

Letter of Findings: 18-20170211
Taxation of Financial Institutions
For the Year 2015

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Financial Institutions failed to demonstrate that the payments they received pursuant to Shared-Loss Agreements were "notes, debentures, bonds, or other such obligations" issued by the Federal Deposit Insurance Corporation ("FDIC"); therefore, the FDIC Shared-Loss payments were not exempt from the Indiana Financial Institutions Tax ("FIT"), a nondiscriminatory franchise tax.

ISSUE

I. Financial Institution Tax - US Government Obligations - FDIC Loss-Sharing.

Authority: I.R.C. § 63; 12 U.S.C. § 1811 *et. seq.*; 12 U.S.C. § 1824; 12 U.S.C. § 1825; 31 U.S.C. § 3124; IC § 6-5.5-1-2; IC § 6-5.5-2-1; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Smith v. Davis*, 323 U.S. 111 (1944); *Gunter v. Hutcheson*, 674 F.2d 862 (11th Cir. 1982); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Miller Brewing Co. v. Indiana Dep't of State Revenue*, 903 N.E.2d 64 (Ind. 2009); *Scopolite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480 (Ind. Tax Ct. 2012); *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988); [45 IAC 17-2-5](#); Income Tax Information Bulletin 19 (January 2003); Income Tax Information Bulletin 19 (May 2012); Financial Institution Tax Booklet, 2015 Form FIT-20; The Federal Deposit Insurance Corporation, Managing the Crisis: The FDIC and RTC Experience.

Taxpayers protested the proposed assessment claiming that payments they received from the FDIC pursuant to Shared-Loss Agreements during 2015 were exempt from FIT.

STATEMENT OF FACTS

Taxpayers are affiliates that conduct the business of financial institutions. Taxpayers provide various financial products and services to consumers and businesses. Taxpayers file their Indiana tax returns, FIT-20 forms, on a combined basis.

In 2016, Taxpayers filed their 2015 Indiana return, Form FIT-20. Upon review, the Indiana Department of Revenue ("Department") made two (2) adjustments to Taxpayers' return which resulted in additional tax, penalty, and interest. The first adjustment was correction of an error made by the Department in adding back an additional amount to Taxpayers' income. The issue of that error was moot because the Department corrected the error.

The second adjustment was the Department's disallowance of one deduction Taxpayer claimed. In Line 12A of Schedule A to their FIT-20 return, Taxpayers deducted \$53,558,992 it received from the FDIC, stating that the "Payments From FDIC Obligations [were] Exempt Under Section 15(A) of the Federal Deposit Insurance Act" ("Income at Issue"). This adjustment resulted in a proposed assessment of approximately \$7,700, in addition to penalty and interest.

Taxpayers timely protested the Department's disallowance of the deduction regarding the FDIC payments. A phone conference was held during which Taxpayers asked that the Department make its determination based on the supporting documentation Taxpayers submitted. This Letter of Findings ensues. Additional facts will be provided as necessary.

DISCUSSION

I. Financial Institution Tax - US Government Obligations - FDIC Loss-Sharing.

The Department denied Taxpayers' claim, made on Line 12A of their 2015 FIT-20 return. Taxpayers argued that the payments they received from the FDIC pursuant to Shared-Loss Agreements (SLAs) were tax exempt under the FDIC "immunity statute" and were not subject to Indiana FIT.

Indiana mandates that every person who is subject to a listed Indiana tax must keep books and records, including all source documents, "so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a). "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." IC § 6-8.1-5-1(a). All tax assessments are *prima facie* evidence that the Department's claim for the unpaid tax is valid; 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 State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). "Each assessment and each tax year stands alone." *Miller Brewing Co. v. Indiana Dep't of State Revenue*, 903 N.E.2d 64, 69 (Ind. 2009). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Also, "all statutes are presumptively constitutional." *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014) (*citing UACC Midwest, Inc. v. Indiana Dep't of State Rev.* 629 N.E.2d 1295, 1299 (Ind. Tax Ct. 1994)). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

Indiana imposes a financial institution tax pursuant to IC § 6-5.5-2-1(a) (applicable for the tax year 2015) which states, as follows:

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

When a taxpayer is taxable under the FIT ([IC 6-5.5](#)), the taxpayer is not subject to certain taxes, such as the adjusted gross income tax under [IC 6-3](#). [45 IAC 17-2-5\(a\)](#).

