

## NOTES

### 2002 AMENDMENT TO INDIANA FINANCIAL INSTITUTIONS TAX: HAS THE UNITARY PRINCIPLE BEEN ABANDONED IN FAVOR OF RELIANCE ON ECONOMIC NEXUS?

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#### INTRODUCTION

Effective January 1, 2002, the Indiana General Assembly amended the Financial Institutions Tax law to redefine the Indiana unitary group to include only those members of the unitary group transacting business in Indiana.<sup>1</sup> This change was considered minor and went largely unnoticed by commentators. However, tax planners within the banking industry did take notice. The law as amended presents two potential costly problems for the State. First, it opens the door to a dramatic increase in the number of entities able to engage the State in the constitutional challenges associated with the “physical presence” versus “economic nexus” debate.<sup>2</sup> Second, financial institutions have responded to the amendment by restructuring certain business transactions to take advantage of the potential to shelter income from the tax using a variety of pass-thru entities.

While the Indiana financial institutions tax has contained provisions that establish nexus based on economic activity since its enactment, it has also always contained a presumption that a financial institution and all of its subsidiaries constitute a unitary business.<sup>3</sup> A unitary business means that the operations and activities of all of the commonly controlled entities contribute to a single overall business enterprise.<sup>4</sup> Prior to the 2002 amendment, the tax was imposed on the apportioned income of all the members of the unitary business group without

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1. IND. CODE § 6-5.5-1-18(a) (2006).

2. The U.S. Supreme Court has yet to decide if a state may constitutionally impose an income, franchise, or excise tax on an entity with no physical presence in the state based solely on the entity’s exploitation of the economic market provided by the state.

3. IND. CODE §§ 6-5.5-1-18, -3-1 (2006).

4. See *infra* Part II.D.

regard for separately formed legal entities or their in-state activity.<sup>5</sup> The Supreme Court has found this method of taxing a unitary business enterprise constitutional.<sup>6</sup> The majority of large non-resident financial institutions have been unable to mount a constitutional challenge to the economic nexus provisions in the statute because they have at least one subsidiary that has a physical presence in the State. That subsidiary provides a jurisdictional hook for the State to impose the tax on the apportionable income of the entire group without reliance on the economic nexus provisions.

The current law as amended excludes members of the unitary business enterprise that are not transacting business in Indiana, as defined in the statute, from the Indiana unitary group.<sup>7</sup> This runs contrary to the concept that the entire group is being taxed as a single business enterprise. As a result, Indiana will no longer be able to rely on the unitary concept to provide a jurisdictional hook for those members of the financial institution's unitary group without a physical presence in the State. The State will be forced to rely on the constitutionality of the economic nexus concept to include financial institutions and their subsidiaries that lack physical presence in the State, in the Indiana unitary group's apportionable tax base. If the economic nexus concept is found unconstitutional, the potential cost to the State is significant because most of the members of a non-resident financial institution's unitary group, particularly profitable credit card and mortgage operations, will not have a physical presence in Indiana.

The economic nexus concept is attractive to cash strapped states because it expands the state's taxing jurisdiction to include businesses that exploit the benefits of a state's economic market without maintaining an office, warehouse, inventory, employees or agents in the state.<sup>8</sup> This approach has gained popularity among states largely in response to the effort of businesses to restructure their operations to avoid state tax.<sup>9</sup> Businesses attempt to avoid state tax by shifting income to a subsidiary or pass-thru entity that has established a physical presence only in a state in which its income is not taxed.

It is unclear if the Supreme Court will endorse the economic nexus approach for income and franchise taxes in light of the bright line physical presence test mandated for sale/use taxes. Even in an age of e-commerce, the economic nexus approach is a significant expansion of the state's ability to tax interstate commerce. The Court may reject such an expansion in favor of the more limiting physical presence test given that the unitary business principle, already

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5. IND. CODE § 6-5.5-2-4 (2006).

6. *See generally* Allied-Signal, Inc. v. Dir. Div. of Taxation, 504 U.S. 768, 783 (1992) (reaffirming the constitutional test for a unitary business that focuses on functional integration, centralized management, and economies of scale); Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 179 (1983); *see also infra* Part II.D.

7. IND. CODE § 6-5.5-1-18(a) (2006).

8. R. Todd Ervin, Comment, *State Taxation of Financial Institutions: Will Physical Presence or Economic Presence Win the Day?*, 19 VA. TAX REV. 515, 523-26 (2000).

9. *See infra* Part II.C.

established as permissible by the Court, provides states a fair method of taxing the income of such business enterprises.

Even if the economic nexus concept is declared constitutional, the State will still face restructured transactions that use pass-thru entities, such as Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs), and partnerships, to avoid the full impact of the tax. These loopholes appear to be the result of two provisions in the statute. The first provision fails to include the ownership of an interest in a pass-thru entity engaged in financing transactions in Indiana in the definition of transacting business in the State.<sup>10</sup> The second defines a taxpayer as a corporation for financial institutions tax purposes.<sup>11</sup> Financial institutions can move profitable operations into pass-thru entities, or several tiers of pass-thru entities, that are owned by holding corporations. The receipts from the pass-thru entities flow through to the holding corporations. While the holding corporations are defined as taxpayers, they are not transacting business in Indiana and therefore are not members of the Indiana unitary group. The pass-thru entities are not taxpayers under the statute's definition of that term.

The statute is somewhat ambiguous as to whether a pass-thru entity must be included as a member of the unitary group, or whether the corporate owners must report the income on a separate return. If the pass-thru entity is included in the unitary return, the apportionment percentage will be diluted because the statute provides that only the receipts of taxpayer members of the unitary group are included in the numerator, while the receipts of all members of the group are included in the denominator.<sup>12</sup> If the corporate owners report on a separate return, income from the unitary group is reported in a non-unitary fashion. This has the potential to distort the income apportioned to Indiana to the State's detriment. The problem is exacerbated when tiers of pass-thru entities are utilized as it may be possible for the pass-thru income to escape taxation entirely by using several tiers of pass-thru entities.

This Note explores, in Part I, the history of changes in the banking industry that led to the original enactment of the financial institutions tax and the subsequent 2002 amendment. Part II concentrates on the constitutional aspects of the economic nexus approach taken by the statute's definition of transacting business in the State. Finally, Part III focuses on the efforts of the banking industry to restructure transactions to avoid the financial institutions tax, as amended, through the use of a variety of pass-thru entities. This section includes a discussion of the options available to the State to respond to those efforts. In Part IV, this Note concludes that while the adoption of the economic nexus concept is an unnecessary expansion of the state's jurisdiction to impose tax, the financial institutions tax law is easily rehabilitated through either a return to the accepted method of applying the unitary business principle, or by altering the definition of transacting business in Indiana to include ownership of an interest in a pass-thru entity transacting business in Indiana and expanding the definition

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10. IND. CODE § 6-5.5-3-1 (2006).

11. *Id.* § 6-5.5-1-17(a).

12. *Id.* § 6-5.5-2-4.

of a taxpayer to include pass-thru entities.

### I. HISTORY OF THE BANKING INDUSTRY

Historically, federal banking regulations have restricted financial institutions from physically locating in multiple states.<sup>13</sup> However, the regulations have never proscribed interstate banking transactions.<sup>14</sup> Banks were initially slow to take advantage of the opportunity to engage in interstate business transactions, largely due to consumers' demand for localized banking.<sup>15</sup> The proliferation of home computers, internet access and the use of unsecured credit, mostly in the form of credit cards, over the last thirty years have dramatically changed consumer expectations with respect to banking services.<sup>16</sup> Consumer demand has moved the provision of banking services away from traditional "bricks and mortar" locations in favor of remote banking via the Internet, mail or telephone.<sup>17</sup> As a result, financial institutions now provide a variety of products and services to customers throughout the U.S. without having a physical location in the state in which its customers are located.<sup>18</sup> It is now commonplace to apply for a mortgage, pay bills, obtain unsecured loans and manage savings, checking and retirement accounts from the comfort of home.

Changes in banking laws and the explosion of e-commerce have combined to produce a market for banks that did not previously exist.<sup>19</sup> The shift in banking laws ushered in an era of unprecedented consolidation within the industry in the 1990s. During that same period, e-commerce fueled customer demand for remote banking.<sup>20</sup> Large financial institutions realized that certain segments of their business, such as mortgage loans, consumer loans, and credit cards, which can be conducted without maintaining a physical location, could be operated by subsidiaries that would only have to report their income to one state-taxing jurisdiction, rather than the several states from which the income was derived. The Indiana financial institutions tax law was the legislature's response to this business climate.<sup>21</sup>

#### A. *State Response to Changing Business Climate*

While states have generally relied on the traditional nexus approach requiring a physical presence to impose tax on financial institutions, a few states have passed legislation that establishes nexus for out-of-state financial institutions

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13. Ervin, *supra* note 8, at 521.

