DEPARTMENT OF STATE REVENUE

18-20080696REV.LOF
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Letter of Findings: 08-0696; 08-0697
Financial Institutions Tax
For the Years 2001, 2002, 2003, 2004

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ISSUES

I. Financial Institutions Tax – Disallowance of Deferred Dividend Income Recognition (CY 2001 & CY 2002).

Authority: IC§ 6-8.1-5-1; IC § 6-5.5-1-18; IC § 6-5.5-5-1; I.R.C. § 441; I.R.C. § 859; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E. 2d 289 (Ind. Tax Ct. 2007); Changes in Accounting Periods, 67 FR 35009-01.

Taxpayer protests the disallowance of deferred dividend income recognition.

II. Financial Institutions Tax – Disallowance of REIT's Dividend Paid Deduction (CY 2002, CY 2003, CY 2004).

Authority: IC§ 6-8.1-5-1; IC § 6-5.5-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E. 2d 289 (Ind. Tax Ct. 2007); Ind. S. 2009-LS7560, Reg. Sess., SB541 Fiscal Impact Statement (Jan. 13, 2009).

Taxpayer protests the disallowance of a REIT's dividend paid deduction for dividends paid to affiliated entities outside the Indiana combined filing.

III. Financial Institutions Tax – "Mathematical" Issues.

Authority: Documented agreement between Taxpayer and the Department.

Taxpayer protested a number of calculation issues.

IV. Tax Administration – Negligence Penalty.

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

Taxpayer protested the assessment of negligence penalty.

STATEMENT OF FACTS

Taxpayers, a bank holding company and its full service banking affiliates, were variously the lead filers for their unitary group for combined financial institutions tax ("FIT") reporting purposes in Indiana (which is why this Letter of Findings addresses protests under two docket numbers and will heretofore refer to "Taxpayer" singly). Taxpayer's combined filing as reported included a real estate investment trust ("REIT") that held interests in mortgages and mortgage-backed securities.

The Indiana Department of Revenue ("Department") conducted an FIT audit of Taxpayer for the years 2001 through 2004 and made several proposed adjustments and included interest and penalty. Taxpayer protested some of the adjustments and penalty. The issues Taxpayer protests fall into two categories: substantive legal issues and "mathematical" issues. A hearing was held and this Letter of Findings ensues.

Taxpayer was audited by the Internal Revenue Service ("IRS") for the years 2001 through 2003. Taxpayer filed amended Indiana returns with the Department to reflect those changes made by the IRS. The amended returns were processed by the Department and served as the starting point for any adjustments proposed by the Department's audit. Additional facts will be provided as necessary.

I. Financial Institutions Tax – Disallowance of Deferred Dividend Income Recognition CY 2001 & CY 2002.

DISCUSSION

The Department's audit disallowed the deferred recognition of dividend income received by one of Taxpayer's subsidiaries ("Deferred Holdings") from another subsidiary, a real estate investment trust ("REIT"). Taxpayer protested the disallowance of this deferred recognition stating that it followed federal law.

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

As a preliminary matter it should be noted that IC § 6-5.5-1-18 was amended for years beginning after December 31, 2001, to redefine members of a unitary group that are included in a combined return. Prior to 2002, all members of a unitary group were to be included in the combined return whether or not all of the members were doing business in Indiana. After December 31, 2001, only entities transacting business in Indiana were to be included in the combined Indiana return. Taxpayer's examination straddles both regimes.

On December 31, 2001, REIT issued dividends to Deferred Holdings. REIT took the dividend paid deduction in CY 2001. Deferred Holdings did not recognize the income until CY 2002. The reason Deferred Holdings recognized the income in 2002 is because it is on a "52-53-week year" that ended on December 26, 2001, therefore, the dividend paid deduction taken by REIT in CY 2001 included dividends paid to Deferred Holdings in the few days after Deferred Holdings' year end, but prior to December 31, 2001. This meant that the deduction was taken by REIT in CY 2001, but the income was reported by Deferred Holdings in CY 2002. Deferred Holdings is the majority owner of REIT. Deferred Holdings' only activity is to hold its interest in REIT.

