DEPARTMENT OF STATE REVENUE

18-20170812.SLOF

Supplemental Letter of Findings: 18-20170812
Financial Institutions Tax
For Tax Years 2010-14

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Funding Company did not provide sufficient documentation to show that it was not a financial institution. Therefore, the Department correctly assessed Financial Institution Tax.

ISSUE

I. Financial Institutions Tax–Assessment.

Authority: IC § 6-5.5-1-17; IC § 6-8.1-5-1; *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *MBNA America Bank, N.A. v. Indiana Dep't of Revenue*, 895 N.E.2d 140 (Ind. Tax 2008); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Fresenius USA Marketing, Inc. v. Indiana Dep't of State Revenue*, 56 N.E.3d 734 (Ind. Tax Ct. 2016); *Mason Metals Company, Inc. v. Ind. Dep't of State Revenue*, 590 N.E.2d 672 (Ind. Tax Ct. 1992); 45 IAC 17-2-4; Black's Law Dictionary (9th ed. 2009); Letter of Findings 18-20130319 (February 2014).

Taxpayer protests the assessment of financial institutions tax.

STATEMENT OF FACTS

Taxpayer is a business incorporated outside Indiana. Taxpayer was filing in Indiana as a financial institution. Taxpayer determined that it was incorrectly filing as a financial institution and requested a refund for tax periods ending May 29, 2011, through May 26, 2013. The Indiana Department of Revenue ("Department") determined that Taxpayer was properly filing as a financial institution. The Department denied Taxpayer's refund request and further determined that it owed Financial Institutions Tax ("FIT") for the tax year 2014. The Department therefore issued a proposed assessment of FIT for 2014. Taxpayer protested the imposition of FIT for 2014, stating that it is not subject to FIT, does not have nexus with Indiana, and has never conducted the business of a financial institution in Indiana. Letter of Findings 18-20160506 ("LOF") was issued denying Taxpayer's protest but sustaining Taxpayer's protest of penalty. Taxpayer requested a rehearing, which was granted. An administrative rehearing was held and this Supplemental Letter of Findings results. A corresponding Supplemental Final Order Denying Refund 18-20170811R is issued separately. Further facts will be supplied as necessary.

I. Financial Institutions Tax–Assessment.

DISCUSSION

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing. . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

Taxpayer protests the Department's assessment of FIT. Taxpayer, a funding company, provides its related affiliates ("Affiliate") with receivables factoring services. Affiliate sells goods to customers, including Indiana customers, creating an accounts receivables account. Taxpayer then buys the accounts receivables from Affiliate at a discount. Taxpayer then collects upon the accounts receivables from customers.

Taxpayer originally filed as a financial institution for 2010-2014. Taxpayer then filed amended returns seeking a refund of FIT for tax years 2010-2013 and has elected to be treated as a C-corporation for income tax purposes. Taxpayer is included in its parent's consolidated federal return. The Department determined that Taxpayer's factoring agreements are the economic equivalent of short term loans by Taxpayer to its affiliates. The Indiana FIT statute states that a taxpayer will be taxed as a Financial Institution if over 80 percent of their income is either "loans arising in factoring [or] any other transaction with a comparable economic effect." IC § 6-5.5-1-17(d)(2)(A)(vii-viii).

The LOF determined that Taxpayer had properly filed its original returns as a financial institution and the Department's subsequent assessment was correct. On rehearing, Taxpayer argues that it is not subject to FIT because accounts receivables are not loans, Taxpayer does not meet the 80 percent rule for corporations operating as a financial institution, and there is no nexus between Taxpayer and Indiana. This decision will first determine whether the protested transactions meet the activity statutorily determined to be the activity of a financial institution. Next this decision will determine whether Taxpayer meets the 80 percent threshold for financial institutions. Finally, the Department will determine whether Taxpayer has nexus to Indiana for FIT purposes.

A) Whether the transaction activity meets the statutorily defined activity of a business operating as a financial institution.

Indiana defines taxpayers conducting activity of a financial institution under, IC § 6-5.5-1-17, which states:

(a) "Taxpayer" means a corporation that is transacting the business of a financial institution in Indiana, 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.
. . .