14. *Id.*

15. *Id.* at 522.

16. *Id.*

17. *Id.*

18. *Id.* at 523.

19. *Id.*

20. *Id.* at 521-23.

21. Interview with Terry Griggs, Audit Adm'r, Ind. Dep't of Revenue, in Indianapolis, Ind. (Oct. 19, 2005) [hereinafter Griggs Interview].

based on “economic nexus.”<sup>22</sup> “Economic nexus” bases the state’s jurisdiction to tax an out-of-state financial institution on the institution’s exploitation of the benefits of the state’s economic market rather than its physical presence within the taxing state.<sup>23</sup> A financial institution’s economic presence within a state is determined using factors such as the number of customers, the value of deposits or other intangible property, the receipts attributable to customers, and the value of the benefits provided by the institution which are consumed in the state.<sup>24</sup>

Indiana, Kentucky, Massachusetts, Minnesota, Tennessee, and West Virginia have all imposed a tax on financial institutions based on economic presence in the state.<sup>25</sup> The statutes passed in these states impose either an income, franchise or excise tax on financial institutions regularly engaging in business in the state.<sup>26</sup> Regularly engaging in business in the state is defined to include such activities as obtaining or soliciting business in the state, providing services the benefits of which are consumed in the state, the receipt of deposits from customers in the state, and receipts attributable to sources within the state.<sup>27</sup> Receipts attributable to sources within the state include income derived from making loans to customers in the state, making loans secured by property located in the state, and transactions involving intangible property that result in income flowing from within the state to the financial institution.<sup>28</sup> The conduct of the economic activities, without regard to physical presence, is sufficient to subject out-of-state financial institutions to the tax.

The Kentucky and West Virginia statutes both presume a financial institution is regularly engaged in business in the state if it obtains or solicits business from twenty or more persons or if receipts attributable to sources in the state exceed \$100,000.<sup>29</sup> Indiana and Minnesota likewise have a twenty customer threshold, while Massachusetts’ is one hundred.<sup>30</sup> Massachusetts’ threshold for receipts attributable to the state is \$500,000.<sup>31</sup> Indiana and Minnesota have a \$5 million threshold for both assets and deposits, while Massachusetts has only a \$10 million threshold on assets and Tennessee has a \$5 million threshold on the sum of assets and deposits.<sup>32</sup>

Indiana, Minnesota, and Tennessee<sup>33</sup> have specifically enumerated certain

22. JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ¶ 6.29[1] (3d ed. 2005), available at 1999 WL 1398893.

23. *Id.*

24. *Id.* at [2-3].

25. *Id.* ¶ 6.29.

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. However, the state statute notwithstanding, the Tennessee Court of Appeals has held that the Commerce Clause prohibited the State from taxing an out-of-state credit card company that has

activities in their definition of transacting business in the state. These activities include directly or indirectly making, acquiring, servicing, and selling of loans either to customers in the state or that are secured by property located in the state; the sale of products and services in the state; providing services the benefits of which are consumed in the state; and engaging in transactions with customers in the state that result in income flowing from the state to the financial institution.<sup>34</sup>

Indiana's statute is unique because, in addition to the economic nexus provisions, it contains a presumption that financial institutions and their subsidiaries constitute a unitary business.<sup>35</sup> The "unitary business principle"<sup>36</sup> allows the income of entities without a physical presence in the taxing state to be combined with the income of those entities having traditional nexus in the state if the operation and activities of the entities form a single business enterprise.<sup>37</sup> A unitary business means that the business activities and operations of each entity are mutually beneficial, dependant on or contributory to transacting the business of the enterprise as a whole.<sup>38</sup> The unitary presumption allowed Indiana to include, in the apportionable base,<sup>39</sup> the income of all the subsidiaries and pass-thru entities owned by the financial institution without regard to the artificial boundaries represented by separately formed legal entities or in-state activity.<sup>40</sup> As a result, the State did not need to rely heavily on the economic nexus concept to generate the taxable base.

As federal banking regulations continued to evolve during the 1990s, regional banks complained that the financial institutions tax law put them at a competitive disadvantage with respect to large national financial institutions.<sup>41</sup> Notably, in 1994, the Riegle-Neal Interstate Banking and Branch Efficiency Act<sup>42</sup> removed the barrier to acquisitions and branching, allowing financial institutions to engage in nationwide interstate banking.<sup>43</sup> In response to the relaxation of federal banking regulations in the 1990s,<sup>44</sup> the Indiana General Assembly amended the financial institutions tax law to redefine the Indiana unitary group

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no physical presence in the State. *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 842 (Tenn. Ct. App. 1999); *see also infra* Part II.C.

34. HELLERSTEIN & HELLERSTEIN, *supra* note 22, ¶ 6.29[2-4].

35. *Id.* at [1]; *see* IND. CODE § 6-5.5-1-18(b) (2006).

36. *See infra* Part II.D.

37. Ashley B. Howard, Comment, *Does the Internal Revenue Code Provide a Solution to a Common State Taxation Problem?: Proposing State Adoption of § 367(D) to Tax Intangibles Holding Subsidiaries*, 53 EMORY L.J. 561, 571 (2004).

38. IND. CODE § 6-5.5-1-18(a) (2006).

39. The apportionable base is the total income to which the Indiana apportionment percentage will be applied to determine the portion of the income subject to tax in Indiana.

40. HELLERSTEIN & HELLERSTEIN, *supra* note 22, ¶ 8.07[2].

41. Griggs Interview, *supra* note 21.

42. Pub. L. No. 103-328, 101-03, 108 Stat. 2338 (1994).

43. Ervin, *supra* note 8, at 523-26.

44. Griggs Interview, *supra* note 21.

to include only those members transacting business in the State.<sup>45</sup>

## II. CONSTITUTIONAL ANALYSIS

A constitutional challenge to the economic nexus provisions in the Indiana statute has not reached the courts despite numerous hearings on the issue at the administrative level that have uniformly ruled against financial institutions. While there are a few financial institutions, mostly credit card companies, whose unitary groups include no members with a physical presence in the State, none have challenged the statute.<sup>46</sup> The broad reach of the treatment of financial institutions and their subsidiaries as a unitary business is likely responsible for the reluctance of other financial institutions to seek relief from the statute. The 2002 amendment to the statute<sup>47</sup> has the potential to dramatically increase the number of financial institutions willing to expend the resources necessary for such a challenge.<sup>48</sup>

The 2002 amendment to the financial institutions tax statute has the effect of taxing only selected parts of the unitary business. While the amendment purports to change nothing more than the definition of the unitary group, what remains is, in substance, a consolidated return comprised of those members transacting business in Indiana. The Supreme Court has not endorsed taxing only selected parts of a unitary business. The Court's holdings concerning the unitary method of taxation reveals the opposite approach. The Court has consistently held that businesses could not remove selected pieces of income earned by a unitary business enterprise outside the state from the apportionable tax base of a state in which the unitary business has sufficient activity to support nexus.<sup>49</sup> Since the Indiana statute no longer relies on the unitary business concept, as established by the Supreme Court, to tax entities with no physical presence in the State, the economic nexus concept inherent in the statute's definition of transacting business in Indiana will trigger conflict as to the constitutionality of taxing those

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45. IND. CODE § 6-5.5-1-18(a) (2006).

46. One such credit card company has filed an appeal with the tax court challenging the economic nexus provisions of the statute as of the writing of this Note. *MBNA Am. Bank, N.A. & Affiliates v. Ind. Dep't of State Revenue*, No. 49T10-0506-TA-53, case docketed (Ind. Tax Ct., June 30, 2005). However, even this institution has independent contractors in the State. This company contracts with organizations, such as universities, to market credit cards in the State with the organization's logo on the card in return for a percentage of the card's receipts. These organizations provide applications and sometimes offer promotional incentives to induce customers in Indiana to sign up for the card.

47. IND. CODE § 6-5.5-1-18(a) (2006).

48. This is particularly so in light of the Tennessee court's refusal to uphold the taxation of a credit card business based solely on economic nexus under a substantially similar statute passed by its legislature. *See supra* note 33; *see also infra* Part II.C.

