT on any corporation that lacks a physical presence with Indiana.

Taxpayer's constitutional objection is without foundation having been addressed squarely by the Indiana Tax Court in MBNA America Bank, N.A. & Affiliates v. Indiana Dept. of State Revenue, 895 N.E.2d 140 (Ind. Tax. Ct. 2008). In that decision, the court held that, "The Commerce Clause does not require [petitioner bank] to have a physical presence in Indiana to be subject to FIT – its economic presence is enough." Id. at 144.

The audit report found that the two taxpayer affiliate banks "currently earn[] interest, service fees, over-limit fees, and assorted miscellaneous income from loans to Indiana customers." Therefore, the banks established a lively and profitable economic presence within this state and are subject to Indiana's FIT.

B. Fairly Reflect.

Taxpayer objects on the ground that the proposed multi-million dollar assessment is unwarranted because the amount of tax is not "fairly related to the services provided by the state." Taxpayer points out that the assessment is substantially related to the inclusion of the two banks and that the two banks "receive virtually no services for the amount of tax they are paying." Without saying as much, presumably taxpayer asks that the amount of the assessment be modified to reflect Indiana's contribution to its ability to conduct business within the state.

The Department notes that all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer bases its substantive objection on the Supreme Court's decision in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) when the Court held that a state tax for the privilege of doing business within that state would survive a Commerce Clause objection "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." Id. at 279 (Emphasis added).

Other than taxpayer's bare assertion that the amount of the assessment is disproportionate to the advantages gained from doing business within this state, taxpayer has failed to explain how or on what basis the assessment should be modified. Based on the income attributable to its Indiana customers, taxpayer apparently gains some advantage from doing business with those Indiana individuals. For example, taxpayer presumably has access to Indiana courts if it should need to enforce the terms of a disputed loan contract. Taxpayer has failed to meet its statutory burden under IC § 6-8.1-5-1(c) of demonstrating that the assessment is incorrect.

FINDING

Taxpayer's protest is respectfully denied.

II. Loan Portfolios – Financial Institutions Tax.

DISCUSSION

Taxpayer maintains that two of its affiliates are not subject to FIT because they do originate loans with Indiana customers. According to taxpayer, the affiliates merely hold loans "which may have been securitized."

As noted in Part I above, Indiana imposes a franchise tax, known as the FIT on corporations transacting the business of a financial institution inside the state. IC § 6-5.5 et seq.

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. A taxpayer, not filing a combined return, determines its FIT liability based on the taxpayer's adjusted gross income "multiplied by the quotient of... the taxpayer's total receipts attributable to transacting business in Indiana, as determined under IC 6-5.5-4; divided by... the taxpayer's total receipts attributable to transacting business in all taxing jurisdictions as determined under IC 6-5.5-4." IC § 6-5.5-2-3. In contrast, a taxpayer filing a

combined return determines its FIT liability based on its apportioned income consisting of the taxpayer's "(1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by... the quotient of... all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by... the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions." IC § 6-5.5-2-4.

Non-resident corporations, such as the taxpayer's affiliates, transacting the business of a financial institution, are subject to the FIT, when the non-resident corporation has established an economic presence in Indiana pursuant to IC § 6-5.5-3-1. As noted above, taxpayer has established an economic presence in Indiana.

The FIT definition of "transacting business" within this state includes the activities of a company which "regularly engages in transactions with customers in Indiana that involve intangible property, including loans... [that] result in receipts flowing to the taxpayer from within Indiana." IC § 6-5.5-3-1(6) (Emphasis added).

However, taxpayer states that the two affiliates "do not purposefully direct their activities toward the state." The Department must disagree with taxpayer's argument because the intent of the parties is not a factor in determining FIT liability. The assertion, that taxpayer's affiliates did not "purposefully" direct their business activities to potential Indiana customers, is irrelevant. The issue is whether the affiliates – having established an economic presence in this state – earned money from Indiana customers when the affiliates transacted the business of a financial institution in the state. See IC § 6-5.5-3-1(6).

Whether the affiliates originated the loans or merely "held" the loans is not determinative of the issue because, under IC § 6-5.5-3-1(6), the affiliates were transacting the business of a financial institution within this state and had receipts flowing to them from customers within Indiana. Because taxpayer has failed to meet its burden under IC § 6-8.1-5-1(c) of demonstrating that the affiliates earned money, interest, and fees from Indiana customers pursuant to their activities as financial institutions, the audit correctly imposed the assessment.

FINDING

Taxpayer's protest is respectfully denied.

III. Calculation Errors – Financial Institutions Tax.

DISCUSSION

Taxpayer states that the audit made certain calculation errors in preparing the proposed assessment and asks that those errors be corrected. As noted above, all tax assessments are presumed to be accurate, and the taxpayer bears the burden of p roving that any assessment is incorrect. IC § 6-8.1-5-1(c) (Emphasis added).

A. 2004 RAR Adjustment.

Taxpayer maintains that the audit failed to take into account a 2004 RAR bad debt adjustment and that the audit's calculation of the specific adjustment evidenced on page 12 of the workpapers was erroneous. Taxpayer asks that the proposed assessment be recalculated to account for a corrected adjustment and has forwarded a copy of its federal 2004 return for that purpose. The Audit Division is asked to review the original workpapers, taxpayer's written protest, the 2004 federal return, and to make whatever adjustments it deems appropriate.