(d) For purposes of this section and when used in this article, "business of a financial institution" means the following:
(1) For a holding company, a regulated financial corporation, or a subsidiary of either, the activities that each is authorized to perform under federal or state law, including the activities authorized by regulation or order of the Federal Reserve Board for such a subsidiary under Section 4(c)(8) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(8)), as in effect on December 31, 1990.
(2) For any other corporation described in subsection (a)(4), all of the corporation's business activities if eighty percent (80[percent]) or more of the corporation's gross income, excluding extraordinary income, is derived from one (1) or more of the following activities:
(A) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include:
(i) secured or unsecured consumer loans;
(ii) installment obligations;
(iii) mortgage or other secured loans on real estate or tangible personal property;
(iv) credit card loans;
(v) secured and unsecured commercial loans of any type;
(vi) letters of credit and acceptance of drafts;
(vii) loans arising in factoring; and
(viii) any other transactions with a comparable economic effect.
(B) Leasing or acting as an agent, broker, or advisor in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes.
(C) Operating a credit card, debit card, charge card, or similar business.
As used in this subdivision, "gross income" includes income from interest, fees, penalties, a market discount

or other type of discount, rental income, the gain on a sale of intangible or other property evidencing a loan or extension of credit, and dividends or other income received as a means of furthering the activities set out in this subdivision.

45 IAC 17-2-4 states:

(a) The tax is also imposed upon any corporation if the corporation is organized under the laws of the United States, this state, another taxing jurisdiction, or a foreign government and the corporation is carrying on the business of a financial institution within Indiana.
(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.)*
(2) Leasing that is the economic equivalent of extending credit.
(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.
(5) Rental income.
(6) The gain on a sale of intangible or other property evidencing a loan or extension of credit.
(7) Dividends or other income received as a means of furthering any of the three (3) activities listed in subsection (b).
(d) Extraordinary income is excluded from gross income for purposes of satisfying the eighty percent (80 [percent]) test. Extraordinary income includes income which is unusual, infrequent, nonrecurring, and unrelated to the extension of credit.
(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, leasing that is the economic equivalent of the extension of 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; installment obligations; mortgage or other secured loans on real estate or tangible personal property; credit card loans; secured and unsecured commercial loans of any type; letters of credit and acceptance of drafts; loans arising in factoring; and any other transactions with a comparable economic effect. The following are examples of extending credit:
(A) A corporation is a manufacturer of widgets. In 19x9, the corporation received one million dollars ($1,000,000) in gross income from the sale of widgets. In selling such widgets, the corporation makes available an installment obligation plan whereby its customers buy widgets over an extended period of time. In 19x9, the corporation received one hundred thousand dollars ($100,000) in interest and fees from such installment obligations. Because only ten percent (10 [percent]) of the corporation's total receipts from all sources is derived from extending credit, the corporation is not considered a taxpayer for purposes of the FIT.
(B) Corporation A is primarily engaged in the business of a collection agency. Various other corporations enter into contracts with Corporation A for purposes of having delinquent loan monies collected. Corporation A does not originate or acquire the loans. Corporation A receives income from the various corporations based upon the percentage of payments collected. Corporation A is not a taxpayer for purposes of the FIT. Although one hundred percent (100 [percent]) of Corporation A's income is from servicing loans, Corporation A is not extending credit.
(2) Leasing or acting as an agent, broker, or advisor, in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes. If the lease is the economic equivalent of the extension of credit, and the lease is not treated as a lease for federal income tax purposes, the income derived from the lease is included in gross income for purposes of satisfying the eighty percent (80 [percent]) test whether the corporation is leasing its own real or personal property or is the lessor of real or personal property owned by another.
(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.
(*Emphasis added.*)

The Department's audit report determined that Taxpayer was a financial institution acquiring and servicing accounts receivables, and the accounts receivables at issue were "loans arising in factoring." The statute does not define "loans arising in factoring" therefore the Department looks to the plain meaning of the phrase within the statute. Of relevance here, "Loan" is defined in Black's Law Dictionary 1019 (9th ed. 2009) ("Black's") as: "1. An act of lending; a grant of something for temporary use. 2. A thing lent for the borrower's temporary use; esp., a sum of money lent at interest." Next, "Factoring" is defined as: "The buying of accounts receivable at a discount." *Id*. at 671. In addition, Blacks defines "arise" as, "to originate; to stem from." *Id*. at 122. Finally, "in" is defined as "under or based on the law of." *Id*. at 827.