49. *See, e.g.,* *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S.159 (1983); *Exxon Corp. v. Wisc. Dep't of Revenue*, 447 U.S. 207 (1980); *Mobile Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425 (1980).

entities included in the Indiana unitary group that do not have a physical presence in the State.

The Supreme Court has yet to decide the constitutional viability of the imposition of state taxes, other than sales tax, on entities conducting business in interstate commerce that have no physical presence in the taxing state.<sup>50</sup> Likewise, Congress's only guidance with respect to the taxation of business conducted in interstate commerce is a prohibition against imposing a tax on the sale of tangible goods in interstate commerce where the business has not exceeded mere solicitation in the taxing state.<sup>51</sup> It is against this backdrop that conflict has emerged among corporate America, tax planners, states, and even academia as to whether "physical presence" or "economic nexus" is the proper measure to determine the circumstances under which a state can constitutionally impose taxes based on income.

### A. *Origin of the Physical Presence Standard*

The 1992 Supreme Court decision in *Quill v. North Dakota*<sup>52</sup> is cited as the starting point to resolve the quagmire that has developed in state taxation by proponents of both the economic nexus approach and the physical presence test. *Quill* was a business that sold office supplies by mail order.<sup>53</sup> *Quill* had a significant amount of sales in North Dakota, but had no office, employees or other physical presence in the State.<sup>54</sup> North Dakota sought to require *Quill* to collect the State's use tax on sales to customers in the State.<sup>55</sup>

The Court found that *Quill* did not have nexus in North Dakota for the purpose of requiring *Quill* to collect the tax.<sup>56</sup> In doing so, the Supreme Court reaffirmed the use of a bright line "physical presence" test to determine if a business' activities in a state would establish nexus for sales/use tax.<sup>57</sup> *Quill* also established that the nexus requirements under the Due Process Clause and the Commerce Clause were not equivalent because they did not address the same concerns.<sup>58</sup> Due Process seeks to ensure that a business has fair notice that a tax may be imposed.<sup>59</sup> It is based on the belief that it is fundamentally unfair for a

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50. *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992) (declining to require physical presence to establish nexus for taxes other than sales taxes).

51. 15 U.S.C. § 381 (2000) provides that a state may not impose a net income tax on a person whose only business activity is the solicitation of orders approved and filled outside the state.

52. 504 U.S. at 298.

53. *Id.* at 302. *Quill*, a Delaware corporation, had almost \$1 million in sales to over 3000 customers in North Dakota. *Id.*

54. *Id.*

55. *Id.* at 303.

56. *Id.*

57. *Id.* at 314.

58. *Id.* at 314-15.

59. *Id.* at 305.

state to impose tax on a business with no connection to the taxing state.<sup>60</sup> In contrast, the Commerce Clause seeks to prevent states from placing a burden on the national economy.<sup>61</sup> The Court found that *Quill*'s exploitation of the economic market of North Dakota was sufficient to establish nexus under the Due Process "minimum contacts" standard.<sup>62</sup> However, the Court found that the Commerce Clause prohibited North Dakota from compelling *Quill* to collect the tax.<sup>63</sup>

The United States Supreme Court established the physical presence nexus requirement for sales/use tax in *National Bellas Hess, Inc. v. Department of Revenue of Illinois* in 1967.<sup>64</sup> The Supreme Court of North Dakota determined that *Bellas Hess* was no longer controlling<sup>65</sup> in light of the Supreme Court's 1977 decision in *Complete Auto Transit, Inc. v. Brady*.<sup>66</sup> The *Complete Auto* Court stated that "a state tax is unconstitutional only if the activity lacks the necessary connection with the taxing state to give 'jurisdiction to tax,' or if the tax discriminates against interstate commerce, or if the activity is subject to multiple taxation."<sup>67</sup> *Complete Auto* established a four-part test to determine the constitutionality of a state tax. The test required: 1) a business have a substantial nexus with the taxing state; 2) the tax be fairly apportioned; 3) the tax does not discriminate against interstate commerce; and 4) the tax is fairly related to the services provided by the state.<sup>68</sup> The *Quill* decision centered on the first prong of the *Complete Auto* test.<sup>69</sup>

The North Dakota Supreme Court concluded that the first prong of the *Complete Auto* test did not require a physical presence in the State emphasizing the evolution of the national economy and the law since the *Bellas Hess* decision.<sup>70</sup> However, the Supreme Court rejected North Dakota's reasoning. The *Quill* Court found that the *Complete Auto* analysis "reflects concerns about the national economy."<sup>71</sup> The Court explained that the first and fourth prongs of the *Complete Auto* test ensure that interstate commerce will not be unfairly burdened by requiring substantial nexus and a relationship between the services provided

60. *Id.* at 312.

61. *Id.*

62. *Id.* at 308.

63. *Id.* at 313 (concluding the use tax statute provides an example of "how a state might unduly burden interstate commerce" if all "6000-plus taxing jurisdictions" imposed such a duty—the compliance burden would be significant).

64. *Id.* at 314; see *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753 (1967).

65. *Quill*, 504 U.S. at 303-04.

66. 430 U.S. 274 (1977).

67. *Id.* at 280-81.

68. *Id.* at 279.

69. *Quill*, 504 U.S. at 311 (concluding that *Bellas Hess* "stands for the proposition that a vendor whose only contact with the taxing State are by mail and common carrier lacks the 'substantial nexus' required under the Commerce Clause").

70. *Id.* at 303.

71. *Id.* at 313.

by the taxing state and the entity sought to be taxed.<sup>72</sup> The second and third prongs require fair apportionment and non-discrimination to prevent interstate commerce from shouldering an undue portion of the tax burden.<sup>73</sup>

The Court found that the *Bellas Hess* physical presence test was consistent with the first prong of *Complete Auto*,<sup>74</sup> affirming that physical presence is necessary to establish substantial nexus under Commerce Clause for sales/use taxes.<sup>75</sup> The Court concluded that the retention of the physical presence test established in *Bellas Hess* was a “means for limiting state burdens on interstate commerce.”<sup>76</sup> The Court further justified the preference for a “bright line test” on policy grounds, finding that the certainty provided by the test settled businesses’ expectations, fostering investment in interstate commerce.<sup>77</sup> However, the Court declined to decide if the physical presence requirement applied to taxes other than sales/use taxes.<sup>78</sup>

In reaffirming the physical presence test for sales/use taxes, the Court expressed that had *Bella Hess* been decided at the time of *Quill* it might have been decided differently.<sup>79</sup> The Court noted that Congress has the ultimate power under the Commerce Clause to resolve the underlying issue and that Congress had chosen not to overturn *Bellas Hess*.<sup>80</sup> It has been suggested that the Court bifurcated the Due Process and Commerce Clause analysis to encourage Congress to legislate in this area.<sup>81</sup> Unmooring the Due Process requirement from the Commerce Clause requirement leaves Congress free to allocate the burdens as it sees fit; Congress has the sole power to regulate commerce between the states.<sup>82</sup> In any event, Congress has yet to accept the Court’s invitation to legislate in this area.

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72. *Id.*

73. *Id.*

74. *Id.* at 311.

75. *Id.* at 317.

76. *Id.* at 313-14.

77. *Id.* at 316 (noting that the business community has relied on *Bellas Hess* in ordering their affairs and speculating that it is not unlikely that the dramatic growth in the mail-order industry is in part attributable to the bright-line exemption from state taxation in concluding a bright-line rule is more beneficial than a case by case review to determine nexus).

78. *Id.* at 314, 317 (noting that in cases subsequent to *Bellas Hess* concerning other types of taxes, no similar bright-line rule has been adopted).

79. *Id.* at 311 (finding that “contemporary Commerce Clause jurisprudence might not dictate the same result” if the issue were one of first impression today).

80. *Id.* at 318.

81. James L. Kronenberg, *A New Commerce Clause Nexus Requirement: The Analysis of Nexus in Quill Corp. v. North Dakota*, 1994 ANN. SURV. AM. L. 1, 27. Kronenberg suggests that the only justification for an independent nexus requirement is the desire to prompt Congress to legislate in this area. *Id.*

82. *Quill*, 504 U.S. at 318 (noting that since the Due Process concerns have been put to rest, Congress is free to legislatively overturn the *Bellas Hess* bright-line rule).

