IN THE SUPREME COURT
OF THE
STATE OF SOUTH DAKOTA

---

APPEAL NO. 29338

---

U.S. BANK NATIONAL ASSOCIATION

Appellant,

-vs-

SOUTH DAKOTA DEPARTMENT
OF REVENUE,

Appellee.

---

APPEAL FROM THE CIRCUIT COURT
SIXTH JUDICIAL CIRCUIT
HUGHES COUNTY, SOUTH DAKOTA

---

THE HONORABLE BOBBI J. RANK
CIRCUIT COURT JUDGE, PRESIDING

---

# BRIEF OF APPELLANT
# U.S. BANK NATIONAL ASSOCIATION

---


CRAIG B. FIELDS
NICOLE L. JOHNSON
BLANK ROME LLP
1271 AVENUE OF
THE AMERICAS
NEW YORK, NY 10020
(212) 885-5000

ATTORNEYS FOR
APPELLANT

JUSTIN L. BELL
MAY, ADAM, GERDES
& THOMPSON, LLP
PO BOX 160
PIERRE, SD 57501
(605) 224-8803

ATTORNEYS FOR
APPELLANT

JOHN T. RICHTER
SD DEPARTMENT
OF REVENUE
445 E. CAPITOL AVE.
PIERRE, SD 57501
(605) 773-57501

ATTORNEY FOR
APPELLEE


---

NOTICE OF APPEAL FILED MAY 28, 2020

## TABLE OF CONTENTS

**Page**

## TABLE OF AUTHORITIES

**Page(s)**

**CASES**



**STATUTES**

**STATUTES, CONT.**



**OTHER AUTHORITIES**

## PRELIMINARY STATEMENT

For the convenience of the Court, the following abbreviations shall be used: Appellant U.S. Bank National Association will be referred to as "U.S. Bank." Appellee South Dakota Department of Revenue will be referred to as the "Department." The Administrative Record will be cited as "AR ___."

## JURISDICTIONAL STATEMENT

This is an administrative appeal by U.S. Bank under SDCL 1-26-30 et. seq. from the Final Decision and Order of the Secretary of the Department of Revenue (the "Final Decision"), dated July 18, 2018, notice of entry of which was given on July 19, 2018, which adopted, with substantial modifications, the Proposed Decision of Hearing Examiner Catherine Duenwald, dated May 22, 2018.

The Hughes County Circuit Court entered a Memorandum Decision and Order on May 1, 2020, affirming the Secretary of the Department of Revenue's Final Decision. Appendix ("App."), pp. 1-27. A Notice of Appeal was filed on May 28, 2020. This Court has jurisdiction over this appeal pursuant to SDCL 1-26-37 and SDCL 15-26A-3.

## STATEMENT OF THE ISSUES

1. WHETHER U.S. BANK IS ENTITLED TO A DEDUCTION UNDER SDCL 10-43-10.3(3)?[1]

   The Circuit Court made the conclusory statement that "U.S. Bank has not met its burden of proof regarding entitlement" to the deduction. App., p. 27.

   Authority:

   SDCL 10-43-10.3(3)
   IRC § 11 (2012)

[1] In 2016, the deduction at issue was re-codified at SDCL 10-43-10.3(2).

2. IF SO, WHAT IS THE APPROPRIATE METHODOLOGY FOR DETERMINING THE AMOUNT OF THAT DEDUCTION?

   The Circuit Court did not provide a methodology for determining the amount of the deduction.

   Authority:

   SDCL 10-43-10.3(3)
   IRC § 11 (2012)

## STATEMENT OF THE CASE

A financial institution computes its South Dakota Franchise Tax by starting with its federal taxable income and then making certain statutory modifications (both additions and subtractions) to arrive at its South Dakota net income. The income and the tax are computed on a separate return basis whereby each corporation that is subject to tax separately computes its own taxable income and resulting tax liability.[2]

In computing its South Dakota net income, U.S. Bank computed its federal taxable income as if it had filed its federal income tax return on a separate return basis even though it filed as part of a consolidated federal income tax return filed by its parent corporation, U.S. Bancorp.

One of the South Dakota statutory modifications to federal taxable income is a deduction for federal income "[t]axes imposed upon the financial institution." SDCL 10-43-10.3(3) ("Federal Tax Deduction"). The Department has not issued any guidance on the methodology used to compute the Federal Tax Deduction. Thus, U.S. Bank was left to determine an appropriate methodology.

[2] As opposed to a combined or consolidated basis, which includes the income of two or more separate legal entities.

Consistent with the way it computed its federal taxable income, U.S. Bank computed its Federal Tax Deduction by multiplying its federal taxable income computed on a separate return basis by 35% (i.e., the same amount of federal income taxes that U.S. Bank would have paid had it filed its federal income tax return on a separate return basis).

After an audit, the Department's auditor conceded that "U.S. Bank should be allowed some type of deduction." AR 366. Nevertheless, the Department denied the Federal Tax Deduction in full for 2012 and denied the refund claims for 2010 and 2011 (which corrected the amount of the Federal Tax Deduction).

However, U.S. Bank's methodology for computing the Federal Tax Deduction is correct. First, U.S. Bank's methodology was consistent with the way it computed its South Dakota net income (i.e., on a separate return basis). Second, U.S. Bank's methodology results in the same amount of Federal Tax Deduction as U.S. Bank's portion of the consolidated group's federal taxable income and resulting federal tax due.

Third, this methodology is (1) the same method provided by the Federal Department of the Treasury in a Policy Statement which provides for tax allocations on a separate return basis, (2) consistent with other provisions of the SDCL, which provide that other deductions are computed as if the financial institution filed a separate federal income tax return as a C Corporation, (3) is the same method contained in a federal treasury regulation providing that the allocation of the consolidated tax liability is based on each corporation's liability computed on a separate basis, and (4) is the exact same method used for Missouri Bank Franchise Tax purposes with respect to its deduction for federal taxes paid.

The Circuit Court muddles the issues in this case. However, it is inescapable that the record in this case establishes that U.S. Bank is entitled to the Federal Tax Deduction. Further, the record establishes that U.S. Bank's methodology for computing the Federal Tax Deduction was proper.

The Memorandum Decision and Order was issued by the Honorable Bobbi J. Rank, Sixth Circuit Court Judge, and affirmed the Final Decision and Order of the Secretary of the Department of Revenue, dated July 18, 2018, which adopted, with substantial modifications, the Proposed Decision of Hearing Examiner Catherine Duenwald, dated May 22, 2018.

## STATEMENT OF THE FACTS

The following are the relevant facts in the case, which are supported by the record:

### I. U.S. Bank's Operations

U.S. Bank is a financial institution with commercial and retail bank operations. AR 310. U.S. Bank is headquartered in Minneapolis, Minnesota. Id. It is a wholly-owned subsidiary of U.S. Bancorp, which is a publicly traded company. AR 311.

### II. Federal Tax Returns

U.S. Bancorp (the parent corporation of U.S. Bank) filed consolidated federal income tax returns, which included U.S. Bank. AR 21-51; 52-84; 85-120; 325-26. The total income tax shown as due, before application of credits, on the consolidated returns was as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |

December 31, 2012 $1,985,176,947

AR 23; 54; 87; 313.

The total income tax due was paid with both cash and credits. AR 21-51; 52-84; 85-120; 314. U.S. Bank made cash payments to the Internal Revenue Service ("IRS") to pay the remaining tax due (i.e., the amount remaining after credits). The total payments were as follows:

| Tax Year Ended | Total Cash Payments | + | Total Credits | = | Total Payment |
|---|---|---|---|---|---|
| December 31, 2010 | $524,920,206 | + | $ 617,333,443 | = | $1,142,253,649 |
| December 31, 2011 | $617,186,234 | + | $ 631,349,674 | = | $1,248,535,908 |
| December 31, 2012 | $981,865,059 | + | $1,003,311,888 | = | $1,985,176,947 |

AR 21; 52; 85; 324-63; 314-15.

The net income tax shown as due, after application of credits, on the consolidated returns was as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

AR 23; 54; 87.

U.S. Bank's taxable income consisted of the majority of the consolidated group's taxable income as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | ÷ | Consolidated Group's Federal Taxable Income | = | %[3] |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | ÷ | $3,263,581,855 | = | 74% |
| December 31, 2011 | $2,342,731,149 | ÷ | $3,567,245,451 | = | 66% |
| December 31, 2012 | $4,925,219,278 | ÷ | $5,671,934,133 | = | 87% |

AR 21-51; 52-84; 85-120.

[3] Percentage amounts have been rounded.

In addition, U.S. Bank prepared pro forma federal income tax returns. AR 121-25; 126-30; 131-35; 321-22. These pro forma returns were prepared to show U.S. Bank's taxable income on a separate return basis for states, such as South Dakota, that impose tax on a separate return basis (i.e., as if U.S. Bank had filed a separate federal income tax return rather than filing as part of a consolidated federal income tax return). AR 322. The pro forma returns do not calculate – and are not required to calculate – any tax due. AR 323.

## III. Tax Sharing Agreement

U.S. Bank and U.S. Bancorp entered into an Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp ("Tax Sharing Agreement") with certain affiliates. AR 264-72; 324. The Tax Sharing Agreement, in part, provides for the allocation of the federal income tax liability among the members of the consolidated group, including U.S. Bank. Id. It is designed to allocate the proper amount of the federal tax liability or benefit to the member that generated the income or loss. AR 324.

Pursuant to the Tax Sharing Agreement, each member's federal tax liability is computed as if it had filed a separate federal income tax return (i.e., separate return federal taxable income multiplied by 35%). AR 264-72; 326. If a member of the consolidated group had a loss for the year, the member was paid for the use of that loss (i.e., the loss multiplied by 35%) as the loss would be used to offset the income of another affiliate. AR 264-72; 326-27. In accordance with the Tax Sharing Agreement, U.S. Bank's federal tax liability was as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | x | Tax Rate | = | U.S. Bank's Federal Tax Liability |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x | 35% | = | $ 840,313,825 |
| December 31, 2011 | $2,342,731,149 | x | 35% | = | $ 819,955,902 |
| December 31, 2012 | $4,925,219,278 | x | 35% | = | $1,723,826,747 |

AR 21-51; 52-84; 85-120; 121-25; 126-30; 131-35; 264-72.

The Tax Sharing Agreement is a binding contract between the affiliates. AR 264-72; 326; 340. U.S. Bank complied with the terms of the Tax Sharing Agreement. AR 327. Such compliance required that cash be paid to those members that incurred losses or that generated credits. Id.

Moreover, U.S. Bank is required by its federal regulators to ensure compliance with the Tax Sharing Agreement. Id. In particular, U.S. Bank is audited by the Office of the Comptroller of the Currency (the "OCC"), the Federal Reserve System and the Federal Deposit Insurance Corporation (the "FDIC") – all of which provide for, and audit compliance with, the Tax Sharing Agreement. AR 328. The OCC ensures that U.S. Bank has the proper amount of capital and audits U.S. Bank's financial statements. Id. Similarly, the FDIC audits U.S. Bank to ensure that U.S. Bank has the proper amount of assets. AR 329.

Other affiliates were also audited by the OCC, the Federal Reserve System and the FDIC to ensure their compliance with the Tax Sharing Agreement. AR 328-29.

EY, formerly Ernst & Young, U.S. Bank's independent auditor, also audited U.S. Bank's compliance with the Tax Sharing Agreement. AR 330. Likewise, internal auditors routinely audited the transactions between U.S. Bank and its affiliates, including the transactions under the Tax Sharing Agreement. AR 330-31.

## IV. U.S. Bank's South Dakota Franchise Tax on Financial Institutions Returns

U.S. Bank timely filed South Dakota Franchise Tax on Financial Institutions returns ("South Dakota Returns"). AR 136-41; 142-47; 159-63. In computing its South Dakota tax liability, U.S. Bank used the total federal taxable income reflected on its pro forma federal returns as the starting point in computing its taxable income for South Dakota purposes. See AR 136-41; 142-47; 150-53; 154-58; 159-63. The Department did not adjust these amounts. AR 164-215; 216.

On its South Dakota Returns for 2005, 2006 and 2007, U.S. Bank calculated its Federal Tax Deduction by multiplying U.S. Bank's federal taxable income by 35%. AR 273-77; 278-82; 283-87; 334-35. If U.S. Bank had filed its federal income tax returns on a separate return basis, rather than being included in a consolidated return, this is the amount of federal income tax that U.S. Bank would have paid.

Beginning with the 2008 South Dakota Return, an error occurred in the methodology used to compute the Federal Tax Deduction. AR 333. In preparing its South Dakota Return for 2012, U.S. Bank identified the error and filed amended South Dakota Returns for 2009, 2010 and 2011.[4] AR 150-53; 154-58; 333. The amended South Dakota Returns for 2010 and 2011 corrected the error and requested a refund. AR 150-53; 154-58; 332. The amended South Dakota Returns calculated the Federal Tax Deduction by multiplying U.S. Bank's federal taxable income by 35%. Id. The 2010 amended South Dakota Return specifically provided the calculation methodology for the Federal Tax Deduction. AR 153.

[4] An amended South Dakota Return was not filed for 2008 as the statute of limitations had expired. AR 333. In addition, the 2009 amended South Dakota Return was later denied as it was filed after the statute of limitations had expired. Id.; AR 164-215.

On its 2012 South Dakota Return, U.S. Bank calculated its Federal Tax Deduction by multiplying its federal taxable income by 35%. AR 159-163; 333.

**V. The Department's Audit**

U.S. Bank was selected as a test audit by the Department. AR 377-78. The Department sent Notices of Intent to Audit for 2011 and 2012. AR 244-46. A Notice of Intent to Audit was not issued for 2010. AR 381-82. The audit was conducted by Steven Onken and Donald Larson, contract auditors for the Department. AR 244-46; 355-56; 360-61.

During the course of the audit, the relevant portions of the consolidated federal income tax returns, U.S. Bank's pro forma federal income tax returns and the Tax Sharing Agreement were provided to the auditors, along with other documents. AR 297-302; 374; 382.

The Department's auditor, Mr. Larson, determined that "U.S. Bank should be allowed some type of deduction." AR 366; see also AR 382 (stating that it was Mr. Larson's "recommendation" that U.S. Bank be entitled to some amount of the Federal Tax Deduction). Further, Mr. Larson testified that "the exact amount of money that was sent up to [U.S.] Bancorp for the payment of federal taxes, we will use that as a starting point" for the Federal Tax Deduction. AR 382. Nevertheless, Mr. Larson testified that he did not have a methodology to compute the Federal Tax Deduction. Id.

On December 28, 2015, the Department issued the Certificate of Assessment ("Certificate") for 2012. AR 216. The Certificate asserted as due $508,926.11, which consisted of $364,169 of additional tax and $144,757.11 of interest. Id. Attached to the Certificate was a copy of Mr. Larson's report. AR 164-215. The report states that the

refund claims related to the Federal Tax Deduction for 2010 and 2011 were denied in full and the entire Federal Tax Deduction for 2012 was denied. Id.

## STANDARD OF REVIEW

The general standard of review in administrative appeals such as this case is set forth in SDCL 1-26-37. The interpretation and application of a tax statute is a question of law that is reviewed de novo. Citibank, N.A. v. S.D. Dep't of Revenue, 868 N.W.2d 381, 385 (S.D. 2015). Regarding questions of law, this Court may "interpret statutes without any assistance from the administrative agency." In re State Sales & Use Tax Liab. of Pam Oil, 459 N.W.2d 251, 255 (S.D. 1990). This case involves the interpretation and application of SDCL 10-43-10.3(3) and, therefore, the standard of review is de novo.

## ARGUMENT

### I.

### U.S. BANK IS ENTITLED TO THE FEDERAL TAX DEDUCTION

In calculating a financial institution's net income, South Dakota law provides for the Federal Tax Deduction and states as follows:

> Subtracted from taxable income are:…
>
> (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375

SDCL 10-43-10.3(3).[5]

Neither South Dakota law nor any Department regulation or pronouncement defines "taxes imposed." However, based on the plain language of the statute, in order to

[5] There are no taxes imposed under 26 U.S.C. Section 1374 or 26 U.S.C. Section 1375 that are at issue in this case.

qualify for the Federal Tax Deduction, taxes must be imposed on U.S. Bank under the Internal Revenue Code ("IRC").

### A. Under the Internal Revenue Code, Taxes Are Imposed on U.S. Bank's Federal Taxable Income

In interpreting a statute, it is fundamental "to ascertain the real intention of the lawmakers." In re Famous Brands, Inc., 347 N.W.2d 882, 885 (S.D. 1984). That intention is determined based on the language used in the statute. Id. The words in a statute are given "their plain meaning and effect." Id.

The dictionary definition of terms can be used to determine their plain meaning. Citibank, 868 N.W.2d at 389 (determining the plain meaning of the term "implement" by reference to the American Heritage Dictionary); Wiersma v. Maple Leaf Farms, 543 N.W.2d 787, 790 (S.D. 1996) (determining the plain meaning of "unborn" by reference to the Webster's New World Dictionary).

Merriam-Webster defines "impose" as "to establish or apply by authority – impose a tax." Merriam-Webster's Online Dictionary (2020), *available at* www.merriam-webster.com/dictionary/impose (last visited Sept. 5, 2020). Therefore, based on the plain meaning of "impose," federal income taxes are imposed when such taxes are established or applied by authority.

The Circuit Court subverted this plain meaning by referring to a sub-definition of "impose." App., p. 16 (stating that "impose" also means "to establish or bring about as if by force"). However, the Circuit Court's claims are without merit.

The applicable definition of "impose" (i.e., to establish or apply by authority – impose a tax") specifically refers to imposing taxes. However, the sub-definition references situations such as "those limits imposed by our own inadequacies." Merriam-

Webster's Online Dictionary (2020), *available at* www.merriam-webster.com/dictionary/impose. The use of impose in the tax statute is clearly not that situation. Thus, when determining what "impose" means for purposes of taxes, the definition referencing taxes applies.

Moreover, the IRC provides that a "tax is hereby imposed for each taxable year on the taxable income of every corporation." IRC § 11 (2012) (entitled "Taxes Imposed) (emphasis added). U.S. Bank is included in the consolidated federal income tax returns filed by U.S. Bancorp under the authority of the IRC. AR 21-51; 52-84; 85-120. By inclusion in the consolidated group, tax is imposed on U.S. Bank's federal taxable income by the authority of the IRC. In addition, as a member of a consolidated group, U.S. Bank is severally liable for the taxes imposed on the entire consolidated group (i.e., the total tax due). 26 C.F.R. § 1.1502-6(a).

**B. The Circuit Court's Unsupported Conclusions are Without Merit**

It is evident that the IRC imposed an income tax on U.S. Bank – a fact which is undisputed by the Department and was conceded by the Department's own auditor. AR 366 (stating Mr. Larson determined that "U.S. Bank should be allowed some type of deduction"); AR 382 (stating that it was Mr. Larson's "recommendation" that U.S. Bank be entitled to some amount of the Federal Tax Deduction). Nevertheless, the Circuit Court makes a conclusory statement that "U.S. Bank has not met its burden of proof regarding entitlement" to the Federal Tax Deduction. App., p. 27.

Under the plain language of the Federal Tax Deduction, in order to be entitled to the deduction, taxes must be imposed on U.S. Bank under the IRC. As explained above, such taxes are imposed on U.S. Bank by the IRC. The Circuit Court does not provide any

explanation as to the necessary requirements for entitlement to the Federal Tax Deduction. The Circuit Court does not address in any detail whether taxes were imposed on U.S. Bank by the IRC – the requirement of the Federal Tax Deduction.

Therefore, under the plain language of the Federal Tax Deduction, U.S. Bank is entitled to the Federal Tax Deduction and the Circuit Court's conclusion is without merit. See AR 366; 382.

### C. The Federal Tax Deduction Applies to "Taxes Imposed" Not "Net Taxes Imposed"

The plain language of the Federal Tax Deduction expressly states that the deduction applies to "[t]axes imposed." SDCL 10-43-10.3(3). Nevertheless, when promulgating the regulation regarding deductibility, the Department attempts to add a word to the statute. ARSD 64:26:01:01(4). Specifically, the Department attempts to define "taxes imposed" as "net taxes imposed." Id. However, the word "net" is noticeably absent from the language of the Federal Tax Deduction – instead, it references "[t]axes imposed." When interpreting a statute, a "court must confine itself to the language used." In re Appeal of AT&T Info. Sys., 405 N.W.2d 24, 27 (S.D. 1987). In accordance with the plain language of the statute, the Federal Tax Deduction is based on the "taxes imposed," not the "net taxes imposed."

Given the plain language of the statute, the Department's regulation stating that "net federal income taxes are deductible" is invalid as the regulation exceeds the scope of the statute. ARSD 64:26:04:28; see also Paul Nelson Farm v. S.D. Dep't of Revenue, 847 N.W.2d 550, 558 (S.D. 2014) (stating that "[r]ules adopted in contravention of statutes are invalid") (citations omitted).

Even if the regulation is correct – which it is not – the regulation does not define when taxes are "imposed." See ARSD 64:26:01:01(4). Therefore, as the foregoing demonstrates, taxes were imposed on U.S. Bank by the IRC and U.S. Bank is entitled to the Federal Tax Deduction.

## II.

## U.S. BANK PROPERLY COMPUTED THE FEDERAL TAX DEDUCTION

After a taxpayer establishes that it has qualified for a deduction, the next step is to calculate the deduction. The Department was authorized to promulgate administrative rules concerning the Federal Tax Deduction. SDCL 10-43-42.1. The Department has issued two regulations regarding the Federal Tax Deduction. The first regulation provides as follows:

> Net federal income taxes are deductible from taxable income in the year in which they are paid when the cash method of accounting is used in determining the net income of the taxpayer. Net federal income taxes are deductible from taxable income in the tax year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. Any other income, franchise, or privilege taxes which were deducted to determine federal taxable income are not deductible.

ARSD 64:26:04:28. The second regulation defines "net federal income tax" as "that federal income tax in excess of any federal income tax refund received during the tax year for which the deduction is claimed." ARSD 64:26:01:01(4). Neither of the Department's regulations provide any methodology for a taxpayer to use to calculate the deduction. Id.

The Department's South Dakota Franchise Tax on Financial Institutions return instructions are similarly without guidance and provide as follows:

> FEDERAL INCOME TAXES PAID OR ACCRUED - LINE 15. Federal income taxes shall be deducted from taxable income in the year in which

> they are paid when the cash method of accounting is used in determining net income. Federal income taxes shall be deducted from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining net income.

S.D. Fran. Tax Ret. Instructions, *available at* www.state.sd.us/eforms/secure/eforms/nonE0883V7-FinancialInstitutionFranchiseTaxYearlyReturn.pdf. The Department's auditor also stated that he "didn't have" a methodology for computing the Deduction. AR 382.

Without any guidance or direction from the Department, U.S. Bank was left to determine its own methodology for computing the Federal Tax Deduction. To compute its Federal Tax Deduction, U.S. Bank multiplied its federal taxable income by 35%.

## A. The Department Has Failed to Provide Any Method to Compute the Federal Tax Deduction

One of the key tenants of South Dakota tax law is that the Department has "[a]n unwavering commitment to the uniform and fair application of our tax laws." See The South Dakota Taxpayers' Bill of Rights, *available at* www.dor.sd.gov/media/4qwgc4r0/taxpayerbillofrights.pdf (last visited Sept. 5, 2020). This guiding principle ensures that all taxpayers are aware of how the Department believes that the tax law applies. However, the Department's failure to provide any guidance or method by which to calculate the Federal Tax Deduction creates a result that is anything but uniform. Instead of uniformity, each taxpayer is left to determine its own methodology.

This troubling outcome is highlighted by the Circuit Court. The Circuit Court states that the Department had only two options: (1) accept U.S. Bank's methodology; or (2) deny the claimed deductions in full. App., p. 23. The obvious third option would be

for the Department to provide a method that could be uniformly applied by all taxpayers. Without such guidance, taxpayers are left to develop their own methodologies – which is what U.S. Bank did.

### B. The Amount of "Taxes Imposed" For the Federal Tax Deduction Is Computed on a Separate Return Basis

South Dakota law provides that "[a]n annual tax is hereby imposed on each financial institution doing business in this state." SDCL 10-43-2. The South Dakota financial institution tax is imposed on a financial institution's federal taxable income with certain modifications. SDCL 10-43-10.1. Financial Institutions that are included in a consolidated federal income tax return, such as U.S. Bank, nevertheless report their federal taxable income to the Department on a separate return basis. Id.; see also SDCL 10-43-36 (requiring or allowing consolidated reports for South Dakota Returns only in certain circumstances that are inapplicable here).

As required, U.S. Bank filed its South Dakota Returns on a separate return basis. AR 136-41; 142-47; 150-53; 154-58; 159-63. On those returns, U.S. Bank computed its South Dakota net income by starting with its federal taxable income from the pro forma federal income tax returns. Id. For example, U.S. Bank's Line 3 Taxable Income on its 2012 South Dakota Return (i.e., $4,925,219,278) was the same amount as U.S. Bank's Line 30 Taxable Income on its 2012 pro forma federal return (i.e., $4,925,219,278). Compare AR 131 with AR 160. The Department did not adjust this starting point on U.S. Bank's South Dakota Returns. AR 164-215; 216.

In calculating the Federal Tax Deduction, U.S. Bank multiplied its federal taxable income by 35% — the amount that is due when the IRC is applied to U.S. Bank's federal taxable income. It would be incongruous to compute South Dakota net income in a

different manner than that used to compute the Federal Tax Deduction. Therefore, as with computing South Dakota net income, the Federal Tax Deduction is computed on a separate return basis.

**1. U.S. Bank's Methodology Is Consistent With South Dakota Law**

U.S. Bank's methodology is consistent with the other provisions of SDCL 10-43-10.3. In particular, subsection 10 provides for a deduction of "imputed federal income taxes that would have been paid on net income" had an election to file as an S Corporation not been made. Thus, this deduction in the SDCL is computed as if the financial institution filed a separate federal income tax return as a C Corporation. In addition, the deduction is available even if no federal income tax is paid. SDCL 10-43-10.3(10) (2012).

Similarly, subsection 11 of SDCL 10-43-10.3 provides for a deduction for limited liability companies of "imputed federal income taxes in an amount equal to the taxes that would have been paid on net income" had an election to file as a C Corporation been made. Thus, this deduction in the SDCL is computed as if the entity filed a separate federal income tax return as a C Corporation. Similar to the deduction under subsection 10, this deduction is also available even if no federal income tax is paid. SDCL 10-43-10.3(11) (2012). Consistent with these provisions enacted by the State Legislature, U.S. Bank's methodology calculates the taxes imposed as if it had filed a separate federal income tax return as a C Corporation.

The Circuit Court unpersuasively ignores these consistencies. App., p. 17. First, the Circuit Court notes that U.S. Bank does not qualify for the deductions contained in subsections 10 and 11. Id. However, U.S. Bank had never claimed that it did qualify for

those deductions. Instead, those subsections were referenced to establish the consistency within the same statute. Those consistencies are not lost merely because U.S. Bank does not qualify for those deductions.

Second, the Circuit Court states that the South Dakota Legislature did not use the same language. Id. However, the minor differences in language do not detract from the consistency of methodology (i.e., the deductions are all computed on a separate company basis).

### C. U.S. Bank Properly Computed Its Federal Tax Deduction

The appropriateness of U.S. Bank's methodology to compute the Federal Tax Deduction is apparent when compared to U.S. Bank's portion of the consolidated group's federal taxable income and resulting tax due. Specifically, U.S. Bank's share of the consolidated group's federal taxable income was as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | ÷ | Consolidated Group's Federal Taxable Income | = | %[6] |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | ÷ | $3,263,581,855 | = | 74% |
| December 31, 2011 | $2,342,731,149 | ÷ | $3,567,245,451 | = | 66% |
| December 31, 2012 | $4,925,219,278 | ÷ | $5,671,934,133 | = | 87% |

AR 21-51; 52-84; 85-120. Applying U.S. Bank's income percentage to the consolidated tax liability (i.e., the taxes imposed by the IRC) results in the following:

| Tax Year Ended | U.S. Bank's % | x | Consolidated Group's Tax Liability | = | U.S. Bank's Share |
|---|---|---|---|---|---|
| December 31, 2010 | 74% | x | $1,142,253,649 | = | $ 840,313,825 |
| December 31, 2011 | 66% | x | $1,248,535,908 | = | $ 819,955,902 |
| December 31, 2012 | 87% | x | $1,985,176,947 | = | $1,723,826,747 |

[6] Percentage amounts have been rounded.

Id. These amounts are the same as multiplying U.S. Bank's federal taxable income by 35%:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | x | Separate Return Tax Rate | = | U.S. Bank's Tax Liability |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x | 35% | = | $ 840,313,825 |
| December 31, 2011 | $2,342,731,149 | x | 35% | = | $ 819,955,902 |
| December 31, 2012 | $4,925,219,278 | x | 35% | = | $1,723,826,747 |

Id. It was U.S. Bank's separate return federal tax liability (i.e., U.S. Bank's share of the consolidated federal tax liability) that was deducted on its amended South Dakota Returns for 2010 and 2011 and its original South Dakota Return for 2012. AR 150-53; 154-58; 159-63.[7]

The Department's auditor testified that "the exact amount of money that was sent up to [U.S.] Bancorp for the payment of federal taxes, we will use that as a starting point" for the Federal Tax Deduction. AR 382. U.S. Bank's payment for federal income taxes was $1,723,826,747 in 2012 — the same starting point referenced by the auditor and the same amount of the Federal Tax Deduction on U.S. Bank's 2012 South Dakota Return. See AR 159-63; 264-72. Therefore, as the auditor stated, U.S. Bank started with the proper amount in computing its Federal Tax Deduction.

**1. U.S. Bank's Methodology Does Not Exceed the Consolidated Tax Liability**

The Circuit Court inaccurately states that "U.S. Bank's methodology results in it taking a much larger deduction for federal income taxes imposed than the entire

[7] The calculation of the Federal Tax Deduction on the 2010 and 2011 amended South Dakota Returns included federal adjustments to taxable income and the resulting tax liability.

consolidated group paid for income taxes." App., p. 20. However, a review of a tax return shows the inaccuracy of that statement.

For federal income tax purposes, the net tax computation is contained on Schedule J, which is as follows:

Form 1120 (2012) Page 3

**Schedule J** **Tax Computation and Payment** (see instructions)

**Part I–Tax Computation**

| | | | | | |
|---|---|---|---|---|---|
| 1 | Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐ | | | | |
| 2 | Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐ | | | 2 | |
| 3 | Alternative minimum tax (attach Form 4626) | | | 3 | |
| 4 | Add lines 2 and 3 | | | 4 | |
| 5a | Foreign tax credit (attach Form 1118) | 5a | | | |
| b | Credit from Form 8834, line 30 (attach Form 8834) | 5b | | | |
| c | General business credit (attach Form 3800) | 5c | | | |
| d | Credit for prior year minimum tax (attach Form 8827) | 5d | | | |
| e | Bond credits from Form 8912 | 5e | | | |
| 6 | **Total credits.** Add lines 5a through 5e | | | 6 | |
| 7 | Subtract line 6 from line 4 | | | 7 | |
| 8 | Personal holding company tax (attach Schedule PH (Form 1120)) | | | 8 | |
| 9a | Recapture of investment credit (attach Form 4255) | 9a | | | |
| b | Recapture of low-income housing credit (attach Form 8611) | 9b | | | |
| c | Interest due under the look-back method—completed long-term contracts (attach Form 8697) | 9c | | | |
| d | Interest due under the look-back method—income forecast method (attach Form 8866) | 9d | | | |
| e | Alternative tax on qualifying shipping activities (attach Form 8902) | 9e | | | |
| f | Other (see instructions—attach statement) | 9f | | | |
| 10 | **Total.** Add lines 9a through 9f | | | 10 | |
| 11 | **Total tax.** Add lines 7, 8, and 10. Enter here and on page 1, line 31 | | | 11 | |

Line 2 "Income Tax" contains the total income tax due (i.e., federal taxable income multiplied by the applicable tax rate). Line 11 "Total Tax" provides the net tax due. Line 11 includes interest (Lines 9c and 9d), recapture of certain credits (Lines 9a and 9b) and other adjustments (Line 9f). AR 21-51; 52-84; 85-120. Nevertheless, the Federal Tax Deduction only applies to "[t]axes imposed." SDCL 10-43-10.3(3). Certainly, interest, recapture of credits and other adjustments are not "taxes imposed."

Instead, the consolidated tax liability is Line 2 "Income tax," which is the total income tax due on the consolidated income. Norwest Corp. v. Comm'r, T.C. Memo 1995-600 (T.C. 1995) (finding that "tax imposed on the affiliated group is the tax assessed against its consolidated income"). Those amounts were as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

AR 23; 54; 87; 313.

In order for U.S. Bank's methodology to result in a "much larger deduction," Line 11 would need to be used as the starting point – not Line 2, as follows:

| Tax Year Ended | U.S. Bank's Federal Tax Deduction | ÷ | Consolidated Group's Line 11 | = | % |
|---|---|---|---|---|---|
| December 31, 2010 | $ 840,313,825 | ÷ | $524,920,206 | = | 160% |
| December 31, 2011 | $ 819,955,902 | ÷ | $617,186,234 | = | 133% |
| December 31, 2012 | $1,723,826,747 | ÷ | $981,865,059 | = | 176% |

AR 21-51; 52-84; 85-120.

However, when Line 2 is used, it is clear that the Circuit Court is incorrect and U.S. Bank's methodology results in a deduction that is proportionate to U.S. Bank's share of the consolidated group's federal taxable income as follows:

| Tax Year Ended | U.S. Bank's Federal Tax Deduction | ÷ | Consolidated Group's Federal Taxable Liability | = | % |
|---|---|---|---|---|---|
| December 31, 2010 | $ 840,313,825 | ÷ | $1,142,253,649 | = | 74% |
| December 31, 2011 | $ 819,955,902 | ÷ | $1,248,535,908 | = | 66% |
| December 31, 2012 | $1,723,826,747 | ÷ | $1,985,176,947 | = | 87% |

Id.

**2. The Consolidated Tax Liability Was Paid By Both Cash and Credits**

The total income taxes due (i.e., Line 2) were paid by both cash and credits. AR 21-51; 52-84; 85-120; 314. The Circuit Court incorrectly states that credits are not payments. App., p. 21. The Circuit Court further states that U.S. Bank's methodology

"increase[s] its federal [tax] deduction for taxes paid to foreign jurisdictions." Id.[8] However, the Circuit Court misconstrues U.S. Bank's methodology for computing the Federal Tax Deduction. U.S. Bank began with total income taxes due (i.e., Line 2 of Schedule J). The total income taxes due are computed by multiplying the consolidated group's federal taxable income by the tax rate (i.e., 35%). The following is the calculation of the total income taxes due for the tax year ended December 31, 2012:

| | | |
|---|---|---|
| Consolidated Federal Taxable Income | | 5,671,934,133 |
| Tax Rate | x | 35% |
| Total Income Tax Due | | 1,985,176,947 |

AR 85-87.

Significantly, the total income tax amount is not reduced by or increased by credits. AR 21-51; 52-84; 85-120. Instead, that amount of tax imposed by the IRC is paid by both cash and credits. "A credit is essentially a payment, a form of payment, just like a payment of cash would be." AR 338. This Court has held that a credit is a rebate. Burlington N. R.R. v. Strackbein, 398 N.W.2d 144, 147 (S.D. 1986). Thus, U.S. Bank is not including credits as taxes imposed – just as it is not including cash payments as taxes imposed.

### 3. U.S. Bank's Methodology Complies with Federal Provisions and Caselaw

U.S. Bank's methodology is further supported by federal provisions. Specifically, the IRC provides that a "tax is hereby imposed for each taxable year on the taxable income of every corporation." IRC § 11 (2012) (emphasis added). Thus, under the IRC, tax is imposed on a corporation's taxable income. A corporation reports its taxable

[8] U.S. Bancorp claimed foreign tax credits of less than 1% of the total Line 2 "Income Tax" for each of the tax years ended December 31, 2010 through December 31, 2012. AR 21-51; 52-84; 85-120.

income on Line 30 of the federal income tax return, which is entitled "Taxable income." See e.g., AR 85. U.S. Bank properly calculated its Federal Tax Deduction by taking its federal taxable income (Line 30 of the federal tax return) and multiplying that amount by 35%, which is the tax rate imposed under the IRC (and is the amount reported on Line 2 of Schedule J).

In addition, the Department of the Treasury, which is responsible for administering the IRC, along with other federal agencies, issued a Policy Statement that provides that "intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity." AR 429-31 (Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 63 Fed. Reg. 64757 (Nov. 23, 1998)) (notations made by the Department and not in original). Consistent with the Department of Treasury's policy, the Federal Tax Deduction should be computed as if the financial institution filed its income tax return as a separate entity – which is exactly what U.S. Bank did in this case.

Moreover, contrary to the Circuit Court's conclusions, the U.S. Tax Court's decision in Norwest Corp., T.C. Memo 1995-600, actually supports U.S. Bank's methodology. The Circuit Court incorrectly asserts that U.S. Bank's methodology was rejected by the court in Norwest Corp. App., p. 21. However, the Circuit Court fails to analyze the holding in that case. In analyzing the taxes imposed on a corporation that was a member of an affiliated group (i.e., consolidated group), the U.S. Tax Court held that such amount was a portion of the "tax imposed on the consolidated taxable income of the affiliated group." Norwest Corp., T.C. Memo 1995-600. Here, U.S. Bank's

methodology results in a portion of the tax imposed on the consolidated group – the same method approved in Norwest Corp.

#### 4. Missouri's Deduction for Federal Income Taxes Supports U.S. Bank's Methodology for Computing the Federal Tax Deduction

U.S. Bank's methodology for computing the Federal Tax Deduction is the same methodology used for Missouri Bank Franchise Tax purposes. Under the Missouri Bank Franchise Tax, a deduction is allowed for "all taxes paid or accrued during the income period to the United States." Mo. Rev. Stat. § 148.040(3). The Missouri Department of Revenue has promulgated a regulation interpreting the deduction, which states for an accrual basis taxpayer that "[t]he deduction shall equal the federal form, Schedule J, total tax liability as if a separate federal return had been filed." Mo. Code Regs. Ann. tit. 12, § 10-10.135(2)(B) (emphasis added). Further, the instructions to the Missouri Bank Franchise Tax return provide as follows:

> A taxpayer that is a member of an affiliated group of corporations which filed a consolidated federal income tax return shall determine its deduction for, or its gross income in respect of federal income taxes paid or accrued during the income period to the United States as if it and all other members of the affiliated group of which it was a member had filed separate federal income tax returns for all relevant income periods.

Mo. Dep't of Revenue, General Instructions – Bank Franchise Tax Return (2012) (emphasis added), *available at* www.dor.mo.gov/forms/INT-2_Instructions_2012.pdf.

Both the regulation and return instructions make clear that the deduction is calculated as if the financial institution had filed a separate income tax return (i.e., separate return federal taxable income multiplied by 35%). Therefore, U.S. Bank's method for calculating the Federal Tax Deduction in this case is the exact same method used for Missouri Bank Franchise Tax purposes – the federal income tax imposed on a

financial institution as if a separate federal income tax return had been filed – and is also consistent with the plain language of the Federal Tax Deduction found in SDCL 10-43-10.3.

Unlike the Missouri Department of Revenue, the Department here has not issued any guidance on the Federal Tax Deduction. In the absence of such guidance, U.S. Bank developed a methodology that is similar to that used by Missouri.

## III.

## U.S. BANK HAS MET ITS BURDEN OF PROOF

The Federal Tax Deduction is a deduction for which a taxpayer has the burden of proving that it is entitled. Pam Oil, 459 N.W.2d at 255. In order to qualify for the Federal Tax Deduction, a taxpayer must prove that taxes were imposed on it by the IRC. SDCL 10-43-10.3(3). As the foregoing establishes, U.S. Bank has proved that taxes were imposed on it by the IRC. U.S. Bank has also established the amount of taxes imposed on it were as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | x | Separate Return Tax Rate | = | U.S. Bank's Tax Liability |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x | 35% | = | $ 840,313,825 |
| December 31, 2011 | $2,342,731,149 | x | 35% | = | $ 819,955,902 |
| December 31, 2012 | $4,925,219,278 | x | 35% | = | $1,723,826,747 |

AR 21-51; 52-84; 85-120.

These amounts were established by the documents provided to the auditor during the audit. AR 297-302; 374; 382. The Circuit Court states that the Department was never provided with the detail on the Federal Tax Deduction computation that U.S. Bank used on its original returns for the tax years ended December 31, 2010 and December 31, 2011. App., p. 27. However, that calculation was corrected on amended returns filed by

U.S. Bank – for which detail was provided. AR 150-53; 154-58. Therefore, there was no requirement – or need – to provide the detail on an incorrect calculation to the Department.

The Circuit Court also states that U.S. Bank never provided "information regarding taxes actually paid." App., p. 27. To the contrary, U.S. Bank provided such information when it was specifically requested. AR 247-63; 316-19.

Finally, the Circuit Court states that information regarding credits claimed by U.S. Bank was not provided. App., p. 27. It is worth noting that the Department's request related to "what, if any, credits were being claimed by the taxpayer." AR 297. It does not state whether this related to credits at the federal or state level. The actual request for information is not in the record.

While the record does not provide whether the requested information was provided, the auditor stated that the only information he needed to compute the Federal Tax Deduction was the detail on the incorrect methodology used on the original 2010 and 2011 South Dakota Returns. AR 384-385. It is inexplicable as to why the Circuit Court determined that this information was necessary, when the Department's own auditor did not find it so.

U.S. Bank has met its burden of proof in this case. The Circuit Court's unsupported statements to the contrary are merely a red herring.