The 52-53-week tax year is a unique type of tax year allowed under federal code (I.R.C. § 441), which, as the name suggests, varies in length from 52 to 53 weeks. The fiscal year-end also does not fall on the same date each year. Some companies choose to end their fiscal year on the same day of the week (for example, the Friday closest to the end of January). Companies that have weekday business hours may thus be able to take inventory and close the books over the weekend. Companies choosing this method report on what is known as a 52-53-week fiscal year-end since there will always be either 52 or 53 full weeks in each fiscal year. The 53 weeks will occur about once every seven years. The 52-53-week year is typically elected because there are clear business reasons for doing so and is most typically used in retail operations where tracking inventory consistently is an important consideration. According to the Department's audit, this delayed recognition of income described above did not fairly reflect Taxpayer's income because Deferred Holdings' employment of the 52-53-week year caused substantial deferral of income between members of the same return such that income of a passthrough entity and its owner were not reported in the same year. Therefore the income of the Indiana unitary group for CY 2001 did not fairly represent Taxpayer's income within Indiana. Furthermore, the Department's audit noted that Deferred Holdings, a company whose only activity was to hold its interest in REIT, had no business reason to choose a 52-53-week year. The only reason for Deferred Holdings to so choose, was to defer recognition of its income and manipulate the related tax consequences.

REITS are required to use calendar years for tax purposes. I.R.C. § 859. However, a corporation may use a 52-53-week tax year. I.R.C. § 441. The only limitation is that the tax years must end in the same month or by reference to the same month. For certain pass-through entities, federal "anti-abuse" provisions were put in place to prevent substantial deferral and distortion of income reporting. Basically, if a corporation and a pass-through entity have years that end in the same month (or by reference to the same month), income is reallocated to the reference month. Thus, in the case of the REIT, if it is considered a passthrough entity, Taxpayer would have been required to include the income in its 2001 return (REIT's year of payment) even though it was technically received in Deferred Holdings' 2002 year because the income was received in December. The policy behind this anti-abuse provision is precisely to prevent taxpayers from being able to manipulate income from year to year based on accounting technicalities. The federal regulations reflected the policy for most passthrough entities. However, when it came to REITs, taxpayers were able to set up the timing of REIT distributions to exploit the tax year differentials because until mid-2002 REITs were not technically considered to be passthrough entities under the federal regulations. In mid-2002, the regulations were changed to include certain REITs in the definition of "passthrough entity." The IRS announced these changes and stated the following in part:

> In an attempt to reduce the potential for deferral of estimated taxes in the case of certain owners of interests in closely-held REITs, the final regulations have been modified to add: (1) a closely-held REIT (within the meaning of section 6655(e)(5)(B)) to the definition of a pass-through entity, and (2) an owner of an interest (within the meaning of section 6655(e)(5)(A)) in a closely-held REIT to the definition of an owner of a passthrough entity. Thus, these owners of interests in these closely-held REIT with 52-53-week taxable years that reference December 31 will be required under the final regulations to recognize income from the closely-held REIT as if their taxable year ends on December 31.
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> Changes in Accounting Periods, 67 FR 35009-01.

Indeed, Taxpayer argues that it followed federal law and that the Internal Revenue Service ("IRS") audited Taxpayer and did not make any adjustments. However in discussions with Taxpayer subsequent to the hearing, the Department's auditor rightly pointed out that unlike the Indiana combined FIT return, a REIT files separately for purposes of federal consolidation purposes, such that what was apparent at the state level is not necessarily apparent at the federal level. The Department's auditor explained that for federal purposes the deferral had less of an impact than it did at the state level because Taxpayer's apportioned income (which remains 100 percent at the federal level) and tax group remained the same in 2001 and 2002. For Indiana purposes, however, the apportionment percentage changed from 7.54 percent for 2001 to 1.5019 percent for 2002. Also, due to the change in Indiana's FIT law mentioned above, Taxpayer's Indiana filing group totally changed in 2002.

The Department's audit cited to IC § 6-5.5-5-1(b) when it made its adjustment to reallocate the dividend income of Deferred Holdings from 2002 to 2001. IC § 6-5.5-5-1(b) states:

> 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.

The deferral of this income certainly had the effect of not fairly representing Taxpayer's Indiana income for both 2001 and 2002. This distortion is recognized (if for different reasons) by the federal anti-abuse measures that apply to REITs as of 2002. Going forward, Taxpayer, presumably, will not be able to defer Deferred Holdings' dividend income given the application of the federal measures to real estate investment trusts. However, a plain reading of the FIT "fairly represent" statue allows one of three things to happen: (1) a separate accounting, or (2) the filing of a separate return for the taxpayer, or (3) the reallocation of tax items between a taxpayer and a member of the taxpayer's unitary group. The statute does not present the option of reallocating a single entity's income from one year to the other in order to more fairly represent Taxpayer's Indiana income for each of the years in question.

FINDING

Taxpayer's protest is sustained.