### B. Business Response to the Physical Presence Test

The reaffirmation of the physical presence test in *Quill* fueled an explosion of corporate restructuring by multi-state business operations in the 1990s for the purpose of shifting income away from state taxation. The success of these restructuring schemes relies on the proposition that an entity must have a physical presence in a state before that state can impose a tax. The most prevalent form of corporate restructuring to successfully shift income beyond the reach of state taxing jurisdictions is an intangibles holding company.

Many multi-state corporations have either created or acquired valuable intangible assets, such as trade names, trademarks, and patents.<sup>83</sup> The estimated value of these intangibles for corporations such as Intel, GM and IBM is in the billions.<sup>84</sup> As a result of marketing by accounting firms, corporations with valuable intangible assets began transferring them to wholly owned subsidiaries incorporated in states such as Delaware that do not impose tax on the receipts from those intangibles.<sup>85</sup> The intangibles holding subsidiary then leases the use of the intangible back to the parent corporation in exchange for a royalty payment.<sup>86</sup> This arrangement results in: 1) large amounts of royalty expense being deducted by the parent corporation, which lowers the income reported to separate reporting states, and 2) correspondingly large amounts of royalty income earned by the subsidiary that is not taxable in any state or is taxed at an “acceptably low” rate.<sup>87</sup>

### C. Emergence of the Economic Nexus Concept

Some states have seized on the opening left by *Quill* concerning the question of whether physical presence is necessary to establish the requisite nexus for income and franchise taxes in order to combat the revenue drain that resulted from these types of income shifting business structures.<sup>88</sup> These states contend that the intangibles holding subsidiary companies have established a nexus in the state based either on the benefits that the state’s economic market has provided to the holding company, or the economic presence of the subsidiary’s intangibles in the state.<sup>89</sup> However, the response from state courts to the “economic nexus” argument has not been uniform.<sup>90</sup> The Supreme Court has refused to grant

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83. See generally Giles Sutton & Todd Zoellick, *The Ins and Outs of Related Party Add-Backs*, *Tax Executive*, 57 TAX EXECUTIVE INST. 238 (2005), available at 2005 WLNR 12338438; see also Xuan-Thao N. Nguyen, *Holding Intellectual Property*, 39 GA. L. REV. 1155, 1162 (2005).

84. Nguyen, *supra* note 83, at 1162.

85. Howard, *supra* note 37, at 561-63.

86. *Id.* at 564.

87. *Id.* at 564-65.

88. *Id.* at 574; Ervin, *supra* note 8, at 534.

89. Ervin, *supra* note 8, at 534.

90. See generally Christine C. Bauman & Michael S. Schadewald, *More States Challenge Trademark Holding Companies*, 74 CPA J. 38 (Apr. 2004), available at 2004 WLNR 11368394 (providing a synopsis of the various states’ responses to the subsidiary holding company structure

certiorari for these cases thus far.<sup>91</sup>

*Geoffrey, Inc. v. South Carolina Tax Commission*<sup>92</sup> is the most cited of the state court decisions that endorse the economic nexus theory. *Geoffrey, Inc.*, a wholly owned subsidiary of Toys R Us, was incorporated in Delaware to hold and manage the intangible assets of Toys R Us.<sup>93</sup> *Geoffrey* licensed these intangibles to Toys R Us for a royalty fee based on a percentage of Toys R Us sales at retail locations throughout the country, including South Carolina.<sup>94</sup> South Carolina imposed a tax on *Geoffrey's* royalty income based on the utilization of *Geoffrey's* intangible assets within the State, despite the fact that it had no physical presence there.<sup>95</sup> The South Carolina Supreme Court easily found nexus under the Due Process Clause, as *Geoffrey* clearly had directed its business activity toward the market provided by South Carolina.<sup>96</sup> The court then distinguished *Quill* as applying only to sales taxes,<sup>97</sup> finding that the economic presence of *Geoffrey's* intangibles in the State provided the substantial nexus necessary under *Complete Auto* for the State to impose a tax on *Geoffrey's* income.<sup>98</sup>

*Geoffrey* has been widely criticized by tax practitioners, and some states have rejected the economic nexus theory.<sup>99</sup> The criticism stems from *Geoffrey's* failure to adequately address the Commerce Clause requirement.<sup>100</sup> The *Geoffrey* court's Commerce Clause analysis merely distinguished *Quill* as applicable only to sales taxes without advancing any reasoning for rejecting the physical presence standard for income taxes or attempting to establish any alternative standard.<sup>101</sup> Critics charge that *Geoffrey* collapsed the Commerce Clause analysis into the Due Process standard, notwithstanding *Quill's* pronouncement that a separate standard applies.<sup>102</sup>

North Carolina has followed *Geoffrey's* lead.<sup>103</sup> In *A & F Trademark, Inc.*

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generally and economic nexus specifically).

91. See, e.g., *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C.), cert. denied, 510 U.S. 992 (1993); *A & F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), cert. denied, 2005 U.S. LEXIS 6003 (2005).

92. 437 S.E.2d at 13.

93. *Id.* at 15.

94. *Id.*

95. *Id.* at 15-18.

96. *Id.* at 16-17.

97. *Id.* at 18 n.4.

98. *Id.* at 18.

99. Ervin, *supra* note 8, at 537; Howard, *supra* note 37, at 577-78.

100. HELLERSTEIN & HELLERSTEIN, *supra* note 22, ¶ 6.11[2].

101. See *id.* The *Geoffrey* court made no attempt to determine if there were differences between an income tax and a sales tax that would dictate different treatment of the two types of taxes. *Id.*

102. *Id.*

103. Ervin, *supra* note 8. New Mexico and New Jersey are among the other states that have followed *Geoffrey*. *Id.*

*v. Tolson*,<sup>104</sup> the North Carolina Court of Appeals found that the use of a trademark within the State provided “a substantial nexus . . . sufficient to satisfy the Commerce Clause,” even though A & F had no physical presence in the State.<sup>105</sup> However, the North Carolina court determined that “there are important distinctions between sales and use taxes and income and franchise taxes ‘that makes [sic] the physical presence test . . . inappropriate as a nexus test.’”<sup>106</sup> The court found that “[t]he use tax collection cases were based on the vendor’s activities in the state, whereas, the income and franchise taxes [imposed on intangible holding companies] are based solely on ‘the use of [intangible] property in this [S]tate,’” rather than the taxpayer’s activity in the State.<sup>107</sup> The court stated that presence in a state was not essential for the state to impose tax on a non-resident that received income from intangible property in the state.<sup>108</sup> The court also noted that unlike an income tax that is “paid only once a year, to one taxing jurisdiction and at one rate,” sales and use tax is collected by a vendor acting as an agent of the state and paid over at regular intervals during the year, “to more than one taxing jurisdiction within a state and at varying rates.”<sup>109</sup>

In contrast, in *J.C. Penney National Bank v. Johnson*,<sup>110</sup> the Tennessee Court of Appeals implicitly rejected the contention that mere economic presence within the State satisfies the *Complete Auto* substantial nexus requirement.<sup>111</sup> In *J.C. Penney*, Tennessee sought to impose its franchise tax on income generated by J.C. Penney National Bank’s (JCPNB) credit card operations in the state.<sup>112</sup> JCPNB, a Delaware corporation, had no employees or offices in Tennessee.<sup>113</sup> The court found that, in light of *Quill*, JCPNB’s activities within the State did not satisfy “the substantial nexus requirement of *Complete Auto*.”<sup>114</sup> In doing so, the court acknowledged that the Supreme Court has not articulated a physical presence requirement for taxes other than sales/use taxes.<sup>115</sup> However, the court found that the physical presence required under *Quill* governed the imposition of the franchise tax because it could find no basis to conclude that the analysis for franchise taxes should be different than that used for sales/use taxes.<sup>116</sup> While

104. 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 2005 U.S. LEXIS 6033 (2005).

105. *Id.* at 195.

106. *Id.* at 194 (quoting Jerome R. Hellerstein, *Geoffrey and the Physical Presence Nexus Requirement of Quill*, 8 STATE TAX NOTES 671, 676 (1995)).

107. *Id.* (quoting Hellerstein, *supra* note 106, at 676).

108. *Id.* at 194-95 (citing *Int’l Harvester Co. v. Wisc. Dep’t of Taxation*, 322 U.S. 435, 441-42 (1944)).

109. *Id.* at 195 (quoting *Kmart Props., Inc. v. Taxation and Revenue Dep’t of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001)).

110. *J.C. Penney Nat’l Bank v. Comm’r of Revenue*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

111. *Id.* at 839.

