DEPARTMENT OF STATE REVENUE

18-20120211.LOF

Letter of Findings: 18-20120211
Financial Institutions Tax
For the Years 2006, 2007, and 2008

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ISSUES

I. Combined Return – Financial Institutions Tax.

Authority: IC § 6-5.5-1-12; IC § 6-5.5-1-13; IC § 6-5.5-1-17; IC § 6-5.5-1-18; IC § 6-5.5-2-1; IC § 6-5.5-2-4; IC § 6-5.5-3-1; IC § 6-5.5-3-8; IC § 6-5.5-4-5; IC § 6-5.5-5-1; IC § 6-8.1-5-1; 45 IAC 17-2-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Caterpillar Financial Services Corp. v. Indiana Department of State Revenue, 849 N.E.2d 1235 (Ind. Tax Ct. 2005); Treas. Reg. § 301.7701-3; 12 Del.C. § 3801; Black's Law Dictionary (8th ed. 2004); Webster's II New Riverside University Dictionary (1st ed. 1988).

Taxpayer maintains that the Department's audit incorrectly determined that certain related entities should be included in Taxpayer's combined tax return.

II. Underpayment Penalty – Financial Institutions Tax.

Authority: IC § 6-5.5-6-3; IC § 6-5.5-7-1.

Taxpayer challenges the Department's imposition of a ten-percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of providing loans to customers throughout the United States. Taxpayer consists of a holding company and a number of subsidiaries. Taxpayer engages in securitization transactions as part of its lending financing strategy. Taxpayer completes on average 5 to 10 securitizations each year. In each securitization transaction, a subsidiary corporation of Taxpayer (Corp A) sells loans to a trust (hereafter referred to collectively as "Trusts"), which Taxpayer has elected to treat as a disregarded entity for tax purposes. The Trusts issue bonds backed by the loans. The Trusts acquire, own, and manage the loans/other assets within the trusts, issue and make payments on the notes, and conduct other related trust activities.

The depositor (Depositor) of the loans into each of the Trusts is a single member LLC of Corp A. Depositor acquires the loans from Corp A under a purchase agreement and sells them to each of the Trusts under a sales agreement. Under the trust agreement, each of the Trusts issues a "residual interest certificate" to Depositor. Under the purchase agreement, Depositor transfers the "residual interest certificate" to Corp A as part of the consideration for the sale of the loans that Corp A sells to Depositor. Corp A then transfers the "residual interest certificate" to one of two of Taxpayer's subsidiary corporations (Investment Corp and Services Corp). The Trusts, as stated above, are disregarded entities and, thus, Investment Corp and Services Corp are the filing entities for the trusts.

The Department of Revenue (Department) conducted an audit review of Taxpayer's business records and tax returns for the 2006, 2007, and 2008 tax years. The Department determined that Investment Corp and Services Corp were subject to Indiana Financial Institutions Tax (FIT) and included them in the combined return resulting in an assessment of additional FIT for the 2006 and 2007 tax years. The Department also assessed an estimate tax penalty for the 2007 tax year. Taxpayer protested. An administrative hearing was held, and this Letter of Findings results.

I. Combined Return – Financial Institutions Tax.

DISCUSSION

Taxpayer objects to the inclusion of two of its related entity subsidiaries, Investment Corp and Services Corp, in its combined returns.

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); 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 corporations with gross income derived from the activities associated with the "[m]aking, acquiring, selling, or servicing loans or extensions of credit." IC § 6-5.5-1-17(d)(2)(A). The provision goes on to say that, "For the purpose of this subdivision, loans and extension of credit include (i) secured or unsecured consumer loans." Id.

For FIT purposes, a "unitary group" must file a "combined return" that includes all the entities transacting the business of a financial institution in the "unitary business" and compute its adjusted gross income in accordance with IC § 6-5.5-2-4. IC § 6-5.5-5-1. However, IC § 6-5.5-1-18 provides that an entity is not part of the "unitary group" if the entity does not transact business in Indiana. Thus, the issue is whether Investment Corp and Services Corp are or are not conducting the business of a financial institution in Indiana.

Taxpayer disputes the audit's conclusion that Investment Corp and Services Corp were conducting the business of a financial institution in Indiana. Taxpayer argues that the activities of Investment Corp and Services Corp are not sufficient to establish that Investment Corp and Services Corp are transacting the business of a financial institution in Indiana. Taxpayer argues that what Investment Corp and Services Corp receive from the Trusts is not interest income and, therefore, they do not meet the eighty percent test. Taxpayer argues that Investment Corp and Services Corp receive receipts from the Trusts that are not interest income. Taxpayer contends that Investment Corp and Services Corp are simply the reporting entities of the Trusts and neither owned the loans nor serviced the loans themselves.

Taxpayer also argues that if the income received by Investment Corp and Services Corp is determined to be interest income, then Investment Corp and Services Corp would be conducting the business of a financial institution but not in Indiana. Taxpayer explains that due to the nature of the relationship between Investment Corp and Services Corp and the Trusts, what Investment Corp and Services Corp receive is income from the Trusts and not income directly from Indiana customers. Taxpayer argues that while the loan transactions result in receipts flowing from within Indiana, it is the Trusts and not Investment Corp and Services Corp that engage in the transactions and receive the Indiana loan receivables.