II. Financial Institutions Tax – Disallowance of REIT's Dividend Paid Deduction (CY 2002, CY 2003, CY 2004).

DISCUSSION

The Department's audit made an adjustment to disallow the dividends paid deduction of REIT to affiliated controlled entities that were not included in the Indiana combined return such that Indiana income of the combined group would fairly reflect the combined group's income on their Indiana income tax returns. Taxpayer protested this adjustment arguing that Indiana FIT statutes, unlike the Indiana adjusted gross income statutes, do not provide for the "add-back" of dividends paid by a REIT.

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

The Department's audit discusses the nature of REITs generally:

> A REIT is a special purpose entity that would otherwise be taxed as domestic corporation if it were not for its REIT election. REITs are required to hold real estate investments, primarily in either mortgage pools through publicly backed mortgage securities or in income producing real property. REITS were established to allow small investors the ability to invest and reap the benefits of holding ownership in large scale or commercial real estate ventures through the vehicle of an equity investment. Based on its definition as an investment vehicle for small shareholders, a REIT is required to have one hundred beneficial owners. REITs cannot be closely held as that term is defined under the Internal Revenue Code for personal holding companies. Unlike a regular corporate entity REITs are required to distribute 90 percent of their annual taxable income to their shareholders. The allowance of the dividends paid deduction in determining taxable income and the required distribution of dividends to the shareholders results in the REIT being a pass-through entity, in that the tax liability for the income is passed through to the shareholders.

The Department's audit then proceeds to demonstrate that in Taxpayer's case, the REIT in question is majority owned by corporate members of Taxpayer's controlled group, and that public ownership is less than 10 percent. Within the controlled group's ownership, one entity ("Recipient") owns the majority of shares. The Audit also points out that public ownership was limited to C-preferred stock, whereas common stock and therefore voting power, were entirely owned within the controlled group. Recipient is a holding company with no other business activity other than holding its ownership interests. The Department's audit appears to question the REIT's status because of the closely-held nature of its ownership; however the audit's adjustments do not flow from any such determination.

More importantly, the Department's audit points out that while Recipient was in Taxpayer's Indiana FIT group in the years prior to 2002 so that the dividend income was represented on the Indiana return, when the law changed in 2002, Recipient fell outside the Indiana group because it was not itself doing business in Indiana and therefore removed that income from the Indiana FIT returns for those years. The REIT did business in Indiana, it had Indiana customers and owned Indiana assets, and yet "dividended" all its income out of Indiana thereby avoiding Indiana taxation. The audit concludes that Taxpayer's Indiana FIT returns for 2002, 2003, and 2004, do not, therefore, fairly represent its business income earned in Indiana. The audit relies on IC § 6-5.5-5-1(b)(3) to disallow the dividend paid deduction of the dividends paid to Recipient and the other affiliated entities outside the Indiana combined filing.

Taxpayer makes several arguments in support of its protest including the argument that Indiana's FIT statutes do not contain an "add back" of REIT dividends provision available in the Adjusted Gross Income statutes. And while this does not necessarily preclude an "add back" under a "fairly represent" theory, Taxpayer's argument that the Indiana legislature specifically considered such a provision under FIT, but rejected it, conditions the application of IC § 6-5.5-5-1(b). Taxpayer states that on January 15, 2009, legislation was introduced (SB 541) that would require certain REITs taxable under FIT to add back dividends and that on January 27, 2009, the Senate Committee on Tax and Fiscal Policy (SB 541-1) removed the proposed language from the legislation.

The Indiana legislature, as explained by the fiscal impact statement quoted below, was given the option of adding this "escaped" dividend income back to the REIT and it chose not to. The Fiscal Impact Statement states:

> Captive REIT Addback: The bill establishes the same captive real estate investment trusts (REIT) addback for purposes of the Financial Institutions Tax (FIT) that exists under current statute for purposes of the Corporate Adjusted Gross Income Tax. Under current statute, a captive REIT is a REIT that is owned or

controlled by (or captive of) a single corporation. Current statute requires a corporate taxpayer to add back amounts deducted from federal taxable income that represent dividends paid to the corporation by a captive REIT. The bill would require the same for a financial institution under the FIT. The amount of revenue that could potentially be captured due to the FIT add back is indeterminable and dependent on the number of financial institutions currently utilizing captive REITs to reduce taxable income.