112. *Id.* at 832.

113. *Id.* at 839.

114. *Id.*

115. *Id.*

116. *Id.* The court stated that any constitutional differences between the franchise tax imposed

the court felt bound by the ruling in *Quill*, it stopped short of finding that “physical presence” is required for the imposition of all state taxes under the Commerce Clause.<sup>117</sup> Texas and Missouri are among the states that seem to have similarly rejected *Geoffrey’s* economic nexus concept.<sup>118</sup>

#### D. *The Unitary Alternative*

Rather than venture into the economic nexus/physical presence debate, many states simply require combined reporting. This method of reporting, which is based on the “unitary business principle,”<sup>119</sup> eliminates the effect of income shifting restructuring.<sup>120</sup> The unitary method, which the Supreme Court has found constitutional,<sup>121</sup> is currently required by about a dozen states.<sup>122</sup> Additionally, roughly twenty other separate filing states permit, and may also require, the combined filing to fairly reflect the income derived from within the state.<sup>123</sup> Indiana is among those states with respect to adjusted gross income tax.<sup>124</sup>

The unitary business principle considers commonly controlled entities a single business enterprise without regard to corporate structure, so long as the activities of all of the entities included in the combined reporting contribute to the conduct of the business enterprise as a whole.<sup>125</sup> The relation of the business’s out-of-state activities to the in-state activities provides the “‘definite link’ or ‘minimum connection’” necessary to include all of the business

by Tennessee and the sales/use tax in *Quill* were “not within the purview of this court to discern.” *Id.*

117. *Id.* at 842.

118. See generally Bauman & Schadewald, *supra* note 90.

119. Cory D. Olson, *Follow the Giraffe’s Lead—Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire That Is State Taxation*, 6 MINN. J. L. SCI. & TECH. 789, 802 (2005).

120. *Id.*

121. See generally Bauman & Schadewald, *supra* note 90; see also *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 179 (1983); *Mobile Oil Corp. v. Comm’r of Taxes of Vt.*, 445 U.S. 425, 438 (1980); Olson, *supra* note 119, at 802.

122. Olson, *supra* note 119, at 802.

123. *Id.*

124. The Indiana Code states:

[i]n the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

IND. CODE § 6-3-2-2(m) (2006).

125. William F. Fox et. al., *How Should a Subnational Corporate Income Tax on Multistate Businesses Be Structured?*, 58 NAT’L TAX J. 139 (Mar. 2005), available at 2005 WLNR 5727054, at \*9, \*17-18.

enterprise's income in the state's apportionable base.<sup>126</sup> A unitary relationship among entities is generally evidenced by 1) common ownership, 2) centralized management, and 3) economic interdependency such as vertical integration, inter-company transactions and/or shared economies of scale.<sup>127</sup>

The combined reporting method is not without its drawbacks. The primary drawback is that corporations generating a loss that form a part of the unitary business are drawn into the state that would otherwise be excluded in a separate reporting scheme.<sup>128</sup> Additionally, some states might have to overhaul their taxing scheme to implement the unitary method.<sup>129</sup> While the unitary method is favored by academics,<sup>130</sup> the high price associated with a restructuring of a state taxing scheme, along with political concerns, may render it impractical for states to implement a unitary taxing structure.<sup>131</sup>

### III. RESPONSE OF THE BANKING INDUSTRY TO THE 2002 AMENDMENT

The 2002 amendment limited the Indiana unitary group to members of the unitary business enterprise transacting business in Indiana.<sup>132</sup> With the unitary business concept effectively discarded, banks discovered that their business could be restructured using a variety of pass-thru and special purpose entities that had the potential to avoid taxation under the statute. The use of such entities, if successful, could cost the State millions of dollars at a time when the State is struggling to meet its financial obligations. However, the statute does contain provisions that can potentially be used by the State to bring these entities within the scope of the law. There likely will be vigorous disagreement between the banking industry and the State concerning the use of these provisions.

Even after the 2002 amendment, the statute still embraces the economic nexus concept.<sup>133</sup> The economic nexus concept results in the imposition of tax on business entities that are engaged in activities included in the definition of transacting business in Indiana even though those entities have no physical presence in the State.<sup>134</sup> The statute includes engaging in any of the following activities in its definition of transacting business in Indiana: 1) "regularly soliciting business from customers in Indiana"; 2) "regularly perform[ing]

126. HELLERSTEIN & HELLERSTEIN, *supra* note 22, ¶ 8.07[1].

127. *Id.* at [3]; Fox et al., *supra* note 125, at \*18.

128. Howard, *supra* note 37, at 571.

129. Olson, *supra* note 119, at 802.

130. *Id.*

131. *Id.*

132. IND. CODE § 6-5.5-1-18(a) (2006). As a result, the income of members of the unitary business enterprise that are not transacting business in Indiana will no longer be included in the taxable base subject to apportionment to Indiana. *Id.*

133. The Indiana Code includes in the definition of doing business in Indiana activities that derive income from the Indiana economic market without regard to whether a physical presence is maintained in the State. *Id.* § 6-5.5-3-1.

134. *Id.*

services outside Indiana that are consumed within Indiana”; 3) “regularly selling products or services to Indiana customers”; and 4) “regularly engag[ing] in transactions with customers in Indiana that involve intangible property that results in receipts flowing from within Indiana to the taxpayer.”<sup>135</sup> The statute does not include in its definition of transacting business in Indiana, ownership of an interest in a pass-thru entity engaged in the listed activities.<sup>136</sup> This omission, in conjunction with the provision that defines a taxpayer for financial institution tax purposes as a corporation, has prompted banks to restructure business transactions to avoid the tax using REITs, RICs, and partnerships.

#### A. REITs

A REIT is an investment company that holds real estate investments.<sup>137</sup> A REIT is special purpose pass-thru entity that would otherwise be taxed as a domestic corporation which allows small investors to pool their funds to obtain diversification and skilled portfolio management.<sup>138</sup> REITs are commonly used to hold pools of mortgages that back publicly traded mortgage backed securities. REITs are also used to hold investments in income producing real property such as office complexes. An entity is required to have at least one hundred (100) beneficial owners to qualify as a REIT.<sup>139</sup> In addition, a REIT cannot be closely held as that term is defined under the Internal Revenue Code provisions applicable to personal holding companies.<sup>140</sup>

REITs receive favorable treatment under the Internal Revenue Code. Unlike other types of business entities, REITs are allowed to deduct dividends paid to shareholders in determining their net federal taxable income,<sup>141</sup> which is the starting point for calculating the Indiana financial institutions tax liability.<sup>142</sup> The Internal Revenue Code also provides a one hundred percent (100%) deduction for dividends received from members of a taxpayer’s affiliated group.<sup>143</sup> These two Internal Revenue Code provisions taken together afford financial institutions a unique tax planning opportunity.

Financial institutions can form a REIT to hold their investment in mortgage pools secured by real property and rent producing real property. The financial institution must also form a wholly owned subsidiary corporation to hold the interest in the REIT. The interest, rent and other gains earned by the REIT are

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135. *Id.*

136. *Id.*

137. *The States Abusive Tax Shelter Symposium*, FED’N OF TAX ADMIN., Aug. 2004 (on file with author) [hereinafter *Shelter Symposium*].

138. *Id.*

139. I.R.C. § 856(a)(5) (2000).

140. *Id.*

141. *Id.* § 857(b)(2)(B).

142. IND. CODE § 6-5.5-1-2 (2006).

143. I.R.C. § 243 allows for the deduction of dividends received from a member of the taxpayer’s affiliated group.

passed to the holding company in the form of a dividend from the REIT, reducing the REIT's income to zero.<sup>144</sup> The holding company then issues the dividend to the parent financial institution. The holding company is not a member of the Indiana unitary group because holding an interest in a REIT is specifically excluded from the definition of transacting business in Indiana.<sup>145</sup> Therefore the holding company escapes the tax on the REIT dividend. The dividend paid by the holding company is included in the parent financial institution's income, however, the parent eliminates the dividend from its net income utilizing the deduction allowed for dividends received from a member of its affiliated group.<sup>146</sup> The result is that the income from financial institution's real property holdings escape taxation entirely, even though the REIT is transacting the business of a financial institution in Indiana and is includible in the Indiana unitary return.<sup>147</sup>

Indiana has not addressed the use of REITs by financial institutions to shelter income thus far. There are several possible responses to this structure. The first is to disallow the deduction of the dividend in computing the REIT's taxable income because it is a transaction without economic substance.<sup>148</sup> The crux of this argument is that the taxpayer has structured a transaction without true economic substance for the sole purpose of obtaining a tax benefit.<sup>149</sup> Transactions that have been undertaken for the sole purpose of tax avoidance have been disallowed under "economic substance doctrine."<sup>150</sup> The State will point out that purpose of the REIT is to allow small investors to diversify; allowing large corporate investors to use a REIT to shelter income defeats the purpose for which these entities were conceived.<sup>151</sup> Financial institutions will have to offer a valid business purpose for the creation of the REIT to avoid disallowance of the dividend deduction.