## CONCLUSION

Federal income taxes are imposed on U.S. Bank. U.S. Bank has established that its methodology for computing the Federal Tax Deduction was proper and that it has met its burden of proof.

For all of the foregoing reasons, U.S. Bank prays that the Court reverse the Circuit Court and conclude that U.S. Bank is entitled to a refund for 2010 and 2011 and no additional tax is due for 2012.

## REQUEST FOR ORAL ARGUMENT

U.S. Bank respectfully requests the opportunity to present oral argument.

Dated: September 16, 2020 By: /s/ Justin L. Bell
One of its Attorneys

Craig B. Fields
Nicole L. Johnson
BLANK ROME LLP
1271 Avenue of the Americas
New York, New York 10020
(212) 885-5000

Justin L. Bell
MAY, ADAM, GERDES & THOMPSON LLP
503 S. Pierre St.
Pierre, South Dakota 57501
(605) 224-8803

ATTORNEYS FOR APPELLANT
U.S. BANK NATIONAL ASSOCIATION

## CERTIFICATE OF SERVICE

The undersigned hereby certifies that one true copy of the Brief of Appellant in the above-entitled action was duly served upon John T. Richter by being hand-delivered on the 16th day of September, 2020, to the following named person at his last known address as follows:

John T. Richter
Attorney at Law
South Dakota Department of Revenue
445 East Capitol Avenue
Pierre, SD 57501-3185

The undersigned further certifies that the original and two (2) copies of the Brief of Appellant in the above-entitled action were hand-delivered to Ms. Shirley A. Jameson-Fergel, Clerk of the Supreme Court, State Capitol, 500 East Capitol, Pierre, SD 57501 on the date above written.

/s/ Justin L. Bell
JUSTIN L. BELL

## CERTIFICATE OF COMPLIANCE

Justin L. Bell, attorney for Appellant, hereby certifies that the foregoing Brief of Appellant complies with the type volume limitation imposed by SDCL 15-26A-66(b)(4). Proportionally spaced typeface Times New Roman has been used. Brief of Appellant, exclusive of the table of contents, table of cases, jurisdictional statement, statement of legal issues, any addendum materials, and any certificates of counsel, contains 6,513 words and does not exceed 32 pages. Microsoft Word processing software has been used.

Dated this 16th day of September, 2020.

/s/ Justin L. Bell
JUSTIN L. BELL

## APPENDIX

| | | |
|---|---|---|
| STATE OF SOUTH DAKOTA | ) | IN CIRCUIT COURT |
| | ) | |
| COUNTY OF HUGHES | ) | SIXTH JUDICIAL CIRCUIT |
| | ) | |
| U.S. Bank National Association | ) | |
| | ) | 32CIV18-000169 |
| v. | ) | |
| | ) | **MEMORANDUM DECISION** |
| South Dakota Department of Revenue | ) | **AND ORDER** |
| | ) | |

This is an administrative appeal, pursuant to SDCL Chapter 1-26, of a final decision of the South Dakota Department of Revenue. The Department rejected the methodology of U.S. Bank for calculating its federal income tax deduction for purposes of the South Dakota bank franchise tax for tax years 2010, 2011, and 2012. As a result, the Department denied U.S. Bank's request for a refund for 2010 and 2011 and disallowed the entire deduction for 2012. The Department issued a certificate of assessment for additional tax and interest for 2012.

After full consideration of the administrative record, the briefs submitted, and the arguments made by the attorneys at oral argument, the Court hereby AFFIRMS the Department's decision.

## PRELIMINARY STATEMENT

This opinion references several agencies and documents. The South Dakota Department of Revenue is "the Department," and the South Dakota Office of Hearing Examiners is "the OHE." U.S. Bank National Association is "U.S. Bank." The Internal Revenue Service is the "IRS," and the United States Department of Treasury is the "U.S. Treasury."

The administrative record is "AR," followed by the page number. The transcript of hearing before the OHE (AR 303-407) is "HT," followed by the transcript page number. All referenced exhibits (AR 21-297) are part of the OHE hearing record.

The South Dakota bank franchise tax is the "SD BFT." The Notice of Proposed Adjustment #1 is the "NOPA," and the Information Document Request #002 is the "IDR2." A tax year for purposes of both the SD BFT returns and the federal corporate income tax returns is from January 1 to December 31.

The federal corporate income tax return is the "Form 1120." "Schedule J" is part of that form. The federal corporate income tax return of the consolidated group is the "U.S. Bancorp Form 1120." U.S. Bank's pro forma federal corporate income tax return is the "Pro Forma 1120." The "Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp" is the "Tax Sharing Agreement."

The Proposed Decision, Findings of Fact and Conclusions of Law and Proposed Order of OHE (AR 585-600) is the "Proposed Decision." The Final Decision and Order of the Department (AR 607-626) is the "Final Decision."

Finally, SDCL Chapter 10-43 (bank franchise tax) was extensively revised after the audit referenced herein. SL 2016 Chapt. 62. Unless otherwise indicated, this opinion cites to the pre-2016 version of Chapter 10-43 (2010 main volume). Prior to 2016, the federal income tax deduction at issue was codified at SDCL 10-43-10.3(3). In 2016, SDCL 10-43-10.3*(3)* was renumbered to 10-43-10.3*(2)*, with no substantive change to the language. SL 2016 Chapt. 62, § 6. For consistency, SDCL 10-43-10.3(*3*) (2010) is the version cited throughout this opinion.

## FACTS AND PROCEDURAL HISTORY[1]

### U.S Bank Business Structure and Consolidated Federal Tax Returns

[1]The Department rejected as irrelevant some findings in the Proposed Decision regarding the Tax Sharing Agreement and federal returns. Final Decision at AR 615-623. However, those facts are necessary background to understand the issues.

U.S. Bank is a financial institution, principally engaged in the business of banking, with its headquarters located in Minneapolis, Minnesota. HT 8, 55. It is a member of a consolidated group of corporations owned by U.S. Bancorp, which is a publicly traded holding company. HT 9. U.S. Bank uses accrual basis accounting; it recognizes revenue or expenses when actually incurred, even if cash payment would occur at a different time. HT 19; Ex. 15 at SR 223.

U.S. Bancorp, as the parent company of the consolidated group, is responsible for filing the Form 1120 U.S. Corporation Income Tax Return. HT 9-10, 56. For all years at issue, U.S. Bancorp filed the consolidated group's Form 1120 (U.S. Bancorp 1120), which included U.S. Bank's activities amongst the supporting schedules filed with the return. HT 10-11, 56-57; Ex. 1 at AR 30; Ex. 2 at AR 61; Ex. 3 at AR 93. U.S. Bank's role in the process was to provide its information, which was used to determine the income and expenses and the taxes paid and credits on the U.S. Bancorp Form 1120. HT 10-11, 56-57.

Schedule J of the Form 1120, entitled "Tax Computation," provides the tax calculation to determine the net federal income taxes of a financial institution. Ex. 1 at AR 23; Ex. 2 at AR 54; Ex. 3 at AR 87. The calculation on Schedule J begins by multiplying Taxable Income (line 30 on p. 1 of the Form 1120) by the appropriate tax rate to arrive at Income Tax (Schedule J, line 2) HT 71-72. That number is then reduced by the foreign tax credit and general business credit (Schedule J, lines 5a and 5c) to arrive at Total Tax (Schedule J, line 10 or 11).[2] This Total Tax figure is then recorded on line 31 of the Form 1120 (p. 1). Ex. 1 at AR 21; Ex. 2 at AR 52; Ex. 3 at AR 55. This represents the federal tax liability that must be paid to the IRS.

U.S. Bank and U.S. Bancorp entered into a Tax Sharing Agreement to allocate the proper amount of federal tax liability or benefit to each individual company in the consolidated group

[2] The "Total Tax" is line *10* on the 2010 Form 1120 Schedule J and line *11* on the 2011 and 2012 Form 1120 Schedule J. Ex. 1 at AR 23; Ex. 2 at AR 54; Ex. 3 at AR 87. The remainder of this opinion will call it line 11.

that generated the income or loss. HT 22; Ex. 18 at AR 264-72. This Tax Sharing Agreement was executed in 2005 and remained in effect during the relevant period. HT 24.

Under the Tax Sharing Agreement, U.S. Bank pays to U.S. Bancorp "an amount up to [U.S. Bank's] separate income tax liability attributable to the net taxable income of [U.S. Bank] that would have been paid if [U.S. Bank] had filed a separate tax return." Ex. 18 at AR 264. According to U.S. Bank, each member of the consolidated group computes its federal taxable income, which is the amount before credits, and multiplies it by the federal tax rate of 35%. HT 24. If the member incurs a loss, the member receives a refund of that tax benefit to the extent the loss is used in determining the consolidated taxable income. HT 24-25; Ex. 18 at AR 265. Members also receive refunds or cash payments for the credits they generate. HT 25.

The Tax Sharing Agreement is a binding contract amongst the entities. HT 24, 38; Ex. 18. "[P]ayments are made back and forth so that each company is theoretically made whole either for the benefit that is generated for the group or for the tax it had to pay for the group." HT 23. U.S. Bank was audited by non-IRS regulators[3] and its own independent auditors to verify that it and other affiliates were making the payments amongst each other internally, according to the Tax Sharing Agreement, to ensure that the bank was maintaining proper liquidity and capital to operate as a bank. HT 25-28. However, the IRS does not dictate the terms of the Tax Sharing Agreement, and the amount paid by U.S. Bank pursuant to the agreement is not necessarily the amount of tax imposed upon U.S. Bank by the IRS. HT 38. The Tax Sharing Agreement itself is not an imposition of tax by the IRS. *Id.*

The total federal income tax of the consolidated group on the U.S. Bancorp Form 1120 (Schedule J, line 2), before application of credits, was:

[3] These included the Office of the Comptroller of the Currency (OCC), the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC).

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

HT 11; Ex. 1 at AR 23; Ex. 2 at AR 54; Ex. 3 at AR 87.

The total tax liability due to the IRS by the consolidated group on the U.S. Bancorp Form 1120 (Schedule J, line 11), after application of credits, was:

| Tax Year Ended | Total Tax Liability |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

*Id.*

Because U.S. Bank's activities are included in the U.S. Bancorp Form 1120, U.S. Bank does not file a separate Form 1120. HT 10-11. Instead, U.S. Bank prepares a pro forma, or "matter of form," Form 1120 (Pro Forma 1120). HT 19-21. The Pro Forma 1120 is not signed or filed with the IRS. HT 21, 57. It shows what U.S. Bank's federal taxable income would be if it was standing on its own subject to tax. HT 20-21. The first thirty lines are filled out, and it includes a Schedule L, balance sheet. HT 20-21; Ex. 4-6 at AR 121-35. However, the Pro Forma 1120 does not show credits or computation of federal tax in Schedule J or line 31 (p. 1). Ex. 4 at AR 121, 123; Ex. 5 at AR 126, 128; Ex. 6 at AR 131, 133. It is intended as a starting point for the computation of SD BFT. HT 20-21.

According to the Pro Forma 1120, U.S. Bank's federal taxable income consisted of the majority of the consolidated group's taxable income. These amounts were:

| Tax Year Ended | U.S. Bank Fed. Taxable Inc. | U.S. Bancorp Fed. Taxable Income | % |
|---|---|---|---|
| Dec. 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| Dec. 31, 2011 | $2,342,731,149 | $3,567,245,451 | 66% |
| Dec. 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Ex. 1 at AR 21, 30; Ex. 2 at AR 52, 61; Ex. 3 at AR 85, 93; Ex. 4 at AR 121; Ex. 5 at AR 126; Ex. 6 at AR 131.

**South Dakota Bank Franchise Tax Filings**

U.S. Bank does business within South Dakota, although U.S. Bancorp does not. U.S. Bank is subject to the SD BFT, which imposes an income tax on banks and financial corporations. SDCL 10-43-2.1. For purposes of the SD BFT, U.S. Bank could deduct from its taxable income the "taxes imposed on the financial institution within the tax year, under the Internal Revenue Code..." SDCL 10-43-10.3(3). On the SD BFT return, this deduction is described as "Federal income taxes paid or accrued" at line 15. Ex. 10 at AR 151; Ex. 11 at AR 155; Ex. 12 at AR 160.

2005-2011 original returns

U.S. Bank filed SD BFT returns for tax years 2005-2012. From 2005 to 2007, U.S. Bank calculated the deduction by multiplying its federal taxable income by 35%, the federal income tax rate. HT 32-33. From 2008 to 2011, U.S. Bank changed its calculation of the deduction. For those years, the deduction was calculated by "taking separate taxable income of U.S. Bank, as a ratio over the total positive taxable income of the consolidated group, and that ratio was multiplied by total federal tax after credits." HT 30.

Using this method, U.S. Bank timely filed its tax year 2010 and 2011 SD BFT returns on September 27, 2011, and September 11, 2012, respectively. HT at 30; Ex. 7 at AR 136-40; Ex. 8 at AR 142-47. Each return included a copy of the Pro Forma 1120 for that tax year, but it did not include a copy of the U.S. Bancorp Form 1120. Ex. 15 at AR 231, 238. The 2011 SD BFT return listed an overpayment of estimated tax. Ex. 8 at AR 142.

At some point after submitting the original 2010 and 2011 SD BFT returns, U.S. Bank realized the discrepancy between how its pre-2008 and post-2008 federal income tax deduction had been calculated on its SD BFT returns. HT 30-31. At that point, U.S. Bank decided to go back to calculating the deduction in the same way it did from tax years 2005 to 2007, which meant taking its separate federal taxable income by 35%. HT 31. U.S. Bank filed amended 2010 and 2011 SD BFT returns,[4] and the 2012 SD BFT return, utilizing this methodology. The chronological timeline of these filings is laid out below.

2011 Amended Return

On December 27, 2012, U.S. Bank filed an amended tax year 2011 SD BFT return. HT 31-33; Ex. 11 at AR 154-58. The amended 2011 SD BFT return substantially increased the federal income tax deduction claimed on the original 2011 return; it went from $346,485,702 to $819,955,902. Ex. 8 at AR 143 (line 15); Ex. 11 at AR 155 (line 15). The explanation, contained in the amended return, stated, "Return is amended to adjust the state deduction for federal income taxes paid or accrued, Page 2 Line 15." Ex. 11 at AR 157. By increasing the amount of the deduction claimed, the amended 2011 SD BFT return reduced U.S. Bank's SD BFT liability from $258,866 on the original return to $193,101 on the amended return. Ex. 8 at AR 142; Ex. 11 at AR 154. This amounted to a decrease of $65,765. Ex. 15 at AR 238. When combined with the overpayment of estimated tax listed on the original 2011 SD BFT return, the total overpayment was listed as $77,899. *Id.* During the audit process discussed below, U.S. Bank requested a refund of this amount. Ex. 15 at AR 217.

[4] Tax years 2008 and 2009 were outside the statute of limitations, and U.S. Bank has not appealed any determination of the Department regarding those years. Ex. 15 at AR 217; Appellant's Brief at n. 3.

The total tax liability of the consolidated group on the 2011 US Bancorp Form 1120, subsequently received by the Department, was $617,186,234. Ex. 2 at AR 52 (line 31). Therefore, the $346,485,702 deduction reflected on U.S. Bank's *original* 2011 SD BFT return was about 56% of the total tax liability of the consolidated group. The $819,955,902 deduction claimed on U.S. Bank's *amended* 2011 SD BFT return, however, was about 133% of the total tax liability of the consolidated group. In other words, the deduction on the amended 2011 SD BFT return was $202,769,668 more than the entire consolidated group federal tax liability for 2011. Ex. 15 at AR 239-40.

2012 Return

On September 26, 2013, U.S. Bank timely filed its 2012 SD BFT return using the same methodology as the amended 2011 SD BFT return (separate taxable income by 35%). HT 30-31; Ex. 12 at AR 159. The 2012 SD BFT return included a copy of the 2012 Pro Forma 1120 but did not include a copy of the 2012 U.S. Bancorp Form 1120. Ex. 15 at AR 240. On the 2012 SD BFT return, U.S. Bank claimed a federal income tax deduction of $1,723,826,747. Ex. 15 at AR 160 (line 15). The 2012 U.S. Bancorp Form 1120, subsequently received by the Department, showed a total consolidated federal tax liability of $981,865,059. Ex. 3 at AR 85 (line 31). The $1,723,826,747 deduction claimed on the 2012 SD BFT return was more than 175% of the total tax liability of the consolidated group. In other words, U.S. Bank's claimed federal income tax deduction on its 2012 SD BFT return was $741,961,688 more than the entire consolidated group federal tax liability for 2012. Ex. 15 at AR 241.

October 2013 Documentation Request

In October of 2013, the Department requested additional documentation regarding U.S. Bank's amended 2010 SD BFT[5] and amended 2011 SD BFT returns. In part, the Department requested pages 1-5 of the 2010 and 2011 U.S. Bancorp Form 1120 and "consolidated numbers for the members of the consolidated group that tied into pages 1-5." Ex. 15 at AR 231, 239. The Department also requested an explanation of the computation of federal tax liability (line 15) on the amended 2010 SD BFT return, including "documentation that the amounts claimed were imposed upon a financial institution under the Internal Revenue Code." Ex. 15 at AR 232.

2010 Amended Return

In response to the Department's October 2013 requests, U.S. Bank, on November 26, 2013, filed a second amended 2010 SD BFT Return. Ex. 15 at AR 232. The primary adjustment on the second amended 2010 SD BFT return was to claim a federal income tax deduction in the amount of $862,815,157 rather than the $317,843,634 reported on the original return. Ex. 7 at AR 137 (line 15); Ex. 10 at AR 151 (line 15); Ex. 15 at AR 232. On the return, this was represented to be a deduction equal to 35% of U.S. Bank's federal taxable income. Ex. 10 at AR 153; Ex. 15 at AR 233.

The total federal tax liability of the consolidated group for 2010 was $534,594,245. Ex. 15 at AR 233. The $317,843,634 claimed on original 2010 SD BFT return represented about 61% of that total consolidated tax liability. The $862,815,157 deduction claimed on the second amended 2010 SD BFT return, however, represented about 161% of that total consolidated tax liability. As noted by the auditor, the claimed deduction on the second amended 2010 SD BFT

[5] U.S. Bank's first amended tax year 2010 SD BFT return was submitted on September 9, 2013, and reflected a taxable income increase as a result of an IRS audit. HT 73-74; Ex. 15 at SR 231. Both the 2010 and 2011 amended SD BFT returns prompted requests for information by the Department.

return was $328,220,912 more than the entire consolidated group federal tax liability. Ex. 15 at U.S. Bank requested a refund of amounts it alleged were overpaid. Ex. 10 at AR 150.

**Department Audit of Tax Years 2011 and 2012**

Based upon these returns, the Department determined that an audit was necessary. On October 2, 2014, the Department sent U.S. Bank a Notice of Intent to Audit the 2011 and 2012[6] SD BFT returns, with a commencement date of November 3, 2014. HT 58-59; Ex. 16 at AR 244-46. The Notice of Intent stated, "All records, books, and documents must be prepared for presentation to the auditor on the commencement date of the audit. Any documents or records required to be kept by law to evidence reduction, deduction, or exemption from tax (such as exemption certificates) not prepared for presentation to the auditor within sixty days of the commencement date of the audit need not be considered by the auditor." Ex. 16 at AR 245-46.

On October 23, 2014, the Department issued Information Document Request #002 (IDR2) to U.S. Bank, which included a November 4, 2014, deadline to respond. Ex. 9 at AR 148-149; Ex. 15 at AR 240-241. Regarding the tax year 2010 and 2011 SD BFT returns, IDR2 requested:

1. The US Bancorp...Forms 1120 for tax years 2011 and 2012, pages 1, 2, 3, and 4 and the Profit and Loss computation for ... all of the Affiliated Group Members.

2. The Tax Sharing Agreement...

3. The internal work papers and legal analysis to support the amounts reported on SD BFT page 2, Line 15 as Federal income taxes paid or accrued. Ex. 9 at AR 148.

[6] The 2010 SD BFT returns were not audited because it was beyond the statute of limitations. Ex. 15 at AR 224.

The Department eventually received the information referenced in numbers 1 and 2 above, but it took multiple requests. HT 60-61, 80, 82; Ex. 24 at AR 297. Regarding item 3, the internal work papers and legal analysis, on November 15, 2014, U.S. Bank responded that someone at the Department told them to use 35% of taxable income for the SD BFT return, line 15 deduction, but the name was not provided. HT at 61-62; Ex. 15 at AR 241. *See* SDCL 10-59-27 (Reliance on advice from the Department must be in writing and be retained by taxpayer). No other relevant information was provided to the Department at that time regarding item 3 of IDR2, despite the Department providing an extension of time. HT 62; Ex. 15 at 241. The record also indicates that the Department requested credits claimed by U.S. Bank, but there is no indication that this information was received. Ex. 24 at 297.

On December 22, 2014, the Department issued a Notice of Proposed Adjustment #1 (NOPA) in which it denied U.S. Bank's methodology for calculating the deduction. HT 65. The NOPA identifies the facts, the law, the argument, and a conclusion or position. It asks the taxpayer to agree or disagree. If the taxpayer does not agree, it requires an auditor to continue with the audit and provide formalized conclusions. HT 65. Ex. 15 at AR 241. *See* SDCL 10-59-35; ARSD 64:01:01:28.

On May 8, 2015, U.S. Bank submitted a response to the NOPA. U.S. Bank did not agree and believed it should be able to use the separate company method of multiplying its separate company federal taxable income by 35%. It claimed the statute was ambiguous regarding the calculation of the federal income tax deduction, and the separate company tax sharing should be deemed a federal tax. Ex. 15 at AR 241.

U.S. Bank provided no proof of payment of the 35% amount or other internal workpapers to support the amount, beyond the U.S. Bancorp Form 1120 and Pro Forma 1120. Ex. 15 at AR

242; Ex. 24 at AR 29. Neither of those forms show a computation of federal tax for U.S. Bank or credits attributable to U.S. Bank. HT 64.

The Department interpreted SDCL 10-43-10.3(3) to allow a deduction for taxes actually imposed and paid. HT 81-82; Ex. 15 at AR 225-27, 234, 236-37. Overall, the Department could not reconcile the amount reported on U.S. Bank's SD BFT returns to the federal taxes imposed upon and paid by the consolidated group. HT 63, 71-73. According to the auditor, U.S. Bank's methodology did not make sense, "[b]ut it was clear to us that they wouldn't get a deduction of $2 if the total assessment was only 50 cents." HT 64.

The auditor believed that U.S. Bank should be allowed some type of deduction, but he did not know what that methodology should be. HT 64, 80. If U.S. Bank had given the auditor information necessary to review the exact amount of money sent up to U.S. Bancorp to pay U.S. Bank's taxes, it could have been used as a starting point and go up or down. HT 80-81. But without that information, the auditor could not make a determination. HT 80.

On December 28, 2015, the Department completed the audit of U.S. Bank's SD BFT returns for tax years 2011 and 2012. HT 69; Ex. 13 at AR 168. The Department rejected U.S. Bank's methodology for calculating the deduction. The Department disallowed in full the federal income tax deduction claimed by U.S. Bank for 2012. Ex. 15 at AR 243. This resulted in a deficiency of $364,169. A certificate of assessment was issued on December 28, 2015, for that amount plus $144,757.11 in interest, for a total of $508,926.11. Ex. 14.

The Department also did not accept the federal income tax deduction claimed by U.S. Bank in the amended 2010 and 2011 SD BFT returns. However, because the Department was time barred from issuing an assessment for more tax in those years, it could not disallow the deduction in full. Ex. 13 at AR 168; SDCL 10-59-16. It instead adjusted these returns to the

auditor's report and denied in full U.S. Bank's refund requests for 2010 and 2011. Ex. 15 at AR 224, 235, 240.

**Protest and Appeal**

On February 24, 2016, U.S. Bank protested the Certificate of Assessment for 2012 and denial of its refund claims for 2010 and 2011 and requested a hearing. Ex. 15 at AR 217-19.[7] In the Letter of Protest, U.S. Bank argued that there was no South Dakota law or guidance regarding the proper calculation of taxes paid when the financial institution is included on a consolidated federal tax return and that the ambiguous tax law was to be construed liberally in its favor. Ex. 15 at AR 218.

A hearing was held by OHE on September 28, 2017. On May 22, 2018, OHE issued its Proposed Decision in which it recommended that the Certificate of Assessment for 2012 and denial of refund requests for 2010 and 2011 be affirmed in all respects. On July 18, 2018, the Department issued its Final Decision affirming the ultimate conclusion of the OHE but modifying some of the underlying findings of fact, conclusions of law, and reasoning.

A Notice of Appeal was timely filed and served on August 17, 2018, pursuant to SDCL 1-26-30.2 and 1-26-31, and the venue was Hughes County pursuant to SDCL 1-26-31.1.

## ISSUES

**I. DID THE DEPARTMENT ERR IN REJECTING U.S. BANK'S METHODOLOGY FOR CALCULATING THE SDCL 10-43-10.3(3) DEDUCTION FOR 2010, 2011, AND 2012?**

**II. AFTER REJECTING U.S. BANK'S METHODOLOGY, DID THE DEPARTMENT ERR IN NOT ALLOWING U.S. BANK AN ALTERNATIVE METHODOLGY?**

---

[7] Attached as exhibits to the Letter of Protest are the Certificate of Assessment and Audit Report. Ex. 15 at AR 217-43. Multiple identical copies of the Certificate of Assessment and Auditor's Report are found in Exhibit 13-Audit File (AR 164-215) and Exhibit 14-Certificate of Assessment (AR 216). For consistency, Exhibit 15 is cited throughout this opinion.

## LEGAL STANDARD

This Court's review of a decision from an administrative agency is governed by SDCL 1-26-36.

> The court shall give great weight to the findings made and inferences drawn by an agency on questions of fact. The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if substantial rights of the appellant have been prejudiced because the administrative findings, inferences, conclusions, or decisions are:
>
> (1) In violation of constitutional or statutory provisions;
> (2) In excess of the statutory authority of the agency;
> (3) Made upon unlawful procedure;
> (4) Affected by other error of law;
> (5) Clearly erroneous in light of the entire evidence in the record; or
> (6) Arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.
>
> A court shall enter its own findings of fact and conclusions of law or may affirm the findings and conclusions entered by the agency as part of its judgment.

SDCL 1-26-36. This requires the circuit court "to give great weight to the findings of the agency and reverse only when those findings are clearly erroneous in light of the entire record." *Manuel v. Toner Plus, Inc.*, 2012 S.D. 47, ¶ 8, 815 N.W.2d 668, 670 (quoting *Williams v. S.D. Dept. of Agirc.*, 2010 S.D. 19, ¶ 5, 779 N.W.2d 397, 400). "However, questions of law are reviewed de novo." *Id.* (citing *Vollmer v. Wal–Mart Store, Inc.*, 2007 S.D. 25, ¶ 12, 729 N.W.2d 377, 382). "Mixed questions of law and fact require further analysis." *Id.* (citing *Darling v. W. River Masonry, Inc.*, 2010 S.D. 4, ¶ 10, 777 N.W.2d 363, 366). The interpretation and application of a tax statute is a question of law and reviewed de novo. *Citibank, N.A. v. S.D. Dep't of Revenue*, 2015 S.D. 67, ¶ 7, 868 N.W.2d 381, 385 (citing *Rushmore Shadows, LLC v. Pennington Cnty. Bd. of Equalization*, 2013 S.D. 73, ¶ 7, 838 N.W.2d 814, 816).

## ANALYSIS

### I. DID THE DEPARTMENT ERR IN REJECTING U.S. BANK'S METHODOLOGY FOR CALCULATING THE SDCL 10-43-10.3(3) DEDUCTION FOR 2010, 2011, AND 2012?

Financial institutions doing business within South Dakota are subject to bank franchise tax pursuant to SDCL Chapter 10-43. The Department is responsible for administering that chapter. SDCL 10-43-42.1.

Specifically, "[a]n annual tax is ... imposed upon every national banking corporation ...doing business within [South Dakota], according to or measured by net income, to be computed in the manner provided in [Chapter 10-43], on the basis of its net income during any part of its tax year." SDCL 10-43-2.1.[8] The bank franchise tax itself is based upon the net income of the institution that is assignable to South Dakota. SDCL 10-43-4. Even though U.S. Bank was part of a consolidated group, it was required to file an individual SD BFT return. SDCL 10-43-36; ARSD 64:26:03:13. The SD BFT final return for the tax year is due within fifteen days after the federal income tax return is due. SDCL 10-43-30.

For purposes of the SD BFT, "[n]et income ... is taxable income as defined in the Internal Revenue Code ... but subject to the adjustments as provided in ... §§ 10-43-10.2 and 10-43-10.3." SDCL 10-43-10.1. Financial institutions are allowed to deduct from taxable income "[t]axes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC §1374 and 26 USC § 1375[.]" SDCL 10-43-10.3(3).

[8] Repealed by SL 2016, ch 62, §§ 3, 32.

The issue in this case is the proper interpretation of the term "taxes imposed" within SDCL 10-43-10.3(3). The term "taxes imposed" is not specifically defined within SDCL Chapter 10-43. However, U.S. Bank argues that the dictionary definition of "impose" is "to establish or apply by authority-impose a tax." Appellant's Brief at 10. Therefore, the plain meaning of "taxes imposed," according to U.S. Bank, is the result of the 35% tax rate that the IRC applies to U.S. Bank's federal taxable income, without regard to credits. *Id.* at 11. U.S. Bank claims that any attempt to further define "taxes imposed" would be reading words into the statute and not honoring the stated intention of the Legislature. *See In re: Appeal of AT&T Info. Sys.*, 405 N.W.2d 24, 27 (S.D. 1987) ("When the language is clear, certain, and unambiguous, there is no reason for construction, and the court's only function is to declare the meaning of the statute as clearly expressed.")

U.S. Bank also argues that the intent of SDCL 10-43-10.3(3) can be deemed from analyzing the statute as a whole. Specifically, U.S. Bank argues that SDCL 10-43-10.3(10) & (11) support the reasonableness of its methodology. Appellant's Brief at 14. These subsections are specifically geared toward LLCs and S Corporations and provide a deduction for "imputed federal income taxes in an amount equal to the taxes that would have been paid on net income as defined in § 10-43-10.1...." SDCL 10-43-10.3(10)(11).

However, U.S. Bank's asserted "plain meaning" of "taxes imposed" does not, in fact, clarify the meaning of that term. The dictionary cited by U.S. Bank defines "impose" as not only "to establish or apply," but also "to establish or bring about as if by force." AR at 586. This latter definition of "impose" could reference the forced payment of the tax due. Resultantly, turning to a dictionary definition does not assist in defining "taxes imposed."

Additionally, subsections (10) and (11) of SDCL 10-43-10.3 do not assist the analysis of subsection (3) for purposes of this case. U.S. Bank does not fit within the categories laid out in (10) or (11). Even if those subsections did allow the methodology proposed by U.S. Bank in this case, the South Dakota Legislature did not use the same language in describing the deduction in SDCL 10-43-10.3(3). It is presumed that if the Legislature had intended for the description of the deduction in subsection (3) to match that in subsections (10) or (11), it would have said so. *See Steinberg v. S.D. Dept. of Military and Veterans Affairs*, 2000 S.D. 36, ¶ 10, 607 N.W.2d 596, 600. It did not.

Therefore, the Court must turn to the rules of statutory construction to determine the meaning of "taxes imposed." When courts are "called on to interpret a statute granting an exemption, a deduction, or a credit ... the statute is strictly construed against the taxpayer." *Burlington Northern R. Co. v. Strackbein*, 398 N.W.2d 144, 146 (S.D. 1986) (other citations omitted). Deductions "are privileges accorded as a matter of legislative grace and not as a matter of taxpayer right." *Id.* at 147.

As stated previously, the South Dakota Legislature has not specifically defined "taxes imposed." It has, however, given the Department express authority to promulgate administrative rules concerning: "(1) The procedure for filing tax returns and payment of tax...(3) *The definition and deductibility of net federal income taxes*; [and] (4) The application of the tax and exemptions..." SDCL 10-43-42.1 (emphasis added). Courts "read statutes as a whole, as well as enactments relating to the same subject." *AEG Processing Center No. 58, Inc. v. SD Dept. of Rev.*, 2013 S.D. 75, ¶ 17, 838 N.W.2d 843, 849. When giving effect to all these provisions, it becomes clear that the Legislature intended the deduction for federal income taxes imposed as

referenced in SDCL 10-43-10.3(3) to be *net* federal income taxes. The question, then, becomes how those net federal income taxes are defined and calculated.

"The construction and interpretation given a statute by an administrative body charged with its administration is entitled to great weight." *In re: State Sales and Use Tax Liability of Pam Oil, Inc.*, 459 N.W.2d 251, 256 (S.D. 1990). *See also Northern States Power Co. v. S.D. Dept. of Rev.*, 1998 S.D. 57, ¶ 4, 578 N.W.2d 579, 580 (Agency interpretation of statute given great weight when Legislature has given the agency that express authority). Pursuant to this authority, the Department has defined "net federal income tax" as "that federal income tax in excess of any federal income tax refund received during the tax year for which the deduction is claimed." ARSD 64:26:01:01(4). Further, the Department has stated:

> ...Net federal income taxes are deductible from taxable income in the tax year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. Any other income, franchise, or privilege taxes which were deducted to determine federal taxable income are not deductible.

ARSD 64:26:04:28.[9]

The Department's position is that Schedule J of Form 1120 provides the calculation of these net federal income taxes:

1. Multiply taxable income (Form 1120, line 30, page 1) by the appropriate tax rate to arrive at "income tax," and record that number on Schedule J, line 2.
2. Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at "total tax" (Schedule J, Line 11), which is then recorded on line 31 of the Form 1120.

[9] U.S. Bank claims that this regulation is invalid because it exceeds the scope of SDCL 10-43-10.3(3). Appellant's Brief at n. 4. This ignores the specific rulemaking authority granted to the Department in SDCL 10-43-42.1(3).

Appellee's Brief at 13. The Department argues that this "total tax" number represents the taxes imposed (net federal income taxes). In other words, the taxes imposed referenced in SDCL 10-43-10.3(3) are the federal income taxes which must be paid to the IRS *after* reduction by tax credits. Appellee's Brief at 13.

U.S. Bank, however, argues that the "taxes imposed" calculation ends at Schedule J, line 2, which represents its separate taxable income multiplied by the 35% tax rate imposed by the IRC. Further, U.S. Bank argues that the federal tax liability of both U.S. Bank and the consolidated group is the amount *before* application of credits because both cash *and* credits are considered payments of federal income tax. Reply Brief at 6-7.

According to U.S. Bank, this is the same amount of federal income taxes that U.S. Bank would have paid if it had filed income tax on a separate return basis, so it equals the "taxes imposed" by the IRC. Appellant's Brief at 2; Reply Brief at 2. This also happens to be, according to U.S. Bank, its share of the consolidated federal tax liability computed on a separate company basis under the Tax Sharing Agreement.[10] U.S. Bank claims that this methodology is reasonable because "intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity." Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 63 Fed. Reg. 64757 (Nov. 23, 1998). AR at 429.

However, the policy and purpose behind the Tax Sharing Agreement is that it is an internal contract amongst the entities and not the actual imposition of tax by the IRS. HT 25-28, 38. The payments back and forth pursuant to the Tax Sharing Agreement are to theoretically

[10] On the one hand, U.S. Bank argues that it is not allocating its tax liability based on a tax sharing agreement. On the other hand, however, U.S. Bank points out that the method it has used to calculate the deduction (separate company federal taxable income multiplied by 35%) is indistinguishable from the method used to compute its share of the consolidated tax liability under the Tax Sharing Agreement. Reply Brief at 11-12.

make each company whole and do not necessarily represent the amount of tax imposed upon U.S. Bank by the IRS. *Id.*

Moreover, U.S. Bank's methodology results in it taking a much larger deduction for federal income taxes imposed than the entire consolidated group paid for income taxes. Specifically, U.S. Bank's claimed SD BFT deduction over each of the three years at issue (2010-2012) was between 133% to 175% higher than the entire consolidated group's tax payments to the IRS. *Supra, pp. 6-10.* Overall, the combined deduction for taxes imposed claimed by U.S. Bank on its SD BFT returns was $1,272,952,268 higher than the combined federal income taxes actually paid by the consolidated group over those years. *Id.*

The United States Tax Court, when faced with arguments similar to those being made by U.S. Bank regarding the meaning of "taxes imposed," has determined that it means taxes actually imposed, not some other hypothetical computation. *Sparrow v. Commissioner of Internal Revenue*, 86 T.C. No. 55 (1986) (AR 463-67); *Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, T.C. memo. 1995-600 (1995) (AR 458-61).[11]

In *Norwest,* the Tax Court considered "the proper methodology to be used in calculating the amount of [Norwest's] 'regular tax deduction' for purposes of computing its [corporate] minimum tax liability." AR 458. The "regular deduction" in that context, was "an amount equal to the taxes imposed by the chapter for the taxable year." *Id.* Norwest, like U.S. Bank, argued that, in the absence of specific statutory or regulatory guidance, it was reasonable to calculate the deduction for 'taxes imposed' by using the regulations and theories behind the calculation in consolidated returns. AR 459. Also, like U.S. Bank, Norwest's methodology resulted in the regular tax deduction greatly exceeding the amount of tax paid on the consolidated taxable

[11] These cases were attached to a brief submitted to the OHE and are hence part of the administrative record. Cites are to the AR page number.

income of the affiliated group. The Tax Court rejected Norwest's methodology for determining taxes imposed, finding it was not in line with the income tax actually imposed and paid. AR 458-60.

This Court reaches a similar conclusion. Adopting U.S. Bank's methodology in this case would allow it to increase its federal deduction, and hence reduce its SD BFT, to an absurd level. As pointed out above, U.S. Bank's methodology results in it taking a much larger deduction for federal income taxes imposed than the entire consolidated group paid for income taxes.

Moreover, if U.S. Bank's argument that "credits" are payments of tax were to be accepted, it would not mesh with the purpose of a tax credit. *See Burlington Northern,* 398 N.W.2d at 147 (Tax credits are rebates which relieve taxpayers from some tax liability). It would also allow U.S. Bank to increase its federal deduction for taxes paid to foreign jurisdictions, which is one of the federal credits. This would, in essence, make such foreign taxes "taxes imposed" by the Internal Revenue Code. Additionally, the record establishes that U.S. Bank receives a refund or cash payment from the consolidated group for the credits it generates. HT 25-26. Accepting its argument that credits are payments would allow U.S. Bank to take a cash payment from the affiliated group for its portion of a credit. Then, without paying that cash toward federal income tax, U.S. Bank could use the same cash payment to increase its federal deduction and correspondingly decrease its SD BFT.

This Court must read words of a statute in context with their place in the overall statutory scheme, and it will not "interpret a statute to reach an absurd result." *Klein v. Sanford Medical Center,* 2015 S.D. 95, ¶ 13 (citation omitted). Adopting U.S. Bank's interpretation of "taxes imposed" for purposes of the federal deduction would "stand in direct contrast to the revenue-generating purpose of tax statutes." *Polly's Properties LLC v. Vermont Dept. of Taxes*, 998 A.2d

1047, 1057 (Vt. 2010). This the Court cannot do, especially when the statute at issue involves an exemption or deduction *and must be construed in favor of the taxing power. In re: Sales and Use Tax Liability of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990).

For these reasons, the Court affirms the decision of the Department to reject U.S. Bank's methodology for calculating the deduction for "taxes imposed" under SDCL 10-43-10.3(3). The Court further determines that the legislative intent of SDCL 10-43-10.3(3) is that "taxes imposed" should equal net federal income taxes, which represent taxes paid after reduction by credits.[12]

## II. AFTER REJECTING U.S. BANK'S METHODOLOGY, DID THE DEPARTMENT ERR IN NOT ALLOWING U.S. BANK AN ALTERNATIVE METHODOLGY?

Having affirmed the Department's decision to reject the methodology proposed by U.S. Bank, the next question becomes whether U.S. Bank was still entitled to the deduction by an alternate methodology. According to U.S. Bank, because the Department's auditor conceded that it should be allowed *some* type of deduction (HT 64, 80), the Department erred in adjusting the 2012 deduction to zero and denying the 2010 and 2011 refund requests in full. Reply Brief at 2-3, 13-14. Put another way, U.S. Bank argues that it met its burden of entitlement to the deduction, even if not in the amount claimed, and the burden then shifted to the Department to calculate an alternative amount. Reply Brief at 2. U.S. Bank purports that "the Department should *at least* have calculated a deduction for U.S. Bank based on its percentage of the consolidated group's [Schedule J] Line 11 amount..." Reply Brief at 14 n. 7 (emphasis added).

[12] The Court rejects U.S. Bank's argument that the Missouri bank franchise scheme should be instructive to this Court. Appellant Brief at 18-19. Missouri's bank franchise scheme differs substantially from that of South Dakota.

The Department, on the other hand, claims that U.S. Bank never provided the information required to meet its burden to receive the deduction for 2012 or receive a refund in 2010 or 2011. Appellee Brief at 21-22. As a result, the Department was left with only two options: (1) accept U.S. Bank's inflated methodology; or (2) deny U.S. Bank's claimed deductions. Appellee Brief at 22.