B. 2004 Tax Payment.

Taxpayer states that the audit credited taxpayer for $342,283 of 2004 payments. However, taxpayer claims that its "actual tax payments were $356,037." Taxpayer states that it believes it requested a refund of $13,754 – the difference between the two disputed payment amounts – but that it "has not been able to ascertain whether this refund has been paid to [taxpayer]." A review of the Department's records verifies that the audit correctly credited taxpayer for the $342,283 payment. Taxpayer has failed to meet its burden of demonstrating that it made a payment of $356,037 or that it is necessarily entitled to a refund of $13,754. Nonetheless, the Audit Division is requested to conduct a supplementary review of taxpayer's records.

C. 2005 Tax Payment.

Taxpayer states that it made a payment of $1,188,500 for the 2005 tax year and that the audit failed to give it credit for that amount in calculating the amount of tax due. A review of taxpayer's records failed to locate the payment at issue and taxpayer has failed to provide specific information sufficient to meet its burden of demonstrating that the payment was indeed made. Nonetheless, the Audit Division is requested to conduct a supplemental review of taxpayer's records.

D. 2006 Charitable Contributions.

Taxpayer argues that the audit made three errors in adding back amounts of charitable contributions. Essentially, taxpayer states that the audit erroneously added back larger amounts of charitable contributions than warranted. Taxpayer has done nothing to conclusively demonstrate that the amount of contributions should be corrected. Nonetheless, the Audit Division is requested to conduct a supplemental review of taxpayer's records and its charitable contributions.

FINDING

The Audit Division is requested to review taxpayer's assertion that the audit report contained the errors cited above and to make whatever corrections it deems appropriate. Taxpayer's protest is sustained subject to that supplemental audit review.

IV. Ten-Percent Penalties.

DISCUSSION

Taxpayer argues that the imposition of penalties was improper because taxpayer acted reasonably in concluding that the federally chartered and state chartered banks were not required to be included in the combined FIT report.

A. Negligence Penalty.

Taxpayer concludes that the Department should waive the ten-percent negligence penalty because it had reasonable cause for deciding that it was not subject to FIT during 2004, 2005, and 2006.

IC § 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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...."

Taxpayer correctly points out that the issue of whether its affiliate members are subject to FIT has been the object of discussion with the Department in the past. However, the previous issues were settled by means of an amnesty settlement in which taxpayer paid a substantial – though not total – amount of the tax assessed. Although the Tax Court decision verifying that out-of-state entities conducting the business of a financial institution are subject to FIT based on the entities' mere "economic nexus" was issued in 2008, the Department has long held that view. The results contained within the current 2008 audit report did not represent a change in the Department's long-held stance on these issues and should not have caught taxpayer unawares.

The Department is unable to agree that failure to report any of the income received from Indiana customers constitutes the "reasonable care, caution, or diligence as would be expected from an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

The penalty assessed pursuant to IC § 6-8.1-10-2.1 shall not be abated.

B. Underpayment Penalty.

Taxpayer asks that the Department abate the ten-percent penalty which was allegedly assessed because taxpayer underpaid its estimated taxes. Taxpayer makes this argument because it believes it had adequate grounds for determining its 2004, 2005, and 2006 Indiana tax liability as it did.

IC § 6-5.5-6-3 requires taxpayers subject to the FIT to make an estimated tax payment. "Each taxpayer subject to taxation under this article shall report and pay quarterly an estimated tax equal to twenty-five percent (25 [percent]) of the taxpayer's total estimated tax liability imposed by this article for the taxable year." IC § 6-5.5-6-3(a). IC § 6-5.5-7-1(a) prescribes the penalty for failing to pay the correct amount of estimated tax. "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." IC § 6-8.1-10-2.1(b) sets the amount of penalty as ten percent.

Taxpayer was assessed a penalty because it underpaid its estimated taxes. Taxpayer does not challenge the manner in which the amount of penalty was calculated but repeats its substantive argument that the money, fees, and interest it received from Indiana customers was not subject to Indiana's FIT. In effect, taxpayer asks the Department to abate the underpayment penalty because taxpayer presented a colorable argument justifying its failure to report the income. Taxpayer asks the Department to exercise a discretionary authority it does not have. The Department has no authority to abate the underpayment penalty.

The penalty assessed pursuant to IC § 6-5.5-7-1(a) shall not be abated.

FINDING

Taxpayer's protest of the underpayment and negligence penalties is denied.

CONCLUSION

Taxpayer's argument that it does not have "substantial nexus" with Indiana is denied because it has established an economic presence in Indiana. Taxpayer's argument that two of its affiliates are not subject to FIT because they merely held loan portfolios is denied because the affiliates were conducting the business of a financial institution and earned income from Indiana customers. Taxpayer's argument – that the specific calculation errors should be corrected – is sustained subject to the results of a supplemental audit. Taxpayer's request for abatement of the "negligence" and "underpayment" penalties is denied.

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