If a financial institution can provide a valid business purpose for the REIT structure, the State will be forced to resort to the use of the "fairly represents"

144. I.R.C. § 857(b)(2)(B) (2000).

145. IND. CODE § 6-5.5-3-8(5)(A) (2006).

146. I.R.C. § 243 (2000).

147. Indiana Code section 6-5.5-3-1(6) includes holding mortgages secured by real property in Indiana in the definition of transacting business in Indiana. IND. CODE § 6-5.5-3-1(6) (2006). Indiana Code section 6-5.5-1-18(a) defines the unitary group as all members of the unitary business transacting business in Indiana without regard to the classification of the entity as a corporation or a pass-thru entity. *Id.* § 6-5.5-1-18(a). Indiana Code section 6-5.5-5-1 requires all members of the Indiana unitary group to file one combine return. *Id.* § 6-5.5-5-1.

148. *Shelter Symposium, supra* note 137.

149. *Id.*

150. Peter J. Connors et al., *Recent Cases Involving the Economic Sham Transaction Doctrine-Or Whatever They Are Calling It Now*, 683 TAX & LAW PRAC. 1261, 1269-70 (PLI Tax L. & Est. Plan. Course, Handbook Series 2004). Connors's survey of cases finds that "if there is no primary business purpose for a transaction, the courts have been reluctant to respect the transaction for tax purposes." *Id.*

151. *Shelter Symposium, supra* note 137.

language included in the statute to recapture the income. The statute includes a catch all provision that allows reallocation of tax items between members of the unitary group if the use of the provisions provided under the statute do not fairly represent the income derived from Indiana sources.<sup>152</sup> The State will need to successfully argue that the holding company's dividend must be reallocated to the financial institution parent to fairly represent income from Indiana sources. Financial institutions will contend that the holding company's income was explicitly excluded from taxation under the statute and that requiring its inclusion is contrary to the intent of the legislature. If a court is not willing to disallow the REIT structure for lack of economic substance, it is unlikely it will allow effectively the same outcome using the "fairly represents" approach, particularly when the holding company is not includible as a member of the Indiana unitary group.

### B. RIC

A RIC is an investment company that invests or trades in securities.<sup>153</sup> A RIC is special purpose pass-thru entity that allows for small investors to pool their funds to obtain diversification and skilled portfolio management.<sup>154</sup> An entity is required to have at least one hundred (100) shareholders and an intent to make a public offering to qualify as a RIC.<sup>155</sup> In addition, a RIC must be listed with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940.<sup>156</sup> In its most common form, a RIC is used to facilitate mutual funds.<sup>157</sup> Like a REIT, the dividends paid to shareholders by a RIC are deductible in determining the RIC's taxable income.<sup>158</sup>

Financial institutions can form a RIC held by a subsidiary holding corporation to hold their investment portfolios. The interest, dividends and other gains earned by the RIC are passed to the holding company as a dividend, which is deducted from the net income of the RIC, reducing the RIC's net income to zero.<sup>159</sup> The holding company receiving the RIC dividend is not subject to the financial institutions tax because it is not conducting the business of a financial institution in Indiana.<sup>160</sup> The holding company remits the dividend to the parent financial corporation. The holding company dividend is included in the parent financial institution's income, however, the parent eliminates the dividend from

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152. Indiana Code section 6-5.5-5-1(b) allows the Department of Revenue to reallocate tax items between a taxpayer and a member of the unitary group if the result of applying the statute does not fairly represent the taxpayer's income within Indiana. IND. CODE § 6-5.5-1(b) (2006).

153. *Shelter Symposium*, *supra* note 137.

154. *Id.*

155. Investment Company Act of 1940, 15 U.S.C. § 80 (2000).

156. *Id.* §§ 80a-1-80b-2; I.R.C. § 851(a)(1) (2004).

157. *Shelter Symposium*, *supra* note 137.

158. I.R.C. § 852(b)(2)(D) (2000).

159. *Id.* § 851(a)(1).

160. IND. CODE § 6-5.5-3-1 (2006).

its net income utilizing the deduction allowed for dividends received from a member of the affiliated group.<sup>161</sup> As a result the portfolio income previously included in the taxable base escapes taxation entirely.

While a RIC is largely unnecessary to avoid the Indiana financial institution tax, it is likely that large non-resident financial institutions that file returns in Indiana will use the RIC structure to avoid tax in other states. Unlike the activities of a REIT, the management of the financial institution's own portfolio is not included in the definition of transacting business for financial institutions tax purposes.<sup>162</sup> Therefore, the financial institution can merely form a wholly owned subsidiary corporation to hold the investment portfolio to achieve the same result. The activities of the subsidiary investment company would only be subject to the tax if the investment company maintains an office or employees in the State.<sup>163</sup> A financial institution headquartered outside Indiana would have little incentive to locate its investment company's office or employees inside the State.

A RIC is most useful for resident financial institutions to shelter portfolio income from taxation by states other than Indiana. For financial institutions that have all of their property and payroll located in Indiana, the formation of a subsidiary incorporated in a tax friendly<sup>164</sup> state is an attractive option to attempt to insulate investment portfolio income from the tax. The drawback of this planning strategy is that generally, in an effort to maintain control of the investments, the officers of the financial institution in Indiana will also be the officers of the subsidiary. Likewise, the financial institution's employees will direct the investments and perform management and accounting functions for the subsidiary. The subsidiary will report no payroll in Indiana because both the officers and employees are paid by the parent; however, these financial institutions may find it difficult to contend that the investment company does not maintain an office or representatives in Indiana due to the activities of these officers and employees, regardless of the subsidiary's state of incorporation.<sup>165</sup>

As with REITs, Indiana has not addressed the use of RICs by financial institutions to shelter income. The range of possible State responses is somewhat similar to those available with REITs. However, because the activities of the RIC are not independently subject to the tax,<sup>166</sup> Indiana will have a greater incentive to disallow the deduction of the dividend from the parent financial institution's federal taxable income rather than disallowing the dividend

161. I.R.C. § 243.

162. IND. CODE § 6-5.5-3-1.

163. *Id.*

164. A state that either does not tax such income or taxes it at a lower rate.

165. Typically, the officers or employees of the financial institution are also the officers of the investment company even if the company has a registered agent outside the state in which the financial institution is headquartered. Likewise, the investment company's managerial, accounting, and administrative functions are generally performed by the financial institution's employees.

166. IND. CODE § 6-5.5-3-1.

deduction from the RIC.<sup>167</sup>

Similar to a REIT, RICs are vulnerable to attack as lacking economic substance. Financial institutions will have to offer a valid business purpose for the creation of the RIC structure. However, the State will be forced to resort to the use of the “fairly represents” language included in the statute to reallocate the dividend received by the holding company to the financial institution parent if a valid business purpose is shown for the RIC.<sup>168</sup> This seems even less likely to be blessed by a court in the case of a RIC, as opposed to a REIT, because the RIC’s income would not be subject to the tax if the portfolio was held by a regular corporation.<sup>169</sup>

The income from other banking services such as credit card operations, secured and unsecured consumer loans and the extension of commercial credit has the potential to be sheltered in whole or in part from the tax through the use of more traditional pass-thru entities such as partnerships and limited liability companies. The use of these pass-thru entities is most effective when at least one tier of holding companies is used to hold the interest in the pass-thru thereby insulating the receipts from the tax.

### C. Partnerships

Financial institutions can form a variety of structures involving traditional pass-thru entities in attempting to minimize or avoid the tax. The simplest of these structures is accomplished by forming two holding corporations that will each hold an interest in a partnership. The operation the financial institution seeks to protect is transferred to, then operated by, the partnership. This structure attempts to allow the financial institution to minimize tax by controlling the manner in which income from the operation is reported and the effect of the operation’s receipts on the Indiana unitary group’s apportionment percentage.