A certificate of assessment is deemed prima facie correct. SDCL 10-59-8. The burden is on the taxpayer to overcome the presumption by establishing that there has been a mistake of fact or error of law. SDCL 10-59-9. *See also Doctor's Associates, Inc., v. S.D. Dept. of Rev.*, 2006 S.D. 18, ¶ 14, 711 N.W.2d 237, 242. Additionally, deductions are an act of legislative grace and never presumed. *Burlington Northern*, 398 N.W.2d at 147; *Pam Oil, Inc.,* 459 N.W.2d at 255. Tax exemptions are construed in favor of the taxing power, and the taxpayer has the burden of proving entitlement to a statutory exemption or deduction. *Pam Oil* at 255. Generally, a taxpayer has the burden to prove both the entitlement to a deduction and the proper amount. *Doyal v. Commissioner of Internal Revenue*, 616 F.2d 1191, 1192 (10th Cir. 1980); *Washington Mutual, Inc. v. United States*, 130 Fed.Cl. 653, 686-87 (Fed. Cl. 2017).

As a SD BFT taxpayer, U.S. Bank was under the following retention and production requirements for the relevant tax years:

> Every person subject to tax under this chapter shall make and keep for a period of six years *such records as required by the secretary ... for the administration of this chapter*. Such books and documents shall, at all times during business hours of the day, be subject to inspection by the secretary ... *to determine the amount of tax due.*
>
> If in the normal conduct of the business, the required records are maintained and kept at an office outside the State of South Dakota, it shall be a sufficient compliance with this section if the records are made available for audit and examination by the Department of Revenue at the office outside of South Dakota.

SDCL 10-43-43.1 (emphasis added). *See also* SDCL 10-59-21 (Taxpayer seeking recovery of allegedly overpaid tax "shall provide any information requested or considered necessary by the secretary to determine the validity of a claim.") Additionally, U.S. Bank was required to submit with the SD BFT return "a copy of the federal income tax return and schedules filed with the Internal Revenue Service for the tax year." ARSD 64:26:02:04.

The Department also had authority to require the production of certain records during the audit.

> ...Unless the secretary determines that delay may jeopardize the collection of a tax, the secretary shall mail a notice of intent to audit at least thirty days before commencement of the audit to the person to be audited...*Any documents or records required to be kept by law to evidence reduction, deduction, or exemption from tax not prepared for presentation to the auditor within sixty days from the commencement date of the audit do not have to be considered by the auditor or the secretary.* However, additional pertinent papers or documents shall be considered if all the following apply:
>
> (1) The additional pertinent papers or documents are material;
> (2) There were good reasons for failure to present other pertinent papers or documents as referenced in § 10-45-45 or 10-46-43, within the prescribed time period; and
> (3) The additional pertinent papers or documents are submitted within a reasonable time period prior to any hearing scheduled pursuant to § 10-59-9.

SDCL 10-59-7 (emphasis added).

> Additionally, the notice of intent to audit must include the following language:
>
> All records, books, and documents must be prepared for presentation to the auditor on the date of commencement of the audit. All documents evidencing reduction, deduction or exemption of tax not prepared for presentation within sixty days of the date of commencement of the audit need not be considered by the auditor.

SDCL 10-59-3.

U.S. Bank argues that the Department was provided everything necessary to calculate the deduction and should have done so. Reply Brief at 13. U.S. Bank filed its 2010, 2011, and 2012

SD BFT returns with the Pro Forma 1120 for each year. Ex. 15 at AR 231, 238, 240. The U.S. Bancorp Form 1120 was not included, even though all tax returns and schedules filed with the IRS were required to be submitted with the SD BFT return. ARSD 64:26:02:04.

The Department requested information from U.S. Bank before and after the commencement of the audit. This information was required to be provided by U.S. Bank pursuant to the statutes cited above. In October of 2013, after U.S. Bank filed amended SD BFT returns for 2010 and 2011, the Department requested pages 1-5 of the U.S. Bancorp Form 1120s and consolidated numbers for the members of the consolidated group that tied into those pages. Ex. 15 at AR 231, 239. Regarding the 2010 amended SD BFT return, the Department specifically requested an explanation of the computation of the deduction and "documentation that the amounts claimed were imposed upon a financial institution under the Internal Revenue Code." Ex. 15 at 232.

U.S. Bank did not directly respond to this request. Instead, it filed its second amended 2010 BFT Return which increased the deduction and noted that the deduction claimed thereon was equal to 35% of U.S. Bank's taxable income. Ex. 10 at AR 153; Ex. 15 at AR 233.

On October 2, 2014, the Department sent U.S. Bank the Notice of Intent to Audit the 2011 and 2012 SD BFT returns. HT 58-59; Ex. 16 at AR 244-46. The notice informed U.S. Bank of the commencement date of November 3, 2014, and the sixty-day deadline as required by SDCL 10-59-3. HT 59; Ex. 16 at AR 245-46.

On October 23, 2014, the Department issued IDR2 to U.S. Bank. It requested pages 1-4 of the U.S. Bancorp Form 1120 for 2011 (for the second time) and 2012 and "the Profit and Loss computation for ... all of the Affiliated Group Members." Ex. 9 at AR 148. It also requested the "internal work papers and legal analysis to support the amounts reported on SD BFT page 2,

Line 15 as Federal income taxes paid or accrued." *Id.* The deadline to respond was November 4, 2014. *Id.*

Ultimately the U.S. Bancorp Form 1120s were received for 2010-2012. U.S. Bank informed the Department that it was relying upon its separate company taxable income multiplied by 35%. Ex. 15 at AR 241. However, U.S. Bank provided no proof of payment of that amount or other internal workpapers to support that amount as requested in IDR2. HT 62-64.; Ex. 15 at AR 242; Ex. 24 at AR 297. Additionally, there is no indication that credits claimed by U.S. Bank were received by the Department. Ex. 24 at 297.

The U.S. Bancorp Form 1120, although it included some financial information for U.S. Bank, did not include the amount of tax paid by U.S. Bank or credits attributable to U.S. Bank. HT 60-64, 80-82. Additionally, the Pro Forma 1120 provided with each return did not include a tax calculation or credits attributable to U.S. Bank. Ex. 4 at AR 121-25; Ex. 5 at AR 126-30; Ex. 6 at AR 131-35.

During the hearing, U.S. Bank offered bank statements (Exhibit 17) as proof that it made the payments to the IRS for the consolidated tax liability. HT 15-17, 47-48; Ex. 1 at AR 21-23; Ex. 2 at AR 52-54; Ex. 3 at AR 85-87; Ex. 17 at 247-263. The Department objected because the documents were not received until almost three years after the commencement of the audit, with no good reason. SDCL 10-59-7 and 10-59-3; HT 17-18. Ultimately, the Department rejected these documents. Final Decision at AR 625.

The Department was correct to disregard these documents as being produced well past the sixty-day period in SDCL 10-59-7 and only a few days before hearing, without good reason for delay. However, even if these payments were considered, there is no indication that they were amounts paid by U.S. Bank for its individual tax liability. U.S. Bank was designated as the

settlement agent for the affiliated group and was responsible for the payment of all consolidated income taxes and the transferring of settlement amounts owed between the affiliates from demand deposit accounts maintained at U.S. Bank. Ex. 18 at AR 265.

Ultimately, the auditor could not reconcile the amount reported on U.S. Bank's SD BFT returns to the taxes imposed and paid on the US Bancorp 1120. HT 63. U.S. Bank provided documents which could have served as the starting point for calculating the deduction for U.S. Bank. But it never provided information regarding taxes actually paid or credits generated by U.S. Bank which could lead to the end point. HT 21, 80-85.[13] For this reason, neither its rejected calculation for 2010-2012, nor its alternative calculation, is supported by the record. Reply Brief at 14.

For these reasons, U.S. Bank has not met its burden of proof regarding entitlement and amount of the deduction. The Department did not err in not allowing U.S. Bank an alternate methodology for 2010-2012.

ORDER OF AFFIRMANCE

Based upon the foregoing memorandum opinion, which is incorporated into this Order as if set forth in full, it is hereby ORDERED that the Department's denial of U.S. Bank's 2010 and 2011 refund requests, and the Department's issuance of the 2012 Certificate of Assessment (Exhibit 14) are hereby AFFIRMED.

Dated this 1st day of May, 2020.

Bobbi J. Rank
Circuit Court Judge

[13] According to 26 CFR § 1.1502-75, which governs the filing of consolidated returns, details of the items of gross income, deductions, and credits for each affiliate may be readily audited. 26 CFR § 1.1502-75(j).

STATE OF SOUTH DAKOTA
OFFICE OF HEARING EXAMINERS

| | |
|---|---|
| U.S. BANK NATIONAL ASSOCIATION<br><br>v.<br><br>SOUTH DAKOTA DEPARTMENT OF REVENUE | DOR 16-34<br><br>FINAL DECISION AND ORDER |

An administrative hearing was held in this matter on September 28, 2017. Petitioner, U.S. Bank National Association ("U.S. Bank"), was represented by Craig Fields and Nicole Johnson of Morrison & Foerster, LLP, and Justin Bell of May, Adams, Gerdes & Thompson, LLP. The South Dakota Department of Revenue ("Department") was represented by John Richter.

The Office of Hearing Examiners, through Hearing Examiner Catherine Duenwald, entered a Proposed Decision and Proposed Order on May 22, 2018. After reviewing the record and the Proposed Decision, I modify the Proposed Decision and Proposed Order. Pursuant to SDCL 1-26D-8, I am required to give my reasons for modifying or rejecting the Hearing Examiner's proposed findings or proposed decision. My modifications and reasons are detailed below:

1. In the first sentence of paragraph 1 of the Statement of Issues, the Hearing Examiner stated the following:

> On December 28, 2015, the Department issued a Certificate of Assessment to U.S. Bank in the amount of $508,926.11 following an audit of the tax year 2012.

I modify the first sentence of paragraph 1 of the Statement of Issues to:

> On December 28, 2015, the Department issued a Certificate of Assessment to U.S. Bank in the amount of $508,926.11 following an audit of the tax year ending December 31, 2012.

The modification is made for accuracy and consistency purposes.

2. In the second sentence of paragraph 1 of the Statement of Issues, the Hearing Examiner stated the following:

> The Department also denied a change in the amount for the tax year 2011.

I modify the second sentence of paragraph 1 of the Statement of Issues to:

> During the audit, U.S. Bank made requests for refund relating to the periods ending December 31, 2010 and December 31, 2011. Those refund requests were denied.

This modification is made because the initial statement is vague and incomplete. The modification set forth above is supported by the record, *see* Exhibit 13, and provides complete information on the transactions at issue.

3. In the third sentence of paragraph 1 of the Statement of Issues, the Hearing Examiner stated the following:

> In a letter dated February 24, 2015, U.S. Bank appealed the certificate and requested an administrative hearing on the matter.

I modify the first sentence of paragraph 1 of the Statement of Issues to:

> In a letter dated February 24, 2016, U.S. Bank appealed the Certificate of Assessment and the denial of the refund claims.

The modification is made to correct the date and for completeness. *See* Ex. 15.

4. In paragraph 2 of the Statement of Issues, the Hearing Examiner stated the following:

> The issue before the hearing examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3(2); and if any, what is the appropriate methodology to determine that amount.

I modify paragraph 2 of the Statement of Issues to:

> The issue before the hearing examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3(2). At the time of the assessment, SDCL 10-43-10.3(2) was codified as SDCL 10-43-10.3(3). For ease, this decision will reference SDCL 10-43-10.3(2) throughout.

The modification is made because the language of SDCL 10-43-10.3(2) provides the methodology to determine any deduction. Moreover, the modification is made for clarification purposes.

5. I reject the Hearing Examiner's Proposed Reasoning as I disagree with it, it contains irrelevant and incorrect statements of fact and law, and I find it

incomplete. The reasoning section set forth below is supported by the record and the law.

SDCL chapter 10-43 governs the procedure for South Dakota's bank franchise taxes. SDCL 10-43-2.1 provides, "An annual tax is hereby imposed upon every national banking corporation ... doing business within this state, according to or measured by its net income[.]" "Net income, in the case of a financial institution, is taxable income as defined in the Internal Revenue Code[.]" SDCL 10–43–10.1. "Each taxpayer shall file the final return for the tax year within fifteen days after the taxpayer's federal income tax return is due." SDCL 10–43–30.

In calculating a financial institution's net income, South Dakota law provides for the following deduction:

> Subtracted from taxable income are:
> . . .
> (2) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375;

SDCL 10-43-10.3(2). ARSD 64:26:04:28 references SDCL 10-43-10.3 and, in pertinent part, further clarifies:

> . . . Net federal income taxes are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See supra.* The steps are as follows:

> **Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."
>
> **Step 2.** Record that number on Schedule J, line 2 of Form 1120.
>
> **Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).
>
> **Step 4.** Record Total tax liability on Schedule J, line 10.
>
> **Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the Internal Revenue Service.

HT 71-72; *See Exs.* 1-3, 13. If U.S. Bancorp were doing business within the State of South Dakota, it would use this amount as the deduction on its bank franchise tax return (page 2, line 15 of the bank franchise tax return), since it completed the Form 1120. *See* Exs 6-8, 10-12. However, U.S. Bancorp is not the one doing business within the State of South Dakota – instead, one of its affiliates, U.S. Bank, is.

In this case, instead of using a Form 1120 consolidated return to calculate the federal income tax deduction, U.S. Bank simply calculated the federal income tax deduction by multiplying Line 30, on its pro forma returns by 35%. HT 56-58.

*1. U.S. Bank's Methodology.*

Not only does U.S. Bank's methodology stop short in terms of calculating the net federal income tax, as described above, but it runs counter to federal law. *See* discussion *supra*; 26 CFR 1.1502-75(f)(2). 26 CFR 1.1502-75(f)(2), in pertinent part, discusses the allocation of tax liability to the separate entities of a consolidated federal income tax return.

> (2) Allocation of tax liability. In any case *in which amounts have been assessed and paid* upon the basis of a consolidated return ...

(Emphasis added). Consistent with this provision, taxes imposed, in the context of a federal consolidated return, are those amounts that have actually been assessed and paid. 26 CFR 1.1502-75(f)(2); *see also* Ex. 13. The term "paid" is defined in South Dakota law under SDCL 10-43-1(9) as:

> (9) "Paid," for the purposes of the deductions means paid or accrued or paid or incurred, and the terms paid or incurred and paid or accrued are construed according to the accounting method used for computing net income; received, for the purpose of the computation of net income means received or accrued, and the term received or accrued is construed according to the accounting method used for computing net income;

The question in this case boils down to, what did the IRS actually require U.S. Bank to pay? *See* U.S. Bank Brief at 1-5.

Under U.S. Bank's methodology, it includes credits as taxes imposed. Credits are not taxes imposed. *See Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); HT 37, 71-72. They are simply a reduction to determine what is owed. HT 71-72. U.S. Bank witness, Brett Scribner, conceded "[t]he credit is

not a tax imposed, no." HT 37. Consequently, U.S. Bank's proposed methodology is rejected.

2. *Norwest Corporation and Subsidiaries v. Commissioner of Internal Revenue.*

The question of taxes actually imposed versus hypothetical taxes that could have been imposed has been litigated in cases involving minimum tax, which examined the "taxes imposed" language of the Internal Revenue Code. *Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); Ex. 13. Courts have consistently held that "taxes imposed" means taxes actually imposed, not some other hypothetical computation. *Id.*

In *Norwest*, the Court was asked "to determine the proper methodology to be used in calculating the amount of [Norwest's] 'regular tax deduction' for purposes of computing its [corporate] minimum tax liability." *Id.* at 1. In the context of minimum tax, the term "regular deduction" was defined as "an amount equal to the taxes imposed by the chapter for the taxable year." *Id.* Norwest was part of an affiliated group of corporations that filed a consolidated income tax return. *Id.* at 2. In *Norwest*, the petitioner allocated:

> [t]he consolidated tax of the group . . . among those members that had taxable income for the year. [The] allocation was based on the ratio that each member's regular tax (computed on a separate return basis) bore to the sum of the separate return regular taxes of all the members. An additional amount of tax was then allocated to each member that had positive taxable income. The additional amount allocated was the excess of the member's separate return tax over the tax already allocated to the member.

*Id.* at 2. Norwest argued that, in the absence of specific statutory or regulatory guidance, it was reasonable to calculate the "regular deduction" for "taxes imposed" by using a methodology set forth in the consolidated return regulations. *Id.*

The IRS argued, and the Tax Court agreed, that an "allocation of an intercompany liability is not the kind of tax liability contemplated by section 56(c) [the regular deduction]." *Id.* The Court went on to note that (1) under the petitioner's methodology, the regular tax deduction would generally exceed the amount of tax paid on the consolidated taxable income of the affiliated group; and (2) the "legislative history of the minimum tax also indicates that the regular tax refers to the income tax actually imposed and paid." *Id.* at 2-3. Consequently, the petitioner's methodology relying on intercompany liability allocation was rejected. *Id.*; *See also Sparrow v. C.I.R.*, 86 T.C. 929 (1986) (rejecting petitioner's allocation method and holding that "[t]he amounts allocated to each member of an affiliated group under the 1502-33(d) allocation

are certainly derived from and may in the aggregate equal the amount of taxes imposed on the affiliated group pursuant to chapter one of subtitle A of the Code for the taxable year, but are not, themselves, taxes so imposed.").

Like the petitioner in *Norwest*, U.S. Bank is part of an affiliated group of corporations that filed a consolidated income tax return. *Id.* at 2. In this case, U.S. Bank attempts to allocate its tax liability based on a tax sharing agreement. *See* U.S. Bank's Brief. First and foremost, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

Furthermore, the tax sharing agreement parallels the allocation methods that were explicitly rejected in *Norwest* and *Sparrow*. U.S. Bank witness Brett Scribner testified that the tax sharing agreement:

> [I]s designed to share or provide the – allocate the proper amount of tax liability or benefit that is generated by each individual company in a particular group.
>
> So it applies to federal consolidated returns. It also applies to the allocation of what are known as unitary or combined state income tax liabilities. There are states, some states, that also tax a consolidated or a combined group of companies similar to the federal process. And so the federal is a consolidated return.
>
> So this is designed to allocate that and then make sure that the payments are made back and forth so that each company is *theoretically* made whole either for the benefits it generated for the group or for the tax it had to pay for the group. Or because it had income or loss, as the case may be.

HT 23 (emphasis added). The tax sharing agreement does not answer what was actually paid – and is only theoretical. HT 23; *See* Ex. 18. Moreover, like in *Norwest*, the allocation utilized by U.S. Bank is not the kind of tax liability contemplated by SDCL 10-43-10.3(2) in that it is not taxes imposed by the Internal Revenue Code. HT 38 (Again, U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Furthermore, also like in *Norwest* and, as discussed above, the tax deduction claimed by U.S. Bank is based on a number that greatly exceeds the

amount of taxes paid by the entire consolidated group. *See* discussion *supra.* Based on the holdings in *Norwest* and *Sparrow* U.S. Bank's intercompany liability allocation argument is rejected.

U.S. Bank's witness, Brett Scribner, conceded the following:

- The FDIC does not impose tax. HT 38.
- The IRS does not dictate the terms of the tax sharing agreement and the tax sharing agreement is not an imposition of tax under the Internal Revenue Code. HT 38-39.
- Estimated payments are not taxes imposed. HT 39.

As to the estimated payment concession, Exhibit 17 was improperly admitted into evidence. SDCL 10-59-3 and 10-59-7 require that all evidence of reduction, deduction, or exemption be provided within 60 days of the commencement of the audit or it need not be considered. In this case, Exhibit 17 was not presented until September 22, 2017, nearly three years after the November 3, 2014 audit commencement date. *Compare* HT 18 *to* Ex. 16. The evidence offered is exactly the type contemplated by SDCL 10-43-43.1. Moreover, U.S. Bank offered no good reason for not presenting it until September 22, 2017. *See* HT 18, AR. Based on the preceding, Exhibit 17 need not be considered.

The question is: What taxes were imposed under the Internal Revenue Code? HT 4. The tax sharing agreement, the OCC, the Federal Reserve System, and the FDIC do not impose tax under the Internal Revenue Code nor are they taxes imposed under the Internal Revenue Code. *See* I.R.C. Therefore, they are all irrelevant in answering the question of what deduction, if any, U.S Bank is entitled to under SDCL 10-43-10.3(2).

*3. U.S. Bank's Comparisons to Missouri's Administrative Rules are Misplaced.*

U.S. Bank asserted that its methodology for computing the federal tax deduction is the same it uses for Missouri's bank franchise tax purposes. U.S. Bank Brief at 12. Despite that Missouri's law is irrelevant, U.S. Bank stated that "[t]he Missouri Department of Revenue has promulgated a regulation that interprets its federal tax deduction to equal the federal income tax 'as if a separate federal return had been filed' (i.e., separate company federal taxable income multiplied by 35%). 12 Mo. Code Regs. 10-10.135(2)(B) (methodology for accrual based taxpayers)." This statement is inconsistent with the administrative rule cited.

> 12 Mo. Code Regs. 10-10.135(2) states, in pertinent part:
> (2) Consolidated Group. A taxpayer that is a member of an affiliated group of corporations, which files a consolidated federal

> income tax return, shall be allowed a deduction for federal income taxes paid or accrued during the income period, as follows:
>
> (B) Accrual Basis. *The deduction shall equal the federal form, Schedule J, total tax* liability as if a separate return had been filed. The taxpayer who is a member of an affiliated group of corporations shall include in gross income benefits received for a net operating loss or unused credits generated during the current period. In the event an affiliated group incurs a net operating loss carryback or a carryback of unused credits, income shall be increased by an amount equal to the member's separately computed share of the federal refund received from any carryback to consolidated return years, plus the amount of any federal refund received which results from a carryback to any member's separate return years. Income shall be increased by an amount equal to the federal refunds that would have been received if amended federal returns would have been filed by the taxpayer on a separate return basis. This refund could result from a net operating loss (NOL) carryback or a carryback of unused credits.

(Emphasis added). "Schedule J, Total Tax," is line 10 of the Schedule J and flows to line 31 on the Form 1120.. Exs. 1-3. This parallels the calculation used to calculate South Dakota's net federal income tax deduction. *See supra.* The regulation's language is consistent with the position taken by the Department in this matter. *Compare* discussion *supra to* 12 CSR 10-10.135(2)(b).

*4. U.S. Bank Failed to Preserve its Alternative Argument.*

U.S. Bank asks that the Tax Sharing Agreement payments be deductible as ordinary and necessary business expenses in computing federal taxable income under SDCL 10-43-10.1. HT 13-14. First, this request was never presented to the auditor, nor was it mentioned in U.S. Bank's request for hearing. Exs. 13, 15; SDCL 10-59-9 provides, in pertinent part:

> Any taxpayer against whom a certificate of assessment is issued may request a hearing before the secretary if the taxpayer believes that the assessment is based upon a mistake of fact or an error of law. A request for hearing shall be made in writing within sixty days from the date of the certificate of assessment and shall contain a statement indicating the portion of the assessment being contested and the mistake of fact or error of law the taxpayer believes resulted in an invalid assessment. Amended or additional statements of facts or errors of law may be made not less than fourteen days prior to the hearing if the hearing examiner determines such additional or amended statements are in the interest of justice and do not prejudice either party.

Moreover, the Hearing Examiner initially stated that, "[t]he issue before the Hearing Examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3[(2)], and, if any, what is the appropriate methodology to determine that amount?". HT 4. In response, U.S. Bank's counsel asked to clarify two things, (1) the years at issue; and (2) that SDCL 10-43-10.3(2) used to be codified at (3). HT 6. U.S. Bank never raised the SDCL 10-43-10.1 argument, and as such, it is not properly before the Hearing Examiner and must be rejected. *See* SDCL 10-59-9.

It appears that this is an issue that U.S. Bank should have raised to the IRS if the Tax Sharing Agreement payments were actually business expenses. *See* U.S. Bank Brief at 13-14. However, they did not do so with either the Department or the IRS. Therefore, U.S. Bank's argument is rejected. Moreover, a review of IRC §§ 162 and 164 make it clear that payments to affiliates are not a federal tax or a deduction. *See* IRC §§ 162 and 164.

5. *A Deduction was Available to U.S. Bank.*

U.S. Bank stated in its brief that, "[i]t is undisputed that U.S. Bank is entitled to the Federal Tax Deduction." U.S. Bank Brief at 1. The Department agreed that a deduction would be available to U.S. Bank if it would have shown that it fit squarely within the plain language of the deduction. *See Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990). In fact, the Department, through the Notice of Intent and issuing IDR #002, specifically requested the methodology utilized on the 2010 and 2011 originally filed returns. Ex. 9; Ex. 13 at 18-19; Ex. 16; HT 60-31. Considering the information requested is statutorily required to be maintained by the taxpayer and presented to the Department upon request, there is no reason that U.S. Bank did not provide it. *See* SDCL 10-43-43.1.

> 10-43-43.1. Each person subject to tax under this chapter shall make and keep for a period of six years after federal taxable income has been finally determined by the United States any records as required by the secretary of revenue or otherwise necessary for the administration of this chapter. The records shall, at all times during business hours of the day, be subject to inspection by the secretary to determine the amount of tax due.
>
> If in the normal conduct of the business, the required records are maintained and kept at an office outside the State of South Dakota, it shall be a sufficient compliance with this section if the records are made available for audit and examination by the Department of Revenue at the office outside of South Dakota.

Regardless, U.S. Bank never provided information as to its computation of the deduction as initially filed nor did it provide a methodology consistent with the

plain language of SDCL 10-43-10.3(2). Ex. 9; Ex. 13 at 18-19; Ex. 16; HT 60-31. Because U.S. Bank never provided the requested information to the Department, the Department's auditor was left with one of two options: (1) accept U.S. Bank's methodology; or (2) deny U.S. Bank's claimed deductions in full. HT 62-63. The Department correctly denied U.S. Bank's claimed deduction in full as U.S. Bank failed to meet its burden to receive the deduction. *See Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990).

6. In paragraph 10 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank and U.S. Bancorp entered into an Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp ("Tax Sharing Agreement") with certain affiliates. Ex. 18; HT. 22.

I reject paragraph 10 of the Findings of Fact as it is irrelevant in determining the SDCL 10-43-10.3(2) deduction. The tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

7. In paragraph 11 of the Findings of Fact, the Hearing Examiner stated:

> The Tax Sharing Agreement, in part, provides for the allocation of the federal income tax liability among the members of the consolidated group, including U.S. Bank. *Id.*

I reject paragraph 11 of the Findings of Fact because the statement is incorrect and is irrelevant in determining the SDCL 10-43-10.3(2) deduction. Again, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

8. In paragraph 12 of the Findings of Fact, the Hearing Examiner stated:

It is designed to allocate the proper amount of the federal tax liability or benefit to the member that generated the income or loss. HT. 22.

I reject paragraph 12 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision.

9. In paragraph 13 of the Findings of Fact, the Hearing Examiner stated:

> Pursuant to the Tax Sharing Agreement, each member's federal tax liability is computed as if it had filed a separate federal income tax return (i.e., separate company federal taxable income multiplied by 35%). Ex. 18; HT. 24.

I reject paragraph 13 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision. Moreover, the Tax Sharing Agreement does not compute each members federal tax liability. *See* ¶ 7.

10. In paragraph 14 of the Findings of Fact, the Hearing Examiner stated:

> If a member of the consolidated group had a loss for the year, the member was paid for the use of that loss (i.e., the loss multiplied by 35%). Ex. 18; HT. 24-25.

I reject paragraph 14 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision.

11. In paragraph 15 of the Findings of Fact, the Hearing Examiner stated:

> In accordance with the U.S. Bancorp Tax Sharing Agreement, U.S. Bank paid the following taxes:
>
> U.S. Bank's Federal Taxes Paid
>
| Tax Year Ended | Taxable Income | Agreement Rate | Tax Paid to IRS |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x 35% = | $840,313825 |
| December 31, 2011 | $2,342,73,149 | x 35% = | $819,955,902 |
| December 31, 2012 | $4,925,219,278 | x 35% = | $1,723,826,747 |

> Ex. 1-6; 18.

I reject paragraph 15 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision. U.S. Bank admitted that the tax sharing agreement does not represent taxes *imposed* pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Consequently, it does not represent taxes paid either.

12. In paragraph 16 of the Findings of Fact, the Hearing Examiner stated:

> The 35% tax amount paid by U.S. Bank to the IRS is not necessarily the amount of tax imposed by the IRS upon U.S. Bank.

I reject paragraph 16 of the Findings of Fact for the same reasons contained in ¶¶ 7 and 11 of this decision.

13. In paragraph 17 of the Findings of Fact, the Hearing Examiner stated:

> The Tax Sharing Agreement is a binding contract between the affiliates of U.S. Bancorp. Ex. 18; HT. 24, 38.

I modify paragraph 17 of the Findings of Fact to:

> The tax sharing agreement is a binding contract amongst the entities.

The reason for this modification is to make it consistent with Brett Scribner's testimony. U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S." HT 38 It is a contract. *Id.* Scribner testified that "[i]t's a binding contract amongst the entities"). *Id.*

14. In paragraph 18 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank complied with the terms of the Tax Sharing Agreement as required by its regulators. HT. 25. U.S. Bank and U.S. Bancorp undergo numerous internal and independent audits by a number of regulators on a regular basis.

I reject paragraph 18 of the Findings of Fact for the same reasons contained in ¶ 6 of this decision.

15. In paragraph 23 of the Findings of Fact, the Hearing Examiner stated:

> The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed by the Internal Revenue Service or the federal tax liability. HT 7-72; *See* Exs. 1-3, 13.

I modify paragraph 23 of the Findings of Fact to:

> The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed or the federal tax liability that must be paid to the Internal Revenue Service. HT 7-72; *See* Exs. 1-3, 13.

The modification is made for accuracy and precision purposes.

16. In paragraph 25 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bancorp filed consolidated federal income tax returns, which included U.S. Bank. Ex. 1-3; HT. 23-24.

I reject paragraph 25 of the Findings of Fact for clarity purposes and being unnecessary. As set forth in Findings of Fact 3 through 6:

3. U.S. Bank is a member of an affiliated group of corporations under U.S. Bancorp. HT 9, 56; Ex. 13 at 1.

4. As the parent company of the consolidated group, U.S. Bancorp is responsible for filing a Form 1120, U.S. Corporation Income Tax Return. HT 9-10, 56; Ex. 13 at 1.

5. U.S. Bank's activities were included in the federal consolidated return, Form 1120, filed by U.S. Bancorp. HT 56.

6. As an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120, because its activities were included on the federal consolidated income tax returns filed by U.S. Bancorp for the years at issue. HT 9-10, 56; Exs. 1-3; *see* also Ex. 13.

17. In paragraph 26 of the Findings of Fact, the Hearing Examiner stated:

> The total income tax shown as due, before application of the credits, on the consolidated returns was as follows:
>
| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253.649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

> Ex. 1, p.3; Ex. 2, p.3; Ex. 3 p.3; HT.11

I reject paragraph 26 of the Findings of Fact because it is an incorrect statement that is inconsistent with the record. Moreover, there is no "total income tax shown as due" on the consolidated returns. The tax calculation is as follows:

> Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See supra.* The steps are as follows:
>
> > **Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."

Step 2. Record that number on Schedule J, line 2 of Form 1120.

Step 3. Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).

Step 4. Record Total tax liability on Schedule J, line 10.

Step 5. That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the Internal Revenue Service.

18. In paragraph 27 of the Findings of Fact, the Hearing Examiner stated:

> The total income tax due was paid through cash and credits. Ex. 1-3; HT.12.

I reject paragraph 27 of the Findings of Fact because it is an incorrect statement that is inconsistent with the record. Credits are not taxes imposed. *See Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); HT 37, 71-72. They are simply a reduction to determine what is owed. HT 71-72. U.S. Bank witness, Brett Scribner, conceded "[t]he credit is not a tax imposed, no." HT 37.

19. In paragraph 28 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank made cash payments to the Internal Revenue Service ("IRS") to pay the remaining tax due, after application of the credits, as follows:
>
| Tax Year Ended | Total Cash Payments |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

> Ex. 1, p.1; Ex. 2, p.1; Ex. 3 p.1; HT.113

I reject paragraph 28 of the Findings of Fact because it is an incorrect statement that is inconsistent with the record. The U.S. Bancorp consolidated federal tax returns for years ending 2010, 2011, and 2012 reflect total consolidated federal tax liability of $524,920,206, $617,186,234, and $981,865,059 respectively – not any form of cash payment. Ex. 13.

20. In paragraph 29 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank's taxable income consisted of the majority of the consolidated group's taxable income as follows:
>
| | U.S. Bank's Federal | Consolidated Group's |
|---|---|---|

| Tax Year Ended | Taxable Income | Federal Taxable Income | % |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| December 31, 2011 | $2,342,73,149 | $3,567,245,451 | 66% |
| December 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Ex. 1-3.

I reject paragraph 29 as it is irrelevant to the determination of the SDCL 10-43-10.3(2) exemption and is confusing.

21. In paragraph 30 of the Findings of Fact, the Hearing Examiner stated:

> In computing its federal taxable income, U.S. Bank treated the payments made pursuant to the Tax Sharing Agreement as federal income tax payments and did not deduct such amounts in computing its federal taxable income. See Ex. 1-6.

I reject paragraph 30 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision. U.S. Bank admitted that the tax sharing agreement does not represent taxes *imposed* pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Consequently, it does not represent taxes paid.

22. In paragraph 31 of the Findings of Fact, the Hearing Examiner stated:

> The bank statements provided by U.S. Bank on Exhibit 17 do not give explanation for the payments made to the IRS by U.S. Bank. These payments are not necessarily for federal tax liability imposed upon U.S. Bank, but could be for taxes imposed upon U.S. Bancorp or any affiliates. These could also be payments made in advance for estimated tax liability.

I reject paragraph 31 of the Findings of Fact because it is irrelevant, speculative, and inconsistent with the record. Moreover, Exhibit 17 does not be considered pursuant to SDCL 10-59-3 and 10-59-7.

23. In paragraph 32 of the Findings of Fact, the Hearing Examiner stated:

> In addition, U.S. Bank prepared pro forma federal income tax returns using accrual basis accounting. Ex. 4-6; HT. 19-20.

I reject paragraph 32 of the Findings of Fact because it is unnecessary. Finding of Fact 2 states: "U.S. Bank utilizes the accrual method of accounting. HT 19; Ex. 13 at 1." Moreover, only the returns that are federally filed have any bearing on U.S. Bank's federal income tax liability.

24. In paragraph 33 of the Findings of Fact, the Hearing Examiner stated:

> The pro forma returns were prepared to show U.S. Bank's taxable income on a separate company basis for states, such as South Dakota, that impose tax on a separate return basis (i.e., as if U.S. Bank filed a separate federal income tax return rather than filing as part of a consolidated federal income tax return). HT. 20.

I reject paragraph 33 of the Findings of Fact because it is unnecessary and more precisely stated in Findings of Fact 6 through 9.

6. As an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120, because its activities were included on the federal consolidated income tax returns filed by U.S. Bancorp for the years at issue. HT 9-10, 56; Exs. 1-3; *see* also Ex. 13.

7. For the years at issue, U.S. Bank prepared pro forma federal income tax returns. HT 20, 57; Exs. 4-6.

8. Pro forma means as a matter of form. In the context of consolidated groups, corporations are required to provide all information that would have been included in a separate company federal income tax return had the corporation filed a separate company income tax return with the federal government. *See* HT 19-20.

9. Pro forma returns are not filed with the Internal Revenue Service. HT 21, 57.

25. In the second sentence of paragraph 84 of the Findings of Fact, the Hearing Examiner stated:

> This exhibit shows a series of bank statements for demand deposit accounts (DDA) owned by U.S. Bank. Compare HT 18 to Ex. 16.

I reject the second sentence of paragraph 84 of the Findings of Fact because Exhibit 17 is irrelevant and does not be considered pursuant to SDCL 10-59-3 and 10-59-7.

26. In paragraph 85 of the Findings of Fact, the Hearing Examiner stated:

> The DDA statements in Exhibit 17 indicate how much money was paid by U.S. Bank to the IRS. These amounts are not necessarily how much money was owed to the IRS by U.S. Bank. These payments are not the amounts imposed upon U.S. Bank by the IRS. U.S. Bank paid the IRS a certain amount pursuant to the Tax Sharing Agreement as well as estimated tax liability.

I reject paragraph 85 of the Findings of Fact because it is unsupported by the record, speculative, and irrelevant. Moreover, Exhibit 17 is irrelevant and does not be considered pursuant to SDCL 10-59-3 and 10-59-7. Furthermore, the tax sharing agreement is irrelevant. Again, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

27. In paragraph 5 of the Conclusions of Law, the Hearing Examiner stated:

> SDCL 10-43-50 sets three (3) years, after the return is filed with the Department, as a time deadline for amending or correcting a return.

I modify paragraph 5 of the Conclusions of Law to:

> SDCL 10-43-50, at the time of the assessment, provided:
>
> As soon as practicable and in any event within three years after the return is filed, the secretary of revenue shall examine it and determine the correct amount of tax, and the amount so determined by the secretary is the tax. If the tax found due is greater than the amount previously paid, the excess, together with interest and penalty as provided in §10-59-6 shall be paid by the taxpayer within ten days after the secretary gives notice to the taxpayer by registered or certified mail.

The reason for this modification is for accuracy purposes.

28. In the second sentence of the Proposed Order, the Hearing Examiner stated:

> Furthermore, it is proposed that South Dakota Statute, 10-43-10.3(3), regarding "taxes imposed", be interpreted by the Department as the amount of tax an entity would be liable to pay the IRS had they filed taxes as a separate entity.

I reject the second sentence of the Proposed Order because it is contrary to the plain language of SDCL 10-43-10.3(2).

29. In the third sentence of the Proposed Order, the Hearing Examiner stated:

> Furthermore, requested amendments to the 2010 and 2011 returns are denied as time barred.

I modify the third sentence of the Proposed Order to:

> Furthermore, U.S. Bank's request for refunds made during the audit period are denied.

My reasons for modifying the third sentence of the Proposed Order are as follows:

- During the audit, U.S. Bank made requests for refund. Those requests for refund related to the periods ending December 31, 2010 and December 31, 2011. Ex. 13.
- U.S. Bank initially utilized a method to calculate the federal income tax deduction that was based roughly on 56% of the total federal tax liability of the consolidated group.
- The 2010 original return was allowed as filed since the time to assess further by the Department had expired. *Id.*
- The 2011 return was adjusted in the auditor's report. *Id.*
- Through requests for refunds made during the audit, U.S. Bank sought an additional refund, based on the methodology utilized on its 2012 bank franchise tax return. *Id.*
- The Department did not agree with the methodology U.S. Bank utilized on its 2012 bank franchise tax return -- consequently, U.S. Bank's requests for refund made during the audit period were denied. *Id.*

30. In the fourth sentence of the Proposed Order, the Hearing Examiner stated:

> It is finally proposed, consistent with the certificate of assessment, that for the year 2012, U.S. bank is assessed $364,169 of additional tax and $144,757.11 of interest.

I reject the fourth sentence of the Proposed Order as it is unnecessary based on the language of the first sentence and the modified third sentence.

31. For completeness and consistency with the record, I modify the Hearing Examiner's Proposed Decision so that the following Findings of Fact be added to read:

> 87. U.S. Bancorp does not do business within the State of South Dakota. One of its affiliates, U.S. Bank does.

88. The bank franchise tax return did not include a copy of the U.S. Bancorp consolidated federal return

89. Because U.S. Bank did not provide any proof of payment that would reconcile the South Dakota bank franchise tax line 15 deduction, the Department's auditor was left with two options: (1) accept the methodology to calculate the deduction U.S. Bank utilized on its 2011 amended return and 2012 return which exceeded the entire consolidated group's Federal tax liability; or (2) deny U.S. Bank's claimed deductions. HT 62-63.

90. U.S. Bank did not provide the information requested by the Department during the audit.

91. U.S. Bank offered no reason why it did not provide it. *See* AR.

92. At the administrative hearing, the Hearing Examiner initially stated that, "[t]he issue before the Hearing Examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3[(2)], and, if any, what is the appropriate methodology to determine that amount?". HT 4.

93. In response, U.S. Bank's counsel asked to clarify two things, (1) the years at issue; and (2) that SDCL 10-43-10.3(2) used to be codified at (3). HT 6.

94. Exhibit 17 was not presented until September 22, 2017, nearly three years after the November 3, 2014 audit commencement date. *Compare* HT 18 *to* Ex. 16.

95. No reason was offered by U.S. Bank as to why Exhibit 17 was not presented.

32. For completeness and consistency with the record, I modify the Hearing Examiner's Proposed Decision so that the following Conclusions of Law be added to read:

26. U.S. Bank has not provided the Department with any information on what taxes it actually paid the IRS.

27. Exhibit 17 was not timely provided and will not be considered. SDCL 10-59-3 and 10-59-7.

28. The tax sharing agreement, the OCC, the Federal Reserve System, and the FDIC do not impose tax under the Internal Revenue Code, nor are they taxes imposed under the Internal Revenue Code. *See*

I.R.C. Therefore, they are all irrelevant in answering the question of what deduction, if any, U.S Bank is entitled to under SDCL 10-43-10.3(2).

29. Missouri's law is irrelevant. Regardless, 12 Mo. Code Regs. 10-10.135(2)(B) language is consistent with the position taken by the Department in this matter. "Schedule J, Total Tax," is line 10 of the Schedule J and flows to line 31 on the Form 1120. Exs. 1-3. *Compare* discussion *supra to* 12 CSR 10-10.135(2)(b).

30. The issue of whether the Tax Sharing Agreement payments being deductible as ordinary and necessary business expenses in computing federal taxable income under SDCL 10-43-10.1, was never presented to the auditor, nor was it mentioned in U.S. Bank's request for hearing. Therefore, the was not properly preserved and need not be considered. Exs. 13, 15; SDCL 10-59-9.

NOW, THEREFORE,

IT IS ORDERED that the Hearing Examiner's Proposed Decision be modified and amended consistent with the additions, rejections, and modifications as set forth above.

