**DEPARTMENT OF STATE REVENUE**

18-20181837R.MOD

**Memorandum of Decision: 18-20181837R**
**Financial Institutions Tax**
**For the Year 2009**

**NOTICE:** IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Memorandum of Decision.

## HOLDING

Credit Card Company was entitled to include proceeds from a settlement agreement with one of its competitors in the denominator of its Financial Institutions Tax apportionment factor but was required to include the proceeds in the numerator as well.

## ISSUE

**I. Financial Institutions Tax - Settlement Proceeds.**

**Authority:** IC § 6-5.5-1-17(d)(2); IC § 6-2.5-2-1(a); IC § 6-5.5-2-4; IC § 6-5.5 et seq.; IC § 6-5.5-3-1; 45 IAC 17-2-1(a).

Taxpayer argues that it is entitled to a refund of 2009 Financial Institutions Tax on the ground that it was justified in including in the denominator of its apportionment factor, money received as a result of a settlement agreement with a competitor company.

## STATEMENT OF FACTS

Taxpayer is a bank holding company which provides its customers credit card and other financial services. Taxpayer and its affiliates file combined Indiana Financial Institution Tax ("FIT") returns. Taxpayer filed an amended 2009 FIT return reporting income it received pursuant to a settlement with a competitor. The amended return sought a refund of approximately $800,000.

The Indiana Department of Revenue ("Department") reviewed the return, disagreed with Taxpayer's analysis, its calculation, and denied the refund. The Department found that the settlement money should not have been included in the FIT apportionment denominator on the ground that the settlement proceeds did not consist of "receipts from transacting business" but that these the proceeds were properly categorized as "other income."

The Department agreed with Taxpayer that the proceeds should not have been included in the FIT *numerator* on the ground that Taxpayer is headquartered at an out-of-state location.

Taxpayer disagreed with the Department's decision and submitted a protest to that effect.

An administrative hearing was conducted by telephone during which Taxpayer's representatives explained the basis for the protest. This Memorandum of Decision results.

**I. Financial Institutions Tax - Settlement Proceeds.**

## DISCUSSION

The issue is whether Taxpayer has established that it is entitled to a refund of 2009 FIT based on including - in the denominator of its FIT apportionment factor - money received in 2009 as the result of a settlement agreement.

Indiana imposes a franchise tax, known as the Financial Institutions Tax (FIT), on corporations transacting the business of a financial institution within the state. IC § 6-5.5 et seq. The tax is imposed on resident financial institutions, nonresident financial institutions, and non-bank entities that transact the business of a financial institution. 45 IAC 17-2-1(a). Non-resident corporations, such as Taxpayer, transacting the business of a financial institution, are required to report and pay the FIT, when they meet one of the eight tests listed in IC § 6-5.5-3-1 whereby the non-resident corporation demonstrates that it has established an economic presence in Indiana.

IC § 6-2.5-2-1(a) (*applicable to the tax year at issue*) provides the jumping off point in calculation of an entity's FIT. The statute provides:

> There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of *transacting the business of a financial institution in Indiana*. The amount of the tax for a taxable year shall be determined by multiplying eight and one-half percent (8.5[percent]) times the remainder of:
> (1) the taxpayer's apportioned income; minus
> (2) the taxpayer's deductible Indiana net operating losses as determined under this section; minus
> (3) the taxpayer's net capital losses minus the taxpayer's net capital gains computed under the Internal Revenue Code for each taxable year or part of a taxable year beginning after December 31, 1989, multiplied by the apportionment percentage applicable to the taxpayer under IC 6-5.5-2 for the taxable year of the loss.

(*Emphasis added*).

IC § 6-5.5-2-4 provides the apportionment formula for determining the taxable income of each taxpayer filing a combined return for a unitary group.

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

(*Emphasis added*).

IC § 6-5.5-1-17(d)(2) defines "business of a financial institution" for entities such as Taxpayer which is not a "regulated financial corporation" such as a traditional bank or credit union.

> 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.

Taxpayer disagrees with the Department's conclusion that the settlement income did not constitute "receipts from transacting business" and should not be included in the receipts factor.