A REIT is a corporation, trust or association that acts as an investment agent specializing in real estate and real estate mortgages. Under the Internal Revenue Code a REIT, unlike an ordinary corporation, is entitled to claim a deduction for dividends paid to shareholders against their ordinary income and net capital gains. A REIT must meet certain requirements as to ownership and organization, source of income, investment of assets, and distribution of income to shareholders. The financial institution captive REIT model could involve an Indiana financial institution that establishes a REIT to hold its mortgages or mortgage backed securities. Instead of the mortgage interest income accruing to the financial institution that pays FIT, the interest income accrues to the REIT. The REIT can avoid Corporate AGI tax by claiming the dividends paid deduction and would pass the income through to the shareholders of the REIT, which could be an affiliate of the financial institution in another state not subject to Indiana tax.

Ind. S. 2009-LS7560, Reg. Sess., SB541 Fiscal Impact Statement, at 4 (Jan. 13, 2009).

The income that is not subjected to Indiana FIT in this case, was removed from Indiana on the basis of a statutory change in 2002 that required entities on the Indiana return not only to be treated as unitary, but to each be doing the business of a financial institution in Indiana. In the case of REITs, the Indiana legislature has considered the "add back" of dividend income distributed by captive REITs to Indiana and declined to do so.

It should be noted that after the hearing and pursuant to discussions with Taxpayer, the Department's auditor noted that should this issue be decided in favor of Taxpayer, a review of Taxpayer's return is necessary to verify that Taxpayer did not eliminate intercompany receipts in its apportionment calculations.

FINDING

Taxpayer's protest is sustained, subject to verification by audit that Taxpayer did not eliminate intercompany receipts in its apportionment calculations.

III. Financial Institutions Tax – "Mathematical" Issues.

DISCUSSION

Subsequent to the hearing, Taxpayer and the Department's auditor worked together to address some of the "mathematical" issues stated in Taxpayer's protest.

A. Calculation of an adjustment of REIT's incorrectly reported income and dividend paid deduction.

In reporting federal taxable income on its Indiana FIT-20 for 2001, Taxpayer intended to include the consolidated taxable income of Taxpayer as reported on its federal form 1120 and the taxable income net of the dividends paid deduction as reported by REIT on form 1120-REIT. Taxpayer incorrectly reported REIT's income and dividend paid deduction on its Indiana combined unitary return. Initially, there was a dispute as to the calculation of the adjustment.

Taxpayer and the Department now agree that the adjustment should be $18,552,005.

B. Proposed intercompany eliminations.

Taxpayer now agrees to the audit's proposed intercompany eliminations.

C. Dollar amount of the adjustment predicated on the disallowance of dividend income deferral.

In addition to protesting this adjustment on the merits of the legal question (see Issue I), Taxpayer protests the dollar amount of the adjustment that results from the disallowance of deferred recognition of dividend income. Taxpayer states that in disallowing the deferred recognition, the Department's audit incorrectly double-counted a $93,491,057 dividend. Taxpayer argues that this dividend, which was declared and paid on December 20, 2001, was already included in Holding's 2001 dividend income.

This issue is moot given the resolution of Issue I in Taxpayer's favor.

FINDINGS

A. Taxpayer and the Department agree the calculation of the adjustment of REIT's reported income and dividend paid deduction is $18,552,005.

B. Taxpayer agrees to the Department's intercompany eliminations.

C. The protest that the Department's audit double-counted a $93,491,057 dividend is now moot given the resolution of Issue I in Taxpayer's favor.

IV. Tax Administration – Negligence Penalty.

DISCUSSION

The Taxpayer also protested 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.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

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.

Taxpayer has not affirmatively established that it had reasonable cause, as required by 45 IAC 15-11-2(c), to underreport its FIT on the issues remaining in this audit. Taxpayer's protested issues have been mostly sustained, thus the overall negligence penalty will be reduced accordingly.

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

Issue I: Taxpayer is sustained on its protest of the disallowance of deferred dividend income recognition for CY 2002 and the reallocation of income to CY 2001.

Issue II: Taxpayer is sustained on its protest of the disallowance of REIT's dividend paid deductions for dividends paid to affiliated entities outside the Indiana combined filing - subject to verification by audit that Taxpayer did not eliminate intercompany receipts in its apportionment calculations.

Issue III:

A. Taxpayer and the Department agree the calculation of an adjustment of REIT's reported income and dividend paid deduction is $18,552,005.

B. Taxpayer agrees to the Department's intercompany eliminations.

C. The protest that the Department's audit double-counted a $93,491,057 dividend is now moot given the resolution of Issue I in Taxpayer's favor.

Issue IV: Taxpayer is denied on its protest of the negligence penalty assessed on the remaining issues of the audit. Taxpayer's protested issues have been mostly sustained, thus the overall negligence penalty will be reduced accordingly.

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