IT IS FURTHER ORDERED that, except as modified and amended, consistent with the additions, rejections, and modifications as set forth above, the Hearing Examiner's Proposed Decision is adopted.

Parties are hereby advised of the right to further appeal the final decision to Circuit Court within thirty (30) days of receiving such decision pursuant to the authority of SDCL 1-26.

Dated this 18 day of July, 2018.

Andy Gerlach, Secretary
Department of Revenue

STATE OF SOUTH DAKOTA
OFFICE OF HEARING EXAMINERS
Pierre, South Dakota

---

| | |
|---|---|
| **U.S. BANK NATIONAL ASSOCIATION,**<br>**Petitioner,** | **DOR 16-34** |
| **v.** | **PROPOSED DECISION FINDINGS OF FACT AND CONCLUSIONS OF LAW AND PROPOSED ORDER** |
| **SOUTH DAKOTA DEPARTMENT OF REVENUE,**<br>**Respondent.** | |

---

This matter came for hearing before the Office of Hearing Examiners on September 28, 2017. U.S. Bank National Association ("U.S. Bank") appealed the Certificate of Assessment issued December 28, 2015 and the denial of two refund claims. The South Dakota Department of Revenue ("Department") was represented by its attorney, John Richter, and U.S. Bank was represented by Craig Fields and Nicole Johnson of Morrison & Foerster, LLP, and Justin Bell of May, Adams, Gerdes & Thompson, LLP. The Office of Hearing Examiners, having reviewed the administrative record and having heard the arguments of counsel in this matter, hereby enters the following Proposed Decision, Findings of Fact and Conclusions of Law, and Proposed Order.

## Statement of Issues

On December 28, 2015, the Department issued a Certificate of Assessment to U.S. Bank in the amount of $508,926.11 following an audit of the tax year 2012. The Department also denied a change in the amount for the tax year 2011. In a letter dated February 24, 2015, U.S. Bank appealed the certificate and requested an administrative hearing on the matter.

The issue before the hearing examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3(2); and if any, what is the appropriate methodology to determine that amount.

## Proposed Decision

U.S. Bank is a wholly owned subsidiary of U.S. Bancorp. As allowed by the Internal Revenue Code, and encouraged by the U.S. Department of the

Treasury, U.S. Bank and U.S. Bancorp entered into a tax sharing agreement. This tax sharing agreement allocated the federal income tax liability among the members of the consolidated group. Pursuant to the tax code, 26 U.S. Code § 1501, this sort of arrangement is allowed. 26 U.S.C. §1502 provides for the regulations of these sort of arrangements. This law allows the Secretary of the Treasury to "prescribe rules that are different from the provision of chapter 1 that would apply if such corporations filed separate returns." 26 U.S.C. §1502. (Aug. 16, 1954, ch. 736, 68A Stat. 367; Pub. L. 94–455, title XIX, § 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834; Pub. L. 108–357, title VIII, § 844(a), Oct. 22, 2004, 118 Stat. 1600.)

The specific South Dakota code at issue is SDCL 10-43-10.3(3) which reads: "Subtracted from taxable income are: (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC §1374 and 26 UC §1375." The primary issue in this case relates to the deduction of federal income tax from the amount of bank franchise tax owed by U.S. Bank to the State of South Dakota.

U.S. Bank argues that they are entitled to take a larger deduction due to errors in methodology in filing their past IRS tax returns. U.S. Bank amended the 2011 and 2012 IRS returns and requested that the Department reflect that new amount of tax liability for the SD bank franchise tax. The Department argues that the methodology was not shown to them during the audits and therefore, should not be considered during this appeal. Furthermore, notwithstanding the audit delay, U.S. Bank should not be able to deduct that specific amount because the amended tax return showed a tax amount that was a share based upon their consolidated taxes.

At the center of the dispute is that the parties disagree as to the definition of "taxes imposed[1]." U.S. Bank argues that the taxes imposed upon them are the taxes that U.S. Bank is liable for, under the tax sharing agreement. The Department argues that the taxes imposed are the taxes that U.S. Bank would be liable for had they filed their taxes separately.

---

[1] Definition of impose; imposed; imposing: transitive verb meaning (a): to establish or apply by authority impose a tax, impose new restrictions, impose penalties or (b): to establish or bring about as if by force. "Impose." *Merriam-Webster.com*, Merriam-Webster, www.merriam-webster.com/dictionary/impose. Accessed 01 May 2018.

The Federal Regulations set out the tax liability for subsidiary members of a corporation that use a tax sharing agreement. The regulation is found at 26 CFR §1.1502-6(a).

26 CFR § 1.1502-6 Liability for tax.

(a)Several liability of members of group. Except as provided in paragraph (b) of this section, the common parent corporation and each subsidiary which was a member of the group during any part of the consolidated return year shall be severally liable for the tax for such year computed in accordance with the regulations under section 1502 prescribed on or before the due date (not including extensions of time) for the filing of the consolidated return for such year.

(b) *[non-pertinent clause regarding former subsidiary members]*

(c)Effect of intercompany agreements. No agreement entered into by one or more members of the group with any other member of such group or with any other person shall in any case have the effect of reducing the liability prescribed under this section.

26 CFR § 1.1502-6 [T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 9002, 67 FR 43540, June 28, 2002]. (emphasis added)

The term "severally liable" is a legal term of art. Typically, it is seen alongside the word "joint or jointly", but the law specifically omits joint liability. In this case, the subsidiary is "severed" from the parent and is only liable for their share of the taxes paid by the parent corporation. In this case, U.S. Bank is not jointly liable for the whole of the tax liability of U.S. Bancorp or the amount they pay under the tax sharing agreement.

Under (a) of the CFR above, the "several liability" amount is the amount "imposed" upon U.S. Bank by the IRS, per their separate tax return for the year. Even with the tax agreement in place, U.S. Bank cannot be required to pay more taxes to the IRS than if they filed separate tax returns. And by the same token, under (b) of the same rule, the tax sharing agreement cannot reduce the liability or the amount of taxes imposed upon U.S. Bank by the IRS.

U.S. Bank is only responsible, under the Federal Regulations, for the tax liability incurred by U.S. Bank. U.S. Bank, by their belonging to a tax sharing

agreement, may agree to pay a certain portion of the U.S. Bancorp tax, but that is a separate agreement and a potentially different amount that the amount "imposed" upon U.S. Bank by the IRS.

In the second part of the certificate of assessment, the Department specifically denied U.S. Bank's request for amended filings for the years 2010 and 2011. By the time the certificate of assessment was prepared, it was over three years past the date of filing for both 2010 and 2011. SDCL §10-43-50 sets out a three year statute of limitations for refunds to the bank franchise tax. U.S. Bank's request for amended filings for 2010 and 2011 was properly denied by the Department. This was not listed separately as an issue under the Notice of Hearing, but is mentioned here due to the ruling being part of the Certificate of Assessment at issue.

The Parties submitted Proposed Findings of Fact and Conclusions of Law. The following are this Hearing Examiner's Proposed Findings of Fact and Conclusions of Law to be incorporated into the Proposed Decision.

**Findings of Fact**

1. U.S. Bank is a financial institution, principally engaged in the business of banking, with its headquarters located in Minnesota. HT 8, 55.

2. U.S. Bank utilizes the accrual method of accounting. HT 19; Ex. 13 at 1.

3. U.S. Bank is a member of an affiliated group of corporations under U.S. Bancorp. HT 9, 56; Ex. 13 at 1.

4. As the parent company of the consolidated group, U.S. Bancorp is responsible for filing a Form 1120, U.S. Corporation Income Tax Return. HT 9-10, 56; Ex. 13 at 1.

5. U.S. Bank's activities were included in the federal consolidated return, Form 1120, filed by U.S. Bancorp. HT 56.

6. As an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120, because its activities were included on the federal consolidated income tax returns filed by U.S. Bancorp for the year at issue. HT 9-10, 56; Exs. 1-3; *see* also Ex. 13.

7. For the year at issue, U.S. Bank prepared pro forma federal income tax returns. HT 20, 57; Exs. 4-6. Pro forma returns are not filed with the Internal Revenue Service. HT 21, 57.

8. Pro forma means as a matter of form. In the context of consolidated groups, corporations are required to provide all information that would have been included in a separate company federal income tax return had the corporation filed a separate company income tax return with the federal government. *See* HT 19-20.

9. The Form 1120 filed by U.S. Bancorp with the IRS is the starting point for calculating the bank franchise tax deduction at issue in this matter

10. U.S. Bank and U.S. Bancorp entered into an Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp ("Tax Sharing Agreement") with certain affiliates. Ex. 18; HT. 22.

11. The Tax Sharing Agreement, in part, provides for the allocation of the federal income tax liability among the members of the consolidated group, including U.S. Bank. Id.

12. It is designed to allocate the proper amount of the federal tax liability or benefit to the member that generated the income or loss. HT. 22.

13. Pursuant to the Tax Sharing Agreement, each member's federal tax liability is computed as if it had filed a separate federal income tax return (i.e., separate company federal taxable income multiplied by 35%). Ex. 18; HT. 24.

14. If a member of the consolidated group had a loss for the year, the member was paid for the use of that loss (i.e., the loss multiplied by 35%). Ex. 18; HT. 24-25.

15. In accordance with the U.S. Bancorp Tax Sharing Agreement, U.S. Bank paid the following taxes:

U.S. Bank's Federal Taxes Paid

| Tax Year Ended | Taxable Income | | Agreement Rate | | Tax Paid to IRS |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x | 35% | = | $840,313,825 |
| December 31, 2011 | $2,342,731,149 | x | 35% | = | $819,955,902 |
| December 31, 2012 | $4,925,219,278 | x | 35% | = | $1,723,826,747 |

Ex. 1-6; 18.

16. The 35% tax amount paid by U.S. Bank to the IRS is not necessarily the amount of tax imposed by the IRS upon U.S. Bank.

17. The Tax Sharing Agreement is a binding contract between the affiliates of U.S. Bancorp. Ex. 18; HT. 24, 38.

18. U.S. Bank complied with the terms of the Tax Sharing Agreement as required by its regulators. HT. 25. U.S. Bank and U.S. Bancorp undergo

numerous internal and independent audits by a number of regulators on a regular basis.

19. Since U.S. Bank does business in South Dakota, it is subject to South Dakota's bank franchise tax, which imposes an income tax on banks and financial corporations. SDCL 10-43-2.1.

20. Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See* Exs. 1-3, 13 (Schedule J appears on page 3 of the Form 1120).

21. The calculation of Form 1120, Schedule J, begins by multiplying taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax" (Schedule J, line 2 of Form 1120). HT 71-72; *See* Exs. 1-3, 13.

22. That number is then reduced by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10). HT 71-72; *See* Exs. 1-3, 13.

23. The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed by the Internal Revenue Service or the federal tax liability. HT 71-72; *See* Exs. 1-3, 13.

24. If U.S. Bancorp were doing business within the State of South Dakota, it would use this amount as the deduction on its bank franchise tax return (page 2, line 15 of the bank franchise tax return), since it completed the Form 1120. *See* Exs 6-8, 10-12.

Federal Tax Returns

25. U.S. Bancorp filed consolidated federal income tax returns, which included U.S. Bank. Ex. 1-3; HT. 23-24.

26. The total income tax shown as due, before application of the credits, on the consolidated returns was as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

Ex. 1, p. 3; Ex. 2, p. 3; Ex. 3, p. 3; HT. 11.

27. The total income tax due was paid through cash and credits. Ex. 1-3; HT. 12.

28. U.S. Bank made cash payments to the Internal Revenue Service ("IRS") to pay the remaining tax due, after application of the credits, as follows:

| Tax Year Ended | Total Cash Payments |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

Ex. 1, p. 1; Ex. 2, p. 1; Ex. 3, p. 1; Ex. 17; HT. 13.

29. U.S. Bank's taxable income consisted of the majority of the consolidated group's taxable income as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | Consolidated Group's Federal Taxable Income | % |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| December 31, 2011 | $2,342,731,149 | $3,567,245,451 | 66% |
| December 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Ex. 1-3.

30. In computing its federal taxable income, U.S. Bank treated the payments made pursuant to the Tax Sharing Agreement as federal income tax payments and did not deduct such amounts in computing its federal taxable income. See Ex. 1-6.

31. The bank statements provided by U.S. Bank on Exhibit 17 do not give explanation for the payments made to the IRS by U.S. Bank. These payments are not necessarily for federal tax liability imposed upon U.S. Bank, but could be for taxes imposed upon U.S. Bancorp or any affiliates. These could also be payments made in advance for estimated tax liability.

32. In addition, U.S. Bank prepared pro forma federal income tax returns using accrual basis accounting. Ex. 4-6; HT. 19-20.

33. The pro forma returns were prepared to show U.S. Bank's taxable income on a separate company basis for states, such as South Dakota, that impose tax on a separate return basis (i.e., as if U.S. Bank filed a separate federal income tax return rather than filing as part of a consolidated federal income tax return). HT. 20.

34. Instead of using a Form 1120 consolidated return to calculate the federal income tax deduction, U.S. Bank simply calculated the federal income tax deduction by multiplying Line 30, on its pro forma returns by 35%. HT 56-58.

S.D. Bank Franchise Tax Return

35. On September 11, 2012, U.S. Bank filed a bank franchise tax return for the tax period ending December 31, 2011. Ex. 13 at 16.

36. The bank franchise tax return included a copy of a pro forma Form 1120 for U.S. Bank, but was missing the computation for federal tax liability. *Id.*

37. The U.S. Bancorp consolidated federal return would have identified the total consolidated federal tax liability for 2011 as $617,186,234. *Id.*

38. On or about December 27, 2012, U.S. Bank filed an amended bank franchise tax return for the tax year ending December 31, 2011, increasing the state deduction (line 15 of the bank franchise tax return) for federal taxes paid from $346,485,702 to $819,955,902. *Id.*

39. U.S. Bank's explanation, contained in the amended return, was:

> Return is amended to adjust the state deduction for federal income taxes paid or accrued, Page 2 Line 15. Adjustment results in an increased overpayment to credit to 2012, the total of which is shown on the amended return.

*Id.*

40. By increasing the amount of the deduction claimed, U.S. Bank's 2011 amended return reduced U.S. Bank's bank franchise tax liability from $258,866 on the original return to $193,101 on the amended return, a decrease of $65,765. *Id.*

41. The original $12,134 overpayment was also added to the decrease to show a revised overpayment of $77,899 on Line 6 of the amended bank franchise tax return.

42. The U.S. Bancorp consolidated federal tax return, which the Department eventually received, reflected a total consolidated federal tax liability of $617,186,234.00. Ex. 13 at 17.

43. On October 28, 2013, the Department requested, in part, the following information relating to the amended 2011 bank franchise tax return:

> Pages 1-5 of the 2011 U.S. Bancorp consolidated Federal return Form 1120, and consolidated numbers for the members of the consolidated group that tie into pages 1-5[.]

Ex. 13 at 17.

44. In review of this information, the Department's auditor observed:

- The $346,485,702.00 originally reflected on the bank franchise tax return represents about 56% of the total tax liability of the consolidated group.

- The $819,955,902.00 reflected on the amended bank franchise tax return, an increase of $463,470,200.00, represents about 133% of the total tax liability of the consolidated group.

- Put another way, U.S. Bank took a deduction that exceeded the entire consolidated group's Federal tax liability by $202,769,668.00.

*Id.*

45. On September 26, 2013, U.S. Bank timely filed a bank franchise tax return for the tax period ending December 31, 2012. Ex. 13 at 18.

46. The bank franchise tax return included a copy of a pro forma Form 1120 for U.S. Bank; however, like the 2011 return, the pro forma Form 1120 did not include a computation of the federal tax liability. *Id.*

47. Also, like the 2011 return, U.S. Bank's 2012 return did not include a copy of U.S. Bancorp's consolidated federal return. *Id.*

48. For the year ending December 31, 2012, U.S. Bank claimed a deduction for taxes paid or accrued in the amount of $1,723,826,747.00 (line 15 of the bank franchise tax return). Ex. 13 at 19.

49. The U.S. Bancorp consolidated federal tax return for 2012 subsequently requested and received by the Department, reflected total consolidated federal tax liability of $981,865,059. *Id.*

50. In review of this information, the Department's auditor observed:

- The $1,723,826,747.00 that U.S. Bank claimed on its 2012 bank franchise tax return represents in excess of 175% of the total tax liability of the entire consolidated group.
- Put another way, U.S. Bank claimed a deduction for $741,961,688 more than the entire consolidated group federal tax paid in federal taxes.

*Id.*

51. Based on those bank franchise returns, the Department determined that an audit was necessary. *Id.*

The Audit

52. On October 2, 2014, the Department initiated an audit and sent U.S. Bank a Notice of Intent to Audit. HT 58-59; Ex. 13 at 18; Ex. 16.

53. Through the course of the audit, the Department requested more information pertaining to the deductions claimed by U.S. Bank. HT 58-59; Ex. 9; Ex. 13 at 18; Ex. 16.

54. On October 23, 2014, the Department issued Information Document Request (IDR) #002 with a deadline to respond by November 4, 2014. HT 60; Ex. 9; Ex. 13 at 18-19.

55. IDR #002 requested, in part, the Tax Sharing Agreement between the members of the Affiliated Group and the internal work papers and legal analysis to support the amounts reported on SD BFT [bank franchise tax return] Page 2, Line 15, Federal income taxes paid or accrued. Ex. 9; Ex. 13 at 18-19; HT 60-61.

56. According to the auditor's report, the Tax Sharing Agreement; the legal analysis to support the amounts reported on Page 2, Line 15; the change of method or accounting for federal income taxes from the initial bank franchise tax returns filed for 2009, 2010, and 2011; and the name of the Department representative U.S. Bank claimed that it had talked to were not provided. HT 60-61; Ex. 13 at 19-20.

57. Therefore, on December 22, 2014, the Department issued a Notice of Proposed Adjustment (NOPA) #01, wherein the federal tax deduction was adjusted. HT 62; Ex. 13 at 19.

58. A NOPA is a document that is similar to one used by the Internal Revenue Service. It identifies the facts, the law, the argument, and a conclusion or position. It asks the taxpayer to agree or disagree. If a taxpayer does not agree, it requires an auditor to continue with the audit and provide formalized conclusions. *See* HT 65.

59. On May 8, 2015, U.S. Bank, in part, suggested it should be able to use the separate company method of multiplying its separate company federal taxable income by 35%; that percentage would be the federal tax deduction because:

a) The statute is ambiguous regarding the calculation of the federal income tax deduction, and
b) The separate company tax sharing should be deemed a federal tax.

Ex. 13 at 19-20.

60. Ultimately, U.S. Bank did not provide any proof of payment that would reconcile the South Dakota bank franchise tax line 15 deduction. HT 62-64 (The Department's auditor testified that, "we couldn't reconcile the amount reported on the bank franchise tax return to the taxes imposed and paid on the 1120 tax return for the consolidated group."); Ex. 13 at 19-20.

61. The Department, through the Notice of Intent and issuing IDR #002, specifically requested the methodology utilized on the 2010 and 2011 originally filed returns. Ex. 9; Ex. 13 at 18-19; Ex. 16; HT 60-31.

62. The information requested by the Department auditors is statutorily required to be maintained by the taxpayer and presented to the Department upon request. *See* SDCL 10-43-43.1.

63. Based on the review of the years ending December 31, 2011 and December 31, 2012, the Department's auditor denied U.S. Bank's claimed deductions. HT 62-64; Ex. 13 at 21.

64. The Department's auditor testified that, U.S. Bank's methodology did not make sense, "[b]ut it was clear to us that they wouldn't get a deduction of $2 if the total assessment was only 50 cents." HT 64.

65. As a result, U.S. Bank's bank franchise tax return Line 15 and 20 were adjusted to zero and tax due in the amounts of $113,877 for 2011 and $364,169 for 2012 were recommended. Ex. 13 at 21.

66. On December 28, 2015, the Department completed the audit of U.S. Bank for the tax years ending December 31, 2011 and December 31, 2012. HT 69; Ex. 13.

67. On December 28, 2015, a certificate of assessment was issued to U.S. Bank in the amount of $508,926.11, consisting of $364,169.00 of tax and $144,757.11 of interest for the tax year ending December 31, 2012. Ex. 13.

68. The Department determined it could not issue a certificate of assessment for the year ending December 31, 2011 because that period was time-barred pursuant to SDCL 10-43-50. Ex. 13.

69. During the audit, U.S. Bank made requests for refund. Those requests for refund related to the periods ending December 31, 2010 and December 31, 2011. Ex. 13.

70. U.S. Bank initially utilized a method to calculate the federal income tax deduction that was based roughly on 56% of the total federal tax liability of the consolidated group.

71. The 2010 original return was allowed as filed since the time to assess further by the Department had expired. *Id.*

72. The 2011 return was adjusted in the auditor's report. *Id.*

73. Through requests for refunds made during the audit, U.S. Bank sought an additional refund, based on the methodology utilized on its 2012 bank franchise tax return. *Id.*

74. Consequently, U.S. Bank's requests for refund made during the audit period were also denied. *Id.*

Appeal

75. U.S. Bank filed a request for hearing, dated February 24, 2016, appealing the Certificate of Assessment and the denial of the refund claims. Ex. 15.

76. U.S. Bank witness, Brett Scribner, conceded "[t]he credit is not a tax imposed, no." HT 37.

77. U.S. Bank attempts to allocate its tax liability based on a tax sharing agreement. *See* U.S. Bank's Brief.

78. The tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38.

79. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S.").

80. U.S. Bank witness, Brett Scribner, testified that the tax sharing agreement is "a binding contract amongst the entities." HT 38.

81. U.S. Bank witness Brett Scribner testified that the tax sharing agreement:

> [I]s designed to share or provide the – allocate the proper amount of tax liability or benefit that is generated by each individual company in a particular group.
>
> So it applies to federal consolidated returns. It also applies to the allocation of what are known as unitary or combined state income tax liabilities. There are states, some states, that also tax a consolidated or a combined group of companies similar to the federal process. And so the federal is a consolidated return.
>
> So this is designed to allocate that and then make sure that the payments are made back and forth so that each company is *theoretically* made whole either for the benefits it generated for

the group or for the tax it had to pay for the group. Or because it had income or loss, as the case may be.

HT 23 (emphasis added).

82. U.S. Bank's witness, Brett Scribner, conceded the following:

- The FDIC does not impose tax. HT 38.
- The IRS does not dictate the terms of the tax sharing agreement and the tax sharing agreement is not an imposition of tax under the Internal Revenue Code. HT 38-39.
- Estimated payments are not taxes imposed. HT 39.

83. No SDCL 10-43-10.1 issue was presented for review.

84. On September 22, 2017, nearly three years after the November 3, 2014 audit commencement date, U.S. Bank gave the Department a copy of Exhibit 17. This exhibit shows a series of bank statements for demand deposit accounts (DDA) owned by U.S. Bank. *Compare* HT 18 *to* Ex. 16.

85. The DDA statements in Exhibit 17 indicate how much money was paid by U.S. Bank to the IRS. These amounts are not necessarily how much money was owed to the IRS by U.S. Bank. These payments are not the amounts imposed upon U.S. Bank by the IRS. U.S. Bank paid the IRS a certain amount pursuant to the Tax Sharing Agreement as well as estimated tax liability.

86. Any additional findings included in the Reasoning section of this decision are incorporated herein by this reference. To the extent any of the foregoing are improperly designated and are instead conclusions of law, they are hereby redesignated and incorporated herein as conclusions of law.

**Conclusions of Law**

1. The Department of Revenue has jurisdiction over the parties and subject matter of this appeal. The Office of Hearing Examiners was authorized to hear this matter and issue a proposed decision in this matter pursuant to the provisions of SDCL 1-26D.

2. A certificate of assessment is deemed prima facie correct. SDCL 10-59-8.

3. "Exemptions from tax are privileges accorded as a matter of legislative grace and not as a matter of taxpayer right ...Tax exemptions are never presumed ... [T]he general rule has been established that the taxpayer has the burden of proving entitlement to a statutory exemption." *Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990). Furthermore, "[s]tatutes which impose

taxes are to be construed liberally in favor of the taxpayer and strictly against the taxing body. Statutes exempting property from taxation should be strictly construed in favor of the taxing power." *Butler Mach. Co. v. S.D. Dep't of Revenue*, 2002 S.D. 134, ¶ 6, 653 N.W. 2d 757, 759. (Internal citations omitted).

4. SDCL chapter 10-43 governs the procedure for South Dakota's bank franchise tax.

5. SDCL 10-43-50 sets three (3) years, after the return is filed with the Department, as a time deadline for amending or correcting a tax return.

6. SDCL 10-43-2.1 provides, "An annual tax is hereby imposed upon every national banking corporation ... doing business within this state, according to or measured by its net income[.]"

7. "Net income, in the case of a financial institution, is taxable income as defined in the Internal Revenue Code...but subject to the adjustments as provided in §§10-43-10.2 and 10-43-10.3." SDCL 10–43–10.1.

8. "Each taxpayer shall file the final return for the tax year within fifteen days after the taxpayer's federal income tax return is due." SDCL 10–43–30.

9. In calculating a financial institution's net income, South Dakota law provides for the following deduction:

> Subtracted from taxable income are:
>
> . . .
>
> (2) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375[.]

SDCL 10-43-10.3(2).

10. ARSD 64:26:04:28 references SDCL 10-43-10.3 and, in pertinent part, further clarifies:

. . . Net federal income taxes are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

11. Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution.

12. The steps are as follows:

**Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."

**Step 2.** Record that number on Schedule J, line 2 of Form 1120.

**Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).

**Step 4.** Record Total tax liability on Schedule J, line 10.

**Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the Internal Revenue Service.

HT 71-72; *See Exs.* 1-3, 13.

13. U.S. Bank's proposed methodology does not comply with federal law. *See* 26 CFR 1.1502-75(f)(2).

14. 26 CFR 1.1502-75(f)(2), in pertinent part, discusses the allocation of tax liability to the separate entities of a consolidated federal income tax return.

> (2) Allocation of tax liability. In any case in which amounts have been assessed and paid upon the basis of a consolidated return . . . .

15. Consistent with this provision, taxes imposed, in the context of a federal consolidated return, are those amounts that have actually been assessed and paid. 26 CFR 1.1502-75(f)(2); *see also* Ex. 13.

16. The term "paid" is defined in South Dakota law under SDCL 10-43-1(9) as:

> (9) "Paid," for the purposes of the deductions means paid or accrued or paid or incurred, and the terms paid or incurred and paid or accrued are construed according to the accounting method used for computing net income; received, for the purpose of the computation of net income means received or accrued, and the term received or accrued is construed according to the accounting method used for computing net income;

17. U.S. Bank failed to meet its burden to receive the deduction. *See* SDCL 10-43-10.3(2); ARSD 64:26:04:28; *Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990); *Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); HT 37, 71-72.

18. The holdings in *Norwest* and *Sparrow* require that U.S. Bank's intercompany liability allocation argument be rejected.

19. The Tax Sharing Agreement payments are not deductible as ordinary and necessary business expenses. IRC § 162; SDCL 10-43-10.1. HT 13-14.

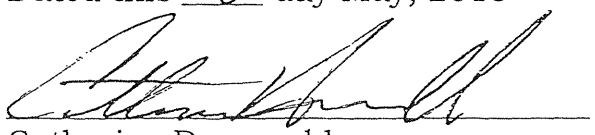
20. Internal Revenue Code §§ 162 and 164 make it clear that payments to affiliates are not a federal tax or a deduction. *See* IRC §§ 162 and 164.

21. Any Conclusions of Law in the Reasoning section of this decision are incorporated herein by reference. To the extent any of the foregoing are improperly designated and are instead findings of fact, they are hereby redesignated and incorporated herein as findings of fact.

## PROPOSED ORDER

It is the Proposed Order to the Secretary of Revenue that the certificate of assessment issued to U.S. Bank on December 28, 2015 be affirmed in all respects. Furthermore, it is proposed that South Dakota Statute, 10-43-10.3(3), regarding "taxes imposed", be interpreted by the Department as the amount of tax an entity would be liable to pay the IRS had they filed taxes as a separate entity. Furthermore, requested amendments to the 2010 and 2011 returns are denied as time barred. It is finally proposed, consistent with the certificate of assessment, that for the year 2012, U.S. Bank is assessed $364,169 of additional tax and $144,757.11 of interest.

Dated this 22nd day May, 2018



Catherine Duenwald
Office of Hearing Examiners

## CERTIFICATE OF SERVICE

I certify that on May 22nd, 2018, at Pierre, South Dakota, a true and correct copy of the Proposed Decision in the above-entitled matter was sent via U.S. Mail to each party listed below.

Ashley Parsons

Ashley Parsons

SECRETARY ANDY GERLACH
DEPARTMENT OF REVENUE
445 EAST CAPITOL AVENUE
PIERRE SD 57501

CRAIG B FIELDS
NICOLE L JOHNSON
MORRISON & FOERSTER LLP
250 WEST 55TH STREET
NEW YORK NY 10019-9601

JUSTIN L BELL
MAY ADAM GERDES & THOMPSON LLP
PO BOX 160
PIERRE SD 57501

JOHN T RICHTER
SENIOR LITIGATION COUNSEL
SD DEPT OF REVENUE
445 E CAPITOL AVE.
PIERRE SD 57501

# 2012 S.D. Codified Laws § 10-43-10.3

2012 South Dakota Code Archive

*LexisNexis ® South Dakota Statutes Annotated > TITLE 10. TAXATION > CHAPTER 10-43. TAXATION OF FINANCIAL INSTITUTIONS*

## § 10-43-10.3. Items subtracted from taxable income

Subtracted from taxable income are:

(1)Interest and dividends from obligations of the United States government and its agencies which this state is prohibited by federal law or treaty from taxing by an income tax, a franchise tax or a privilege tax;

(2)Dividends received from financial institutions subject to taxation under this chapter to the extent such dividends were included in taxable income as determined under the Internal Revenue Code;

(3)Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under *26 USC § 1374* and *26 USC § 1375;*

(4)Additional depreciation expenses to provide for the amortization of the excess, if any, of the remaining undepreciated tax basis as determined under the provisions of this chapter, over the depreciable basis as determined for federal tax purposes. Such excess shall be determined as of January 1, 1977, or on the first day of the first taxable year starting after January 1, 1977, and amortized over the remaining depreciable life of that asset or group of assets;

(5)Any interest expense described in *§§ 291(e)(1)(B)* and *265(b) of the Internal Revenue Code*, which interest expense shall be deductible;

(6)The difference obtained by subtracting net income under the cash method of accounting from net income under the accrual method of accounting. If the difference is less than zero then the provisions of *§ 10-43-10.2* apply. This is an optional adjustment and is available only to financial institutions first doing business in South Dakota after January 1, 1987, or to financial institutions that are required to switch from the cash method of accounting to the accrual method of accounting under *§ 448 of the Internal Revenue Code*;

(7)Any meal expense and entertainment expense disallowed under *§ 274(n) of the Internal Revenue Code*;

(8)Any capital gain from liquidating sales within the twelve-month period beginning on the date on which a financial institution adopts a plan of complete liquidation if all of the assets of the financial institution are distributed in complete liquidation less assets retained to meet claims within such twelve-month period, or from the distribution of property in complete liquidation of the financial institution which is subject to federal corporate income taxes pursuant to *§ 336 of the Internal Revenue Code*;

(9)Any adjustment to taxable income due to a change in the method used to compute the federal bad debt deduction where the adjustment has already been included in taxable income for purposes of the tax imposed by this chapter;

(10)For those financial institutions making an election pursuant to *26 USC § 1362*(a), as amended, and in effect on January 1, 1997, imputed federal income taxes in an amount equal to the taxes that would have been paid on net income as defined in *§ 10-43-10.1* had the financial institution continued to file its federal tax return without making an election to file pursuant to *26 USC § 1362*(a).

(11)For those financial institutions organized as limited liability companies, imputed federal income taxes in an amount equal to the taxes that would have been paid on net income as defined in *§ 10-43-10.1* had the financial institution elected to file as a subchapter C corporation under the Internal Revenue Code.

## History

**Source:**

SL 1977, ch 96, § 4 (2); 1978, ch 83, § 2; 1985, ch 84; 1987, ch 96, §§ 2-4; 1988, ch 104;*1997, ch 64*, § 2; *2004, ch 289*, § 4.



End of Document

## § 11. Tax imposed.

(a)Corporations in general. A tax is hereby imposed for each taxable year on the taxable income of every corporation.

(b)Amount of tax.

(1)In general. The amount of the tax imposed by subsection (a) shall be the sum of--

(A)15 percent of so much of the taxable income as does not exceed $ 50,000,

(B)25 percent of so much of the taxable income as exceeds $ 50,000 but does not exceed $ 75,000,

(C)34 percent of so much of the taxable income as exceeds $ 75,000 but does not exceed $ 10,000,000, and

(D)35 percent of so much of the taxable income as exceeds $ 10,000,000.

In the case of a corporation which has taxable income in excess of $ 100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) $ 11,750. In the case of a corporation which has taxable income in excess of $ 15,000,000, the amount of the tax determined under the foregoing provisions of this paragraph shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) $ 100,000.

(2)Certain personal service corporations not eligible for graduated rates. Notwithstanding paragraph (1), the amount of the tax imposed by subsection (a) on the taxable income of a qualified personal service corporation (as defined in section 448(d)(2) [*26 USCS § 448(d)(2)*]) shall be equal to 35 percent of the taxable income.

(c)Exceptions. Subsection (a) shall not apply to a corporation subject to a tax imposed by--

(1)section 594 [*26 USCS § 594*] (relating to mutual savings banks conducting life insurance business),

(2)subchapter L (sec. 801 and following, relating to insurance companies), or

(3)subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

(d)Foreign corporations. In the case of a foreign corporation, the taxes imposed by subsection (a) and section 55 [*26 USCS § 55*] shall apply only as provided by section 882 [*26 USCS § 882*].

## History

(Aug. 16, 1954, ch 736, 68A Stat. 11; March 30, 1955, ch 18, § 2,*69 Stat. 14*; March 29, 1956, ch 115, § 2, *70 Stat. 66*; March 29, 1957, *P.L. 85-12*, § 2, *71 Stat. 9*; June 30, 1958, *P.L. 85-475*, § 2, *72 Stat. 259*; June 30, 1959, *P.L. 86-75*, § 2, *73 Stat. 157*; June 30, 1960, *P.L. 86-564*, Title II, § 201, *74 Stat. 290*; Sept. 14, 1960, *P.L. 86-779*, § 10(d), *74 Stat. 1009*; June 30, 1961, *P.L. 87-72*, § 2, *75 Stat. 193*; June 28, 1962, *P.L. 87-508*, § 2, *76 Stat. 114*; June 29, 1963, *P.L. 88-52*, § 2, *77 Stat. 72*; Feb. 26, 1964, *P.L. 88-272*, Title I, § 121, *78 Stat. 25*; Nov. 13, 1966, *P.L. 89-809*, Title I, § 104(b)(2), *80 Stat. 1557*; Dec. 30, 1969, *P.L. 91-172*, Title IV, § 401(b)(2)(B), *83 Stat. 602*; March 29, 1975, *P.L. 94-12*, Title III, § 303(a), (b), *89 Stat. 44*; Dec. 23, 1975, *P.L. 94-164*, § 4(a)-(c), *89 Stat. 973*, 974; Oct. 4, 1976, *P.L. 94-455*, Title IX, § 901(a), *90 Stat. 1606*; May 23, 1977, *P.L. 95-30*, Title II, § 201(1), (2), *91 Stat. 141*; Nov. 6, 1978, *P.L. 95-600*, Title III, § 301(a), *92 Stat. 2820*; Aug. 13, 1981, *P.L. 97-34*, Title II, § 231(a), *95 Stat. 249*; July 18, 1984, *P.L. 98-369*, Div A, Title I, § 66(a), *98 Stat. 585*; Oct. 22, 1986, *P.L. 99-514*, Title VI, § 601(a), *100 Stat. 2249*; Dec. 22, 1987, *P.L. 100-203*, Title X, § 10224(a), *101 Stat. 1330*-412; Nov. 10, 1988, *P.L. 100-647*, Title I, § 1007(g)(13)(B), *102 Stat. 3436*; Aug. 10, 1993, *P.L. 103-66*, Title XIII, § 13221(a), (b), *107 Stat. 477*.)



End of Document

IN THE SUPREME COURT
STATE OF SOUTH DAKOTA

No. 29338

U.S. BANK NATIONAL ASSOCIATION,

*Appellant*,

v.

SOUTH DAKOTA DEPARTMENT OF REVENUE,

*Appellee*.

APPEAL FROM THE CIRCUIT COURT
SIXTH JUDICIAL CIRCUIT
HUGHES COUNTY, SOUTH DAKOTA

THE HONORABLE BOBBI J. RANK
Circuit Court Judge

# BRIEF OF APPELLEE
South Dakota Department of Revenue


Craig B. Fields
Nicole L. Johnson
Blank Rome, LLP
1271 Avenue of the Americas
New York, NY 10020
Telephone: (212) 885-5170
e-mail: cfields@blankrome.com
e-mail: nljohnson@blankrome.com

Justin L. Bell
May, Adam, Gerdes & Thompson LLP
P.O. Box 160
Pierre, SD 57501
Telephone: (605) 224-8803
e-mail: jlb@mayadam.net

ATTORNEYS FOR APPELLANT

John T. Richter
S.D. Department of Revenue
445 E. Capitol Ave.
Pierre, SD 57501
Telephone: (605) 773-5124
E-mail: John.Richter@state.sd.us

ATTORNEY FOR APPELLEE



Notice of Appeal Filed May 28, 2020

## TABLE OF CONTENTS

## TABLE OF AUTHORITIES

**STATUTES CITED:** **PAGE**

**CASES CITED:**

**OTHER REFERENCES CITED:**

IN THE SUPREME COURT
STATE OF SOUTH DAKOTA

No. 29338

U.S. BANK NATIONAL ASSOCIATION,

*Appellant*,

v.

SOUTH DAKOTA DEPARTMENT OF REVENUE,

*Appellee*.

**PRELIMINARY STATEMENT**

The South Dakota Department of Revenue, through its attorney of record, John T. Richter, submits this brief in response to Appellant U.S. Bank National Association's brief filed with the Court on September 16, 2020. For the convenience of the Court, Appellee South Dakota Department of Revenue is referred to as "the Department." Appellant U.S. Bank National Association is referred to as "U.S. Bank." The certified record will be cited as "R. __." The Appendix is cited as "App. __." U.S. Bank's brief is cited as "Appellant's Brief at __."[1]

[1] SDCL 15-26A-64 requires that, "[w]henever reference is made in the briefs to any part of the record it shall be made to the particular part of the record, suitably designated, and to the specific pages thereof." For the convenience of the Court, any response to U.S. Bank's arguments will identify and cite to the appropriate part of the certified record and the specific page number.

## JURISDICTIONAL STATEMENT

On May 22, 2018, the Office of Hearing Examiners entered a Proposed Decision affirming the certificate of assessment that the Department issued to U.S. Bank on December 28, 2015. R. 612-28 (App. 1-17). The Proposed Decision also upheld the Department's denial of U.S. Bank's 2010 and 2011 refund requests. *Id.* On July 18, 2018, the Secretary of Revenue issued a Final Decision modifying the hearing examiner's Proposed Decision. R. 652-72 (App. 18-38). In his Final Decision, the Secretary set forth his own findings of fact, conclusions of law, and reasoning supporting the affirmation of the certificate of assessment and the denial of U.S. Bank's refund claims. *Id.* Notice of Entry of the Final Decision and Order was served on July 19, 2018. R. 633.

U.S. Bank filed a Notice of Appeal with the Circuit Court, Sixth Judicial Circuit, on August 17, 2018. R. 1-2. On May 1, 2020, the Circuit Court issued a memorandum decision and order affirming the Secretary's Final Decision. R. 739-65 (App. 39-65). A Notice of Entry of Order of the Circuit Court's decision was served on May 4, 2020. R. 766-94. On May 28, 2020, U.S. Bank filed a Notice of Appeal to this Court. R. 795-6.

## STATEMENT OF LEGAL ISSUES

I.

WHETHER THE DEPARTMENT CORRECTLY REJECTED U.S. BANK'S METHODOLOGY FOR CALCULATING THE NET FEDERAL INCOME TAX DEDUCTION FOR BANK FRANCHISE TAX PURPOSES.

The Circuit Court affirmed the certificate of assessment that the Department had issued to U.S. Bank and upheld the denial of U.S. Bank's refund requests.

**Relevant Statute:**

SDCL 10-43-10.3(3) (2010)[2]

## INTRODUCTION

Banks pay an income tax in South Dakota. The tax is calculated by looking at a bank's taxable income and then adjusting it based on certain statutory additions and subtractions. This case focuses on the following deduction:

> Subtracted from taxable income are:
> . . .
> (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375[.]

U.S. Bank argues that it should be allowed to use a methodology wherein it receives a deduction that greatly exceeds the taxes imposed on the

[2] SDCL Chapter 10-43 (bank franchise tax) was extensively revised after the audit herein. 2016 S.D. SESS. LAWS ch. 62. Prior to 2016, the federal income tax deduction at issue was codified at SDCL 10-43-10.3(3). In 2016, SDCL 10-43-10.3(3) was renumbered to 10-43-10.3(2), with no substantive change in the language. 2016 S.D. SESS. LAWS ch. 62, § 6. For consistency and unless otherwise indicated, this brief cites to the pre-2016 version of Chapter 10-43, SDCL 10-43-10.3(3) (2010 main volume).

*entire* consolidated group that it is a part of. The Department rejected U.S. Bank's methodology, the Office of Hearing Examiners rejected U.S. Bank's methodology, the Circuit Court rejected U.S. Bank's methodology, and this Court should do the same.