Taxpayer explains that the settlement proceeds resulted from Taxpayer's efforts to recover income it was denied because the anticompetitive practices of its competitor. As Taxpayer explains:

> The amount of the settlement agreement was not determined capriciously. It was based on the [T]axpayer's lost business opportunities and the settlement agreement was inextricably linked to both [T]axpayer's business activities and business assets. The [agreement's] punitive damages are intended to compensate for the profit [Taxpayer] could have made on the income (compensatory damages).

Taxpayer further explains:

> [T]o stay in business, taxpayers must engage in lawsuits when its rights have been violated and the ability to produce income has been hampered by unfair competition. To conclude this [income] is outside of a business' activity is to ignore the reality of doing business where the business must insure its continuation and ongoing income stream.

(Emphasis in original).

In the normal course of its credit card business, Taxpayer states that it routinely "charges interest on outstanding credit card balances (compensatory damages)" and "if the credit is not paid timely [Taxpayer] also charges a late fee (punitive damages)." In other words, Taxpayer routinely receives both compensatory and punitive damages in the normal course of business and that the settlement amount consists of identical forms of damages.

Taxpayer further challenges the Department's original argument that - in order for settlement income to derive from "transacting business" - the "income must constitute a receipt for goods or services . . . ." Taxpayer states:

> To require that [settlement] income meet[] this definition would exclude any extraneous income earned by a business such as dividends, penalties received from credit card holders, interest income from investments and gains on currencies.

Taxpayer's settlement was based on the direct economic impact of the anti-competitive practices of its credit card competitor and the "extent to which those rules, policies, and practices harmed [Taxpayer]." The settlement amount calculation is documented in a 116 page economic analysis which quantified the effect the anti-competitive practices had on the different streams of income attributable to Taxpayer's credit card business including lost customers, lost interest income, lost merchant fees, and lost interchange fees. The report is detailed, comprehensive, and is based on a "but-for" analysis of the Taxpayer's and its competitor's business model. The report's financial conclusions are based on the assumption that "but-for" the anti-competitive practices of its competitor, what was the amount of lost income and lost profits which were sustained by Taxpayer. As explained in the report's analysis, its examination and its conclusions "focus on estimating the additional profits [Taxpayer] would have enjoyed had the [anti-competitive] rules not existed and the parties been able to enter into a joint venture [business] agreement in the but-for-world."

The settlement proceeds do not constitute an undifferentiated windfall and, although unlikely to recur, were measurably related to Taxpayer's routine operating activities. Instead of a lump-sum bonanza, the proceeds are predicated upon and measured by Taxpayer's credit card business. As such, the proceeds constitute income from transacting the business of a financial institution; had Taxpayer not been conducting its credit card business, it would have received nothing.

The settlement proceeds fall within IC § 6-5.5-1-17(d)(2) definition of "business of a financial institution" and have a "comparable economic effect" to the day-to-day business of operating a credit card company and can be included in the denominator of Taxpayer's apportionment factor because the proceeds were measured by "transacting business in all taxing jurisdictions." IC § 6-5.5-2-4(2)(B). However, the Department rejects the argument that the proceeds should not have also been included in the numerator. Although Taxpayer's home office may be outside the state, Taxpayer's own analysis reinforces the argument that the settlement proceeds also represent a quantifiable amount of lost Indiana business. Simply stated, Taxpayer cannot have it both ways; if the settlement proceeds represents lost business opportunities throughout the United States, those proceeds also represent lost Indiana business. It is not possible to conclude that the proceeds should have included in the denominator while simultaneously concluding that the proceeds are not "attributable to transacting business in Indiana." IC § 6-5.5-2-4(2)(A).

Based on an analysis for the plain words of the statute, a review of the original audit report, and a review the documentation Taxpayer provided in support of its protest, the Department concludes that the settlement proceeds represent apportionable income attributable to conducting the business of a financial institution both inside and outside Indiana.

**FINDING**

To the extent that Taxpayer argues that the settlement proceeds are attributable to conducting the business of a financial institution and subject to the Audit Division's recalculation of the financial impact of the decision set out in this Memorandum of Decision, Taxpayer's protest is sustained.

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