In other words, Taxpayer, in both arguments, is arguing that even though it elected to treat the Trusts as disregarded entities, these elected-reporting entities (Investment Corp and Services Corp) of the Trusts do not conduct the activities of the Trusts themselves and, therefore, cannot be included in a combined return. However, Taxpayer has cited to no legal authority for this principle. Instead, Taxpayer cites to Caterpillar Financial Services Corp. v. Indiana Department of State Revenue, 849 N.E.2d 1235 (Ind. Tax Ct. 2005) in support of its contention that Investment Corp and Services Corp do not qualify as entities subject to the financial institutions tax. Taxpayer cites to Caterpillar and argues the general proposition that the "Tax Court of Indiana held that 'gross income' as used in IC 6-5.5-1-17(d) was not equivalent to 'gross income' under the [internal revenue code]." Taxpayer further states, "Just as the rental income reported by the taxpayer in Caterpillar on its federal return did not dictate what was included in rental income for purposes of the flush language of IC 6-5.5-1-17(d)(2), the interest income that [Investment Corp or Services Corp] were required to report on their consolidated federal return does not dictate whether or not either entity is subject to FIT."

However, in Caterpillar, the court found that Caterpillar Financial Services was a financial institution because eighty percent of its income was derived from making loans and extending credit through a variety of financing arrangements to the customers of Caterpillar Financial Services. Id. at 1244. No one in Caterpillar disputed that what the taxpayer received were receipts from loans or extensions of credit that were included in the equation found in IC § 6-5.5-1-17(d); however, what was at issue was whether the amounts from these activities were included in the equation on a gross or net basis. Id. at 1240. Therefore, the Caterpillar case does not support the Taxpayer's contention that the Investment Corp and Services Corp, the elected reporting entities of the Trusts, were not subject to the financial institutions tax.

Taxpayer is making an argument based upon an "entity theory of taxation" that does not exist in Taxpayer's situation. Taxpayer did not elect for the Trusts to file as C Corporations and have a separate tax identity from Investment Corp and Services Corp. See Treas. Reg. § 301.7701-3(b)(ii). Instead, Taxpayer elected for the Trusts to be treated as disregarded entities; thus, Taxpayer elected for the activities of the Trusts to be the activities of Investment Corp and Services Corp. Id. If Taxpayer wished for the Trusts and the Investment Corp and Services Corp to have different tax treatment for the Trust activities, Taxpayer could have made a different election for the Trusts.

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 "interest income and other receipts from consumer loans" derived from customers both inside and outside Indiana is set out at IC § 6-5.5-4-5, as follows:

> Interest income and other receipts from consumer loans not secured by real or tangible personal property must be attributed to Indiana if the loan is made to a resident of Indiana, whether at a place of business, by a traveling loan officer, by mail, by telephone, or by other electronic means.

Based on the above, the Trusts, and therefore, Investment Corp and Services Corp, transacted the business of a financial institution in Indiana. The Trusts, and therefore, Investment Corp and Services Corp, held the loan receivables of Indiana customers. The Trusts, and therefore, Investment Corp and Services Corp, regularly billed Indiana customers for payments, interest, and fees on the loan receivables. The receipts from these billings are attributed to Indiana. IC § 6-5.5-4-5. Receipts therefore did flow to Taxpayer from within Indiana. Thus, the requirements of IC § 6-5.5-3-1(6) have been met.

Taxpayer further argued during the Department's audit that Investment Corp and Services Corp were 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 provides:

> 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:
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> ...
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> (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:
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> ...
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> (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 the Trusts, Investment Corp, and Services Corp. First, while Taxpayer has shown that Investment Corp and Services Corp did own the "residual interest certificates," Taxpayer has not shown how this meets the requirements of "owning... an interest in a loan backed security representing ownership or participation in a pool of promissory notes or certificates of interest." It appears Taxpayer is seeking the treatment for Investment Corp and Services Corp that would be given to a third party that had no other connection to Indiana or the notes other than being a note holder of a trust that holds a pool of promissory notes some of which may be from Indiana borrowers. However, regardless of whether Taxpayer's situation would meet the "ownership of interest in the [specific] loan backed security," this ownership of the interest was not the Trusts, Investment Corp, and Services Corp only activity in Indiana as required by the statute Taxpayer cites.

The Trusts issue the certificates to investors, collect payments on the receivables from Indiana customers, and make payments to the institutional investors. The Trusts actually purchased the receivables from Corp A in exchange for "residual interest certificates." Moreover, the Trusts initiate the process when they acquire the loans from Corp A in exchange for "residual interest certificates." In other words, the Trusts are a prime mover in the activities undertaken by the related parties that result in the securitization of the loans. This is evidenced, for example, by the fact that Investment Corp's and Services Corp's interests in the underlying loan receivables are subordinate to the interests of the note holders of the Trusts, the unrelated institutional investors.