Similar to the adjusted gross income tax scheme under [IC 6-3](#), to compute the income subject to Indiana FIT, Indiana adopts a multistep process to calculate the taxpayer's taxable income. IC § 6-5.5-1-2 (applicable for the tax year 2011) references I.R.C. § 63 in providing the starting point to determine a taxpayer's taxable income. Specifically, IC § 6-5.5-1-2(a) states that the term "'adjusted gross income' means taxable income as defined in Section 63 of the Internal Revenue Code" with certain adjustments. In other words, for FIT purposes, in determining the taxpayer's Indiana adjusted gross income, Indiana first refers to I.R.C. § 63 as the beginning point, with modifications thereafter. Modifications to a taxpayer's adjusted gross income are outlined in IC § 6-5.5-1-2(a). IC § 6-5.5-1-2(a)(1) provides that certain income is required to be added back to a taxpayer's adjusted gross income and IC § 6-5.5-1-2(a)(2) allows certain income to be subtracted from the taxpayer's adjusted gross income. For example, "Income that [the] United States Constitution or any statute of the United States prohibits from being used to measure the tax imposed by this chapter." IC § 6-5.5-1-2(a)(2)(A).

The Department's Financial Institution Tax Booklet, 2015 Form FIT-20 (available at <https://www.in.gov/dor/5414.htm>) (last visited December 21, 2017), in relevant part, explains, as follows:

United States Government Obligations

Although interest earned on U.S. obligations is not subject to income taxation, it is not preempted by federal law from being included in the tax base of a franchise tax. Therefore, interest from U.S. obligations is not to be subtracted from federal taxable income in determining the tax base of the franchise tax. (**Emphasis in original**).

"United States Government Obligations" include obligations issued by the organizations, including Federal Deposit Insurance Corporation, which are considered direct United States Government obligations. See the

Department's Income Tax Information Bulletin 19 (January 2003), 26 Ind. Reg. 2148; Income Tax Information Bulletin 19 (May 2012), 20120530 Ind. Reg. 045120249NRA; see also 31 U.S.C. § 3124(a)(1) (stating, in relevant part, that "obligations of the United States Government are exempt from taxation by a State **The exemption applies** to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, **except a nondiscriminatory franchise tax**) (**Emphasis added**).

In this instance, the Department determined that the payments made by the FDIC to Taxpayers were properly included in Taxpayers' FIT return pursuant to the above-mentioned statutes and regulations because the Indiana FIT is a nondiscriminatory franchise tax. As a result, the Department determined that Taxpayers was not allowed to deduct the \$53,558,992 in their FIT return.

Taxpayers claimed that the Department erroneously disallowed their deduction. Taxpayers asserted, in part, that:

For federal income tax purposes, all payments, whether denominated as interest or principal were included in federal taxable income pursuant to I.R.C. § 597 and Treas. Reg. § 1.597-2(d).

Nonetheless, federal banking law, specifically, 12 U.S.C. § 1825(a) (otherwise referred as Section 15 of the Federal Deposit Insurance Act of 1950) prohibits any state **from imposing income tax on either the principal or interest on obligations issued by the FDIC**

(Emphasis added).

Taxpayers seemingly argued that, for state income tax purposes, 12 U.S.C. § 1825(a) affords an exemption for income derived from "[a]ll notes, debentures, bonds or other such obligations issued" by the FDIC. The Department indeed agrees that that income was exempt from Indiana corporate income tax. 31 U.S.C. § 3124(a)(1); Income Tax Information Bulletin 19. Rather, the Department disallowed that income because that income was not exempt from Indiana's FIT, a nondiscriminatory franchise tax. Nonetheless, in this instance, Taxpayers filed their 2015 FIT-20 return, attempting to deduct the income in Line 12A, and thus, presumably, Taxpayers attempted to argue that the Income at Issue was exempt from FIT. Accordingly, this Letter of Findings proceeds to address that argument as follows:

The Congress in 1989 had an opportunity to clarify its intent and it added a new subsection "Other exemptions" (P.L. 101-73, 103 Stat 183, § 219; codified at 12 U.S.C § 1825(b)) to provide the FDIC more exemptions and also added "(a) General Rule.-" before the exemption in question - codified at 12 U.S.C. § 1825(a) - in relevant part, states:

All notes, debentures, bonds, or other such obligations issued by the Corporation shall be exempt, **both as to principal and interest**, from all taxation (except estate and inheritance taxes) now or hereafter imposed . . . by any State . . . *Provided*, That interest upon or any income from any such obligations and gain from the sale or other disposition of such obligations shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under the Internal Revenue Code, or laws amendatory or supplementary thereto. The Corporation, including its franchise, its capital, reserves, and surplus, and its income, shall be exempt from all taxation now or hereafter imposed by . . . any State . . . except that any real property of the Corporation shall be subject to State . . . or local taxation to the same extent according to its value as other real property is taxed. (*Emphasis in original*)(**Emphasis added**).

The FDIC is a federal agency, established by the Congress, primarily to insure bank deposits. 12 U.S.C. § 1811 *et. seq.* As an insurer and an appointed receiver, the FDIC is tasked with facilitating the "purchase and assumption transactions" to ensure stability of the banking system. See *Gunter v. Hutcheson*, 674 F.2d 862, 865 - 66 (11th Cir. 1982) (explaining the "purchase and assumption transactions" in details). The FDIC started to introduce the "loss share method" in "selected purchase and assumption transactions" beginning in 1991. The Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience 193-209*, <https://www.fdic.gov/bank/historical/managing/history1-07.pdf> (last visited June 19, 2017). The FDIC and acquirers enter into SLAs through the "purchase and assumption transactions" and agree to share risk of the losses. The SLAs allow acquirers, such as Taxpayers, to acquire failing or failed banks with minimum risk through "purchase and assumption transactions" facilitated by the FDIC. The acquirers, such as Taxpayers, agree to hold and manage certain covered assets for a set period of time under the SLAs. The FDIC, in return, agrees to reimburse the acquirers for a majority portion (usually 80/20 or 95/5 percent loss/recovery sharing percentages) of the loss incurred on those assets, including single family or commercial loans when certain conditions are met.

In this instance, Taxpayers' supporting documentation demonstrated that they agreed to purchase "whole bank all deposits." Taxpayers' documents also showed that they "specifically purchase[d] all mortgage servicing rights and obligations of the Failed Bank" and that they "shall be entitled to require reimbursement from the [FDIC] for loss sharing on certain loans in accordance with the [] Shared-Loss Agreements" To trigger the Shared-Loss payments made by the FDIC, certain conditions had to be met. Taxpayers' SLAs, in relevant parts, further define:

"Shared-Loss Payment Trigger" means when the sum of the Cumulative Loss Amount under [the] Single Family Shared-Loss Agreement and the Shared-Loss Amount under the Commercial and Other Assets Shared-Loss Agreement, exceeds the First Loss Tranche. If the First Loss Tranche is zero or a negative number, the Shared-Loss Payment Trigger shall be deemed to have been reached upon Bank Closing.

"First Loss Tranche" means the dollar amount of liability that the Assuming Bank will incur prior to the commencement of loss sharing, which is the sum of (i) the Assuming Bank's asset premium (discount) bid, as reflected on the Assuming Bank's bid form, plus (ii) the Assuming Bank's Deposit premium bid, as reflected on the Assuming Bank's bid form, plus (iii) the Equity Adjustment. The First Loss Tranche may be a positive or negative number.

"Equity Adjustment" means the dollar amount resulting by subtracting the Book Value, as of Bank Closing, of all Liabilities Assumed under this Agreement by the Assuming Bank from the purchase price, as determined in accordance with this Agreement, as of Bank Closing, of all Assets acquired under this Agreement by the Assuming Bank, which may be a positive or a negative number.

(Emphasis in original).