The statute contains two seemingly conflicting provisions concerning the treatment of the income of a partnership that is held by a corporate partner, which is in turn owned by a financial institution. Indiana Code section 6-5.5-1-18 includes a pass-thru entity that is conducting the business of a financial institution in Indiana as a member of the Indiana unitary group. The apportioned income of the Indiana unitary group is the aggregate adjusted gross income for all members of the unitary group multiplied by a ratio determined by dividing the Indiana receipts of the group by the receipts of the group everywhere.<sup>170</sup> All members of the Indiana unitary group must be included in the combined unitary return.<sup>171</sup> In contrast, Indiana Code section 6-5.5-2-8 defines the corporate partner as a taxpayer under the statute, and requires the corporate partner to

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167. *Id.* § 6-5.5-3-8(5)(A).

168. *Id.* § 6-5.5-5-1.

169. *Id.* § 6-5.5-3-1.

170. *Id.* § 6-5.5-2-4; see *infra* Part III.D for more in depth discussion of apportionment numerator and denominator.

171. IND. CODE § 6-5.5-5-2 (2006).

include the partnership income in the corporate partner's income. However, the corporate partner cannot be included in the unitary return because, while it is a taxpayer, it does not transact business in Indiana under the statute's definition of that term.<sup>172</sup>

Financial institutions can interpret these two provisions in the statute as allowing them a choice in how to report the income from a partnership using this type of structure. The financial institution will contend that it may choose to include the operating results of the partnership in the unitary return and the receipts of the partnership in the apportionment calculation or the corporate partner may separately report the partnership's income outside the unitary return. This allows the financial institution to control the partnership's effect on the unitary group's apportionment percentage, which is a single factor percentage based solely on receipts.<sup>173</sup> This structure is most useful to shield the unitary apportionment percentage from the impact of the receipts of credit card operations. The receipts from credit card operations generally increase the Indiana apportionment percentage when Indiana credit card receipts are included in the numerator,<sup>174</sup> particularly for large multi-state financial institutions.

The State likely will view the partnership's operating results and receipts for apportionment as includible in the unitary return. This is consistent with the unitary principle<sup>175</sup> on which the financial institutions tax was based and is supported by the statutory definition of a unitary group in the article.<sup>176</sup> Allowing the corporate partner to separately report the partnership results affords non-unitary treatment for a segment of the unitary business. The State can offer that this mode of reporting runs contrary to legislative intent, and also point out that while most taxing jurisdictions, including the IRS,<sup>177</sup> allow a business to choose any type of structure it sees fit, taxing jurisdictions do not allow a taxpayer a choice concerning the manner of taxation after a particular entity type has been selected. Finally, using established pass-thru and unitary principles, the State may successfully attempt to directly attribute the partnership receipts to the corporate partner. Such attribution brings the partner within the definition of transacting business in the State, thereby requiring the inclusion of the corporate partner in the Indiana unitary group.<sup>178</sup>

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172. *Id.* §§ 6-5.5-1-18, -3-1.

173. *Id.* § 6-5.5-2-4.

174. *See infra* Part III.D. There is some doubt that the receipts of a pass-thru entity must be included in the numerator for apportionment.

175. *Hunt Corp. v. Ind. Dep't of Revenue*, 709 N.E.2d 766, 777 (Ind. Tax Ct. 1999).

176. IND. CODE § 6-5.5-1-18 (2006); *see supra* text accompanying notes 80-90 for discussion of unitary business principle as a basis for financial institutions tax.

177. *See generally* 26 U.S.C. §§ 1-9833 (2000) (providing separate taxing schemes based on an entity's classification under I.R.C. § 7701). For instance, C corporations, Subchapter S corporations, partnerships, REITs and RICs are taxed in accordance with their business classification.

178. *See infra* Part III.D. Including the corporate partner is important for the apportionment calculation because the corporation is defined as a taxpayer, but the partnership is not. The

Attempting to shelter all of the partnership's income from the tax requires a structure that adds an additional layer of holding partnerships between the holding company corporations and the operating partnership. The corporate partner in this structure is not subject to the provisions of Indiana Code section 6-5.5-2-8 which requires the partner to file a return to report the partnership income because the corporate partner is not holding an interest in a partnership that is transacting the business of a financial institution.<sup>179</sup> The holding partnership is not a taxpayer because it is not a corporation.<sup>180</sup> Neither the holding company corporate partner nor the holding partnership is transacting business in the state.<sup>181</sup> Therefore, neither the corporate partner nor the holding partnership can be included in the unitary group.<sup>182</sup> Financial institutions contend that the operating partnership's income is attributable to the holding partnership and the holding partnership's income is attributable to the holding company, neither of which is either required to file a return or includible in the unitary group; therefore, the operating partnership is not subject to the tax. This contention has at least one potentially fatal flaw. The operating partnership is includible in the unitary return under the statute.<sup>183</sup> As with the single pass-thru structure, the State can attempt to attribute the receipts from transacting business in Indiana to the holding partnership and then to the corporate partner, bringing both within scope of the Indiana unitary group.

Financial institutions that directly hold pass-thru entities that transact the business of a financial institution may also attempt to derive benefit from the ambiguity contained in the statute with respect to Indiana Code section 6-5.5-2-8. This section of the statute requires that the corporate partner "include in the corporation's adjusted or apportioned income the corporation's percentage of the partnership . . . adjusted gross income or apportioned income."<sup>184</sup> Financial

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numerator of the sales factor includes the receipts of taxpayer members of the unitary group, while the denominator includes the receipts of all members of the unitary group. IND. CODE § 6-5.5-2-4(2)(A), (B) (2006).

179. Indiana Code section 6-5.5-3-1 does not include owning an interest in a pass-thru that is conducting the business of a financial institution in the definition of transacting business in Indiana. IND. CODE § 6-5.5-3-1 (2006). Indiana Code section 6-5.5-2-8(a) requires a corporation that holds an interest in a partnership that is transacting the business of a financial institution to file a return reporting the partnership income. *Id.* § 6-5.5-2-8(a). The corporate holding company is engaged in the business of holding an interest in a holding partnership. The holding partnership, by merely holding an interest in the operating partnership, is not transacting the business of financial institution. *Id.* § 6-5.5-3-1.

180. Under Indiana Code section 6-5.5-2-8(a), an entity that holds an interest in a pass-thru must be a corporation to be a taxpayer. *Id.* § 6-5.5-2-8(a).

181. *Id.* §§ 6-5.5-2-8(a), -3-1.

182. Under Indiana Code section 6-5.5-1-18(a) only members of the unitary group that transact business in Indiana can be included in the unitary filing. *Id.* § 6-5.5-1-18(a).

183. All entities that transact business in Indiana are in the Indiana unitary group, regardless of entity classification. *Id.*

184. *Id.* § 6-5.5-2-8.

institutions can contend that this section allows them to choose to include either the entire adjusted gross income of the partnership in the unitary group's adjusted gross income subject to apportionment or only the Indiana portion of the partnership's income. The Indiana portion of the partnership's income is determined by apportioning the partnership's income prior to inclusion in the combined return. This allows the financial institution to control the effect of the partnership on both the base income of the unitary group subject to apportionment and the Indiana receipts included in determining the Indiana apportionment percentage.

The State can assert that the interpretation of this section of the statute as offering a choice of reporting methods is in error because it can only be reached by reading this code section in isolation from all other sections of the statute. The State can argue that choice of the drafters of the statute to address certain reporting requirements in a single section for both corporate partners that must include adjusted gross income, and those that must report apportioned income cannot be interpreted to nullify the sections of the statute explicitly requiring the inclusion of the adjusted gross income rather than the apportioned income of a partnership in the combined return.<sup>185</sup> The State may insist that the canons of statutory construction require Indiana Code section 6-5.5-2-8 be interpreted in a manner that gives effect to all other sections of the statute.

#### *D. Dilution of Indiana Apportionment Percentage*

In addition to sheltering income from taxation, the pass-thru entities can be used to dilute the Indiana apportionment percentage. The financial institutions tax defines a taxpayer as a corporation.<sup>186</sup> The law relies on I.R.C. § 7701(a)(3) to define a corporation.<sup>187</sup> Under § 7701(a)(3), a pass-thru entity is not a taxpayer for financial institutions tax purposes.<sup>188</sup> However, pass-thru entities

185. Indiana Code section § 6-5.5-5-2 provides that a combine return must include the adjusted gross income of all members of the unitary group, even if some of the members would not otherwise be subject to taxation under the statute. No provision is made for the inclusion of apportioned income. *Id.* § 6-5.5-5-2 (2006). Indiana Code 6-5.5-2-4 defines the apportioned income for a unitary group as the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group multiplied by the Indiana apportionment percentage. Again, no provision is made for apportioned income. *Id.* § 6-5.5-2-4. Indiana Code section 6-5.5-1-18 defines the members of the unitary group to include any entity, regardless of form, engaged in a unitary business transacted in Indiana. *Id.* § 6-5.5-1-18.