Not only are Investment Corp and Services Corp the "residual interest" owners, but under Delaware statutes under which the trusts were formed, Investment Corp and Services Corp are the beneficial owners of the Trusts. See Del. Code Ann. tit. 12, § 3801(a) (2012). Moreover, Taxpayer elected that the Trusts be treated as disregarded entities from Investment Corp and Services Corp meaning the trust activities and the activities of Investment Corp and Services Corp are one in the same for tax purposes. Additionally, the representative Trust Agreement provided to the Department by Taxpayer provides that Investment Corp and Services Corp, as the "residual interest certificate" holders, have a degree of management power over the Trusts and direct the trustee of the Trusts when the trustee is "unable to determine the appropriate course of action between alternative courses of actions permitted or required by the terms of this Agreement." Based on these facts and circumstances, the activities of the Trusts, Investment Corp, and Services Corp exceed the activities contemplated in the statute Taxpayer cites.

During the protest, Taxpayer noted that IC § 6-5.5-3-8(5)(C) provides another "safe harbor" provision that would purportedly also apply to Taxpayer's situation:

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:

...

(C) An interest in a loan or other asset from which the interest is attributed in IC 6-5.5-4-4, IC 6-5.5-4-5, and IC 6-5.5-4-6 and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner.

(Emphasis added).

Taxpayer argues that "independent" does not mean "un-affiliated," and, thus, Taxpayer would meet the requirements of this provision.

The word "independent" is defined in Webster's II New Riverside University Dictionary 622 (1st ed. 1988) as:

1. Politically autonomous: self-governing. 2. Free from the influence, guidance, or control of another or others: self-reliant. 3. Not influenced or determined by someone or something else. 4. Associated with or loyal to no one political party or organization. 5. Not dependent on or affiliated with a larger or controlling group or system.

The Department refers to Black's Law Dictionary 785 (8th ed. 2004), which defines "independent" as:

1. Not subject to the control or influence of another. 2. Not associated with another (often larger) entity. 3. Not dependent or contingent on something else.

The Department also refers to Black's Law Dictionary 63 (8th ed. 2004), which defines "affiliate" in relation to corporations as:

A corporation that is related to another corporation by shareholdings or other means of control.

Thus, the Department agrees with Taxpayer that "independent" is not synonymous with "un-affiliated." However, the Department disagrees with Taxpayer as to how the terms are related and the effect of the statute. In fact, "independent" is a broader term than "un-affiliated" and would include any party that is an "affiliate" as well as other parties whether "affiliates" or not. Therefore, since Investment Corp and Services Corp are receiving interest income from transactions entered into by an affiliated entity, they do not meet the provision requiring that "the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner."

However, regardless of this fact, Investment Corp and Services Corp fall outside the "safe-harbor" provision set out in IC § 6-5.5-3-8(5)(C) because, as provided above, receiving interest from the securitized loans is not the Trusts only Indiana activity, and, therefore, not Investment Corp's and Services Corp's only Indiana activity. The Trusts, and, therefore, Investment Corp and Services Corp were an integral part of the securitization transactions.

Based on the foregoing and under IC § 6-8.1-5-1(c), Taxpayer has failed to meet its burden of demonstrating that the proposed assessment was incorrect. Investment Corp and Services Corp are conducting the business of a financial institution in Indiana because they receive income from Indiana customers attributable to loans originally entered into by a Taxpayer related entity. The activities of the Trusts, Investment Corp, and Services Corps fall squarely within the purview of the FIT. The Department's audit correctly included Investment Corp and Services Corp in the combined return.

FINDING

Taxpayer's protest to imposition of tax from the inclusion of Services Corp and Investment Corp in the combined return is respectfully denied.

II. Underpayment Penalty – Financial Institutions Tax.

DISCUSSION

The Department concluded that Taxpayer underpaid its quarterly estimated income tax payments for the 2007 tax years and assessed a penalty.

Any "underpayment" penalty is based on IC § 6-5.5-6-3(a):

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. A taxpayer that uses a taxable year that ends on December 31 shall file the taxpayer's estimated quarterly financial institutions tax return and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year, without assessment or notice and demand from the department. If a taxpayer uses a taxable year that does not end on December 31, the due dates for filing the estimated quarterly financial institutions tax return and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year. The department shall prescribe the manner and furnish the forms for reporting and payment.

The penalty for underpayment of quarterly estimated income tax payments is based on IC § 6-5.5-7-1 as

follows:

(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.

Based upon the nature of the tax, the amount of tax involved, the issues raised by both Taxpayer and the audit, the Department is prepared to agree that the underpayment penalty should be abated.

FINDING

Taxpayer's protest to the imposition of the underpayment penalty is sustained.

SUMMARY

Taxpayer's protest to imposition of tax from the inclusion of Services Corp and Investment Corp in the combined return is respectfully denied. However, Taxpayer's protests to the imposition of the negligence penalties and underpayment penalty are sustained.

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