## STATEMENT OF THE CASE AND FACTS

U.S. Bank is a financial institution, principally engaged in the business of banking, with its headquarters located in Minneapolis, Minnesota. R. 337, 384. U.S. Bank utilizes the accrual method of accounting; it recognizes revenue or expenses when actually incurred, even if a cash payment would occur at a different time. R. 197, 348.

U.S. Bank is a member of an affiliated group of corporations under U.S. Bancorp. R. 197, 338, 385. As the parent company of the consolidated group, U.S. Bancorp is responsible for filing a Federal Consolidated Form 1120, U.S. Corporation Income Tax Return (hereinafter "Form 1120"), with the Internal Revenue Service (hereinafter "IRS"). R. 197, 338-9, 385. For all years at issue, U.S. Bancorp filed the consolidated group's Form 1120 (U.S. Bancorp 1120). R. 57, 88, 120, 339-40, 385-6. U.S. Bank's activities were included within the supporting schedules filed with the return. *Id.* Consequently, as an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120 as its activities were included in the federal consolidated income tax returns filed by U.S. Bancorp for the years at issue. R. 48-147, 338-40, 385-6, 412 ("U.S. Bank's role in the process

was to provide its information to U.S. Bancorp, which was used to determine the income and expenses and the taxes paid and credits on the U.S. Bancorp Form 1120."); *see* R. 192-242; R. 741.

For the years at issue, U.S. Bank prepared pro forma federal income tax returns. R. 148-62, 349, 386. Pro forma means as a matter of form. In the context of consolidated groups, corporations are required to provide all information that would have been included in a separate company federal income tax return had the corporation filed a separate company income tax return with the federal government. *See* R. 348-9. Pro forma returns are not signed or filed with the IRS. R. 350, 386. As discussed below, this information is important because the Form 1120 serves as the starting point for calculating the bank franchise tax deduction at issue in this matter. *See infra*. Since U.S. Bank does business in South Dakota, it is subject to South Dakota's bank franchise tax which imposes an income tax on banks and financial corporations. SDCL 10-43-2.1.

Financial institutions doing business within South Dakota are subject to bank franchise tax pursuant to SDCL Chapter 10-43. The Department is responsible for administering that chapter. SDCL 10-43-42.1. SDCL chapter 10-43 governs the procedure for South Dakota's bank franchise taxes. Specifically, SDCL 10-43-2.1[3] provides, "[a]n annual tax is hereby imposed upon every national banking

[3] Repealed by SL 2016, ch. 62, §§ 3, 32.

corporation . . . doing business within [South Dakota], according to or measured by its net income, to be computed in the manner provided in [Chapter 10-43], on the basis of its net income during any part of the year." "Net income, in the case of a financial institution, is taxable income as defined in the Internal Revenue Code[.]" SDCL 10–43–10.1. "Each taxpayer shall file the final return for the tax year within fifteen days after the taxpayer's federal income tax return is due." SDCL 10–43–30.

In calculating a financial institution's net income, South Dakota law provides for the following deduction:

> Subtracted from taxable income are:
> . . .
> (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375[.]

SDCL 10-43-10.3(3). ARSD 64:26:04:28 references SDCL 10-43-10.3 and, in pertinent part, further clarifies:

> . . . Net federal income taxes are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. R. 50, 81, 114 (Schedule J appears on page 3 of the Form 1120); *see also* R. 48-147, 192-242 (Exs. 1-3, 13). The calculation begins by multiplying taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to

arrive at "income tax" (Schedule J, line 2 of Form 1120). R. 50, 81, 114, 400-1; *see also* R. 48-147, 192-242. That number is then reduced by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10 or 11).[4] *Id.* The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed or the federal tax liability that must be paid to the IRS. *Id.*

*1. Facts Leading to the Audit of U.S. Bank*

On September 11, 2012, U.S. Bank filed a bank franchise tax return for the tax period ending December 31, 2011. R. 212. The bank franchise tax return included a copy of a pro forma Form 1120 for U.S. Bank, but was missing the computation for federal tax liability.[5] *Id.*

On or about December 27, 2012, U.S. Bank filed an amended bank franchise tax return for the tax year ending December 31, 2011, increasing the state deduction (line 15 of the bank franchise tax return) for federal taxes paid from $346,485,702 to $819,955,902. *Id.* U.S. Bank's explanation, contained in the amended return, was:

---

[4] The "Total Tax" is line 10 on the 2010 Form 1120 Schedule J and line 11 on the 2011 and 2012 Form 1120 Schedule J. R. 50, 81, 114. The remainder of this brief will refer to it as line 10.

[5] Moreover, the bank franchise tax return did not include a copy of the U.S. Bancorp consolidated federal return (which would have identified the total consolidated federal tax liability for 2011 as $617,186,234). R. 212.

> Return is amended to adjust the state deduction for federal income taxes paid or accrued, Page 2 Line 15. Adjustment results in an increased overpayment to credit to 2012, the total of which is shown on the amended return.

*Id.* By increasing the amount of the deduction claimed, U.S. Bank's 2011 amended return reduced U.S. Bank's bank franchise tax liability from $258,866 on the original return to $193,101 on the amended return, a decrease of $65,765.[6] *Id.*

The U.S. Bancorp consolidated federal tax return, which the Department eventually received, reflected a total consolidated federal tax liability of $617,186,234.[7] R. 213. After reviewing of this information, the Department's auditor observed:

- The $346,485,702 originally reflected on the bank franchise tax return represents about 56% of the total tax liability of the consolidated group.
- The $819,955,902 reflected on the amended bank franchise tax return, an increase of $463,470,200, represents about 133% of the total tax liability of the consolidated group.
- Put another way, U.S. Bank took a deduction that exceeded the entire consolidated group's Federal tax liability by $202,769,668.

---

[6] The original $12,134 overpayment was also added to the decrease to show a revised overpayment of $77,899 on Line 6 of the amended bank franchise tax return. R. 212.

[7] On October 28, 2013, the Department requested, in part, the following information relating to the amended 2011 bank franchise tax return:

> Pages 1-5 of the 2011 U.S. Bancorp consolidated Federal return Form 1120, and consolidated numbers for the members of the consolidated group that tie into pages 1-5[.]

R. 213.

*Id.*

On September 26, 2013, U.S. Bank timely filed a bank franchise tax return for the tax period ending December 31, 2012. R. 214. The bank franchise tax return included a copy of a pro forma Form 1120 for U.S. Bank; however, like the 2011 return, the pro forma Form 1120 did not include a computation of the federal tax liability. *Id.* Also, like the 2011 return, U.S. Bank's 2012 return did not include a copy of U.S. Bancorp's consolidated federal return. *Id.* For the year ending December 31, 2012, U.S. Bank claimed a deduction for federal income taxes paid or accrued in the amount of $1,723,826,747 (line 15 of the bank franchise tax return). R. 215.

The U.S. Bancorp consolidated federal tax return for 2012 subsequently requested and received by the Department reflected total consolidated federal tax liability of $981,865,059. *Id.* In review of this information, the Department's auditor observed:

- The $1,723,826,747 that U.S. Bank claimed on its 2012 bank franchise tax return represents in excess of 175% of the total tax liability of the entire consolidated group.
- Put another way, U.S. Bank claimed a deduction of $741,961,688 more than the entire consolidated group paid in federal taxes.

*Id.* Ultimately, the Department determined that an audit was necessary. *Id.*

*2. The Audit of U.S. Bank*

On October 2, 2014, the Department initiated an audit and sent U.S. Bank a Notice of Intent to Audit. R. 214, 271-3, 387-8. Through the course of the audit, the Department attempted to obtain more information pertaining to the deductions claimed by U.S. Bank. R. 175-6, 214, 271-3, 360-1. On October 23, 2014, the Department issued Information Document Request (IDR) #002 with a deadline to respond by November 4, 2014. R. 175-6, 214-5, 389. IDR #002 requested, in part, the Tax Sharing Agreement between the members of the Affiliated Group and the internal work papers and legal analysis to support the amounts reported on [South Dakota bank franchise tax return] Page 2, Line 15, Federal income taxes paid or accrued. R. 175-76; 214-15, 389-90.

According to the auditor's report, the Tax Sharing Agreement; the legal analysis to support the amounts reported on Page 2, Line 15; the change of method or accounting for federal income taxes from the initial bank franchise tax returns filed for 2009, 2010, and 2011; and the name of the Department representative were not provided. R. 215-6, 389-90. Therefore, on December 22, 2014, the Department issued a Notice of Proposed Adjustment (NOPA) #01,[8] wherein the federal tax deduction

[8] A NOPA is a document that is similar to one used by the IRS. It identifies the facts, the law, the argument, and a conclusion or position. It asks the taxpayer to agree or disagree. If a taxpayer does not agree, it

(continued . . .)

was adjusted – see Facts, Law Argument, and Conclusion. R. 215, 391. On May 8, 2015, U.S. Bank, in part, suggested it should be able to use the separate company method of multiplying its separate company federal taxable income by 35%. R. 215-6. U.S. Bank claimed that percentage would be the federal tax deduction because:

a. The statute is ambiguous regarding the calculation of the federal income tax deduction, and
b. The separate company tax sharing should be deemed a federal tax.

*Id.* Ultimately, U.S. Bank failed to provide any proof of payment that would reconcile the South Dakota bank franchise tax line 15 deduction. R. 391-3 (The Department's auditor testified that, "we couldn't reconcile the amount reported on the bank franchise tax return to the taxes imposed and paid on the 1120 tax return for the consolidated group."); R. 215-6.

Consequently, the Department's auditor was left with two options: (1) accept the methodology U.S. Bank utilized to calculate the deduction on its 2011 amended return and 2012 return which exceeded the entire consolidated group's Federal tax liability; or (2) deny U.S. Bank's claimed deductions. R. 391-2. The Department's auditor denied U.S. Bank's

---

requires an auditor to continue with the audit and provide formalized conclusions. *See* R. 394.

(continued . . .)

claimed deductions.[9] R. 217, 391-3. As a result, the auditor adjusted U.S. Bank's bank franchise tax return Line 15 and 20 to zero and tax due in the amounts of $113,877 for 2011 and $364,169 for 2012 were recommended. R. 217.

On December 28, 2015, the Department completed the audit of U.S. Bank for the tax years ending December 31, 2011 and December 31, 2012. R. 192-242, 398. The Department determined it could not issue a certificate of assessment for the year ending December 31, 2011 because that period was time-barred pursuant to SDCL 10-43-50. AR 165-215 (Ex. 13). A certificate of assessment was issued to U.S. Bank in the amount of $508,926.11, consisting of $364,169.00 of tax and $144,757.11 of interest for the tax year ending December 31, 2012. R. 192-242.

*3. Refund Requests*

During the audit, U.S. Bank made requests for refund. Those requests for refund related to the periods ending December 31, 2010 and December 31, 2011. R. 192-242. As discussed above, U.S. Bank initially utilized a method to calculate the federal income tax deduction that was based roughly on 56% of the total federal tax liability of the consolidated group. The 2010 original return was allowed as filed since

[9] The Department's auditor testified that, U.S. Bank's methodology did not make sense, "[b]ut it was clear to us that they wouldn't get a deduction of $2 if the total assessment was only 50 cents." R. 393.

the time to assess further by the Department had expired. *Id.* The 2011 return was adjusted in the auditor's report. *Id.*

Through requests for refunds made during the audit, U.S. Bank sought an additional refund, based on the methodology utilized on its 2012 bank franchise tax return, for the periods ending December 31, 2010 and December 31, 2011. *Id.* Consequently, U.S. Bank's requests for refund were denied. *Id.*

*4. Appeal*

U.S. Bank filed a request for hearing, dated February 24, 2016, appealing the certificate of assessment and the denial of the refund claims. R. 244-70. An administrative hearing was held at the Office of Hearing Examiners, before Hearing Examiner Catherine Duenwald, on September 28, 2017. R. 330. At the administrative hearing, Brett Scribner, U.S. Bank's Corporate Tax Director, testified on behalf of U.S. Bank. R. 308-9. Auditor Donald Larson testified on behalf of the Department. R. 378-9. On May 22, 2018, after reviewing the evidence, the parties' arguments, and the law, Hearing Examiner Duenwald entered a Proposed Decision affirming the certificate of assessment issued to U.S. Bank. R. 612-28 (App. 1-17). The Proposed Decision upheld the denial of U.S. Bank's 2010 and 2011 refund requests. *Id.*

On July 18, 2018, the Secretary of Revenue issued a Final Decision modifying the hearing examiner's Proposed Decision. R. 652-72 (App. 18-38). In his Final Decision, the Secretary set forth his own

findings of fact, conclusions of law, and reasoning supporting the affirmation of the certificate of assessment and denial of U.S. Bank's refund claims. *Id.* Notice of Entry of the Final Decision and Order was served on July 19, 2018. R. 633. On August 17, 2018, U.S. Bank filed a Notice of Appeal with the Circuit Court on August 17, 2018. R. 1-2. On May 1, 2020, "[a]fter full consideration of the administrative record, the briefs submitted, and the arguments made by the attorneys at oral argument," the Circuit Court issued a memorandum decision and order affirming the Secretary's Final Decision. R. 739-65. A Notice of Entry of Order of the Circuit Court's decision was served on May 4, 2020. R. 766-94. On May 28, 2020, U.S. Bank filed a Notice of Appeal to this Court. R. 795-6.

## STANDARD OF REVIEW

"SDCL 1-26-36 sets forth the standard of review for administrative appeals." *Manuel v. Toner Plus, Inc.*, 2012 S.D. 47, ¶ 8, 815 N.W.2d 668, 670. That statute requires this Court "to give great weight to the findings of the agency and reverse only when those findings are clearly erroneous in light of the entire record." *Id.* (*quoting Williams v. S.D. Dep't of Agric.*, 2010 S.D. 19, ¶ 5, 779 N.W.2d 397, 400). "Mixed questions of law and fact require further analysis." *Manuel*, 2012 S.D. 47, ¶ 8, 815 N.W.2d at 670 (citations omitted). This Court has stated:

> If application of the rule of law to the facts requires an inquiry that is 'essentially factual'—one that is founded 'on the application of the fact-finding tribunal's experience with the mainsprings of human conduct'—the concerns of judicial administration will favor

> the [circuit] court, and the [circuit] court's determination should be classified as one of fact reviewable under the clearly erroneous standard. If, on the other hand, the question requires us to consider legal concepts in the mix of fact and law and to exercise judgment about the values that animate legal principles, then the concerns of judicial administration will favor the appellate court, and the question should be classified as one of law and reviewed de novo.

*Id.* (citations omitted). "Whether a statute or regulation imposes a tax under a given factual situation is a question of law" reviewed de novo. *Midwest Railcar Repair, Inc. v. S.D. Dep't of Revenue,* 2015 S.D. 92, ¶ 44, 872 N.W.2d 79, 90; *see also Blood Sys., Inc. v. Dep't of Revenue*, 1998 S.D. 82, ¶ 10, 582 N.W.2d 682, 684.

**ARGUMENT**[10]

SDCL chapter 10-43 governs the procedure for South Dakota's bank franchise taxes. SDCL 10-43-2.1 provides, "[a]n annual tax is hereby imposed upon every national banking corporation . . . doing business within [South Dakota], according to or measured by its net income, to be computed in the manner provided in [Chapter 10-43], on the basis of its net income during any part of the year." The bank franchise tax itself is based upon the net income of the institution that is assignable to South Dakota. SDCL 10-43-4. Even though U.S. Bank was part of a consolidated group, it was required to file an individual South Dakota bank franchise tax return. SDCL 10-43-36; ARSD

[10] Judge Rank's decision is thorough and well-reasoned. Candidly, it can stand on its own in providing this Court a roadmap as to how to decide this matter.

64:26:03:13. The South Dakota bank franchise tax final return for the tax year is due within fifteen days after the federal income tax return is due. SDCL 10-43-30.

For purposes of the South Dakota bank franchise tax, "[n]et income . . . is taxable income as defined in the Internal Revenue Code . . . but subject to the adjustments as provided in . . . §§ 10-43-10.2 and 10-43-10.3." SDCL 10–43–10.1.

In calculating a financial institution's net income, South Dakota law provides for the following deduction:

> Subtracted from taxable income are:
> . . .
> (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375[.]

SDCL 10-43-10.3(3). SDCL 10-43-10.3 is further clarified by ARSD 64:26:04:28 and, in pertinent part, provides:

> . . . Net federal income taxes[11] are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

As discussed above, Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See supra*. The steps are as follows:

---

11 The term "net federal income taxes" is defined in ARSD 64:26:01:01(4) as, "that federal income tax in excess of any federal income tax refund received during the tax year for which the deduction is claimed[.]"

> **Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."
>
> **Step 2.** Record that number on Schedule J, line 2 of Form 1120.
>
> **Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).
>
> **Step 4.** Record Total tax liability on Schedule J, line 10.
>
> **Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the IRS.

R. 400-1; *See* R. 48-147, 192-242. If U.S. Bancorp were doing business within the State of South Dakota, it would use this amount as the deduction on its bank franchise tax return (page 2, line 15 of the bank franchise tax return), since it completed the Form 1120. *See* R. 158-174, 177-190. However, U.S. Bancorp is not doing business in South Dakota – instead, one of its affiliates, U.S. Bank, is.

In this case, instead of using a Form 1120 consolidated return to calculate the federal income tax deduction, U.S. Bank simply calculated its claimed federal income tax deduction by multiplying Line 30 on its pro forma returns by 35%. R. 358-60.

*1. U.S. Bank's Methodology is Flawed*

Not only does U.S. Bank's methodology stop short in terms of calculating the net federal income tax, as described above, but it runs counter to federal law. *See* discussion *supra*; 26 CFR 1.1502-75(f)(2). 26 CFR 1.1502-75(f)(2), in pertinent part, discusses the allocation of tax

liability to the separate entities of a consolidated federal income tax return:

> (2) Allocation of tax liability. In any case *in which amounts have been assessed and paid* upon the basis of a consolidated return . . . .

(Emphasis added). Consistent with this provision, taxes imposed, in the context of a federal consolidated return, are those amounts that have actually been assessed and paid. 26 CFR 1.1502-75(f)(2); *see also* R. 192-242. The term "paid" is defined in South Dakota law under SDCL 10-43-1(9) as:

> (9) "Paid," for the purposes of the deductions means paid or accrued or paid or incurred, and the terms paid or incurred and paid or accrued are construed according to the accounting method used for computing net income; received, for the purpose of the computation of net income means received or accrued, and the term received or accrued is construed according to the accounting method used for computing net income[.]

The question in this case boils down to, what did the IRS actually require U.S. Bank to pay in federal income taxes?

Under U.S. Bank's flawed methodology, it treats credits as taxes imposed. Credits are not taxes imposed. *See Norwest Corp. and Subsidiaries v. Comm'r of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); R. 366, 400-1. They are simply a reduction to determine what is owed. R. 400-1. In fact, U.S. Bank's witness, Brett Scribner, conceded "[t]he credit is not a tax imposed, no." R. 366. Yet, if U.S. Bank's position was accepted, foreign taxes paid would effectively be treated as taxes imposed under the

Internal Revenue Code. *See* R. 353-66. The Circuit Court agreed with the Department's position, rejecting U.S. Bank's argument of credits being taxes imposed.

> Adopting U.S. Bank's methodology in this case would allow it to increase its federal deduction, and hence reduce its [South Dakota bank franchise tax], to an absurd level. . . . U.S. Bank's methodology results in taking a much larger deduction for federal income taxes imposed than the entire consolidated group paid for income taxes.
>
> Moreover, if U.S. Bank's argument that "credits" are payments of tax were to be accepted, it would not mesh with the purpose of a tax credit. *See Burlington Northern*, 398 N.W.2d [144, 147 (S.D. 1986)] (Tax credits are rebates which relieve taxpayers from some tax liability). It would also allow U.S. Bank to increase its federal deduction for taxes paid to foreign jurisdictions, which is one of the federal credits. This would, in essence, make such foreign taxes "taxes imposed" by the Internal Revenue Code. Additionally, the record establishes that U.S. Bank receives a refund or cash payment from the consolidated group for the credits it generates. HT 25-26. Accepting its argument that credits are payments would allow U.S. Bank to take a cash payment from the affiliated group for its portion of a credit. Then, without paying that cash toward federal income tax, U.S. Bank could use the same cash payment to increase its federal deduction and correspondingly decrease its [South Dakota bank franchise tax].
>
> This Court must read words of a statute in context with their place in the overall statutory scheme, and it will not "interpret a statute to reach an absurd result." *Klein v. Sanford Medical Center*, 2015 S.D. 95, ¶ 13 (citation omitted). Adopting U.S. Bank's interpretation of "taxes imposed" for purposes of the federal deduction would stand in direct contrast to the revenue-generating purpose of tax statutes." *Polly's Properties, LLC v. Vermont Dept. of Taxes*, 998 A.2d 1047, 1057 (Vt. 2010).

R. 759-60. U.S. Bank's methodology must be rejected.

*2. Norwest Corporation and Subsidiaries v. Commissioner of Internal Revenue*

U.S. Bank makes various arguments to support its methodology (i.e. citing to the tax sharing agreement, arguing the meaning of taxes imposed, etc.). The question of taxes actually imposed versus hypothetical taxes that could have been imposed has been litigated in cases involving minimum tax, which examined the "taxes imposed" language of the Internal Revenue Code. *Norwest Corp.*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow*, 86 T.C. 929 (1986); R. 192-242. Courts have consistently held that "taxes imposed" means taxes actually imposed, not some other hypothetical computation. *Id.* The majority of U.S. Bank's arguments can be dispatched after a review of *Norwest Corp. and Subsidiaries v. Comm'r of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995).

In *Norwest*, the Court was asked "to determine the proper methodology to be used in calculating the amount of [Norwest's] 'regular tax deduction' for purposes of computing its [corporate] minimum tax liability." *Id.* at 1. In the context of minimum tax, the term "regular deduction" was defined as "an amount equal to the taxes imposed by the chapter for the taxable year." *Id.* Norwest was part of an affiliated group of corporations that filed a consolidated income tax return. *Id.* at 2. In *Norwest*, Norwest allocated:

> [t]he consolidated tax of the group . . . among those members that had taxable income for the year. [The] allocation was based on the ratio that each member's regular tax (computed on a separate return basis) bore to the sum of the separate return regular taxes of all the members. An additional amount of tax was then allocated to each member that had positive taxable income. The

> additional amount allocated was the excess of the member's separate return tax over the tax already allocated to the member.

*Id.* at 2. Norwest argued that, in the absence of specific statutory or regulatory guidance, it was reasonable to calculate the "regular deduction" for "taxes imposed" by using a methodology set forth in the consolidated return regulations. *Id.*

The Tax Court rejected Northwest's argument, holding that an "allocation of an intercompany liability is not the kind of tax liability contemplated by section 56(c) [the regular deduction]." *Id.* The Court found that (1) under Norwest's methodology, the regular tax deduction would generally exceed the amount of tax paid on the consolidated taxable income of the affiliated group; and (2) the "legislative history of the minimum tax also indicates that the regular tax refers to the income tax actually imposed and paid." *Id.* at 2-3. Consequently, Norwest's methodology relying on intercompany liability allocation was rejected. *Id.*; *See also Sparrow v. C.I.R.*, 86 T.C. 929 (1986) (rejecting petitioner's allocation method and holding that "[t]he amounts allocated to each member of an affiliated group under the 1502-33(d) allocation are certainly derived from and may in the aggregate equal the amount of taxes imposed on the affiliated group pursuant to chapter one of subtitle A of the Code for the taxable year, but are not, themselves, taxes so imposed.").

Like Norwest, U.S. Bank is part of an affiliated group of corporations that filed a consolidated income tax return. *Id.* at 2. In this

case, U.S. Bank attempts to allocate its tax liability based on a tax sharing agreement. *See* U.S. Bank's Brief. First and foremost, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* R. 367. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. R. 367 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. *Id.* (Brett Scribner testified that "[i]t's a binding contract amongst the entities"). Obviously, the tax sharing agreement does not represent taxes imposed under the Internal Revenue Code – and this Court should not deem it as such. *See Black Hills Truck & Trailer, Inc. v. S.D. Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law or tax liability.).

The tax sharing agreement parallels the allocation methods that were explicitly rejected in *Norwest* and *Sparrow*. U.S. Bank witness Brett Scribner testified that:

> [The tax sharing agreement] is designed to share or provide the – allocate the proper amount of tax liability or benefit that is generated by each individual company in a particular group.
>
> So it applies to federal consolidated returns. It also applies to the allocation of what are known as unitary or combined state income tax liabilities. There are states, some states, that also tax a consolidated or a combined group of companies similar to the federal process. And so the federal is a consolidated return.
>
> So this is designed to allocate that and then make sure that the payments are made back and forth so that each company is

> *theoretically* made whole either for the benefits it generated for the group or for the tax it had to pay for the group. Or because it had income or loss, as the case may be.

HT 23 (emphasis added). Consistent with the testimony of Brett Scribner, the tax sharing agreement does not answer what was actually paid – and is only theoretical. R. 352; *See* R. 291-99. Moreover, like in *Norwest*, the allocation utilized by U.S. Bank is not the kind of tax liability contemplated by SDCL 10-43-10.3(3) in that it is not taxes imposed by the Internal Revenue Code. R. 367 (Again, U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Furthermore, also like in *Norwest*, and as discussed above, the tax deduction claimed by U.S. Bank is based on a number that greatly exceeds the amount of taxes paid by the *entire* consolidated group. *See* discussion *supra*. Ultimately, the holdings in *Norwest* and *Sparrow* require that U.S. Bank's intercompany liability allocation argument be rejected.

Again, the question before this Court is what taxes were imposed under the Internal Revenue Code. R. 333. The tax sharing agreement is not taxes imposed under the Internal Revenue Code. *See* I.R.C. The OCC, the Federal Reserve System, and the FDIC do not impose tax under the Internal Revenue Code. *See* I.R.C. Therefore, they are all irrelevant in answering the question of what deduction, if any, U.S Bank is entitled to under SDCL 10-43-10.3(3). The fact remains, U.S. Bank's witness, Brett Scribner, conceded the following:

- The FDIC does not impose tax. R. 367.
- The IRS does not dictate the terms of the tax sharing agreement and the tax sharing agreement is not an imposition of tax under the Internal Revenue Code. R. 367-8.
- Estimated payments are not taxes imposed. R. 368.

Regardless, U.S. Bank attempts to extend the definition of "taxes imposed" through a statutory construction argument. *See* Appellant's Brief at 10-14. When courts are "called on to interpret a statute granting an exemption, a deduction, or a credit … the statute is strictly construed against the taxpayer." *Burlington Northern R. Co. v. Strackbein*, 398 N.W.2d 144, 146 (S.D. 1986) (other citations omitted). Deductions "are privileges accorded as a matter of legislative grace and not as a matter of taxpayer right." *Id.* at 147. Despite this backdrop, and to advance its argument, U.S. Bank ignores the fact that the term "net federal income taxes" is specifically defined by administrative rule.

The Legislature gave the Department the express authority to promulgate administrative rules concerning: "(1) The procedure for filing tax returns and payment of tax…(3) *The definition and deductibility of net federal income taxes*; [and] (4) the Application of the tax and exemptions…" SDCL 10-43-42.1 (emphasis added). When giving effect to all these provisions, it becomes clear that the Legislature intended the deduction for federal income taxes imposed, as referenced in SDCL 10-43-10.3(3), to be *net* federal income taxes. *AEG Processing Center No. 58, Inc. v. S.D. Dept. of Rev.*, 2013 S.D. 75, ¶ 17, 838 N.W.2d 843, 849.

(Courts "read statutes as a whole, as well as enactments relating to the same subject."). Pursuant to this authority, the Department defined "net federal income tax" as "that federal income tax in excess of any federal income tax refund received during the tax year for which the deduction is claimed." ARSD 64:26:01:01(4). Administrative rule also provides that:

> … Net federal income taxes are deductible from taxable income in the tax year in which they are incurred when the accrual methods of accounting is used in determining the net income of taxpayer. Any other income, franchise, or privilege taxes which were deducted to determine federal taxable income are not deductible.

ARSD 64:26:04:28. U.S. Bank claims that this regulation is invalid because it exceeds the scope of SDCL 10-43-10.3(3). Appellant's Brief 13. This argument ignores the specific rulemaking authority granted to the Department in SDCL 10-43-42.1(3). "The construction and interpretation given a statute by an administrative body charged with its administration is entitled to great weight." *In re: State Sales and Use Tax Liability of Pam Oil, Inc.*, 459 N.W.2d 251, 256 (S.D. 1990). *See also Northern States Power Co. v. S.D. Dept. of Rev.*, 1998 S.D. 57, ¶ 4, 578 N.W.2d 579, 580 (Agency interpretation of statute given great weight when Legislature has given the agency that express authority). Accordingly, there is no need to look to the dictionary definition of the term "taxes imposed", subsections (10) and (11) of SDCL 10-43-10.3, or IRC § 11 (2012).

Regardless, the Circuit Court specifically held that (1) turning to a dictionary definition of the term "taxes imposed" does not assist in

defining the term;[12] and (2) subsections (10) and (11) of SDCL 10-43-10.3 does not assist in the analysis of subsection (3).[13] The third, IRC § 11 (2012), was not addressed in the Circuit Court's decision, presumably, as it was not raised at the administrative level and deemed waived. R. 440, 527 (noting the absence of IRC § 11 (2012) in U.S. Bank's briefs submitted to the Office of Hearing Examiners); *Finck v. Nw. Sch. Dist. No. 52-3*, 417 N.W.2d 875, 878 (S.D. 1988) (An issue not presented to the fact-finding tribunal will not be reviewed on appeal.); *Stuckey v. Sturgis Pizza Ranch*, 2011 S.D. 1, ¶ 19 n.3, 793 N.W.2d 378, 386 n.3 (Like civil

---

[12] The Circuit Court correctly found:

> The dictionary cited by U.S. Bank defines "impose" as not only "to establish or apply," but also "to establish or bring about as if by force." [citation omitted]. This latter definition of "impose" could reference the forced payment of the tax due. Resultantly, turning to a dictionary definition does not assist in defining "taxes imposed."

R. 754.

[13] The Circuit Court correctly found:

> U.S. Bank does not fit within the categories laid out in (10) or (11). Even if those subsections did allow the methodology proposed by U.S. Bank in this case, the South Dakota Legislature did not use the same language in describing the deduction in SDCL 10-43-10.3(3). It is presumed that if the Legislature had intended for the description of the deduction in subsection (3) to match that in subsections (10) or (11), it would have said so. *See Steinberg v. S.D. Dept. of Military and Veterans Affairs*, 2000 S.D. 36, ¶ 10, 607 N.W.2d 596, 600. It did not.

R. 755.

cases, failure to present issues at the administrative level constitutes waiver of that issue on appeal.); *Enger v. FMC*, 2000 S.D. 48, ¶ 16, 609 N.W.2d 132, 136 ("the need to present an issue to the decision-maker is inherent in administrative proceedings."). U.S. Bank can not escape the fact that nothing is ever imposed on U.S. Bank - to argue that the term "taxes imposed", as it appears in SDCL 10-43-10.3(3), can be extended to mean that hypothetical payments made to a parent corporation based upon a mere separate return calculation of a subsidiary, which is never signed or filed with the IRS, is absurd. The Circuit Court correctly determined "that the legislative intent of SDCL 10-43-10.3(3) is that "taxes imposed" should equal net federal income taxes, which represent taxes paid after reduction by credits." R. 760. This Court should decide the same.

*3. U.S. Bank's Comparisons to Missouri's Administrative Rules are Wrong*

The Circuit Court explicitly "reject[ed] U.S. Bank's argument that the Missouri bank franchise scheme should be instructive to this Court," holding that "Missouri's bank franchise scheme differs substantially from that of South Dakota." R. 760 n.12. South Dakota statutes control in South Dakota. The calculations used to arrive at taxable income and how to apportion that income for Missouri filing purposes differs substantially from the methods used to prepare South Dakota bank franchise tax returns. *Compare* SDCL 10-43-10.1, -10.2, -10.3 (South Dakota's statutes arrive at taxable income by starting on line 30 of Form

1120 and have a variety of additions and subtractions) *with* Mo. Ann. Stat § 143.431 (West) (Missouri's statute arrives at taxable income by starting on line 28 of Form 1120 and has some different additions and subtractions); *compare* SDCL 10-43-22.1 (for apportionment purposes in South Dakota, "[a]ll net income shall be apportioned to this state by multiplying the net income by a fraction, the numerator of which is the property factor, plus the payroll factor plus the receipts factor, the denominator of which is three.") *with* Mo. Ann. Stat § 143.431 (West) (noting that in Missouri, "income shall be apportioned to [Missouri] by multiplying the gross income minus the deduction in subsection 3 of this section by a fraction, the numerator of which is the sum of the property factor, the payroll factor, the receivables factor and the deposits factor, and the denominator of which is four reduced by the number of factors which have a denominator of zero.").[14]

While it is reasonable to assume that the methods used and guidance provided to prepare the Missouri returns accomplish what the Missouri Legislature intended, Missouri's law has no bearing on South Dakota. If the South Dakota Legislature intended for the State of Missouri to direct South Dakota's taxpayers in the proper methods of how to prepare and file South Dakota bank franchise tax returns, the South Dakota Legislature would have adopted Missouri's statutory

[14] It is worth emphasizing that Missouri has a mechanism where it may exclude one of its factors from the apportionment calculation if the denominator is zero. South Dakota does not have a similar mechanism.

scheme. It did not. *See Petition of Famous Brands*, 347 N.W.2d 882, 884 (S.D. 1984) ("[C]ourts have no legislative authority and should avoid judicial legislation . . . the duty of a court is to apply the law objectively as found, and not to revise it."). U.S. Bank's argument is wrong.

*4. A Deduction was Available to U.S. Bank*

The Department agrees that a deduction would have been available to U.S. Bank if it would have shown that it fit squarely within the plain language of the deduction. *See Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990). It did not. In fact, the Department, through the Notice of Intent and issuing IDR #002, specifically requested the methodology utilized on the 2010 and 2011 originally filed returns. R 175-6, 214, 271-3, 389-90. The information requested is statutorily required to be maintained by the taxpayer and presented to the Department upon request, but U.S. Bank did not provide it. *See* SDCL 10-43-43.1.

> 10-43-43.1. Each person subject to tax under this chapter shall make and keep for a period of six years after federal taxable income has been finally determined by the United States any records as required by the secretary of revenue or otherwise necessary for the administration of this chapter. The records shall, at all times during business hours of the day, be subject to inspection by the secretary to determine the amount of tax due.
>
> If in the normal conduct of the business, the required records are maintained and kept at an office outside the State of South Dakota, it shall be a sufficient compliance with this section if the records are made available for audit and examination by the Department of Revenue at the office outside of South Dakota.

*See also* SDCL 10-59-21 (Taxpayer seeking recovery of allegedly overpaid tax "shall provide any information requested or considered necessary by

the secretary to determine the validity of a claim."). Additionally, U.S. Bank was required to submit with the South Dakota bank franchise tax return "a copy of the federal income tax return and schedules filed with the Internal Revenue Service for the tax year." ARSD 64:26:02:04. As previously discussed, the Department also had authority, pursuant to SDCL 10-59-3 and 10-59-7, to require the production of certain records during the audit.

Regardless, U.S. Bank never provided information as to its computation of the deduction as initially filed, nor did it provide a methodology consistent with the plain language of SDCL 10-43-10.3(3). R 175-6, 214, 271-3, 389-90. Because U.S. Bank never provided the requested information to the Department, the Department's auditor was left with one of two options: (1) accept U.S. Bank's incorrect reading of the law with its inflated number; or (2) deny U.S. Bank's claimed deductions in full. R. 391-2. Generally, a taxpayer has the burden to prove both the entitlement to a deduction and the proper amount. *Washington Mutual, Inc. v. United State*s, 130 Fed.Cl. 653, 686-87 (Fed. Cl. 2017). U.S. Bank did neither. Consequently, U.S. Bank failed to meet its burden to receive the deduction. *See Matter of Pam Oil, Inc.*, 459 N.W.2d at 255 (S.D. 1990) (Tax exemptions are construed in favor of the taxing power, and the taxpayer has the burden of proving entitlement to a statutory exemption.); *Burlington Northern*, 398 N.W.2d at 147 (S.D. 1986); P*am Oil, Inc.*, 459 N.W.2d at 255 (Deductions are an act of

legislative grace and never presumed); *Doyal v. Commissioner of Internal Revenue*, 616 F.2d 1181, 1192 (10th Cir. 1980).

**CONCLUSION**

This case boils down the methodology used to calculate the net federal income tax deduction in relation to bank franchise taxes. The calculation flows as follows:

- SDCL 10-43-10.3. Subtracted from taxable income are:

  . . .

  (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375;

- ARSD 64:26:04:28, in pertinent part, provides:

  . . . Net federal income taxes are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

- Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. The steps are as follows:

  **Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."

  **Step 2.** Record that number on Schedule J, line 2 of Form 1120).

  **Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).

  **Step 4.** Record Total tax liability on Schedule J, line 10.

  **Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and

> represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the IRS.

As the party seeking the deduction, U.S. Bank has the burden to show that its activities fit squarely within the statutory language. *See Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990). U.S. Bank had an opportunity to provide information to the Department supporting its originally filed 2010 and 2011 returns. R. 175-6, 214, 271-3, 389-90. It elected not to do so. *Id.* Instead, it chose to employ a methodology based on the Tax Sharing Agreement. *See* U.S. Bank Brief. Like the methodologies employed by the taxpayers in *Norwest* and *Sparrow*, U.S. Bank's methodology resulted in a claimed deduction that was based on a number that greatly exceeded the amount of taxes paid by the entire consolidated group – *175% in 2012*. R. 192-242. Such hypothetical computations have been explicitly rejected by the tax courts and should continue to be rejected here. Ultimately, U.S. Bank has provided no statute, rule, or authority that would support its position in this proceeding.

Based on the above arguments and authorities, the Department requests that the certificate of assessment be affirmed in all respects and

the Department's denial of U.S. Bank's 2010 and 2011 refund requests be upheld as well.

Respectfully submitted this 30th day of October, 2020.

/s/ *John T. Richter*

John T. Richter
Senior Litigation Counsel
S.D. Department of Revenue
445 East Capitol Avenue
Pierre, SD 57501
Telephone: (605) 773-5124
John.Richter@state.sd.us
*Attorney for S.D. Dept. of Revenue*

## CERTIFICATE OF COMPLIANCE

I certify that the Appellee's Brief is within the limitation provided for in SDCL 15-26A-66(b) using Bookman Old Style typeface 12-point type. Appellee's brief contains 7,824 words, excluding the cover, table of contents, table of authorities, jurisdictional statement, statement of legal issues, and certificate of counsel. I have relied on the word count of Microsoft Word, which was used to prepare this brief.

Dated this 30th day of October, 2020.

/s/ *John T. Richter*

John T. Richter
Senior Litigation Counsel
S.D. Department of Revenue
445 East Capitol Avenue
Pierre, SD 57501
Telephone: (605) 773-5124
John.Richter@state.sd.us

*Attorney for S.D. Dept. of Revenue*

**CERTIFICATE OF SERVICE**

The undersigned hereby certifies that on October 30, 2020, a true and correct copy of the Appellee's Brief, in the matter of *U.S. Bank National Association v. South Dakota Department of Revenue,* was served by electronic mail on the following:

Craig B. Fields
Nicole L. Johnson
Blank Rome, LLP
1271 Avenue of the Americas
New York, NY 10020
cfields@blankrome.com
nljohnson@blankrome.com

Justin L. Bell
May, Adam, Gerdes & Thompson, LLP
P.O. Box 160
Pierre, SD 57501
jlb@mayadam.net

Dated this 30th day of October, 2020.

/s/ *John T. Richter*

John T. Richter
Senior Litigation Counsel
S.D. Department of Revenue
445 East Capitol Avenue
Pierre, SD 57501
Telephone: (605) 773-5124
John.Richter@state.sd.us

*Attorney for S.D. Dept. of Revenue*

Table of Contents

**STATE OF SOUTH DAKOTA**
**OFFICE OF HEARING EXAMINERS**
**Pierre, South Dakota**

| | |
|---|---|
| **U.S. BANK NATIONAL ASSOCIATION,** **Petitioner,** | **DOR 16-34** |
| **v.** | **PROPOSED DECISION FINDINGS OF FACT AND CONCLUSIONS OF LAW AND PROPOSED ORDER** |
| **SOUTH DAKOTA DEPARTMENT OF REVENUE,** **Respondent.** | |

This matter came for hearing before the Office of Hearing Examiners on September 28, 2017. U.S. Bank National Association ("U.S. Bank") appealed the Certificate of Assessment issued December 28, 2015 and the denial of two refund claims. The South Dakota Department of Revenue ("Department") was represented by its attorney, John Richter, and U.S. Bank was represented by Craig Fields and Nicole Johnson of Morrison & Foerster, LLP, and Justin Bell of May, Adams, Gerdes & Thompson, LLP. The Office of Hearing Examiners, having reviewed the administrative record and having heard the arguments of counsel in this matter, hereby enters the following Proposed Decision, Findings of Fact and Conclusions of Law, and Proposed Order.

## Statement of Issues

On December 28, 2015, the Department issued a Certificate of Assessment to U.S. Bank in the amount of $508,926.11 following an audit of the tax year 2012. The Department also denied a change in the amount for the tax year 2011. In a letter dated February 24, 2015, U.S. Bank appealed the certificate and requested an administrative hearing on the matter.

The issue before the hearing examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3(2); and if any, what is the appropriate methodology to determine that amount.