In other words, only when the Trigger event occurred, was the FDIC required to reimburse Taxpayers under the SLAs. Likewise, when Taxpayers had profits, Taxpayers were required to pay the FDIC pursuant to the SLAs. Under the SLAs, Taxpayers made reimbursement requests periodically and the FDIC certified the payments. Taxpayers' documentation also demonstrated that they paid the FDIC occasionally when they had profits. Taxpayers' documentation showed that the periodic payments they received from the FDIC did not qualify as "notes," "debentures," or "bonds." (A note is a written promise by one party (the maker) to pay money to another party (the payee) or the bearer; namely, an unsecured debt, usually with a materiality under ten (10) years. A bond is normally an interest-only loan that the borrower will pay the interest every period, but none of the principal will be repaid until the end of the loan. A debenture is an unsecured bond, for which no specific pledge of property is made, usually with a maturity of ten (10) years or more.) The issue thus becomes whether the payments Taxpayers received from the FDIC under the SLAs qualified as "other such obligations" issued by the FDIC pursuant to 12 U.S.C. § 1825(a) and thus should be exempt from FIT.

In this instance, the most applicable statutory exemption is under IC § 6-5.5-1-2(a)(2)(A) based on 12 U.S.C. § 1825(a). A statute which provides a tax exemption is strictly construed against the taxpayer. *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Id.* at 101 (internal citations omitted). In applying any tax exemption, the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of State Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

In *Smith v. Davis*, partners of a contracting and construction business ("Business Partners") had an open account, which was an account receivable for a United States Army construction project. Business Partners claimed that the amount of balance due regarding that open account was exempt from state taxation pursuant to federal statutes and *McCulloch v. State of Maryland* because "the open account was an instrumentality of the United States and hence was immune from state [] taxation." *Smith v. Davis*, 323 U.S. 111, 112-13 (1944). The United States Supreme Court disagreed. The Court explained in relevant part that "an open account claim against the United States does not represent a credit instrumentality of the federal government within the meaning of this constitutional immunity." *Id.* at 113. The Court illustrated that the credit instrumentalities, which it recognized as constitutionally exempt, "have been characterized by (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay." *Id.* at 114-15. The Court concluded that "Congress at no time intended to exempt open account claims . . . [and] that the exemption provisions appeared in statutes authorize[d] the issuance of interest-bearing bonds or Treasury notes." *Id.* at 117-18.

Similar to other federal agencies, the FDIC is authorized to borrow money to carry out its statutory duties. 12 U.S.C. § 1824. Also, similar to the exemptions afforded to other federal agencies under 31 U.S.C. § 3124(a), the exemption provided by 12 U.S.C. § 1825(a), which immediately follows 12 U.S.C. § 1824, generally exempts taxation of income with respect to the "notes, debentures, bonds, or other such obligations issued by the [FDIC], both as to principal and interest . . ." By enumerating "notes, debentures, [or] bonds," the Congress intended to limit "other such obligations" to be obligations similar to "notes," "debentures," or "bonds" - namely, the "issuance of interest-bearing bonds or Treasury notes" alike.

Here, similar to the Business Partners in *Smith*, Taxpayers were contractually obligated to perform certain tasks and the FDIC was contractually obligated to reimburse Taxpayers when reimbursement requests were made pursuant to the Shared-Loss Payment Trigger under SLAs. When Taxpayers had profits, they were obligated to pay a certain percentage of the profits back to the FDIC under the SLAs. The SLAs were contractual obligations and both parties were required to perform under the SLAs. Thus, similar to the Business Partners who had open account claims against the United States Army in *Smith*, Taxpayers here had contractual claims against the FDIC in the nature of the FDIC requirement to pay Taxpayers pursuant to the executed SLAs when the terms and conditions were satisfied as a result. Thus, the FDIC's Shared-Loss payments are not interest-bearing "notes, debentures, bonds or other such obligations" enumerated under 12 U.S.C § 1825(a). The Department is not able to agree that the FDIC's Shared-Loss payments were "other such obligations issued by Corporation" under 12 U.S.C. § 1825(a). Thus, 12 U.S.C § 1825(a) exemption is not applicable.

In short, 12 U.S.C § 1825(a) is not applicable because, under the SLAs, Taxpayers had open account claims and those Shared-Loss payments were not interest-bearing obligations outlined under 12 U.S.C § 1825(a). Thus, the Shared-Loss payments Taxpayers received from the FDIC during 2015 were subject to the Indiana FIT.

FINDING

Taxpayers' protest is respectfully denied.

Posted: 02/28/2018 by Legislative Services Agency
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