In this case, Taxpayer is not lending money to enable the factoring of receivables nor is it borrowing from an Indiana source to purchase the receivables, therefore Taxpayer does not meet the definition of "loans arising in factoring."

Taxpayer also protests that its activities do not meet the definitions of qualifying activities listed in IC § 6-5.5-1-17. Specifically, Taxpayer argues that it does not meet the requirements of FIT because the accounts receivables do not have the economic equivalence of loans; the originating receivables do not have the economic equivalence of an extension of credit for some customers; and in this case indebtedness does not mean loan as defined in the statute.

1) Accounts Receivables have the comparable economic effect as loans.

Taxpayer cites to a previous decision issued by the Department, Letter of Findings 18-20130319 (February 2014), 20140430 Ind. Reg. 045140129NRA ("LOF2") to support its position that accounts receivables are not loans. LOF2 defines receivables and loans and determined that by definition these two activities were not the same. LOF2 also determined that taxpayer was not subject to FIT because it did not factor loans and determined that by definition the receivables at issue in that instance were not loans. In addition LOF2 looked to the function of the transactions and determined that the protested transactions in that particular case did not function as loans and therefore that taxpayer was not subject to FIT.

Because Taxpayer and Affiliate have a factoring agreement in which "receivables" is defined, the Department will look to that agreed upon definition rather than Black's. Taxpayer's factoring agreement defines "receivables" as:

> The indebtedness and other obligations owed (at the time it arises, and before giving effect to any transfer or conveyance contemplated hereunder) to Originator [or Affiliate], whether constituting an account, chattel paper, instrument or general intangible, arising in connection with the provision of goods by Originator [or Affiliate] and includes, without limitation, the obligation to pay any finance charges with respect thereto. Indebtedness and other rights and obligations arising from any one transaction, including, without limitation, indebtedness and other rights and obligations represented by an individual invoice, shall constitute a Receivable separate from a Receivable consisting of the indebtedness and other rights and obligations arising from any other transaction.

Since Taxpayer does not define "indebtedness," the Department looks again to Black's to flush out the plain meaning of the word. "Indebtedness" means "1. The condition or state of owing money 2. Something owed; a debt." 836.

The Indiana Tax Court has stated that the Department and taxpayers must look to the function of a transaction rather than the mere definition of it. In *Mason Metals Company, Inc. v. Ind. Dep't of State Revenue*, 590 N.E.2d 672 (Ind. Tax Ct. 1992), where it provided:

> Although the language of Mason's lease agreements purports to give Mason the right to direct the manner of the tractor's use, the evidence shows Mason actually had no such right. The tractor's drivers were employees of American, and American directed the drivers' actions. Mason also had no control over the routes taken by the drivers in getting to their destinations. Moreover, the tractor was not used exclusively to haul Mason's products. Accordingly, Mason did not have the possession and control of the tractor, under either the Indianapolis Transit test or under 45 I.A.C. 2.2-4-27(d)(3), necessary to characterize its transactions as a leasing of property subject to sales and use tax. Id at 676.

In this case, the Department looks to the function of the transactions between Taxpayer and Affiliates in order to determine the FIT implications of those transactions. In regards to the function of the transactions, Taxpayer discusses that the accounts receivables are collected from customers in one payment by due date or within ten days after the due date, and in some cases Taxpayer has the ability to collect interest on late payments. Taxpayer distinguishes accounts receivables from loans in that loans are paid over a longer term period and in multiple payments.

By Taxpayer's own definition of "receivables," the underlying transaction is the act of owing money. As a matter of functionality, IC § 6-5.5-1-17 does not limit the action to what is listed but rather encompasses actions that have a "comparable economic effect" to loans, installment obligations, secured or unsecured consumer or commercial loans, etc. All the actions listed in the statute have the economic effect of owing and lending money. The economic effect of loaning money is the same as the accounts receivables in this case. The originating transaction begins when a customer creates an accounts receivable with Affiliate. The accounts receivable are entered on Affiliate's balance sheet as an asset which it will credit when cash is debited after customer pays down the receivable. Thus, the Department determines that the accounts receivables in this case have the same economic effect of loans resulting in Taxpayer being subject to FIT.