## Proposed Decision

U.S. Bank is a wholly owned subsidiary of U.S. Bancorp. As allowed by the Internal Revenue Code, and encouraged by the U.S. Department of the

Treasury, U.S. Bank and U.S. Bancorp entered into a tax sharing agreement. This tax sharing agreement allocated the federal income tax liability among the members of the consolidated group. Pursuant to the tax code, 26 U.S. Code § 1501, this sort of arrangement is allowed. 26 U.S.C. §1502 provides for the regulations of these sort of arrangements. This law allows the Secretary of the Treasury to "prescribe rules that are different from the provision of chapter 1 that would apply if such corporations filed separate returns." 26 U.S.C. §1502. (Aug. 16, 1954, ch. 736, 68A Stat. 367; Pub. L. 94–455, title XIX, § 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834; Pub. L. 108–357, title VIII, § 844(a), Oct. 22, 2004, 118 Stat. 1600.)

The specific South Dakota code at issue is SDCL 10-43-10.3(3) which reads: "Subtracted from taxable income are: (3) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC §1374 and 26 UC §1375." The primary issue in this case relates to the deduction of federal income tax from the amount of bank franchise tax owed by U.S. Bank to the State of South Dakota.

U.S. Bank argues that they are entitled to take a larger deduction due to errors in methodology in filing their past IRS tax returns. U.S. Bank amended the 2011 and 2012 IRS returns and requested that the Department reflect that new amount of tax liability for the SD bank franchise tax. The Department argues that the methodology was not shown to them during the audits and therefore, should not be considered during this appeal. Furthermore, notwithstanding the audit delay, U.S. Bank should not be able to deduct that specific amount because the amended tax return showed a tax amount that was a share based upon their consolidated taxes.

At the center of the dispute is that the parties disagree as to the definition of "taxes imposed[1]." U.S. Bank argues that the taxes imposed upon them are the taxes that U.S. Bank is liable for, under the tax sharing agreement. The Department argues that the taxes imposed are the taxes that U.S. Bank would be liable for had they filed their taxes separately.

[1] Definition of impose; imposed; imposing: transitive verb meaning (a): to establish or apply by authority impose a tax, impose new restrictions, impose penalties or (b): to establish or bring about as if by force. "Impose." *Merriam-Webster.com*, Merriam-Webster, www.merriam-webster.com/dictionary/impose. Accessed 01 May 2018.

The Federal Regulations set out the tax liability for subsidiary members of a corporation that use a tax sharing agreement. The regulation is found at 26 CFR §1.1502-6(a).

26 CFR § 1.1502-6 Liability for tax.

(a)Several liability of members of group. Except as provided in paragraph (b) of this section, the common parent corporation and each subsidiary which was a member of the group during any part of the consolidated return year shall be severally liable for the tax for such year computed in accordance with the regulations under section 1502 prescribed on or before the due date (not including extensions of time) for the filing of the consolidated return for such year.

(b) *[non-pertinent clause regarding former subsidiary members]*

(c)Effect of intercompany agreements. No agreement entered into by one or more members of the group with any other member of such group or with any other person shall in any case have the effect of reducing the liability prescribed under this section.

26 CFR § 1.1502-6 [T.D. 6894, 31 FR 11794, Sept. 8, 1966, as amended by T.D. 9002, 67 FR 43540, June 28, 2002]. (emphasis added)

The term "severally liable" is a legal term of art. Typically, it is seen alongside the word "joint or jointly", but the law specifically omits joint liability. In this case, the subsidiary is "severed" from the parent and is only liable for their share of the taxes paid by the parent corporation. In this case, U.S. Bank is not jointly liable for the whole of the tax liability of U.S. Bancorp or the amount they pay under the tax sharing agreement.

Under (a) of the CFR above, the "several liability" amount is the amount "imposed" upon U.S. Bank by the IRS, per their separate tax return for the year. Even with the tax agreement in place, U.S. Bank cannot be required to pay more taxes to the IRS than if they filed separate tax returns. And by the same token, under (b) of the same rule, the tax sharing agreement cannot reduce the liability or the amount of taxes imposed upon U.S. Bank by the IRS.

U.S. Bank is only responsible, under the Federal Regulations, for the tax liability incurred by U.S. Bank. U.S. Bank, by their belonging to a tax sharing

agreement, may agree to pay a certain portion of the U.S. Bancorp tax, but that is a separate agreement and a potentially different amount that the amount "imposed" upon U.S. Bank by the IRS.

In the second part of the certificate of assessment, the Department specifically denied U.S. Bank's request for amended filings for the years 2010 and 2011. By the time the certificate of assessment was prepared, it was over three years past the date of filing for both 2010 and 2011. SDCL §10-43-50 sets out a three year statute of limitations for refunds to the bank franchise tax. U.S. Bank's request for amended filings for 2010 and 2011 was properly denied by the Department. This was not listed separately as an issue under the Notice of Hearing, but is mentioned here due to the ruling being part of the Certificate of Assessment at issue.

The Parties submitted Proposed Findings of Fact and Conclusions of Law. The following are this Hearing Examiner's Proposed Findings of Fact and Conclusions of Law to be incorporated into the Proposed Decision.

**Findings of Fact**

1. U.S. Bank is a financial institution, principally engaged in the business of banking, with its headquarters located in Minnesota. HT 8, 55.

2. U.S. Bank utilizes the accrual method of accounting. HT 19; Ex. 13 at 1.

3. U.S. Bank is a member of an affiliated group of corporations under U.S. Bancorp. HT 9, 56; Ex. 13 at 1.

4. As the parent company of the consolidated group, U.S. Bancorp is responsible for filing a Form 1120, U.S. Corporation Income Tax Return. HT 9-10, 56; Ex. 13 at 1.

5. U.S. Bank's activities were included in the federal consolidated return, Form 1120, filed by U.S. Bancorp. HT 56.

6. As an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120, because its activities were included on the federal consolidated income tax returns filed by U.S. Bancorp for the year at issue. HT 9-10, 56; Exs. 1-3; *see* also Ex. 13.

7. For the year at issue, U.S. Bank prepared pro forma federal income tax returns. HT 20, 57; Exs. 4-6. Pro forma returns are not filed with the Internal Revenue Service. HT 21, 57.

8. Pro forma means as a matter of form. In the context of consolidated groups, corporations are required to provide all information that would have been included in a separate company federal income tax return had the corporation filed a separate company income tax return with the federal government. *See* HT 19-20.

9. The Form 1120 filed by U.S. Bancorp with the IRS is the starting point for calculating the bank franchise tax deduction at issue in this matter

10. U.S. Bank and U.S. Bancorp entered into an Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp ("Tax Sharing Agreement") with certain affiliates. Ex. 18; HT. 22.

11. The Tax Sharing Agreement, in part, provides for the allocation of the federal income tax liability among the members of the consolidated group, including U.S. Bank. Id.

12. It is designed to allocate the proper amount of the federal tax liability or benefit to the member that generated the income or loss. HT. 22.

13. Pursuant to the Tax Sharing Agreement, each member's federal tax liability is computed as if it had filed a separate federal income tax return (i.e., separate company federal taxable income multiplied by 35%). Ex. 18; HT. 24.

14. If a member of the consolidated group had a loss for the year, the member was paid for the use of that loss (i.e., the loss multiplied by 35%). Ex. 18; HT. 24-25.

15. In accordance with the U.S. Bancorp Tax Sharing Agreement, U.S. Bank paid the following taxes:

U.S. Bank's Federal Taxes Paid

| Tax Year Ended | Taxable Income | | Agreement Rate | | Tax Paid to IRS |
|---|---|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x | 35% | = | $840,313,825 |
| December 31, 2011 | $2,342,731,149 | x | 35% | = | $819,955,902 |
| December 31, 2012 | $4,925,219,278 | x | 35% | = | $1,723,826,747 |

Ex. 1-6; 18.

16. The 35% tax amount paid by U.S. Bank to the IRS is not necessarily the amount of tax imposed by the IRS upon U.S. Bank.

17. The Tax Sharing Agreement is a binding contract between the affiliates of U.S. Bancorp. Ex. 18; HT. 24, 38.

18. U.S. Bank complied with the terms of the Tax Sharing Agreement as required by its regulators. HT. 25. U.S. Bank and U.S. Bancorp undergo

numerous internal and independent audits by a number of regulators on a regular basis.

19. Since U.S. Bank does business in South Dakota, it is subject to South Dakota's bank franchise tax, which imposes an income tax on banks and financial corporations. SDCL 10-43-2.1.

20. Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See* Exs. 1-3, 13 (Schedule J appears on page 3 of the Form 1120).

21. The calculation of Form 1120, Schedule J, begins by multiplying taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax" (Schedule J, line 2 of Form 1120). HT 71-72; *See* Exs. 1-3, 13.

22. That number is then reduced by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10). HT 71-72; *See* Exs. 1-3, 13.

23. The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed by the Internal Revenue Service or the federal tax liability. HT 71-72; *See* Exs. 1-3, 13.

24. If U.S. Bancorp were doing business within the State of South Dakota, it would use this amount as the deduction on its bank franchise tax return (page 2, line 15 of the bank franchise tax return), since it completed the Form 1120. *See* Exs 6-8, 10-12.

Federal Tax Returns

25. U.S. Bancorp filed consolidated federal income tax returns, which included U.S. Bank. Ex. 1-3; HT. 23-24.

26. The total income tax shown as due, before application of the credits, on the consolidated returns was as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

Ex. 1, p. 3; Ex. 2, p. 3; Ex. 3, p. 3; HT. 11.

27. The total income tax due was paid through cash and credits. Ex. 1-3; HT. 12.

28. U.S. Bank made cash payments to the Internal Revenue Service ("IRS") to pay the remaining tax due, after application of the credits, as follows:

| Tax Year Ended | Total Cash Payments |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

Ex. 1, p. 1; Ex. 2, p. 1; Ex. 3, p. 1; Ex. 17; HT. 13.

29. U.S. Bank's taxable income consisted of the majority of the consolidated group's taxable income as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | Consolidated Group's Federal Taxable Income | % |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| December 31, 2011 | $2,342,731,149 | $3,567,245,451 | 66% |
| December 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Ex. 1-3.

30. In computing its federal taxable income, U.S. Bank treated the payments made pursuant to the Tax Sharing Agreement as federal income tax payments and did not deduct such amounts in computing its federal taxable income. See Ex. 1-6.

31. The bank statements provided by U.S. Bank on Exhibit 17 do not give explanation for the payments made to the IRS by U.S. Bank. These payments are not necessarily for federal tax liability imposed upon U.S. Bank, but could be for taxes imposed upon U.S. Bancorp or any affiliates. These could also be payments made in advance for estimated tax liability.

32. In addition, U.S. Bank prepared pro forma federal income tax returns using accrual basis accounting. Ex. 4-6; HT. 19-20.

33. The pro forma returns were prepared to show U.S. Bank's taxable income on a separate company basis for states, such as South Dakota, that impose tax on a separate return basis (i.e., as if U.S. Bank filed a separate federal income tax return rather than filing as part of a consolidated federal income tax return). HT. 20.

34. Instead of using a Form 1120 consolidated return to calculate the federal income tax deduction, U.S. Bank simply calculated the federal income tax deduction by multiplying Line 30, on its pro forma returns by 35%. HT 56-58.

S.D. Bank Franchise Tax Return

35. On September 11, 2012, U.S. Bank filed a bank franchise tax return for the tax period ending December 31, 2011. Ex. 13 at 16.

36. The bank franchise tax return included a copy of a pro forma Form 1120 for U.S. Bank, but was missing the computation for federal tax liability. *Id.*

37. The U.S. Bancorp consolidated federal return would have identified the total consolidated federal tax liability for 2011 as $617,186,234. *Id.*

38. On or about December 27, 2012, U.S. Bank filed an amended bank franchise tax return for the tax year ending December 31, 2011, increasing the state deduction (line 15 of the bank franchise tax return) for federal taxes paid from $346,485,702 to $819,955,902. *Id.*

39. U.S. Bank's explanation, contained in the amended return, was:

> Return is amended to adjust the state deduction for federal income taxes paid or accrued, Page 2 Line 15. Adjustment results in an increased overpayment to credit to 2012, the total of which is shown on the amended return.

*Id.*

40. By increasing the amount of the deduction claimed, U.S. Bank's 2011 amended return reduced U.S. Bank's bank franchise tax liability from $258,866 on the original return to $193,101 on the amended return, a decrease of $65,765. *Id.*

41. The original $12,134 overpayment was also added to the decrease to show a revised overpayment of $77,899 on Line 6 of the amended bank franchise tax return.

42. The U.S. Bancorp consolidated federal tax return, which the Department eventually received, reflected a total consolidated federal tax liability of $617,186,234.00. Ex. 13 at 17.

43. On October 28, 2013, the Department requested, in part, the following information relating to the amended 2011 bank franchise tax return:

> Pages 1-5 of the 2011 U.S. Bancorp consolidated Federal return Form 1120, and consolidated numbers for the members of the consolidated group that tie into pages 1-5[.]

Ex. 13 at 17.

44. In review of this information, the Department's auditor observed:

- The $346,485,702.00 originally reflected on the bank franchise tax return represents about 56% of the total tax liability of the consolidated group.

- The $819,955,902.00 reflected on the amended bank franchise tax return, an increase of $463,470,200.00, represents about 133% of the total tax liability of the consolidated group.

- Put another way, U.S. Bank took a deduction that exceeded the entire consolidated group's Federal tax liability by $202,769,668.00.

*Id.*

45. On September 26, 2013, U.S. Bank timely filed a bank franchise tax return for the tax period ending December 31, 2012. Ex. 13 at 18.

46. The bank franchise tax return included a copy of a pro forma Form 1120 for U.S. Bank; however, like the 2011 return, the pro forma Form 1120 did not include a computation of the federal tax liability. *Id.*

47. Also, like the 2011 return, U.S. Bank's 2012 return did not include a copy of U.S. Bancorp's consolidated federal return. *Id.*

48. For the year ending December 31, 2012, U.S. Bank claimed a deduction for taxes paid or accrued in the amount of $1,723,826,747.00 (line 15 of the bank franchise tax return). Ex. 13 at 19.

49. The U.S. Bancorp consolidated federal tax return for 2012 subsequently requested and received by the Department, reflected total consolidated federal tax liability of $981,865,059. *Id.*

50. In review of this information, the Department's auditor observed:

- The $1,723,826,747.00 that U.S. Bank claimed on its 2012 bank franchise tax return represents in excess of 175% of the total tax liability of the entire consolidated group.
- Put another way, U.S. Bank claimed a deduction for $741,961,688 more than the entire consolidated group federal tax paid in federal taxes.

*Id.*

51. Based on those bank franchise returns, the Department determined that an audit was necessary. *Id.*

The Audit

52. On October 2, 2014, the Department initiated an audit and sent U.S. Bank a Notice of Intent to Audit. HT 58-59; Ex. 13 at 18; Ex. 16.

53. Through the course of the audit, the Department requested more information pertaining to the deductions claimed by U.S. Bank. HT 58-59; Ex. 9; Ex. 13 at 18; Ex. 16.

54. On October 23, 2014, the Department issued Information Document Request (IDR) #002 with a deadline to respond by November 4, 2014. HT 60; Ex. 9; Ex. 13 at 18-19.

55. IDR #002 requested, in part, the Tax Sharing Agreement between the members of the Affiliated Group and the internal work papers and legal analysis to support the amounts reported on SD BFT [bank franchise tax return] Page 2, Line 15, Federal income taxes paid or accrued. Ex. 9; Ex. 13 at 18-19; HT 60-61.

56. According to the auditor's report, the Tax Sharing Agreement; the legal analysis to support the amounts reported on Page 2, Line 15; the change of method or accounting for federal income taxes from the initial bank franchise tax returns filed for 2009, 2010, and 2011; and the name of the Department representative U.S. Bank claimed that it had talked to were not provided. HT 60-61; Ex. 13 at 19-20.

57. Therefore, on December 22, 2014, the Department issued a Notice of Proposed Adjustment (NOPA) #01, wherein the federal tax deduction was adjusted. HT 62; Ex. 13 at 19.

58. A NOPA is a document that is similar to one used by the Internal Revenue Service. It identifies the facts, the law, the argument, and a conclusion or position. It asks the taxpayer to agree or disagree. If a taxpayer does not agree, it requires an auditor to continue with the audit and provide formalized conclusions. *See* HT 65.

59. On May 8, 2015, U.S. Bank, in part, suggested it should be able to use the separate company method of multiplying its separate company federal taxable income by 35%; that percentage would be the federal tax deduction because:

a) The statute is ambiguous regarding the calculation of the federal income tax deduction, and
b) The separate company tax sharing should be deemed a federal tax.

Ex. 13 at 19-20.

60. Ultimately, U.S. Bank did not provide any proof of payment that would reconcile the South Dakota bank franchise tax line 15 deduction. HT 62-64 (The Department's auditor testified that, "we couldn't reconcile the amount reported on the bank franchise tax return to the taxes imposed and paid on the 1120 tax return for the consolidated group."); Ex. 13 at 19-20.

61. The Department, through the Notice of Intent and issuing IDR #002, specifically requested the methodology utilized on the 2010 and 2011 originally filed returns. Ex. 9; Ex. 13 at 18-19; Ex. 16; HT 60-31.

62. The information requested by the Department auditors is statutorily required to be maintained by the taxpayer and presented to the Department upon request. *See* SDCL 10-43-43.1.

63. Based on the review of the years ending December 31, 2011 and December 31, 2012, the Department's auditor denied U.S. Bank's claimed deductions. HT 62-64; Ex. 13 at 21.

64. The Department's auditor testified that, U.S. Bank's methodology did not make sense, "[b]ut it was clear to us that they wouldn't get a deduction of $2 if the total assessment was only 50 cents." HT 64.

65. As a result, U.S. Bank's bank franchise tax return Line 15 and 20 were adjusted to zero and tax due in the amounts of $113,877 for 2011 and $364,169 for 2012 were recommended. Ex. 13 at 21.

66. On December 28, 2015, the Department completed the audit of U.S. Bank for the tax years ending December 31, 2011 and December 31, 2012. HT 69; Ex. 13.

67. On December 28, 2015, a certificate of assessment was issued to U.S. Bank in the amount of $508,926.11, consisting of $364,169.00 of tax and $144,757.11 of interest for the tax year ending December 31, 2012. Ex. 13.

68. The Department determined it could not issue a certificate of assessment for the year ending December 31, 2011 because that period was time-barred pursuant to SDCL 10-43-50. Ex. 13.

69. During the audit, U.S. Bank made requests for refund. Those requests for refund related to the periods ending December 31, 2010 and December 31, 2011. Ex. 13.

70. U.S. Bank initially utilized a method to calculate the federal income tax deduction that was based roughly on 56% of the total federal tax liability of the consolidated group.

71. The 2010 original return was allowed as filed since the time to assess further by the Department had expired. *Id.*

72. The 2011 return was adjusted in the auditor's report. *Id.*

73. Through requests for refunds made during the audit, U.S. Bank sought an additional refund, based on the methodology utilized on its 2012 bank franchise tax return. *Id.*

74. Consequently, U.S. Bank's requests for refund made during the audit period were also denied. *Id.*

Appeal

75. U.S. Bank filed a request for hearing, dated February 24, 2016, appealing the Certificate of Assessment and the denial of the refund claims. Ex. 15.

76. U.S. Bank witness, Brett Scribner, conceded "[t]he credit is not a tax imposed, no." HT 37.

77. U.S. Bank attempts to allocate its tax liability based on a tax sharing agreement. *See* U.S. Bank's Brief.

78. The tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38.

79. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S.").

80. U.S. Bank witness, Brett Scribner, testified that the tax sharing agreement is "a binding contract amongst the entities." HT 38.

81. U.S. Bank witness Brett Scribner testified that the tax sharing agreement:

> [I]s designed to share or provide the – allocate the proper amount of tax liability or benefit that is generated by each individual company in a particular group.
>
> So it applies to federal consolidated returns. It also applies to the allocation of what are known as unitary or combined state income tax liabilities. There are states, some states, that also tax a consolidated or a combined group of companies similar to the federal process. And so the federal is a consolidated return.
>
> So this is designed to allocate that and then make sure that the payments are made back and forth so that each company is *theoretically* made whole either for the benefits it generated for

> the group or for the tax it had to pay for the group. Or because it had income or loss, as the case may be.

HT 23 (emphasis added).

82. U.S. Bank's witness, Brett Scribner, conceded the following:

- The FDIC does not impose tax. HT 38.
- The IRS does not dictate the terms of the tax sharing agreement and the tax sharing agreement is not an imposition of tax under the Internal Revenue Code. HT 38-39.
- Estimated payments are not taxes imposed. HT 39.

83. No SDCL 10-43-10.1 issue was presented for review.

84. On September 22, 2017, nearly three years after the November 3, 2014 audit commencement date, U.S. Bank gave the Department a copy of Exhibit 17. This exhibit shows a series of bank statements for demand deposit accounts (DDA) owned by U.S. Bank. *Compare* HT 18 *to* Ex. 16.

85. The DDA statements in Exhibit 17 indicate how much money was paid by U.S. Bank to the IRS. These amounts are not necessarily how much money was owed to the IRS by U.S. Bank. These payments are not the amounts imposed upon U.S. Bank by the IRS. U.S. Bank paid the IRS a certain amount pursuant to the Tax Sharing Agreement as well as estimated tax liability.

86. Any additional findings included in the Reasoning section of this decision are incorporated herein by this reference. To the extent any of the foregoing are improperly designated and are instead conclusions of law, they are hereby redesignated and incorporated herein as conclusions of law.

**Conclusions of Law**

1. The Department of Revenue has jurisdiction over the parties and subject matter of this appeal. The Office of Hearing Examiners was authorized to hear this matter and issue a proposed decision in this matter pursuant to the provisions of SDCL 1-26D.

2. A certificate of assessment is deemed prima facie correct. SDCL 10-59-8.

3. "Exemptions from tax are privileges accorded as a matter of legislative grace and not as a matter of taxpayer right ...Tax exemptions are never presumed ... [T]he general rule has been established that the taxpayer has the burden of proving entitlement to a statutory exemption." *Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990). Furthermore, "[s]tatutes which impose

taxes are to be construed liberally in favor of the taxpayer and strictly against the taxing body. Statutes exempting property from taxation should be strictly construed in favor of the taxing power." *Butler Mach. Co. v. S.D. Dep't of Revenue*, 2002 S.D. 134, ¶ 6, 653 N.W. 2d 757, 759. (Internal citations omitted).

4. SDCL chapter 10-43 governs the procedure for South Dakota's bank franchise tax.

5. SDCL 10-43-50 sets three (3) years, after the return is filed with the Department, as a time deadline for amending or correcting a tax return.

6. SDCL 10-43-2.1 provides, "An annual tax is hereby imposed upon every national banking corporation ... doing business within this state, according to or measured by its net income[.]"

7. "Net income, in the case of a financial institution, is taxable income as defined in the Internal Revenue Code...but subject to the adjustments as provided in §§10-43-10.2 and 10-43-10.3." SDCL 10–43–10.1.

8. "Each taxpayer shall file the final return for the tax year within fifteen days after the taxpayer's federal income tax return is due." SDCL 10–43–30.

9. In calculating a financial institution's net income, South Dakota law provides for the following deduction:

> Subtracted from taxable income are:
>
> . . .
>
> (2) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375[.]

SDCL 10-43-10.3(2).

10. ARSD 64:26:04:28 references SDCL 10-43-10.3 and, in pertinent part, further clarifies:

. . . Net federal income taxes are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

11. Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution.

12. The steps are as follows:

**Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."

**Step 2.** Record that number on Schedule J, line 2 of Form 1120.

**Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).

**Step 4.** Record Total tax liability on Schedule J, line 10.

**Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the Internal Revenue Service.

HT 71-72; *See Exs.* 1-3, 13.

13. U.S. Bank's proposed methodology does not comply with federal law. *See* 26 CFR 1.1502-75(f)(2).

14. 26 CFR 1.1502-75(f)(2), in pertinent part, discusses the allocation of tax liability to the separate entities of a consolidated federal income tax return.

> (2) Allocation of tax liability. In any case in which amounts have been assessed and paid upon the basis of a consolidated return . . . . .

15. Consistent with this provision, taxes imposed, in the context of a federal consolidated return, are those amounts that have actually been assessed and paid. 26 CFR 1.1502-75(f)(2); *see also* Ex. 13.

16. The term "paid" is defined in South Dakota law under SDCL 10-43-1(9) as:

> (9) "Paid," for the purposes of the deductions means paid or accrued or paid or incurred, and the terms paid or incurred and paid or accrued are construed according to the accounting method used for computing net income; received, for the purpose of the computation of net income means received or accrued, and the term received or accrued is construed according to the accounting method used for computing net income;

17. U.S. Bank failed to meet its burden to receive the deduction. *See* SDCL 10-43-10.3(2); ARSD 64:26:04:28; *Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990); *Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); HT 37, 71-72.

18. The holdings in *Norwest* and *Sparrow* require that U.S. Bank's intercompany liability allocation argument be rejected.

19. The Tax Sharing Agreement payments are not deductible as ordinary and necessary business expenses. IRC § 162; SDCL 10-43-10.1. HT 13-14.

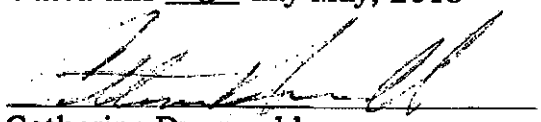
20. Internal Revenue Code §§ 162 and 164 make it clear that payments to affiliates are not a federal tax or a deduction. *See* IRC §§ 162 and 164.

21. Any Conclusions of Law in the Reasoning section of this decision are incorporated herein by reference. To the extent any of the foregoing are improperly designated and are instead findings of fact, they are hereby redesignated and incorporated herein as findings of fact.

**PROPOSED ORDER**

It is the Proposed Order to the Secretary of Revenue that the certificate of assessment issued to U.S. Bank on December 28, 2015 be affirmed in all respects. Furthermore, it is proposed that South Dakota Statute, 10-43-10.3(3), regarding "taxes imposed", be interpreted by the Department as the amount of tax an entity would be liable to pay the IRS had they filed taxes as a separate entity. Furthermore, requested amendments to the 2010 and 2011 returns are denied as time barred. It is finally proposed, consistent with the certificate of assessment, that for the year 2012, U.S. Bank is assessed $364,169 of additional tax and $144,757.11 of interest.

Dated this 22nd day May, 2018



Catherine Duenwald
Office of Hearing Examiners

**CERTIFICATE OF SERVICE**

I certify that on May 22nd, 2018, at Pierre, South Dakota, a true and correct copy of the Proposed Decision in the above-entitled matter was sent via U.S. Mail to each party listed below.

Ashley Parsons

Ashley Parsons

SECRETARY ANDY GERLACH
DEPARTMENT OF REVENUE
445 EAST CAPITOL AVENUE
PIERRE SD 57501

CRAIG B FIELDS
NICOLE L JOHNSON
MORRISON & FOERSTER LLP
250 WEST 55TH STREET
NEW YORK NY 10019-9601

JUSTIN L BELL
MAY ADAM GERDES & THOMPSON LLP
PO BOX 160
PIERRE SD 57501

JOHN T RICHTER
SENIOR LITIGATION COUNSEL
SD DEPT OF REVENUE
445 E CAPITOL AVE.
PIERRE SD 57501

**Step 2.** Record that number on Schedule J, line 2 of Form 1120.

**Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).

**Step 4.** Record Total tax liability on Schedule J, line 10.

**Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the Internal Revenue Service.

18. In paragraph 27 of the Findings of Fact, the Hearing Examiner stated:

> The total income tax due was paid through cash and credits. Ex. 1-3; HT.12.

I reject paragraph 27 of the Findings of Fact because it is an incorrect statement that is inconsistent with the record. Credits are not taxes imposed. *See Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); HT 37, 71-72. They are simply a reduction to determine what is owed. HT 71-72. U.S. Bank witness, Brett Scribner, conceded "[t]he credit is not a tax imposed, no." HT 37.

19. In paragraph 28 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank made cash payments to the Internal Revenue Service ("IRS") to pay the remaining tax due, after application of the credits, as follows:

| Tax Year Ended | Total Cash Payments |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

> Ex. 1, p.1; Ex. 2, p.1; Ex. 3 p.1; HT.113

I reject paragraph 28 of the Findings of Fact because it is an incorrect statement that is inconsistent with the record. The U.S. Bancorp consolidated federal tax returns for years ending 2010, 2011, and 2012 reflect total consolidated federal tax liability of $524,920,206, $617,186,234, and $981,865,059 respectively – not any form of cash payment. Ex. 13.

20. In paragraph 29 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank's taxable income consisted of the majority of the consolidated group's taxable income as follows:
>
> U.S. Bank's Federal Consolidated Group's

| Tax Year Ended | Taxable Income | Federal Taxable Income | % |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| December 31, 2011 | $2,342,73,149 | $3,567,245,451 | 66% |
| December 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Ex. 1-3.

I reject paragraph 29 as it is irrelevant to the determination of the SDCL 10-43-10.3(2) exemption and is confusing.

21. In paragraph 30 of the Findings of Fact, the Hearing Examiner stated:

> In computing its federal taxable income, U.S. Bank treated the payments made pursuant to the Tax Sharing Agreement as federal income tax payments and did not deduct such amounts in computing its federal taxable income. See Ex. 1-6.

I reject paragraph 30 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision. U.S. Bank admitted that the tax sharing agreement does not represent taxes *imposed* pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Consequently, it does not represent taxes paid.

22. In paragraph 31 of the Findings of Fact, the Hearing Examiner stated:

> The bank statements provided by U.S. Bank on Exhibit 17 do not give explanation for the payments made to the IRS by U.S. Bank. These payments are not necessarily for federal tax liability imposed upon U.S. Bank, but could be for taxes imposed upon U.S. Bancorp or any affiliates. These could also be payments made in advance for estimated tax liability.

I reject paragraph 31 of the Findings of Fact because it is irrelevant, speculative, and inconsistent with the record. Moreover, Exhibit 17 does not be considered pursuant to SDCL 10-59-3 and 10-59-7.

23. In paragraph 32 of the Findings of Fact, the Hearing Examiner stated:

> In addition, U.S. Bank prepared pro forma federal income tax returns using accrual basis accounting. Ex. 4-6; HT. 19-20.

I reject paragraph 32 of the Findings of Fact because it is unnecessary. Finding of Fact 2 states: "U.S. Bank utilizes the accrual method of accounting. HT 19; Ex. 13 at 1." Moreover, only the returns that are federally filed have any bearing on U.S. Bank's federal income tax liability.

24. In paragraph 33 of the Findings of Fact, the Hearing Examiner stated:

> The pro forma returns were prepared to show U.S. Bank's taxable income on a separate company basis for states, such as South Dakota, that impose tax on a separate return basis (i.e., as if U.S. Bank filed a separate federal income tax return rather than filing as part of a consolidated federal income tax return). HT. 20.

I reject paragraph 33 of the Findings of Fact because it is unnecessary and more precisely stated in Findings of Fact 6 through 9.

6. As an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120, because its activities were included on the federal consolidated income tax returns filed by U.S. Bancorp for the years at issue. HT 9-10, 56; Exs. 1-3; *see* also Ex. 13.

7. For the years at issue, U.S. Bank prepared pro forma federal income tax returns. HT 20, 57; Exs. 4-6.

8. Pro forma means as a matter of form. In the context of consolidated groups, corporations are required to provide all information that would have been included in a separate company federal income tax return had the corporation filed a separate company income tax return with the federal government. *See* HT 19-20.

9. Pro forma returns are not filed with the Internal Revenue Service. HT 21, 57.

25. In the second sentence of paragraph 84 of the Findings of Fact, the Hearing Examiner stated:

> This exhibit shows a series of bank statements for demand deposit accounts (DDA) owned by U.S. Bank. Compare HT 18 to Ex. 16.

I reject the second sentence of paragraph 84 of the Findings of Fact because Exhibit 17 is irrelevant and does not be considered pursuant to SDCL 10-59-3 and 10-59-7.

26. In paragraph 85 of the Findings of Fact, the Hearing Examiner stated:

> The DDA statements in Exhibit 17 indicate how much money was paid by U.S. Bank to the IRS. These amounts are not necessarily how much money was owed to the IRS by U.S. Bank. These payments are not the amounts imposed upon U.S. Bank by the IRS. U.S. Bank paid the IRS a certain amount pursuant to the Tax Sharing Agreement as well as estimated tax liability.

I reject paragraph 85 of the Findings of Fact because it is unsupported by the record, speculative, and irrelevant. Moreover, Exhibit 17 is irrelevant and does not be considered pursuant to SDCL 10-59-3 and 10-59-7. Furthermore, the tax sharing agreement is irrelevant. Again, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

27. In paragraph 5 of the Conclusions of Law, the Hearing Examiner stated:

> SDCL 10-43-50 sets three (3) years, after the return is filed with the Department, as a time deadline for amending or correcting a return.

I modify paragraph 5 of the Conclusions of Law to:

> SDCL 10-43-50, at the time of the assessment, provided:
>
> As soon as practicable and in any event within three years after the return is filed, the secretary of revenue shall examine it and determine the correct amount of tax, and the amount so determined by the secretary is the tax. If the tax found due is greater than the amount previously paid, the excess, together with interest and penalty as provided in §10-59-6 shall be paid by the taxpayer within ten days after the secretary gives notice to the taxpayer by registered or certified mail.

The reason for this modification is for accuracy purposes.

28. In the second sentence of the Proposed Order, the Hearing Examiner stated:

> Furthermore, it is proposed that South Dakota Statute, 10-43-10.3(3), regarding "taxes imposed", be interpreted by the Department as the amount of tax an entity would be liable to pay the IRS had they filed taxes as a separate entity.

I reject the second sentence of the Proposed Order because it is contrary to the plain language of SDCL 10-43-10.3(2).

29. In the third sentence of the Proposed Order, the Hearing Examiner stated:

> Furthermore, requested amendments to the 2010 and 2011 returns are denied as time barred.

I modify the third sentence of the Proposed Order to:

> Furthermore, U.S. Bank's request for refunds made during the audit period are denied.

My reasons for modifying the third sentence of the Proposed Order are as follows:

- During the audit, U.S. Bank made requests for refund. Those requests for refund related to the periods ending December 31, 2010 and December 31, 2011. Ex. 13.
- U.S. Bank initially utilized a method to calculate the federal income tax deduction that was based roughly on 56% of the total federal tax liability of the consolidated group.
- The 2010 original return was allowed as filed since the time to assess further by the Department had expired. *Id.*
- The 2011 return was adjusted in the auditor's report. *Id.*
- Through requests for refunds made during the audit, U.S. Bank sought an additional refund, based on the methodology utilized on its 2012 bank franchise tax return. *Id.*
- The Department did not agree with the methodology U.S. Bank utilized on its 2012 bank franchise tax return -- consequently, U.S. Bank's requests for refund made during the audit period were denied. *Id.*

30. In the fourth sentence of the Proposed Order, the Hearing Examiner stated:

> It is finally proposed, consistent with the certificate of assessment, that for the year 2012, U.S. bank is assessed $364,169 of additional tax and $144,757.11 of interest.

I reject the fourth sentence of the Proposed Order as it is unnecessary based on the language of the first sentence and the modified third sentence.

31. For completeness and consistency with the record, I modify the Hearing Examiner's Proposed Decision so that the following Findings of Fact be added to read:

> 87. U.S. Bancorp does not do business within the State of South Dakota. One of its affiliates, U.S. Bank does.

88. The bank franchise tax return did not include a copy of the U.S. Bancorp consolidated federal return

89. Because U.S. Bank did not provide any proof of payment that would reconcile the South Dakota bank franchise tax line 15 deduction, the Department's auditor was left with two options: (1) accept the methodology to calculate the deduction U.S. Bank utilized on its 2011 amended return and 2012 return which exceeded the entire consolidated group's Federal tax liability; or (2) deny U.S. Bank's claimed deductions. HT 62-63.

90. U.S. Bank did not provide the information requested by the Department during the audit.

91. U.S. Bank offered no reason why it did not provide it. *See* AR.

92. At the administrative hearing, the Hearing Examiner initially stated that, "[t]he issue before the Hearing Examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3[(2)], and, if any, what is the appropriate methodology to determine that amount?". HT 4.

93. In response, U.S. Bank's counsel asked to clarify two things, (1) the years at issue; and (2) that SDCL 10-43-10.3(2) used to be codified at (3). HT 6.

94. Exhibit 17 was not presented until September 22, 2017, nearly three years after the November 3, 2014 audit commencement date. *Compare* HT 18 *to* Ex. 16.

95. No reason was offered by U.S. Bank as to why Exhibit 17 was not presented.

32. For completeness and consistency with the record, I modify the Hearing Examiner's Proposed Decision so that the following Conclusions of Law be added to read:

26. U.S. Bank has not provided the Department with any information on what taxes it actually paid the IRS.

27. Exhibit 17 was not timely provided and will not be considered. SDCL 10-59-3 and 10-59-7.

28. The tax sharing agreement, the OCC, the Federal Reserve System, and the FDIC do not impose tax under the Internal Revenue Code, nor are they taxes imposed under the Internal Revenue Code. *See*

I.R.C. Therefore, they are all irrelevant in answering the question of what deduction, if any, U.S Bank is entitled to under SDCL 10-43-10.3(2).

29. Missouri's law is irrelevant. Regardless, 12 Mo. Code Regs. 10-10.135(2)(B) language is consistent with the position taken by the Department in this matter. "Schedule J, Total Tax," is line 10 of the Schedule J and flows to line 31 on the Form 1120. Exs. 1-3. *Compare* discussion *supra to* 12 CSR 10-10.135(2)(b).

30. The issue of whether the Tax Sharing Agreement payments being deductible as ordinary and necessary business expenses in computing federal taxable income under SDCL 10-43-10.1, was never presented to the auditor, nor was it mentioned in U.S. Bank's request for hearing. Therefore, the was not properly preserved and need not be considered. Exs. 13, 15; SDCL 10-59-9.

NOW, THEREFORE,

IT IS ORDERED that the Hearing Examiner's Proposed Decision be modified and amended consistent with the additions, rejections, and modifications as set forth above.

IT IS FURTHER ORDERED that, except as modified and amended, consistent with the additions, rejections, and modifications as set forth above, the Hearing Examiner's Proposed Decision is adopted.

Parties are hereby advised of the right to further appeal the final decision to Circuit Court within thirty (30) days of receiving such decision pursuant to the authority of SDCL 1-26.

Dated this 18 day of July, 2018.

Andy Gerlach, Secretary
Department of Revenue

## CERTIFICATE OF SERVICE

Michael S. Houdyshell, Chief Legal Counsel for South Dakota Department of Revenue, does hereby certify that he served by mail a true copy of the **Final Decision and Order** and **Notice of Entry of Final Decision and Order** on

Craig B. Fields
Nicole L. Johnson
Morrison & Foerster, LLP
250 West 55th Street
New York, NY 10019

Justin L. Bell
May, Adam, Gerdes & Thompson, LLP
P.O. Box 160
Pierre, SD 57501

Catherine Duenwald
Chief Hearing Examiner
Office of Hearing Examiners
523 E. Capitol Ave., 3rd Floor
Pierre, SD 57501

John T. Richter
Senior Litigation Counsel
SD Department of Revenue
445 E. Capitol Ave.
Pierre, SD 57501

properly addressed as above, postage prepaid, by mailing first class United States mail at the United States Post Office, Pierre, South Dakota.

Dated and mailed this 19th day of July, 2018.

Michael S. Houdyshell
Chief Legal Counsel
SD Department of Revenue
445 East Capitol Avenue
Pierre, SD 57501-3185
(605) 773-4701

**STATE OF SOUTH DAKOTA**
**OFFICE OF HEARING EXAMINERS**

| | |
|---|---|
| U.S. BANK NATIONAL ASSOCIATION<br><br>v.<br><br>SOUTH DAKOTA DEPARTMENT OF REVENUE | DOR 16-34<br><br>**FINAL DECISION AND ORDER** |

An administrative hearing was held in this matter on September 28, 2017. Petitioner, U.S. Bank National Association ("U.S. Bank"), was represented by Craig Fields and Nicole Johnson of Morrison & Foerster, LLP, and Justin Bell of May, Adams, Gerdes & Thompson, LLP. The South Dakota Department of Revenue ("Department") was represented by John Richter.

The Office of Hearing Examiners, through Hearing Examiner Catherine Duenwald, entered a Proposed Decision and Proposed Order on May 22, 2018. After reviewing the record and the Proposed Decision, I modify the Proposed Decision and Proposed Order. Pursuant to SDCL 1-26D-8, I am required to give my reasons for modifying or rejecting the Hearing Examiner's proposed findings or proposed decision. My modifications and reasons are detailed below:

1. In the first sentence of paragraph 1 of the Statement of Issues, the Hearing Examiner stated the following:

   > On December 28, 2015, the Department issued a Certificate of Assessment to U.S. Bank in the amount of $508,926.11 following an audit of the tax year 2012.

   I modify the first sentence of paragraph 1 of the Statement of Issues to:

   > On December 28, 2015, the Department issued a Certificate of Assessment to U.S. Bank in the amount of $508,926.11 following an audit of the tax year ending December 31, 2012.

   The modification is made for accuracy and consistency purposes.

2. In the second sentence of paragraph 1 of the Statement of Issues, the Hearing Examiner stated the following:

   > The Department also denied a change in the amount for the tax year 2011.

I modify the second sentence of paragraph 1 of the Statement of Issues to:

> During the audit, U.S. Bank made requests for refund relating to the periods ending December 31, 2010 and December 31, 2011. Those refund requests were denied.

This modification is made because the initial statement is vague and incomplete. The modification set forth above is supported by the record, *see* Exhibit 13, and provides complete information on the transactions at issue.