186. *Id.* § 6-5.5-1-17(a).

187. *Id.* § 6-5.5-1-6.

188. REITs and RICs are most likely not corporations under I.R.C. § 7701(a)(3) (2000). Treasury Regulation section 301.7701-2(a) (as amended in 2006) states that a business entity for purposes of I.R.C. § 7701 is any entity recognized for federal tax purposes that is not "otherwise subject to special treatment under the Internal Revenue Code." Treas. Reg. § 301.7701-2(a) (as amended in 2006). Both REITs and RICs are subject to special treatment under the Internal Revenue Code. Therefore, a REIT or RIC is not a business entity within the meaning of § 7701 and

that: 1) hold mortgages on real property located in Indiana, 2) engage in credit card transactions with customers in the State, or 3) extend credit in the form of secured and unsecured loans to borrowers in the State, are transacting business in Indiana. Therefore, these pass-thru entities are included in the Indiana unitary group regardless of their lack of status of as a taxpayer.<sup>189</sup> Curiously, the Indiana apportionment percentage is defined as a ratio, the numerator of which is all receipts attributable to Indiana for taxpayer members of the unitary group, while the denominator is composed of the receipts for all members of the unitary group in all taxing jurisdictions.<sup>190</sup> As a result, the pass-thru entity's Indiana source receipts do not appear to be included in the numerator and the pass-thru entity's receipts from all taxing jurisdictions appear to be included in the denominator.

The State can counter the inclusion of the receipts of pass-thru entities in the denominator and not the numerator using either the basic unitary principles presumed by the law or the "fairly represent" provisions of the statute. The corporate owners of the pass-thru entities are presumed to have a unitary relationship with the pass-thru entities under the FIT law.<sup>191</sup> Where a unitary relationship exists, the partnership receipts flow-thru to the corporate partners in proportion to their ownership percentage.<sup>192</sup> Receipts that flow from a partnership to a corporate partner retain their character.<sup>193</sup> For example, a capital gain at the partnership level flows-thru to the corporate partner as a capital gain. The State can contend that the receipts from transacting the business of a financial institution flow to the corporate partner with that same character, resulting in the corporate partner's receipts being characterized as receipts from transacting business in Indiana, rather than merely receipts from holding a partnership interest. If the Indiana receipts that flow from the pass-thru entity to the corporate partner can be characterized as the Indiana receipts of the corporate partner, the receipts can be included in the numerator of the apportionment factor<sup>194</sup> because the corporate partner will be a taxpayer member of the unitary group.<sup>195</sup>

Financial institutions may respond that these general principles have been accepted for apportionment only for net income taxes, and the financial

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probably falls outside the definition of a corporation for financial institution tax purposes.

189. IND. CODE § 6-5.5-1-18(a) (2006).

190. The numerator of the sales factor includes the receipts of taxpayer members of the unitary group; the denominator includes the receipts of all members of the unitary group. *Id.* § 6-5.5-2-4(2).

191. *Id.* § 6-5.5-1-18(b). Unity is presumed under the law for all entities directly or indirectly owned by the financial institution based on the controlled interaction among entities that are members of the unitary group.

192. *Hunt Corp. v. Ind. Dep't of Revenue*, 709 N.E.2d 766, 777 (Ind. Tax Ct. 1999).

193. I.R.C. § 702(b) (2000) states that "[t]he character of any item of income, gain, loss, deduction, or credit" attributable to the partner shall be treated "as if such item were realized directly from the source from which realized by the partnership."

194. IND. CODE § 6-5.5-2-4(2)(A) (2006).

195. I.R.C. § 702(b); *Hunt Corp.*, 709 N.E.2d at 777.

institutions tax implicitly rejects these general principles by its structure and plain language. However, the financial institutions tax is built on the unitary principles enunciated by the Supreme Court in the net income tax arena.<sup>196</sup>

If the State is unable to attribute the partnership's business receipts directly to the corporate partner, the State will probably have to show that the exclusion of the pass-thru's Indiana receipts from the numerator does not "fairly represent" income from within Indiana.<sup>197</sup> Financial institutions will again argue that inclusion of the pass-thru entities is contrary to the plain meaning of the statute and that it is contrary to legislative intent.

### CONCLUSION

While the economic nexus concept may appear to be a lifeline to states drowning in a sea of red ink, it is an unnecessary expansion of the states' ability in tax interstate commerce. The unitary business principle and state "fairly represent" statutes provide the states with adequate means to ensure their ability to tax their fair share of multi-state business operations. Conversely, the economic nexus concept will almost surely lead to overreaching by the states. If history is indeed a teacher, the temptation for state legislatures to balance budgets on the backs of those unable to vote in the state will ultimately prove irresistible.

The economic nexus approach has the potential to allow states to impose a tax on a single company with minimal contacts to the taxing state. With the emergence of the Internet, smaller businesses that have never had the resources to compete in the national marketplace now have that opportunity. Under an economic nexus standard, revenue hungry states would be free to impose tax on businesses that do not have the resources or sophistication to comply with the taxing schemes of fifty states or mount a defense against overly aggressive state taxes. A small business may very well decide to forgo providing products or services to residents of a given states or states when faced with the additional compliance burden. The states' interest in taxing their fair share of multi-state business operations and/or combating income shifting does not justify such a burden on interstate commerce.

The economic nexus concept will also lead to inefficiency and an increase in double taxation of income. Unlike a bright line physical presence test that

196. *Allied-Signal, Inc. v. Dir. Div. of Taxation*, 504 U.S. 768, 783 (1992); *see also* *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 179 (1983); *Mobile Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425, 438 (1980). Indiana Code section 6-5.5-1-18(a) defines "unitary business" as business operations "that are of mutual benefit, dependent on, or contributory to" the group's "transacting the business of a financial institution." IND. CODE § 6-5.5-1-18(a) (2006). Unity is presumed where there is unity of ownership, centralized management and controlled interaction among entities. *Id.* § 6-5.5-1-18(b).

197. Indiana Code section 6-5.5-5-1(b) allows the Department of Revenue to reallocate tax items between a taxpayer and a member of the unitary group if the result of applying the statute does not fairly represent the taxpayer's income within Indiana. IND. CODE § 6-5.5-5-1(b).

settles the expectations of states and businesses alike, economic nexus will have to be determined on a case by case basis to determine whether a given economic activity satisfies the substantial nexus requirement. This will not only consume considerable judicial resources, it may retard investment in interstate commerce as businesses become more cautious in an atmosphere where state laws are unsettled, lack uniformity and present a greatly increased potential for double taxation.

Left to their own devices, it is unlikely that states will reach the same conclusions as to what, or how much, economic activity constitutes substantial nexus. It is even more unlikely that the states will agree to the manner in which receipts are to be sourced for apportionment purposes. As a result, the potential for the income from any given transaction to be sourced to two, three or more states is increased dramatically. The burden on interstate commerce that double taxation represents and the inefficiencies associated with implementing the economic nexus standard make clear that it should not be utilized until commerce has evolved in a manner that absolutely necessitates it. While there is no doubt that the time will come when such a necessity exists, now is not that time.

The fate of the financial institutions tax as amendment in 2002 is inextricably tied to the constitutionality of the economic nexus concept. This can be cured by returning to the unitary taxing scheme envisioned in the law as originally enacted. In addition, a return to the unitary business principle would eliminate the temptation for financial institutions to restructure their operations to avoid the tax. However, even if the law is not restored to include all members of the unitary group, the law can still be amended to eliminate the ability of financial institutions to shift income away from the state. By altering either: 1) the definition of transacting business in Indiana to include direct and indirect ownership of a pass-thru conducting the business of a financial institution in the State, or 2) the definition of a taxpayer to include pass-thru entities, the majority of the income shifting strategies would be eliminated while restricting the imposition of the tax to only members of the unitary group transacting business in Indiana. These remedial measures would result in the fair apportionment of income to the State while still addressing the concerns of regional banks that a level playing field be preserved.