In addition, Taxpayer states that under the definition of account receivable and loan as cited in LOF2 those definitions must be applied consistently to all taxpayers according to *Fresenius USA Marketing, Inc. v. Indiana Dep't of Revenue*, 56 N.E. 3d 734 (Ind. Tax 2016). Thus, Taxpayer believes this supports their position that these transactions are not loans and therefore Taxpayer is not subject to FIT. While the Department may be bound by a previous decision's definition, Taxpayer itself contractually presented different defined factors, as noted above. Therefore the definitions relied on in LOF2 are not applicable in this case.

2) Extension of Credit.

The LOF stated that "A letter [between customer and Affiliate] even states that affiliate would like to 'extend more generous credit terms.' The letter is clearly extension of credit signed by the affiliate and the customer." Taxpayer, in its rehearing request, explained these are not extensions of credit in the "traditional sense." Taxpayer described the credit limit was for the purchase of goods, meaning the customer cannot get more product than the "limit" until either the invoice is paid or customer makes some cash payments. Taxpayer referred to this as a volume agreement. Taxpayer goes on to state:

> First, the term "line of credit" in the referenced letters is not the same as "extensions of credit", "letters of credit" or "acceptance drafts" as referenced in the statute that would be issued by banks or lending institutions - under which cash advances can and would be made. Neither are these [produce] customer lines of credit like "cash advance checks" that credit card companies use to extend credit to customers for cash purchases or other balance transfer payments. Rather the lines of credit in the referenced [produce] customer letters are offers or agreements to allow credit limits only for the purchase of [produce] on account.
>
> . . .
>
> Moreover, the [produce] customer line of credit does not enable transacting of business in anything other than the purchase of [produce] *from the affiliate* on account. It is not reasonable to conclude that the line of credit was sold to [Taxpayer] - because [Taxpayer] does not have and cannot sell [produce] to the customer under the line of credit, and because the [produce] customer of affiliate cannot borrow against the line of credit in any manner other than by purchasing [produce] *from the affiliate*. The line of credit is an agreement between the [] customer and the affiliate. That agreement was not sold to [Taxpayer].

Emphasis original.

According to Black's, credit means:

> . . .
> 3. The time that the seller gives the buyer to make the payment that is due. 4. The availability of funds either from a financial institution or under a letter of credit. <the bank extended line of credit to the customer.> at. 424.

Under this definition, it seems that, on its face, "extensions of credit" and "letters of credit" are synonymous. However, as stated above the Department must look to the function of the transactions to determine if the underlying transactions meet the criteria of FIT. Here, Affiliate puts a limit on which a customer can draw upon something of value, in this case the item of value is produce rather than cash. Therefore, the activity takes on the form of a "line of credit" in the "traditional sense." Based on the letter of agreement, Affiliate gives customers an extension to which it can draw upon something of value, in this case produce. Customers then must eventually pay the amount due to Affiliate. Taxpayer then purchases these agreements from Affiliate. Thus, Taxpayer is acquiring and servicing extensions of credit from Affiliate. Furthermore, Taxpayer cannot rely on LOF2 because in that case there was no evidence that, LOF2 taxpayer was issuing or purchasing extensions of credit; as stated above, Taxpayer in this case is acquiring and servicing extensions of credit and is the economic equivalent of loans. Thus, Taxpayer's activity falls under IC § 6-5.5-1-17 making Taxpayer subject to FIT.

3) Indebtedness does not equal loans under the statute.

Taxpayer states there was no discussion in the previous decision regarding a distinction between the definition of "indebtedness" as in factoring agreements and the definition of "loans" as used in the statute. Taxpayer argues that a loan is a subset of indebtedness i.e. all loans are evidence of indebtedness but not all evidence of indebtedness are loans. Taxpayer requests the Department address this protest. As stated above in subsection A)1), the Department determines that the accounts receivables in this case have the same economic effect of loans, thus, the accounts receivable in the instant case fall under the definitions in IC § 6-5.5-1-17.

B) Whether Taxpayer meets the 80 percent criteria for FIT.