3. In the third sentence of paragraph 1 of the Statement of Issues, the Hearing Examiner stated the following:

> In a letter dated February 24, 2015, U.S. Bank appealed the certificate and requested an administrative hearing on the matter.

I modify the first sentence of paragraph 1 of the Statement of Issues to:

> In a letter dated February 24, 2016, U.S. Bank appealed the Certificate of Assessment and the denial of the refund claims.

The modification is made to correct the date and for completeness. *See* Ex. 15.

4. In paragraph 2 of the Statement of Issues, the Hearing Examiner stated the following:

> The issue before the hearing examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3(2); and if any, what is the appropriate methodology to determine that amount.

I modify paragraph 2 of the Statement of Issues to:

> The issue before the hearing examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3(2). At the time of the assessment, SDCL 10-43-10.3(2) was codified as SDCL 10-43-10.3(3). For ease, this decision will reference SDCL 10-43-10.3(2) throughout.

The modification is made because the language of SDCL 10-43-10.3(2) provides the methodology to determine any deduction. Moreover, the modification is made for clarification purposes.

5. I reject the Hearing Examiner's Proposed Reasoning as I disagree with it, it contains irrelevant and incorrect statements of fact and law, and I find it

incomplete. The reasoning section set forth below is supported by the record and the law.

SDCL chapter 10-43 governs the procedure for South Dakota's bank franchise taxes. SDCL 10-43-2.1 provides, "An annual tax is hereby imposed upon every national banking corporation ... doing business within this state, according to or measured by its net income[.]" "Net income, in the case of a financial institution, is taxable income as defined in the Internal Revenue Code[.]" SDCL 10–43–10.1. "Each taxpayer shall file the final return for the tax year within fifteen days after the taxpayer's federal income tax return is due." SDCL 10–43–30.

In calculating a financial institution's net income, South Dakota law provides for the following deduction:

> Subtracted from taxable income are:
> . . .
> (2) Taxes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC § 1374 and 26 USC § 1375;

SDCL 10-43-10.3(2). ARSD 64:26:04:28 references SDCL 10-43-10.3 and, in pertinent part, further clarifies:

> . . . Net federal income taxes are deductible from taxable income in the year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. . . .

Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See supra.* The steps are as follows:

> **Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."
>
> **Step 2.** Record that number on Schedule J, line 2 of Form 1120.
>
> **Step 3.** Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at net federal income taxes or total tax (Schedule J, line 10).
>
> **Step 4.** Record Total tax liability on Schedule J, line 10.
>
> **Step 5.** That number then flows to line 31 on the face of Form 1120, entitled "Total tax, Schedule J, line 10" and represents the tax imposed or the federal tax liability the entity completing the Form 1120 must pay to the Internal Revenue Service.

HT 71-72; *See Exs.* 1-3, 13. If U.S. Bancorp were doing business within the State of South Dakota, it would use this amount as the deduction on its bank franchise tax return (page 2, line 15 of the bank franchise tax return), since it completed the Form 1120. *See* Exs 6-8, 10-12. However, U.S. Bancorp is not the one doing business within the State of South Dakota – instead, one of its affiliates, U.S. Bank, is.

In this case, instead of using a Form 1120 consolidated return to calculate the federal income tax deduction, U.S. Bank simply calculated the federal income tax deduction by multiplying Line 30, on its pro forma returns by 35%. HT 56-58.

*1. U.S. Bank's Methodology.*

Not only does U.S. Bank's methodology stop short in terms of calculating the net federal income tax, as described above, but it runs counter to federal law. *See* discussion *supra*; 26 CFR 1.1502-75(f)(2). 26 CFR 1.1502-75(f)(2), in pertinent part, discusses the allocation of tax liability to the separate entities of a consolidated federal income tax return.

> (2) Allocation of tax liability. In any case *in which amounts have been assessed and paid* upon the basis of a consolidated return ...

(Emphasis added). Consistent with this provision, taxes imposed, in the context of a federal consolidated return, are those amounts that have actually been assessed and paid. 26 CFR 1.1502-75(f)(2); *see also* Ex. 13. The term "paid" is defined in South Dakota law under SDCL 10-43-1(9) as:

> (9) "Paid," for the purposes of the deductions means paid or accrued or paid or incurred, and the terms paid or incurred and paid or accrued are construed according to the accounting method used for computing net income; received, for the purpose of the computation of net income means received or accrued, and the term received or accrued is construed according to the accounting method used for computing net income;

The question in this case boils down to, what did the IRS actually require U.S. Bank to pay? *See* U.S. Bank Brief at 1-5.

Under U.S. Bank's methodology, it includes credits as taxes imposed. Credits are not taxes imposed. *See Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); HT 37, 71-72. They are simply a reduction to determine what is owed. HT 71-72. U.S. Bank witness, Brett Scribner, conceded "[t]he credit is

not a tax imposed, no." HT 37. Consequently, U.S. Bank's proposed methodology is rejected.

2. *Norwest Corporation and Subsidiaries v. Commissioner of Internal Revenue.*

The question of taxes actually imposed versus hypothetical taxes that could have been imposed has been litigated in cases involving minimum tax, which examined the "taxes imposed" language of the Internal Revenue Code. *Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 70 T.C.M. (CCH) 1601 (T.C. 1995); *Sparrow v. C.I.R.*, 86 T.C. 929 (1986); Ex. 13. Courts have consistently held that "taxes imposed" means taxes actually imposed, not some other hypothetical computation. *Id.*

In *Norwest*, the Court was asked "to determine the proper methodology to be used in calculating the amount of [Norwest's] 'regular tax deduction' for purposes of computing its [corporate] minimum tax liability." *Id.* at 1. In the context of minimum tax, the term "regular deduction" was defined as "an amount equal to the taxes imposed by the chapter for the taxable year." *Id.* Norwest was part of an affiliated group of corporations that filed a consolidated income tax return. *Id.* at 2. In *Norwest*, the petitioner allocated:

> [t]he consolidated tax of the group . . . among those members that had taxable income for the year. [The] allocation was based on the ratio that each member's regular tax (computed on a separate return basis) bore to the sum of the separate return regular taxes of all the members. An additional amount of tax was then allocated to each member that had positive taxable income. The additional amount allocated was the excess of the member's separate return tax over the tax already allocated to the member.

*Id.* at 2. Norwest argued that, in the absence of specific statutory or regulatory guidance, it was reasonable to calculate the "regular deduction" for "taxes imposed" by using a methodology set forth in the consolidated return regulations. *Id.*

The IRS argued, and the Tax Court agreed, that an "allocation of an intercompany liability is not the kind of tax liability contemplated by section 56(c) [the regular deduction]." *Id.* The Court went on to note that (1) under the petitioner's methodology, the regular tax deduction would generally exceed the amount of tax paid on the consolidated taxable income of the affiliated group; and (2) the "legislative history of the minimum tax also indicates that the regular tax refers to the income tax actually imposed and paid." *Id.* at 2-3. Consequently, the petitioner's methodology relying on intercompany liability allocation was rejected. *Id.*; *See also Sparrow v. C.I.R.*, 86 T.C. 929 (1986) (rejecting petitioner's allocation method and holding that "[t]he amounts allocated to each member of an affiliated group under the 1502-33(d) allocation

are certainly derived from and may in the aggregate equal the amount of taxes imposed on the affiliated group pursuant to chapter one of subtitle A of the Code for the taxable year, but are not, themselves, taxes so imposed.").

Like the petitioner in *Norwest*, U.S. Bank is part of an affiliated group of corporations that filed a consolidated income tax return. *Id.* at 2. In this case, U.S. Bank attempts to allocate its tax liability based on a tax sharing agreement. *See* U.S. Bank's Brief. First and foremost, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

Furthermore, the tax sharing agreement parallels the allocation methods that were explicitly rejected in *Norwest* and *Sparrow*. U.S. Bank witness Brett Scribner testified that the tax sharing agreement:

> [I]s designed to share or provide the – allocate the proper amount of tax liability or benefit that is generated by each individual company in a particular group.
>
> So it applies to federal consolidated returns. It also applies to the allocation of what are known as unitary or combined state income tax liabilities. There are states, some states, that also tax a consolidated or a combined group of companies similar to the federal process. And so the federal is a consolidated return.
>
> So this is designed to allocate that and then make sure that the payments are made back and forth so that each company is *theoretically* made whole either for the benefits it generated for the group or for the tax it had to pay for the group. Or because it had income or loss, as the case may be.

HT 23 (emphasis added). The tax sharing agreement does not answer what was actually paid – and is only theoretical. HT 23; *See* Ex. 18. Moreover, like in *Norwest*, the allocation utilized by U.S. Bank is not the kind of tax liability contemplated by SDCL 10-43-10.3(2) in that it is not taxes imposed by the Internal Revenue Code. HT 38 (Again, U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Furthermore, also like in *Norwest* and, as discussed above, the tax deduction claimed by U.S. Bank is based on a number that greatly exceeds the





Filed: 11/26/2018 2:51 PM CST Hughes County, South Dakota 32CIV18-000169
- Page 657 -

amount of taxes paid by the entire consolidated group. *See* discussion *supra*. Based on the holdings in *Norwest* and *Sparrow* U.S. Bank's intercompany liability allocation argument is rejected.

U.S. Bank's witness, Brett Scribner, conceded the following:

- The FDIC does not impose tax. HT 38.
- The IRS does not dictate the terms of the tax sharing agreement and the tax sharing agreement is not an imposition of tax under the Internal Revenue Code. HT 38-39.
- Estimated payments are not taxes imposed. HT 39.

As to the estimated payment concession, Exhibit 17 was improperly admitted into evidence. SDCL 10-59-3 and 10-59-7 require that all evidence of reduction, deduction, or exemption be provided within 60 days of the commencement of the audit or it need not be considered. In this case, Exhibit 17 was not presented until September 22, 2017, nearly three years after the November 3, 2014 audit commencement date. *Compare* HT 18 *to* Ex. 16. The evidence offered is exactly the type contemplated by SDCL 10-43-43.1. Moreover, U.S. Bank offered no good reason for not presenting it until September 22, 2017. *See* HT 18, AR. Based on the preceding, Exhibit 17 need not be considered.

The question is: What taxes were imposed under the Internal Revenue Code? HT 4. The tax sharing agreement, the OCC, the Federal Reserve System, and the FDIC do not impose tax under the Internal Revenue Code nor are they taxes imposed under the Internal Revenue Code. *See* I.R.C. Therefore, they are all irrelevant in answering the question of what deduction, if any, U.S Bank is entitled to under SDCL 10-43-10.3(2).

*3. U.S. Bank's Comparisons to Missouri's Administrative Rules are Misplaced.*

U.S. Bank asserted that its methodology for computing the federal tax deduction is the same it uses for Missouri's bank franchise tax purposes. U.S. Bank Brief at 12. Despite that Missouri's law is irrelevant, U.S. Bank stated that "[t]he Missouri Department of Revenue has promulgated a regulation that interprets its federal tax deduction to equal the federal income tax 'as if a separate federal return had been filed' (i.e., separate company federal taxable income multiplied by 35%). 12 Mo. Code Regs. 10-10.135(2)(B) (methodology for accrual based taxpayers)." This statement is inconsistent with the administrative rule cited.

> 12 Mo. Code Regs. 10-10.135(2) states, in pertinent part:
> (2) Consolidated Group. A taxpayer that is a member of an affiliated group of corporations, which files a consolidated federal

> income tax return, shall be allowed a deduction for federal income taxes paid or accrued during the income period, as follows:
>
> (B) Accrual Basis. *The deduction shall equal the federal form, Schedule J, total tax* liability as if a separate return had been filed. The taxpayer who is a member of an affiliated group of corporations shall include in gross income benefits received for a net operating loss or unused credits generated during the current period. In the event an affiliated group incurs a net operating loss carryback or a carryback of unused credits, income shall be increased by an amount equal to the member's separately computed share of the federal refund received from any carryback to consolidated return years, plus the amount of any federal refund received which results from a carryback to any member's separate return years. Income shall be increased by an amount equal to the federal refunds that would have been received if amended federal returns would have been filed by the taxpayer on a separate return basis. This refund could result from a net operating loss (NOL) carryback or a carryback of unused credits.

(Emphasis added). "Schedule J, Total Tax," is line 10 of the Schedule J and flows to line 31 on the Form 1120. Exs. 1-3. This parallels the calculation used to calculate South Dakota's net federal income tax deduction. *See supra.* The regulation's language is consistent with the position taken by the Department in this matter. *Compare* discussion *supra to* 12 CSR 10-10.135(2)(b).

4. *U.S. Bank Failed to Preserve its Alternative Argument.*

U.S. Bank asks that the Tax Sharing Agreement payments be deductible as ordinary and necessary business expenses in computing federal taxable income under SDCL 10-43-10.1. HT 13-14. First, this request was never presented to the auditor, nor was it mentioned in U.S. Bank's request for hearing. Exs. 13, 15; SDCL 10-59-9 provides, in pertinent part:

> Any taxpayer against whom a certificate of assessment is issued may request a hearing before the secretary if the taxpayer believes that the assessment is based upon a mistake of fact or an error of law. A request for hearing shall be made in writing within sixty days from the date of the certificate of assessment and shall contain a statement indicating the portion of the assessment being contested and the mistake of fact or error of law the taxpayer believes resulted in an invalid assessment. Amended or additional statements of facts or errors of law may be made not less than fourteen days prior to the hearing if the hearing examiner determines such additional or amended statements are in the interest of justice and do not prejudice either party.

Moreover, the Hearing Examiner initially stated that, "[t]he issue before the Hearing Examiner is what is the federal income tax deduction, if any, that U.S. Bank is entitled to under SDCL 10-43-10.3[(2)], and, if any, what is the appropriate methodology to determine that amount?". HT 4. In response, U.S. Bank's counsel asked to clarify two things, (1) the years at issue; and (2) that SDCL 10-43-10.3(2) used to be codified at (3). HT 6. U.S. Bank never raised the SDCL 10-43-10.1 argument, and as such, it is not properly before the Hearing Examiner and must be rejected. *See* SDCL 10-59-9.

It appears that this is an issue that U.S. Bank should have raised to the IRS if the Tax Sharing Agreement payments were actually business expenses. *See* U.S. Bank Brief at 13-14. However, they did not do so with either the Department or the IRS. Therefore, U.S. Bank's argument is rejected. Moreover, a review of IRC §§ 162 and 164 make it clear that payments to affiliates are not a federal tax or a deduction. *See* IRC §§ 162 and 164.

5. *A Deduction was Available to U.S. Bank*

U.S. Bank stated in its brief that, "[i]t is undisputed that U.S. Bank is entitled to the Federal Tax Deduction." U.S. Bank Brief at 1. The Department agreed that a deduction would be available to U.S. Bank if it would have shown that it fit squarely within the plain language of the deduction. *See Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990). In fact, the Department, through the Notice of Intent and issuing IDR #002, specifically requested the methodology utilized on the 2010 and 2011 originally filed returns. Ex. 9; Ex. 13 at 18-19; Ex. 16; HT 60-31. Considering the information requested is statutorily required to be maintained by the taxpayer and presented to the Department upon request, there is no reason that U.S. Bank did not provide it. *See* SDCL 10-43-43.1.

> 10-43-43.1. Each person subject to tax under this chapter shall make and keep for a period of six years after federal taxable income has been finally determined by the United States any records as required by the secretary of revenue or otherwise necessary for the administration of this chapter. The records shall, at all times during business hours of the day, be subject to inspection by the secretary to determine the amount of tax due.
>
> If in the normal conduct of the business, the required records are maintained and kept at an office outside the State of South Dakota, it shall be a sufficient compliance with this section if the records are made available for audit and examination by the Department of Revenue at the office outside of South Dakota.

Regardless, U.S. Bank never provided information as to its computation of the deduction as initially filed nor did it provide a methodology consistent with the

plain language of SDCL 10-43-10.3(2). Ex. 9; Ex. 13 at 18-19; Ex. 16; HT 60-31. Because U.S. Bank never provided the requested information to the Department, the Department's auditor was left with one of two options: (1) accept U.S. Bank's methodology; or (2) deny U.S. Bank's claimed deductions in full. HT 62-63. The Department correctly denied U.S. Bank's claimed deduction in full as U.S. Bank failed to meet its burden to receive the deduction. *See Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990).

6. In paragraph 10 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank and U.S. Bancorp entered into an Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp ("Tax Sharing Agreement") with certain affiliates. Ex. 18; HT. 22.

I reject paragraph 10 of the Findings of Fact as it is irrelevant in determining the SDCL 10-43-10.3(2) deduction. The tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

7. In paragraph 11 of the Findings of Fact, the Hearing Examiner stated:

> The Tax Sharing Agreement, in part, provides for the allocation of the federal income tax liability among the members of the consolidated group, including U.S. Bank. *Id.*

I reject paragraph 11 of the Findings of Fact because the statement is incorrect and is irrelevant in determining the SDCL 10-43-10.3(2) deduction. Again, the tax sharing agreement is an internal agreement between U.S. Bancorp and its members and is used for accounting purposes. *See* HT 38. U.S. Bank admitted that the tax sharing agreement does not represent taxes imposed pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). It is a contract. HT 38 (Scribner testified that "[i]t's a binding contract amongst the entities"); *see also Black Hills Truck & Trailer, Inc. v. S. Dakota Dep't of Revenue*, 2016 S.D. 47, ¶ 26, 881 N.W.2d 669, 676 (holding taxpayers cannot contract around the law.).

8. In paragraph 12 of the Findings of Fact, the Hearing Examiner stated:

> It is designed to allocate the proper amount of the federal tax liability or benefit to the member that generated the income or loss. HT. 22.

I reject paragraph 12 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision.

9. In paragraph 13 of the Findings of Fact, the Hearing Examiner stated:

> Pursuant to the Tax Sharing Agreement, each member's federal tax liability is computed as if it had filed a separate federal income tax return (i.e., separate company federal taxable income multiplied by 35%). Ex. 18; HT. 24.

I reject paragraph 13 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision. Moreover, the Tax Sharing Agreement does not compute each members federal tax liability. *See* ¶ 7.

10. In paragraph 14 of the Findings of Fact, the Hearing Examiner stated:

> If a member of the consolidated group had a loss for the year, the member was paid for the use of that loss (i.e., the loss multiplied by 35%). Ex. 18; HT. 24-25.

I reject paragraph 14 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision.

11. In paragraph 15 of the Findings of Fact, the Hearing Examiner stated:

> In accordance with the U.S. Bancorp Tax Sharing Agreement, U.S. Bank paid the following taxes:

U.S. Bank's Federal Taxes Paid

| Tax Year Ended | Taxable Income | Agreement Rate | Tax Paid to IRS |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | x 35% = | $840,313825 |
| December 31, 2011 | $2,342,73,149 | x 35% = | $819,955,902 |
| December 31, 2012 | $4,925,219,278 | x 35% = | $1,723,826,747 |

Ex. 1-6; 18.

I reject paragraph 15 of the Findings of Fact for the same reasons as contained in ¶ 7 of this decision. U.S. Bank admitted that the tax sharing agreement does not represent taxes *imposed* pursuant to the Internal Revenue Code. HT 38 (U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S."). Consequently, it does not represent taxes paid either.

12. In paragraph 16 of the Findings of Fact, the Hearing Examiner stated:

> The 35% tax amount paid by U.S. Bank to the IRS is not necessarily the amount of tax imposed by the IRS upon U.S. Bank.

I reject paragraph 16 of the Findings of Fact for the same reasons contained in ¶¶ 7 and 11 of this decision.

13. In paragraph 17 of the Findings of Fact, the Hearing Examiner stated:

> The Tax Sharing Agreement is a binding contract between the affiliates of U.S. Bancorp. Ex. 18; HT. 24, 38.

I modify paragraph 17 of the Findings of Fact to:

> The tax sharing agreement is a binding contract amongst the entities.

The reason for this modification is to make it consistent with Brett Scribner's testimony. U.S. Bank witness Brett Scribner admitted that "the tax sharing agreement itself is not an imposition of tax by the I.R.S." HT 38 It is a contract. *Id.* Scribner testified that "[i]t's a binding contract amongst the entities"). *Id.*

14. In paragraph 18 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bank complied with the terms of the Tax Sharing Agreement as required by its regulators. HT. 25. U.S. Bank and U.S. Bancorp undergo numerous internal and independent audits by a number of regulators on a regular basis.

I reject paragraph 18 of the Findings of Fact for the same reasons contained in ¶ 6 of this decision.

15. In paragraph 23 of the Findings of Fact, the Hearing Examiner stated:

> The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed by the Internal Revenue Service or the federal tax liability. HT 7-72; *See* Exs. 1-3, 13.

I modify paragraph 23 of the Findings of Fact to:

> The net federal income tax figure is then recorded on line 31, labeled "Total tax, Schedule J, line 10," of the Form 1120 and represents the tax imposed or the federal tax liability that must be paid to the Internal Revenue Service. HT 7-72; *See* Exs. 1-3, 13.

The modification is made for accuracy and precision purposes.

16. In paragraph 25 of the Findings of Fact, the Hearing Examiner stated:

> U.S. Bancorp filed consolidated federal income tax returns, which included U.S. Bank. Ex. 1-3; HT. 23-24.

I reject paragraph 25 of the Findings of Fact for clarity purposes and being unnecessary. As set forth in Findings of Fact 3 through 6:

3. U.S. Bank is a member of an affiliated group of corporations under U.S. Bancorp. HT 9, 56; Ex. 13 at 1.

4. As the parent company of the consolidated group, U.S. Bancorp is responsible for filing a Form 1120, U.S. Corporation Income Tax Return. HT 9-10, 56; Ex. 13 at 1.

5. U.S. Bank's activities were included in the federal consolidated return, Form 1120, filed by U.S. Bancorp. HT 56.

6. As an affiliated company of a consolidated group, U.S. Bank does not file a separate Form 1120, because its activities were included on the federal consolidated income tax returns filed by U.S. Bancorp for the years at issue. HT 9-10, 56; Exs. 1-3; *see* also Ex. 13.

17. In paragraph 26 of the Findings of Fact, the Hearing Examiner stated:

> The total income tax shown as due, before application of the credits, on the consolidated returns was as follows:
>
| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253.649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

> Ex. 1, p.3; Ex. 2, p.3; Ex. 3 p.3; HT.11

I reject paragraph 26 of the Findings of Fact because it is an incorrect statement that is inconsistent with the record. Moreover, there is no "total income tax shown as due" on the consolidated returns. The tax calculation is as follows:

> Schedule J of the Form 1120, U.S. Corporation Income Tax Return, entitled "Tax calculation," provides the tax calculation to determine the net federal income taxes of a financial institution. *See supra*. The steps are as follows:
>
> > **Step 1.** Multiply taxable income (line 30 on page 1 of Form 1120) by the appropriate tax rate to arrive at "income tax."

| | | |
|---|---|---|
| STATE OF SOUTH DAKOTA | ) | IN CIRCUIT COURT |
| COUNTY OF HUGHES | ) | SIXTH JUDICIAL CIRCUIT |
| U.S. Bank National Association | ) | 32CIV18-000169 |
| v. | ) | |
| South Dakota Department of Revenue | ) | **MEMORANDUM DECISION AND ORDER** |

This is an administrative appeal, pursuant to SDCL Chapter 1-26, of a final decision of the South Dakota Department of Revenue. The Department rejected the methodology of U.S. Bank for calculating its federal income tax deduction for purposes of the South Dakota bank franchise tax for tax years 2010, 2011, and 2012. As a result, the Department denied U.S. Bank's request for a refund for 2010 and 2011 and disallowed the entire deduction for 2012. The Department issued a certificate of assessment for additional tax and interest for 2012.

After full consideration of the administrative record, the briefs submitted, and the arguments made by the attorneys at oral argument, the Court hereby AFFIRMS the Department's decision.

## PRELIMINARY STATEMENT

This opinion references several agencies and documents. The South Dakota Department of Revenue is "the Department," and the South Dakota Office of Hearing Examiners is "the OHE." U.S. Bank National Association is "U.S. Bank." The Internal Revenue Service is the "IRS," and the United States Department of Treasury is the "U.S. Treasury."

The administrative record is "AR," followed by the page number. The transcript of hearing before the OHE (AR 303-407) is "HT," followed by the transcript page number. All referenced exhibits (AR 21-297) are part of the OHE hearing record.

The South Dakota bank franchise tax is the "SD BFT." The Notice of Proposed Adjustment #1 is the "NOPA," and the Information Document Request #002 is the "IDR2." A tax year for purposes of both the SD BFT returns and the federal corporate income tax returns is from January 1 to December 31.

The federal corporate income tax return is the "Form 1120." "Schedule J" is part of that form. The federal corporate income tax return of the consolidated group is the "U.S. Bancorp Form 1120." U.S. Bank's pro forma federal corporate income tax return is the "Pro Forma 1120." The "Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp" is the "Tax Sharing Agreement."

The Proposed Decision, Findings of Fact and Conclusions of Law and Proposed Order of OHE (AR 585-600) is the "Proposed Decision." The Final Decision and Order of the Department (AR 607-626) is the "Final Decision."

Finally, SDCL Chapter 10-43 (bank franchise tax) was extensively revised after the audit referenced herein. SL 2016 Chapt. 62. Unless otherwise indicated, this opinion cites to the pre-2016 version of Chapter 10-43 (2010 main volume). Prior to 2016, the federal income tax deduction at issue was codified at SDCL 10-43-10.3(3). In 2016, SDCL 10-43-10.3*(3)* was renumbered to 10-43-10.3*(2)*, with no substantive change to the language. SL 2016 Chapt. 62, § 6. For consistency, SDCL 10-43-10.3(*3*) (2010) is the version cited throughout this opinion.

## FACTS AND PROCEDURAL HISTORY[1]

### U.S Bank Business Structure and Consolidated Federal Tax Returns

[1]The Department rejected as irrelevant some findings in the Proposed Decision regarding the Tax Sharing Agreement and federal returns. Final Decision at AR 615-623. However, those facts are necessary background to understand the issues.

U.S. Bank is a financial institution, principally engaged in the business of banking, with its headquarters located in Minneapolis, Minnesota. HT 8, 55. It is a member of a consolidated group of corporations owned by U.S. Bancorp, which is a publicly traded holding company. HT 9. U.S. Bank uses accrual basis accounting; it recognizes revenue or expenses when actually incurred, even if cash payment would occur at a different time. HT 19; Ex. 15 at SR 223.

U.S. Bancorp, as the parent company of the consolidated group, is responsible for filing the Form 1120 U.S. Corporation Income Tax Return. HT 9-10, 56. For all years at issue, U.S. Bancorp filed the consolidated group's Form 1120 (U.S. Bancorp 1120), which included U.S. Bank's activities amongst the supporting schedules filed with the return. HT 10-11, 56-57; Ex. 1 at AR 30; Ex. 2 at AR 61; Ex. 3 at AR 93. U.S. Bank's role in the process was to provide its information, which was used to determine the income and expenses and the taxes paid and credits on the U.S. Bancorp Form 1120. HT 10-11, 56-57.

Schedule J of the Form 1120, entitled "Tax Computation," provides the tax calculation to determine the net federal income taxes of a financial institution. Ex. 1 at AR 23; Ex. 2 at AR 54; Ex. 3 at AR 87. The calculation on Schedule J begins by multiplying Taxable Income (line 30 on p. 1 of the Form 1120) by the appropriate tax rate to arrive at Income Tax (Schedule J, line 2) HT 71-72. That number is then reduced by the foreign tax credit and general business credit (Schedule J, lines 5a and 5c) to arrive at Total Tax (Schedule J, line 10 or 11).[2] This Total Tax figure is then recorded on line 31 of the Form 1120 (p. 1). Ex. 1 at AR 21; Ex. 2 at AR 52; Ex. 3 at AR 55. This represents the federal tax liability that must be paid to the IRS.

U.S. Bank and U.S. Bancorp entered into a Tax Sharing Agreement to allocate the proper amount of federal tax liability or benefit to each individual company in the consolidated group

[2] The "Total Tax" is line *10* on the 2010 Form 1120 Schedule J and line *11* on the 2011 and 2012 Form 1120 Schedule J. Ex. 1 at AR 23; Ex. 2 at AR 54; Ex. 3 at AR 87. The remainder of this opinion will call it line 11.

that generated the income or loss. HT 22; Ex. 18 at AR 264-72. This Tax Sharing Agreement was executed in 2005 and remained in effect during the relevant period. HT 24.

Under the Tax Sharing Agreement, U.S. Bank pays to U.S. Bancorp "an amount up to [U.S. Bank's] separate income tax liability attributable to the net taxable income of [U.S. Bank] that would have been paid if [U.S. Bank] had filed a separate tax return." Ex. 18 at AR 264. According to U.S. Bank, each member of the consolidated group computes its federal taxable income, which is the amount before credits, and multiplies it by the federal tax rate of 35%. HT 24. If the member incurs a loss, the member receives a refund of that tax benefit to the extent the loss is used in determining the consolidated taxable income. HT 24-25; Ex. 18 at AR 265. Members also receive refunds or cash payments for the credits they generate. HT 25.

The Tax Sharing Agreement is a binding contract amongst the entities. HT 24, 38; Ex. 18. "[P]ayments are made back and forth so that each company is theoretically made whole either for the benefit that is generated for the group or for the tax it had to pay for the group." HT 23. U.S. Bank was audited by non-IRS regulators[3] and its own independent auditors to verify that it and other affiliates were making the payments amongst each other internally, according to the Tax Sharing Agreement, to ensure that the bank was maintaining proper liquidity and capital to operate as a bank. HT 25-28. However, the IRS does not dictate the terms of the Tax Sharing Agreement, and the amount paid by U.S. Bank pursuant to the agreement is not necessarily the amount of tax imposed upon U.S. Bank by the IRS. HT 38. The Tax Sharing Agreement itself is not an imposition of tax by the IRS. *Id.*

The total federal income tax of the consolidated group on the U.S. Bancorp Form 1120 (Schedule J, line 2), before application of credits, was:

[3] These included the Office of the Comptroller of the Currency (OCC), the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC).

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

HT 11; Ex. 1 at AR 23; Ex. 2 at AR 54; Ex. 3 at AR 87.

The total tax liability due to the IRS by the consolidated group on the U.S. Bancorp Form 1120 (Schedule J, line 11), after application of credits, was:

| Tax Year Ended | Total Tax Liability |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

*Id.*

Because U.S. Bank's activities are included in the U.S. Bancorp Form 1120, U.S. Bank does not file a separate Form 1120. HT 10-11. Instead, U.S. Bank prepares a pro forma, or "matter of form," Form 1120 (Pro Forma 1120). HT 19-21. The Pro Forma 1120 is not signed or filed with the IRS. HT 21, 57. It shows what U.S. Bank's federal taxable income would be if it was standing on its own subject to tax. HT 20-21. The first thirty lines are filled out, and it includes a Schedule L, balance sheet. HT 20-21; Ex. 4-6 at AR 121-35. However, the Pro Forma 1120 does not show credits or computation of federal tax in Schedule J or line 31 (p. 1). Ex. 4 at AR 121, 123; Ex. 5 at AR 126, 128; Ex. 6 at AR 131, 133. It is intended as a starting point for the computation of SD BFT. HT 20-21.

According to the Pro Forma 1120, U.S. Bank's federal taxable income consisted of the majority of the consolidated group's taxable income. These amounts were:

| Tax Year Ended | U.S. Bank Fed. Taxable Inc. | U.S. Bancorp Fed. Taxable Income | % |
|---|---|---|---|
| Dec. 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| Dec. 31, 2011 | $2,342,731,149 | $3,567,245,451 | 66% |
| Dec. 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Ex. 1 at AR 21, 30; Ex. 2 at AR 52, 61; Ex. 3 at AR 85, 93; Ex. 4 at AR 121; Ex. 5 at AR 126; Ex. 6 at AR 131.

**South Dakota Bank Franchise Tax Filings**

U.S. Bank does business within South Dakota, although U.S. Bancorp does not. U.S. Bank is subject to the SD BFT, which imposes an income tax on banks and financial corporations. SDCL 10-43-2.1. For purposes of the SD BFT, U.S. Bank could deduct from its taxable income the "taxes imposed on the financial institution within the tax year, under the Internal Revenue Code..." SDCL 10-43-10.3(3). On the SD BFT return, this deduction is described as "Federal income taxes paid or accrued" at line 15. Ex. 10 at AR 151; Ex. 11 at AR 155; Ex. 12 at AR 160.

2005-2011 original returns

U.S. Bank filed SD BFT returns for tax years 2005-2012. From 2005 to 2007, U.S. Bank calculated the deduction by multiplying its federal taxable income by 35%, the federal income tax rate. HT 32-33. From 2008 to 2011, U.S. Bank changed its calculation of the deduction. For those years, the deduction was calculated by "taking separate taxable income of U.S. Bank, as a ratio over the total positive taxable income of the consolidated group, and that ratio was multiplied by total federal tax after credits." HT 30.

Using this method, U.S. Bank timely filed its tax year 2010 and 2011 SD BFT returns on September 27, 2011, and September 11, 2012, respectively. HT at 30; Ex. 7 at AR 136-40; Ex. 8 at AR 142-47. Each return included a copy of the Pro Forma 1120 for that tax year, but it did not include a copy of the U.S. Bancorp Form 1120. Ex. 15 at AR 231, 238. The 2011 SD BFT return listed an overpayment of estimated tax. Ex. 8 at AR 142.

At some point after submitting the original 2010 and 2011 SD BFT returns, U.S. Bank realized the discrepancy between how its pre-2008 and post-2008 federal income tax deduction had been calculated on its SD BFT returns. HT 30-31. At that point, U.S. Bank decided to go back to calculating the deduction in the same way it did from tax years 2005 to 2007, which meant taking its separate federal taxable income by 35%. HT 31. U.S. Bank filed amended 2010 and 2011 SD BFT returns,[4] and the 2012 SD BFT return, utilizing this methodology. The chronological timeline of these filings is laid out below.

2011 Amended Return

On December 27, 2012, U.S. Bank filed an amended tax year 2011 SD BFT return. HT 31-33; Ex. 11 at AR 154-58. The amended 2011 SD BFT return substantially increased the federal income tax deduction claimed on the original 2011 return; it went from $346,485,702 to $819,955,902. Ex. 8 at AR 143 (line 15); Ex. 11 at AR 155 (line 15). The explanation, contained in the amended return, stated, "Return is amended to adjust the state deduction for federal income taxes paid or accrued, Page 2 Line 15." Ex. 11 at AR 157. By increasing the amount of the deduction claimed, the amended 2011 SD BFT return reduced U.S. Bank's SD BFT liability from $258,866 on the original return to $193,101 on the amended return. Ex. 8 at AR 142; Ex. 11 at AR 154. This amounted to a decrease of $65,765. Ex. 15 at AR 238. When combined with the overpayment of estimated tax listed on the original 2011 SD BFT return, the total overpayment was listed as $77,899. *Id.* During the audit process discussed below, U.S. Bank requested a refund of this amount. Ex. 15 at AR 217.

[4] Tax years 2008 and 2009 were outside the statute of limitations, and U.S. Bank has not appealed any determination of the Department regarding those years. Ex. 15 at AR 217; Appellant's Brief at n. 3.

The total tax liability of the consolidated group on the 2011 US Bancorp Form 1120, subsequently received by the Department, was $617,186,234. Ex. 2 at AR 52 (line 31). Therefore, the $346,485,702 deduction reflected on U.S. Bank's *original* 2011 SD BFT return was about 56% of the total tax liability of the consolidated group. The $819,955,902 deduction claimed on U.S. Bank's *amended* 2011 SD BFT return, however, was about 133% of the total tax liability of the consolidated group. In other words, the deduction on the amended 2011 SD BFT return was $202,769,668 more than the entire consolidated group federal tax liability for 2011. Ex. 15 at AR 239-40.

2012 Return

On September 26, 2013, U.S. Bank timely filed its 2012 SD BFT return using the same methodology as the amended 2011 SD BFT return (separate taxable income by 35%). HT 30-31; Ex. 12 at AR 159. The 2012 SD BFT return included a copy of the 2012 Pro Forma 1120 but did not include a copy of the 2012 U.S. Bancorp Form 1120. Ex. 15 at AR 240. On the 2012 SD BFT return, U.S. Bank claimed a federal income tax deduction of $1,723,826,747. Ex. 15 at AR 160 (line 15). The 2012 U.S. Bancorp Form 1120, subsequently received by the Department, showed a total consolidated federal tax liability of $981,865,059. Ex. 3 at AR 85 (line 31). The $1,723,826,747 deduction claimed on the 2012 SD BFT return was more than 175% of the total tax liability of the consolidated group. In other words, U.S. Bank's claimed federal income tax deduction on its 2012 SD BFT return was $741,961,688 more than the entire consolidated group federal tax liability for 2012. Ex. 15 at AR 241.

October 2013 Documentation Request

In October of 2013, the Department requested additional documentation regarding U.S. Bank's amended 2010 SD BFT[5] and amended 2011 SD BFT returns. In part, the Department requested pages 1-5 of the 2010 and 2011 U.S. Bancorp Form 1120 and "consolidated numbers for the members of the consolidated group that tied into pages 1-5." Ex. 15 at AR 231, 239. The Department also requested an explanation of the computation of federal tax liability (line 15) on the amended 2010 SD BFT return, including "documentation that the amounts claimed were imposed upon a financial institution under the Internal Revenue Code." Ex. 15 at AR 232.

2010 Amended Return

In response to the Department's October 2013 requests, U.S. Bank, on November 26, 2013, filed a second amended 2010 SD BFT Return. Ex. 15 at AR 232. The primary adjustment on the second amended 2010 SD BFT return was to claim a federal income tax deduction in the amount of $862,815,157 rather than the $317,843,634 reported on the original return. Ex. 7 at AR 137 (line 15); Ex. 10 at AR 151 (line 15); Ex. 15 at AR 232. On the return, this was represented to be a deduction equal to 35% of U.S. Bank's federal taxable income. Ex. 10 at AR 153; Ex. 15 at AR 233.

The total federal tax liability of the consolidated group for 2010 was $534,594,245. Ex. 15 at AR 233. The $317,843,634 claimed on original 2010 SD BFT return represented about 61% of that total consolidated tax liability. The $862,815,157 deduction claimed on the second amended 2010 SD BFT return, however, represented about 161% of that total consolidated tax liability. As noted by the auditor, the claimed deduction on the second amended 2010 SD BFT

[5] U.S. Bank's first amended tax year 2010 SD BFT return was submitted on September 9, 2013, and reflected a taxable income increase as a result of an IRS audit. HT 73-74; Ex. 15 at SR 231. Both the 2010 and 2011 amended SD BFT returns prompted requests for information by the Department.

return was $328,220,912 more than the entire consolidated group federal tax liability. Ex. 15 at U.S. Bank requested a refund of amounts it alleged were overpaid. Ex. 10 at AR 150.

**Department Audit of Tax Years 2011 and 2012**

Based upon these returns, the Department determined that an audit was necessary. On October 2, 2014, the Department sent U.S. Bank a Notice of Intent to Audit the 2011 and 2012[6] SD BFT returns, with a commencement date of November 3, 2014. HT 58-59; Ex. 16 at AR 244-46. The Notice of Intent stated, "All records, books, and documents must be prepared for presentation to the auditor on the commencement date of the audit. Any documents or records required to be kept by law to evidence reduction, deduction, or exemption from tax (such as exemption certificates) not prepared for presentation to the auditor within sixty days of the commencement date of the audit need not be considered by the auditor." Ex. 16 at AR 245-46.

On October 23, 2014, the Department issued Information Document Request #002 (IDR2) to U.S. Bank, which included a November 4, 2014, deadline to respond. Ex. 9 at AR 148-149; Ex. 15 at AR 240-241. Regarding the tax year 2010 and 2011 SD BFT returns, IDR2 requested:

1. The US Bancorp...Forms 1120 for tax years 2011 and 2012, pages 1, 2, 3, and 4 and the Profit and Loss computation for ... all of the Affiliated Group Members.

2. The Tax Sharing Agreement...

3. The internal work papers and legal analysis to support the amounts reported on SD BFT page 2, Line 15 as Federal income taxes paid or accrued. Ex. 9 at AR 148.

[6] The 2010 SD BFT returns were not audited because it was beyond the statute of limitations. Ex. 15 at AR 224.

The Department eventually received the information referenced in numbers 1 and 2 above, but it took multiple requests. HT 60-61, 80, 82; Ex. 24 at AR 297. Regarding item 3, the internal work papers and legal analysis, on November 15, 2014, U.S. Bank responded that someone at the Department told them to use 35% of taxable income for the SD BFT return, line 15 deduction, but the name was not provided. HT at 61-62; Ex. 15 at AR 241. *See* SDCL 10-59-27 (Reliance on advice from the Department must be in writing and be retained by taxpayer). No other relevant information was provided to the Department at that time regarding item 3 of IDR2, despite the Department providing an extension of time. HT 62; Ex. 15 at 241. The record also indicates that the Department requested credits claimed by U.S. Bank, but there is no indication that this information was received. Ex. 24 at 297.

On December 22, 2014, the Department issued a Notice of Proposed Adjustment #1 (NOPA) in which it denied U.S. Bank's methodology for calculating the deduction. HT 65. The NOPA identifies the facts, the law, the argument, and a conclusion or position. It asks the taxpayer to agree or disagree. If the taxpayer does not agree, it requires an auditor to continue with the audit and provide formalized conclusions. HT 65. Ex. 15 at AR 241. *See* SDCL 10-59-35; ARSD 64:01:01:28.

On May 8, 2015, U.S. Bank submitted a response to the NOPA. U.S. Bank did not agree and believed it should be able to use the separate company method of multiplying its separate company federal taxable income by 35%. It claimed the statute was ambiguous regarding the calculation of the federal income tax deduction, and the separate company tax sharing should be deemed a federal tax. Ex. 15 at AR 241.