Taxpayer argues that even if the accounts receivables are considered to be "loans" for purposes of FIT, its income does not meet or exceed the required 80 percent threshold. IC § 6-5.5-1-17(d)(2) states that a corporation's activities are subject to FIT if 80 percent of the corporation's gross income is derived from one of the listed activities. Taxpayer states:

> [T]he factoring discounts that result from the factoring agreements comprise two separate components or activities: 1) a service and bad debt component for collecting and applying accounts receivables (equal to approximately 58.3[percent] of the factoring discount), and 2) an interest component for the time value of money (equal to approximately 41.7[percent] of the factoring discount).
>
> . . .
>
> Therefore, upon bifurcating the factoring discount based on these two separate activities, only the interest component of the factoring discount [] would comprise the economic equivalent of short-term loans from [Taxpayer] to its affiliates. The other 58.3[percent] component represents a fee for services performed.
>
> Moreover, IC § 6-5.5-1-17(d) clearly defines "carrying on the business of a financial institution" for Indiana purposes as resulting when "eighty percent *(80[percent]) or more* of the corporation's gross income . . . is derived from. . . [m]aking, acquiring, selling, or servicing *loans* or *extensions of credit*" []. Since only the 41.7[percent] interest component of the factoring discount can be considered the economic equivalent of making a short-term loan, only 41.7[percent] of [Taxpayer's] factoring discount income earned can be considered income from making or servicing loans or extensions of credit, and the 80[percent] test under the statute cannot be satisfied.

Emphasis original.

Taxpayer however, is mistaken. IC § 6-5.5-1-17(d)(2)(A) states that a corporation's business activity is subject to FIT if 80 percent or more of its gross income includes "the making acquiring, selling, *or* servicing loans or extensions of credit." *Emphasis added*. Thus, because the discount includes servicing the loan Taxpayer clearly meets the statute's 80 percent requirement. Taxpayer is properly determined to be subject to FIT.

C) Whether Taxpayer has nexus with Indiana, subjecting it to Indiana FIT.

Taxpayer next argues that it does not have nexus with Indiana. The actual economic effect of the factoring transaction is Taxpayer purchasing receivables from affiliate at a discount in which both Taxpayer and affiliate are located outside Indiana.

IC § 6-5.5-4-6 states:

> Interest income and other receipts from commercial loans and installment obligations not secured by real or

> tangible personal property must be attributed to Indiana if the proceeds of the loan are to be applied in Indiana. If it cannot be determined where the funds are to be applied, the income and receipts are attributed to the state in which the business applied for the loan. As used in this section, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first.

Furthermore, the Indiana Tax Court concluded in *MBNA America Bank, N.A. v. Indiana Dep't of Revenue* ("*MBNA*"), that "economic presence is sufficient to establish the substantial nexus requirement. . . [in addition] MBNA's confidential FIT returns reported significant gross receipts attributable to its Indiana customers." 895 N.E.2d 140, 144 (Ind. Tax 2008). Thus, during the years at issue, MBNA had a substantial "nexus with Indiana for purposes of the FIT." *Id*.

In this case, the originating account receivables meet the economic equivalent of a loan and the receipts are sourced to where the "loan" originated. In this case, the origination point is in Indiana. Taxpayer is purchasing account receivables that have Indiana customers as a party, and Taxpayer is collecting payments from Indiana customers. Therefore based on IC § 6-5.5-4-6 and *MBNA*, Taxpayer has sufficient economic nexus to subject it to Indiana FIT.

As stated in **A)**, Taxpayer's accounts receivables are considered to have the comparable economic equivalence of "loans" for FIT purposes. As stated in **B)**, Taxpayer does meet the 80 percent threshold required by IC § 6-5.5-1-17. Finally, as stated in **C)**, Taxpayer has nexus in Indiana requiring it to file in Indiana. Based on the above discussion Taxpayer has not met its burden under IC § 6-8.1-5-1(c). Consequently Taxpayer is subject to FIT as outlined in IC § 6-5.5-1-17. This case is particularly fact sensitive thus the position relayed within this document pertains only to this case and its specific set of facts.

FINDING

Taxpayer's protest is denied.

July 25, 2018.

Posted: 11/28/2018 by Legislative Services Agency
An html version of this document.