U.S. Bank provided no proof of payment of the 35% amount or other internal workpapers to support the amount, beyond the U.S. Bancorp Form 1120 and Pro Forma 1120. Ex. 15 at AR

242; Ex. 24 at AR 29. Neither of those forms show a computation of federal tax for U.S. Bank or credits attributable to U.S. Bank. HT 64.

The Department interpreted SDCL 10-43-10.3(3) to allow a deduction for taxes actually imposed and paid. HT 81-82; Ex. 15 at AR 225-27, 234, 236-37. Overall, the Department could not reconcile the amount reported on U.S. Bank's SD BFT returns to the federal taxes imposed upon and paid by the consolidated group. HT 63, 71-73. According to the auditor, U.S. Bank's methodology did not make sense, "[b]ut it was clear to us that they wouldn't get a deduction of $2 if the total assessment was only 50 cents." HT 64.

The auditor believed that U.S. Bank should be allowed some type of deduction, but he did not know what that methodology should be. HT 64, 80. If U.S. Bank had given the auditor information necessary to review the exact amount of money sent up to U.S. Bancorp to pay U.S. Bank's taxes, it could have been used as a starting point and go up or down. HT 80-81. But without that information, the auditor could not make a determination. HT 80.

On December 28, 2015, the Department completed the audit of U.S. Bank's SD BFT returns for tax years 2011 and 2012. HT 69; Ex. 13 at AR 168. The Department rejected U.S. Bank's methodology for calculating the deduction. The Department disallowed in full the federal income tax deduction claimed by U.S. Bank for 2012. Ex. 15 at AR 243. This resulted in a deficiency of $364,169. A certificate of assessment was issued on December 28, 2015, for that amount plus $144,757.11 in interest, for a total of $508,926.11. Ex. 14.

The Department also did not accept the federal income tax deduction claimed by U.S. Bank in the amended 2010 and 2011 SD BFT returns. However, because the Department was time barred from issuing an assessment for more tax in those years, it could not disallow the deduction in full. Ex. 13 at AR 168; SDCL 10-59-16. It instead adjusted these returns to the

auditor's report and denied in full U.S. Bank's refund requests for 2010 and 2011. Ex. 15 at AR 224, 235, 240.

**Protest and Appeal**

On February 24, 2016, U.S. Bank protested the Certificate of Assessment for 2012 and denial of its refund claims for 2010 and 2011 and requested a hearing. Ex. 15 at AR 217-19.[7] In the Letter of Protest, U.S. Bank argued that there was no South Dakota law or guidance regarding the proper calculation of taxes paid when the financial institution is included on a consolidated federal tax return and that the ambiguous tax law was to be construed liberally in its favor. Ex. 15 at AR 218.

A hearing was held by OHE on September 28, 2017. On May 22, 2018, OHE issued its Proposed Decision in which it recommended that the Certificate of Assessment for 2012 and denial of refund requests for 2010 and 2011 be affirmed in all respects. On July 18, 2018, the Department issued its Final Decision affirming the ultimate conclusion of the OHE but modifying some of the underlying findings of fact, conclusions of law, and reasoning.

A Notice of Appeal was timely filed and served on August 17, 2018, pursuant to SDCL 1-26-30.2 and 1-26-31, and the venue was Hughes County pursuant to SDCL 1-26-31.1.

## ISSUES

I. **DID THE DEPARTMENT ERR IN REJECTING U.S. BANK'S METHODOLOGY FOR CALCULATING THE SDCL 10-43-10.3(3) DEDUCTION FOR 2010, 2011, AND 2012?**

II. **AFTER REJECTING U.S. BANK'S METHODOLOGY, DID THE DEPARTMENT ERR IN NOT ALLOWING U.S. BANK AN ALTERNATIVE METHODOLGY?**

[7] Attached as exhibits to the Letter of Protest are the Certificate of Assessment and Audit Report. Ex. 15 at AR 217-43. Multiple identical copies of the Certificate of Assessment and Auditor's Report are found in Exhibit 13-Audit File (AR 164-215) and Exhibit 14-Certificate of Assessment (AR 216). For consistency, Exhibit 15 is cited throughout this opinion.

## LEGAL STANDARD

This Court's review of a decision from an administrative agency is governed by SDCL 1-26-36.

> The court shall give great weight to the findings made and inferences drawn by an agency on questions of fact. The court may affirm the decision of the agency or remand the case for further proceedings. The court may reverse or modify the decision if substantial rights of the appellant have been prejudiced because the administrative findings, inferences, conclusions, or decisions are:
>
> (1) In violation of constitutional or statutory provisions;
> (2) In excess of the statutory authority of the agency;
> (3) Made upon unlawful procedure;
> (4) Affected by other error of law;
> (5) Clearly erroneous in light of the entire evidence in the record; or
> (6) Arbitrary or capricious or characterized by abuse of discretion or clearly unwarranted exercise of discretion.
>
> A court shall enter its own findings of fact and conclusions of law or may affirm the findings and conclusions entered by the agency as part of its judgment.

SDCL 1-26-36. This requires the circuit court "to give great weight to the findings of the agency and reverse only when those findings are clearly erroneous in light of the entire record." *Manuel v. Toner Plus, Inc.*, 2012 S.D. 47, ¶ 8, 815 N.W.2d 668, 670 (quoting *Williams v. S.D. Dept. of Agirc.*, 2010 S.D. 19, ¶ 5, 779 N.W.2d 397, 400). "However, questions of law are reviewed de novo." *Id.* (citing *Vollmer v. Wal–Mart Store, Inc.*, 2007 S.D. 25, ¶ 12, 729 N.W.2d 377, 382). "Mixed questions of law and fact require further analysis." *Id.* (citing *Darling v. W. River Masonry, Inc.*, 2010 S.D. 4, ¶ 10, 777 N.W.2d 363, 366). The interpretation and application of a tax statute is a question of law and reviewed de novo. *Citibank, N.A. v. S.D. Dep't of Revenue*, 2015 S.D. 67, ¶ 7, 868 N.W.2d 381, 385 (citing *Rushmore Shadows, LLC v. Pennington Cnty. Bd. of Equalization*, 2013 S.D. 73, ¶ 7, 838 N.W.2d 814, 816).

## ANALYSIS

### I. DID THE DEPARTMENT ERR IN REJECTING U.S. BANK'S METHODOLOGY FOR CALCULATING THE SDCL 10-43-10.3(3) DEDUCTION FOR 2010, 2011, AND 2012?

Financial institutions doing business within South Dakota are subject to bank franchise tax pursuant to SDCL Chapter 10-43. The Department is responsible for administering that chapter. SDCL 10-43-42.1.

Specifically, "[a]n annual tax is ... imposed upon every national banking corporation ...doing business within [South Dakota], according to or measured by net income, to be computed in the manner provided in [Chapter 10-43], on the basis of its net income during any part of its tax year." SDCL 10-43-2.1.[8] The bank franchise tax itself is based upon the net income of the institution that is assignable to South Dakota. SDCL 10-43-4. Even though U.S. Bank was part of a consolidated group, it was required to file an individual SD BFT return. SDCL 10-43-36; ARSD 64:26:03:13. The SD BFT final return for the tax year is due within fifteen days after the federal income tax return is due. SDCL 10-43-30.

For purposes of the SD BFT, "[n]et income ... is taxable income as defined in the Internal Revenue Code ... but subject to the adjustments as provided in ... §§ 10-43-10.2 and 10-43-10.3." SDCL 10-43-10.1. Financial institutions are allowed to deduct from taxable income "[t]axes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 USC §1374 and 26 USC § 1375[.]" SDCL 10-43-10.3(3).

[8] Repealed by SL 2016, ch 62, §§ 3, 32.

The issue in this case is the proper interpretation of the term "taxes imposed" within SDCL 10-43-10.3(3). The term "taxes imposed" is not specifically defined within SDCL Chapter 10-43. However, U.S. Bank argues that the dictionary definition of "impose" is "to establish or apply by authority-impose a tax." Appellant's Brief at 10. Therefore, the plain meaning of "taxes imposed," according to U.S. Bank, is the result of the 35% tax rate that the IRC applies to U.S. Bank's federal taxable income, without regard to credits. *Id.* at 11. U.S. Bank claims that any attempt to further define "taxes imposed" would be reading words into the statute and not honoring the stated intention of the Legislature. *See In re: Appeal of AT&T Info. Sys.*, 405 N.W.2d 24, 27 (S.D. 1987) ("When the language is clear, certain, and unambiguous, there is no reason for construction, and the court's only function is to declare the meaning of the statute as clearly expressed.")

U.S. Bank also argues that the intent of SDCL 10-43-10.3(3) can be deemed from analyzing the statute as a whole. Specifically, U.S. Bank argues that SDCL 10-43-10.3(10) & (11) support the reasonableness of its methodology. Appellant's Brief at 14. These subsections are specifically geared toward LLCs and S Corporations and provide a deduction for "imputed federal income taxes in an amount equal to the taxes that would have been paid on net income as defined in § 10-43-10.1...." SDCL 10-43-10.3(10)(11).

However, U.S. Bank's asserted "plain meaning" of "taxes imposed" does not, in fact, clarify the meaning of that term. The dictionary cited by U.S. Bank defines "impose" as not only "to establish or apply," but also "to establish or bring about as if by force." AR at 586. This latter definition of "impose" could reference the forced payment of the tax due. Resultantly, turning to a dictionary definition does not assist in defining "taxes imposed."

Additionally, subsections (10) and (11) of SDCL 10-43-10.3 do not assist the analysis of subsection (3) for purposes of this case. U.S. Bank does not fit within the categories laid out in (10) or (11). Even if those subsections did allow the methodology proposed by U.S. Bank in this case, the South Dakota Legislature did not use the same language in describing the deduction in SDCL 10-43-10.3(3). It is presumed that if the Legislature had intended for the description of the deduction in subsection (3) to match that in subsections (10) or (11), it would have said so. *See Steinberg v. S.D. Dept. of Military and Veterans Affairs*, 2000 S.D. 36, ¶ 10, 607 N.W.2d 596, 600. It did not.

Therefore, the Court must turn to the rules of statutory construction to determine the meaning of "taxes imposed." When courts are "called on to interpret a statute granting an exemption, a deduction, or a credit ... the statute is strictly construed against the taxpayer." *Burlington Northern R. Co. v. Strackbein*, 398 N.W.2d 144, 146 (S.D. 1986) (other citations omitted). Deductions "are privileges accorded as a matter of legislative grace and not as a matter of taxpayer right." *Id.* at 147.

As stated previously, the South Dakota Legislature has not specifically defined "taxes imposed." It has, however, given the Department express authority to promulgate administrative rules concerning: "(1) The procedure for filing tax returns and payment of tax...(3) *The definition and deductibility of net federal income taxes*; [and] (4) The application of the tax and exemptions..." SDCL 10-43-42.1 (emphasis added). Courts "read statutes as a whole, as well as enactments relating to the same subject." *AEG Processing Center No. 58, Inc. v. SD Dept. of Rev.*, 2013 S.D. 75, ¶ 17, 838 N.W.2d 843, 849. When giving effect to all these provisions, it becomes clear that the Legislature intended the deduction for federal income taxes imposed as

referenced in SDCL 10-43-10.3(3) to be *net* federal income taxes. The question, then, becomes how those net federal income taxes are defined and calculated.

"The construction and interpretation given a statute by an administrative body charged with its administration is entitled to great weight." *In re: State Sales and Use Tax Liability of Pam Oil, Inc.*, 459 N.W.2d 251, 256 (S.D. 1990). *See also Northern States Power Co. v. S.D. Dept. of Rev.*, 1998 S.D. 57, ¶ 4, 578 N.W.2d 579, 580 (Agency interpretation of statute given great weight when Legislature has given the agency that express authority). Pursuant to this authority, the Department has defined "net federal income tax" as "that federal income tax in excess of any federal income tax refund received during the tax year for which the deduction is claimed." ARSD 64:26:01:01(4). Further, the Department has stated:

> ...Net federal income taxes are deductible from taxable income in the tax year in which they are incurred when the accrual method of accounting is used in determining the net income of taxpayer. Any other income, franchise, or privilege taxes which were deducted to determine federal taxable income are not deductible.

ARSD 64:26:04:28.[9]

The Department's position is that Schedule J of Form 1120 provides the calculation of these net federal income taxes:

1. Multiply taxable income (Form 1120, line 30, page 1) by the appropriate tax rate to arrive at "income tax," and record that number on Schedule J, line 2.
2. Reduce that number by the foreign tax credits (Schedule J, line 5a) and general business credits (Schedule J, line 5c) to arrive at "total tax" (Schedule J, Line 11), which is then recorded on line 31 of the Form 1120.

[9] U.S. Bank claims that this regulation is invalid because it exceeds the scope of SDCL 10-43-10.3(3). Appellant's Brief at n. 4. This ignores the specific rulemaking authority granted to the Department in SDCL 10-43-42.1(3).

Appellee's Brief at 13. The Department argues that this "total tax" number represents the taxes imposed (net federal income taxes). In other words, the taxes imposed referenced in SDCL 10-43-10.3(3) are the federal income taxes which must be paid to the IRS *after* reduction by tax credits. Appellee's Brief at 13.

U.S. Bank, however, argues that the "taxes imposed" calculation ends at Schedule J, line 2, which represents its separate taxable income multiplied by the 35% tax rate imposed by the IRC. Further, U.S. Bank argues that the federal tax liability of both U.S. Bank and the consolidated group is the amount *before* application of credits because both cash *and* credits are considered payments of federal income tax. Reply Brief at 6-7.

According to U.S. Bank, this is the same amount of federal income taxes that U.S. Bank would have paid if it had filed income tax on a separate return basis, so it equals the "taxes imposed" by the IRC. Appellant's Brief at 2; Reply Brief at 2. This also happens to be, according to U.S. Bank, its share of the consolidated federal tax liability computed on a separate company basis under the Tax Sharing Agreement.[10] U.S. Bank claims that this methodology is reasonable because "intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity." Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 63 Fed. Reg. 64757 (Nov. 23, 1998). AR at 429.

However, the policy and purpose behind the Tax Sharing Agreement is that it is an internal contract amongst the entities and not the actual imposition of tax by the IRS. HT 25-28, 38. The payments back and forth pursuant to the Tax Sharing Agreement are to theoretically

[10] On the one hand, U.S. Bank argues that it is not allocating its tax liability based on a tax sharing agreement. On the other hand, however, U.S. Bank points out that the method it has used to calculate the deduction (separate company federal taxable income multiplied by 35%) is indistinguishable from the method used to compute its share of the consolidated tax liability under the Tax Sharing Agreement. Reply Brief at 11-12.

make each company whole and do not necessarily represent the amount of tax imposed upon U.S. Bank by the IRS. *Id.*

Moreover, U.S. Bank's methodology results in it taking a much larger deduction for federal income taxes imposed than the entire consolidated group paid for income taxes. Specifically, U.S. Bank's claimed SD BFT deduction over each of the three years at issue (2010-2012) was between 133% to 175% higher than the entire consolidated group's tax payments to the IRS. *Supra, pp. 6-10.* Overall, the combined deduction for taxes imposed claimed by U.S. Bank on its SD BFT returns was $1,272,952,268 higher than the combined federal income taxes actually paid by the consolidated group over those years. *Id.*

The United States Tax Court, when faced with arguments similar to those being made by U.S. Bank regarding the meaning of "taxes imposed," has determined that it means taxes actually imposed, not some other hypothetical computation. *Sparrow v. Commissioner of Internal Revenue*, 86 T.C. No. 55 (1986) (AR 463-67); *Norwest Corp. and Subsidiaries v. Commissioner of Internal Revenue*, T.C. memo. 1995-600 (1995) (AR 458-61).[11]

In *Norwest,* the Tax Court considered "the proper methodology to be used in calculating the amount of [Norwest's] 'regular tax deduction' for purposes of computing its [corporate] minimum tax liability." AR 458. The "regular deduction" in that context, was "an amount equal to the taxes imposed by the chapter for the taxable year." *Id.* Norwest, like U.S. Bank, argued that, in the absence of specific statutory or regulatory guidance, it was reasonable to calculate the deduction for 'taxes imposed' by using the regulations and theories behind the calculation in consolidated returns. AR 459. Also, like U.S. Bank, Norwest's methodology resulted in the regular tax deduction greatly exceeding the amount of tax paid on the consolidated taxable

[11] These cases were attached to a brief submitted to the OHE and are hence part of the administrative record. Cites are to the AR page number.

income of the affiliated group. The Tax Court rejected Norwest's methodology for determining taxes imposed, finding it was not in line with the income tax actually imposed and paid. AR 458-60.

This Court reaches a similar conclusion. Adopting U.S. Bank's methodology in this case would allow it to increase its federal deduction, and hence reduce its SD BFT, to an absurd level. As pointed out above, U.S. Bank's methodology results in it taking a much larger deduction for federal income taxes imposed than the entire consolidated group paid for income taxes.

Moreover, if U.S. Bank's argument that "credits" are payments of tax were to be accepted, it would not mesh with the purpose of a tax credit. *See Burlington Northern,* 398 N.W.2d at 147 (Tax credits are rebates which relieve taxpayers from some tax liability). It would also allow U.S. Bank to increase its federal deduction for taxes paid to foreign jurisdictions, which is one of the federal credits. This would, in essence, make such foreign taxes "taxes imposed" by the Internal Revenue Code. Additionally, the record establishes that U.S. Bank receives a refund or cash payment from the consolidated group for the credits it generates. HT 25-26. Accepting its argument that credits are payments would allow U.S. Bank to take a cash payment from the affiliated group for its portion of a credit. Then, without paying that cash toward federal income tax, U.S. Bank could use the same cash payment to increase its federal deduction and correspondingly decrease its SD BFT.

This Court must read words of a statute in context with their place in the overall statutory scheme, and it will not "interpret a statute to reach an absurd result." *Klein v. Sanford Medical Center,* 2015 S.D. 95, ¶ 13 (citation omitted). Adopting U.S. Bank's interpretation of "taxes imposed" for purposes of the federal deduction would "stand in direct contrast to the revenue-generating purpose of tax statutes." *Polly's Properties LLC v. Vermont Dept. of Taxes,* 998 A.2d

1047, 1057 (Vt. 2010). This the Court cannot do, especially when the statute at issue involves an exemption or deduction *and must be construed in favor of the taxing power. In re: Sales and Use Tax Liability of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990).

For these reasons, the Court affirms the decision of the Department to reject U.S. Bank's methodology for calculating the deduction for "taxes imposed" under SDCL 10-43-10.3(3). The Court further determines that the legislative intent of SDCL 10-43-10.3(3) is that "taxes imposed" should equal net federal income taxes, which represent taxes paid after reduction by credits.[12]

## II. AFTER REJECTING U.S. BANK'S METHODOLOGY, DID THE DEPARTMENT ERR IN NOT ALLOWING U.S. BANK AN ALTERNATIVE METHODOLGY?

Having affirmed the Department's decision to reject the methodology proposed by U.S. Bank, the next question becomes whether U.S. Bank was still entitled to the deduction by an alternate methodology. According to U.S. Bank, because the Department's auditor conceded that it should be allowed *some* type of deduction (HT 64, 80), the Department erred in adjusting the 2012 deduction to zero and denying the 2010 and 2011 refund requests in full. Reply Brief at 2-3, 13-14. Put another way, U.S. Bank argues that it met its burden of entitlement to the deduction, even if not in the amount claimed, and the burden then shifted to the Department to calculate an alternative amount. Reply Brief at 2. U.S. Bank purports that "the Department should *at least* have calculated a deduction for U.S. Bank based on its percentage of the consolidated group's [Schedule J] Line 11 amount..." Reply Brief at 14 n. 7 (emphasis added).

[12] The Court rejects U.S. Bank's argument that the Missouri bank franchise scheme should be instructive to this Court. Appellant Brief at 18-19. Missouri's bank franchise scheme differs substantially from that of South Dakota.

The Department, on the other hand, claims that U.S. Bank never provided the information required to meet its burden to receive the deduction for 2012 or receive a refund in 2010 or 2011. Appellee Brief at 21-22. As a result, the Department was left with only two options: (1) accept U.S. Bank's inflated methodology; or (2) deny U.S. Bank's claimed deductions. Appellee Brief at 22.

A certificate of assessment is deemed prima facie correct. SDCL 10-59-8. The burden is on the taxpayer to overcome the presumption by establishing that there has been a mistake of fact or error of law. SDCL 10-59-9. *See also Doctor's Associates, Inc., v. S.D. Dept. of Rev.*, 2006 S.D. 18, ¶ 14, 711 N.W.2d 237, 242. Additionally, deductions are an act of legislative grace and never presumed. *Burlington Northern*, 398 N.W.2d at 147; *Pam Oil, Inc.*, 459 N.W.2d at 255. Tax exemptions are construed in favor of the taxing power, and the taxpayer has the burden of proving entitlement to a statutory exemption or deduction. *Pam Oil* at 255. Generally, a taxpayer has the burden to prove both the entitlement to a deduction and the proper amount. *Doyal v. Commissioner of Internal Revenue*, 616 F.2d 1191, 1192 (10th Cir. 1980); *Washington Mutual, Inc. v. United States*, 130 Fed.Cl. 653, 686-87 (Fed. Cl. 2017).

As a SD BFT taxpayer, U.S. Bank was under the following retention and production requirements for the relevant tax years:

> Every person subject to tax under this chapter shall make and keep for a period of six years *such records as required by the secretary ... for the administration of this chapter*. Such books and documents shall, at all times during business hours of the day, be subject to inspection by the secretary ... *to determine the amount of tax due.*
>
> If in the normal conduct of the business, the required records are maintained and kept at an office outside the State of South Dakota, it shall be a sufficient compliance with this section if the records are made available for audit and examination by the Department of Revenue at the office outside of South Dakota.

SDCL 10-43-43.1 (emphasis added). *See also* SDCL 10-59-21 (Taxpayer seeking recovery of allegedly overpaid tax "shall provide any information requested or considered necessary by the secretary to determine the validity of a claim.") Additionally, U.S. Bank was required to submit with the SD BFT return "a copy of the federal income tax return and schedules filed with the Internal Revenue Service for the tax year." ARSD 64:26:02:04.

The Department also had authority to require the production of certain records during the audit.

> ...Unless the secretary determines that delay may jeopardize the collection of a tax, the secretary shall mail a notice of intent to audit at least thirty days before commencement of the audit to the person to be audited...*Any documents or records required to be kept by law to evidence reduction, deduction, or exemption from tax not prepared for presentation to the auditor within sixty days from the commencement date of the audit do not have to be considered by the auditor or the secretary*. However, additional pertinent papers or documents shall be considered if all the following apply:
>
> (1) The additional pertinent papers or documents are material;
> (2) There were good reasons for failure to present other pertinent papers or documents as referenced in § 10-45-45 or 10-46-43, within the prescribed time period; and
> (3) The additional pertinent papers or documents are submitted within a reasonable time period prior to any hearing scheduled pursuant to § 10-59-9.

SDCL 10-59-7 (emphasis added).

Additionally, the notice of intent to audit must include the following language:

> All records, books, and documents must be prepared for presentation to the auditor on the date of commencement of the audit. All documents evidencing reduction, deduction or exemption of tax not prepared for presentation within sixty days of the date of commencement of the audit need not be considered by the auditor.

SDCL 10-59-3.

U.S. Bank argues that the Department was provided everything necessary to calculate the deduction and should have done so. Reply Brief at 13. U.S. Bank filed its 2010, 2011, and 2012

SD BFT returns with the Pro Forma 1120 for each year. Ex. 15 at AR 231, 238, 240. The U.S. Bancorp Form 1120 was not included, even though all tax returns and schedules filed with the IRS were required to be submitted with the SD BFT return. ARSD 64:26:02:04.

The Department requested information from U.S. Bank before and after the commencement of the audit. This information was required to be provided by U.S. Bank pursuant to the statutes cited above. In October of 2013, after U.S. Bank filed amended SD BFT returns for 2010 and 2011, the Department requested pages 1-5 of the U.S. Bancorp Form 1120s and consolidated numbers for the members of the consolidated group that tied into those pages. Ex. 15 at AR 231, 239. Regarding the 2010 amended SD BFT return, the Department specifically requested an explanation of the computation of the deduction and "documentation that the amounts claimed were imposed upon a financial institution under the Internal Revenue Code." Ex. 15 at 232.

U.S. Bank did not directly respond to this request. Instead, it filed its second amended 2010 BFT Return which increased the deduction and noted that the deduction claimed thereon was equal to 35% of U.S. Bank's taxable income. Ex. 10 at AR 153; Ex. 15 at AR 233.

On October 2, 2014, the Department sent U.S. Bank the Notice of Intent to Audit the 2011 and 2012 SD BFT returns. HT 58-59; Ex. 16 at AR 244-46. The notice informed U.S. Bank of the commencement date of November 3, 2014, and the sixty-day deadline as required by SDCL 10-59-3. HT 59; Ex. 16 at AR 245-46.

On October 23, 2014, the Department issued IDR2 to U.S. Bank. It requested pages 1-4 of the U.S. Bancorp Form 1120 for 2011 (for the second time) and 2012 and "the Profit and Loss computation for ... all of the Affiliated Group Members." Ex. 9 at AR 148. It also requested the "internal work papers and legal analysis to support the amounts reported on SD BFT page 2,

Line 15 as Federal income taxes paid or accrued." *Id.* The deadline to respond was November 4, 2014. *Id.*

Ultimately the U.S. Bancorp Form 1120s were received for 2010-2012. U.S. Bank informed the Department that it was relying upon its separate company taxable income multiplied by 35%. Ex. 15 at AR 241. However, U.S. Bank provided no proof of payment of that amount or other internal workpapers to support that amount as requested in IDR2. HT 62-64.; Ex. 15 at AR 242; Ex. 24 at AR 297. Additionally, there is no indication that credits claimed by U.S. Bank were received by the Department. Ex. 24 at 297.

The U.S. Bancorp Form 1120, although it included some financial information for U.S. Bank, did not include the amount of tax paid by U.S. Bank or credits attributable to U.S. Bank. HT 60-64, 80-82. Additionally, the Pro Forma 1120 provided with each return did not include a tax calculation or credits attributable to U.S. Bank. Ex. 4 at AR 121-25; Ex. 5 at AR 126-30; Ex. 6 at AR 131-35.

During the hearing, U.S. Bank offered bank statements (Exhibit 17) as proof that it made the payments to the IRS for the consolidated tax liability. HT 15-17, 47-48; Ex. 1 at AR 21-23; Ex. 2 at AR 52-54; Ex. 3 at AR 85-87; Ex. 17 at 247-263. The Department objected because the documents were not received until almost three years after the commencement of the audit, with no good reason. SDCL 10-59-7 and 10-59-3; HT 17-18. Ultimately, the Department rejected these documents. Final Decision at AR 625.

The Department was correct to disregard these documents as being produced well past the sixty-day period in SDCL 10-59-7 and only a few days before hearing, without good reason for delay. However, even if these payments were considered, there is no indication that they were amounts paid by U.S. Bank for its individual tax liability. U.S. Bank was designated as the

settlement agent for the affiliated group and was responsible for the payment of all consolidated income taxes and the transferring of settlement amounts owed between the affiliates from demand deposit accounts maintained at U.S. Bank. Ex. 18 at AR 265.

Ultimately, the auditor could not reconcile the amount reported on U.S. Bank's SD BFT returns to the taxes imposed and paid on the US Bancorp 1120. HT 63. U.S. Bank provided documents which could have served as the starting point for calculating the deduction for U.S. Bank. But it never provided information regarding taxes actually paid or credits generated by U.S. Bank which could lead to the end point. HT 21, 80-85.[13] For this reason, neither its rejected calculation for 2010-2012, nor its alternative calculation, is supported by the record. Reply Brief at 14.

For these reasons, U.S. Bank has not met its burden of proof regarding entitlement and amount of the deduction. The Department did not err in not allowing U.S. Bank an alternate methodology for 2010-2012.

ORDER OF AFFIRMANCE

Based upon the foregoing memorandum opinion, which is incorporated into this Order as if set forth in full, it is hereby ORDERED that the Department's denial of U.S. Bank's 2010 and 2011 refund requests, and the Department's issuance of the 2012 Certificate of Assessment (Exhibit 14) are hereby AFFIRMED.

Dated this 1st day of May, 2020.

Attest:
Deuter-Cross, TaraJo
Clerk/Deputy

Bobbi J. Rank
Circuit Court Judge

[13] According to 26 CFR § 1.1502-75, which governs the filing of consolidated returns, details of the items of gross income, deductions, and credits for each affiliate may be readily audited. 26 CFR § 1.1502-75(j).

IN THE SUPREME COURT
OF THE
STATE OF SOUTH DAKOTA

---

APPEAL NO. 29338

---

U.S. BANK NATIONAL ASSOCIATION

Appellant,

-vs-

SOUTH DAKOTA DEPARTMENT
OF REVENUE,

Appellee.

---

APPEAL FROM THE CIRCUIT COURT
SIXTH JUDICIAL CIRCUIT
HUGHES COUNTY, SOUTH DAKOTA

---

THE HONORABLE BOBBI J. RANK
CIRCUIT COURT JUDGE, PRESIDING

---

# REPLY BRIEF OF APPELLANT U.S. BANK NATIONAL ASSOCIATION

---


CRAIG B. FIELDS
NICOLE L. JOHNSON
BLANK ROME LLP
1271 AVENUE OF
THE AMERICAS
NEW YORK, NY 10020
(212) 885-5000

ATTORNEYS FOR
APPELLANT

JUSTIN L. BELL
MAY, ADAM, GERDES
& THOMPSON, LLP
PO BOX 160
PIERRE, SD 57501
(605) 224-8803

ATTORNEYS FOR
APPELLANT

JOHN T. RICHTER
SD DEPARTMENT
OF REVENUE
445 E. CAPITOL AVE.
PIERRE, SD 57501
(605) 773-57501

ATTORNEY FOR
APPELLE


---


NOTICE OF APPEAL FILED MAY 28, 2020

## TABLE OF CONTENTS

**Page**

## TABLE OF AUTHORITIES

**Page(s)**

**CASES**



**STATUTES**



**OTHER AUTHORITIES**

## PRELIMINARY STATEMENT

For the convenience of the Court, the following abbreviations shall be used: Appellant U.S. Bank National Association will be referred to as "U.S. Bank." Appellee South Dakota Department of Revenue will be referred to as the "Department." The Administrative Record will be cited as "AR ___." The Department's Brief of Appellee is cited as "Dept. Br., p. ___."

## STATEMENT OF THE ISSUES

U.S. Bank stated the two issues in this case: (1) whether U.S. Bank is entitled to a deduction under SDCL 10-43-10.3(2) (the "Federal Tax Deduction"); and (2) if so, what is the appropriate methodology for determining the amount of that deduction.[1]

The Department attempts to reframe the issue to "[w]hether the Department correctly rejected U.S. Bank's methodology for calculating the net federal income tax deduction for bank franchise tax purposes." Dept. Br., p. 3. Subsequently, the Department restates that issue twice more. See Dept. Br., p. 18 (claiming that "[t]he question in this case boils down to, what did the IRS actually require U.S. Bank to pay"); id. at 23 (claiming that "the question before this Court is what taxes were imposed under the Internal Revenue Code").

Contrary to the Department's attempted restatements, there are two issues in this case. First, whether U.S. Bank is entitled to the Federal Tax Deduction, which the Department's own auditor conceded U.S. Bank was entitled to the deduction. AR 366; 382. Second, what is the appropriate methodology for computing the Federal Tax Deduction.

[1] During the tax years ended December 31, 2010 through December 31, 2012, the deduction at issue was codified at SDCL 10-43-10.3(3).

## STATEMENT OF THE CASE

South Dakota provides a deduction – the Federal Tax Deduction – for federal income "[t]axes imposed upon the financial institution." SDCL 10-43-10.3(2). To compute its Federal Tax Deduction, U.S. Bank multiplied its federal taxable income by 35% – the same amount that U.S. Bank would have paid to the Internal Revenue Service ("IRS") had it filed a federal income tax return on a separate company basis.

Despite having all of the necessary information during the audit to compute the Federal Tax Deduction, the Department alleges that it only had "two options: (1) accept the methodology U.S. Bank utilized to calculate the deduction on its 2011 amended return and 2012 return which exceeded the entire consolidated group's Federal tax liability; or (2) deny U.S. Bank's claimed deductions." Dept. Br., p. 11. However, the Department misses the obvious option – to compute the Federal Tax Deduction with the information available. In fact, the Department failed to provide any method to compute the Federal Tax Deduction in this case – not during the audit, not during the proceeding before the Office of Hearing Examiners, not during the appeal at the Circuit Court and not here.

The law is clear – federal income taxes were imposed upon U.S. Bank's federal taxable income. Therefore, U.S. Bank is entitled to the Federal Tax Deduction. The Department's failure to provide any method to compute the Federal Tax Deduction is untenable. U.S. Bank used an appropriate method for computing the deduction and, therefore, it has met its burden.

## STATEMENT OF THE FACTS

### I. Objections to the Department's Statement of the Case and Facts

U.S. Bank objects to the conclusory nature of many of the statements contained in the Department's Statement of the Case and Facts. U.S. Bank's Statement of the Facts, which was not objected to by the Department, more completely and accurately reflects the record in this case in an unbiased manner. Further, U.S. Bank submits that the Department's "facts" consist of numerous arguments, which are addressed below.

In addition, citing to the audit report, the Department incorrectly claims that the Agreement for the Allocation of Income Tax Liability and Benefits Among Certain Affiliates of U.S. Bancorp ("Tax Sharing Agreement") was not provided during the audit. Dept. Br., p. 10. However, the Department's witness, the auditor, admitted that the Tax Sharing Agreement was provided during the audit. AR 363; 387-88. Therefore, the Department's claims are without merit.

Furthermore, the Department misleadingly labels the amount of federal income taxes due after application of credits as "total consolidated federal tax liability." See Dept. Br., pp. 6, 7, 8, 9, 11, 12, 16, 17, 31. The income tax shown as due, before application of credits and cash payments, on the consolidated returns was as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

AR 23; 54; 87; 313. The income tax shown as due, after application of credits, on the consolidated returns was as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $524,920,206 |
| December 31, 2011 | $617,186,234 |
| December 31, 2012 | $981,865,059 |

AR 23; 54; 87. The Department's unsupported claims that the total consolidated federal tax liability is the income tax due after application of credits is an argument – not a fact.

Finally, the Department alleges that "U.S. Bank failed to provide any proof of payment." Dept. Br., p. 11. To the contrary, U.S. Bank provided such information when it was specifically requested. AR 247-63; 316-19.

## ARGUMENT

### I.

### U.S. BANK IS ENTITLED TO THE FEDERAL TAX DEDUCTION

The Federal Tax Deduction requires a subtraction from a financial institution's separate company taxable income for "[t]axes imposed upon the financial institution within the tax year, under the Internal Revenue Code excluding any taxes imposed under 26 U.S.C. § 1374 and 26 U.S.C. § 1375." SDCL 10-43-10.3(2). Neither South Dakota law nor any Department regulation or pronouncement defines "taxes imposed." Section 11 of the Internal Revenue Code ("IRC") is entitled "Tax Imposed" and provides that a "tax is hereby imposed for each taxable year on the taxable income of every corporation." IRC § 11 (2012) (emphasis added).[2]

[2] The Department incorrectly states that reference to IRC Section 11 "was not raised at the administrative level and deemed waived." Dept. Br., p. 26. In support, the Department cites cases where an issue was not raised and, therefore, deemed waived. Id. at 26-27. However, no new issue was raised. Instead, additional legal support was included. There is no rule prohibiting adding legal support. Therefore, IRC Section 11 is not "deemed waived."

U.S. Bank had federal taxable income during each of the tax years ended December 31, 2010 through December 31, 2012. Therefore, the IRC imposed tax on a U.S. Bank's taxable income.

### A. The Department Failed to Refute that, Under the Internal Revenue Code, Taxes Are Imposed on U.S. Bank's Federal Taxable Income

As established in U.S. Bank's initial brief, based on the plain meaning of the word "imposed," federal income taxes are imposed when such taxes are established or applied by authority. U.S. Bank Br., pp. 10-11. Federal income taxes are imposed on U.S. Bank by its inclusion in the consolidated federal income tax returns filed by U.S. Bancorp under the authority of the IRC. AR 21-51; 52-84; 85-120. By inclusion in the consolidated group, tax is applied at a rate of 35% to U.S. Bank's federal taxable income by the authority of the IRC. Therefore, federal income tax is imposed on U.S. Bank.

The Department makes the unsupported claim that "nothing is ever imposed on U.S. Bank." Dept. Br., p. 27. Yet, such claim is directly contrary to federal law. IRC § 11 (2012). The IRC is clear – "tax is [] imposed … on the taxable income of every corporation." Id. Therefore, the Department's attempts to refute this fact are meritless.

#### 1. The Consolidated Tax Liability Is the Tax Liability Before Credits and Cash Payments

The Department repeatedly misstates the consolidated tax liability. Dept. Br., pp. 6, 7, 8, 9, 11, 12, 16, 17, 31. The Department baldly asserts as fact that the consolidated tax liability is the amount of tax due after application of credits. Id. at 6-7.

The Department claims that Line 11, "Total Tax," represents "the tax imposed or the federal tax liability that must be paid to the [Internal Revenue Service]." Dept. Br., p. 7. However, the Total Tax amount includes interest (Lines 9c and 9d), recapture of

certain credits (Lines 9a and 9b) and other adjustments (Line 9f). AR 21-51; 52-84; 85-120. Nevertheless, the Federal Tax Deduction only applies to "[t]axes imposed." SDCL 10-43-10.3(2). Certainly, interest, recapture of credits and other adjustments are not "taxes imposed."

Instead, the consolidated tax liability is Line 2, "Income tax," which is the total income tax due on the consolidated income. Norwest Corp. v. Comm'r, T.C. Memo 1995-600 (T.C. 1995) (finding that "tax imposed on the affiliated group is the tax assessed against its consolidated income"). Those amounts were as follows:

| Tax Year Ended | Total Income Tax Due |
|---|---|
| December 31, 2010 | $1,142,253,649 |
| December 31, 2011 | $1,248,535,908 |
| December 31, 2012 | $1,985,176,947 |

AR 23; 54; 87; 313.

The Department's regulation defines "net federal income tax" as "federal income tax in excess of any federal income tax refund received during the tax year for which the deduction is claimed." ARSD 64:26:01:01(4). By its own definition, the total income tax is only reduced by tax refunds – it is not reduced by credits. Id.

In accordance with the plain meaning of "taxes imposed" and the Department's definition of "net federal income tax," the consolidated tax liability is reflected on Line 2 of Schedule J.

**2. Credits are a Payment of Tax – Not an Imposition of Tax**

The total income taxes due were paid by both cash and credits. AR 21-51; 52-84; 85-120; 314. The Department incorrectly asserts that U.S. Bank "treats credits as taxes imposed." Dept. Br., p. 18. However, the Department repeatedly misconstrues

U.S. Bank's methodology for computing the Federal Tax Deduction. U.S. Bank began with total income taxes due (i.e., Line 2 of Schedule J). The total income taxes due are computed by multiplying the consolidated group's federal taxable income by the tax rate. The following is the calculation of the total income taxes due for the tax year ended December 31, 2012:

| | | |
|---|---|---|
| Consolidated Federal Taxable Income | | 5,671,934,133 |
| Tax Rate | x | 35% |
| Total Income Tax Due | | 1,985,176,947 |

AR 85-87.

Significantly, the total income tax amount is not reduced by or increased by credits. AR 21-51; 52-84; 85-120. Instead, that amount of tax imposed by the IRC is paid by both cash and credits. "A credit is essentially a payment, a form of payment, just like a payment of cash would be." AR 338. The use of credits as a form of payment is similar to the use of gift cards as a form of payment in a retail transaction – both reduce the remaining balance required to be paid in cash. U.S. Bank is not including credits as taxes imposed – just as it is not including cash payments as taxes imposed.

Moreover, as the Department concedes, credits "are simply a reduction." Dept. Br., p. 18. Accordingly, U.S. Bank properly treated the credits as reductions to (i.e., payments of) the taxes imposed.

### B. U.S. Bank Fits "Squarely" Within the Federal Tax Deduction

The Department states that it "agrees that a deduction would have been available to U.S. Bank if it would have shown that it fit squarely within the plain language of the deduction." Dept. Br., p. 29. The Department's sole complaint in support of its claim is that it was never provided with the detail on the Federal Tax Deduction methodology that

U.S. Bank used on its original returns for the tax years ended December 31, 2010 and December 31, 2011.[3] However, such methodology detail was not required to be provided. Moreover, that methodology calculation was corrected on amended returns filed by U.S. Bank – for which detail was provided. AR 150-53; 154-58.

The Department confuses the requirement to provide necessary information – which U.S. Bank did – with the Department's request for U.S. Bank to detail an incorrect methodology, which was later corrected. The auditor was provided with copies of the federal income tax returns – which was the information necessary to establish that U.S. Bank fit squarely within the Federal Tax Deduction and the information that was necessary to compute the deduction. AR 297-302; 374; 382.

The Department cannot escape the fact that the required information was provided by claiming nonrequired, incorrect information was not provided. The numbers needed to compute the Federal Tax Deduction and the supporting documentation were provided during the audit. Any claims to the contrary are a red herring.

U.S. Bank established that its federal income tax was imposed on its federal taxable income. Therefore, U.S. Bank established that it is entitled to the Federal Tax Deduction.

[3] The Department asserts that SDCL 10-43-43.1 requires taxpayers to maintain and provide the computation information. Dept. Br., p. 29. However, SDCL 10-43-43.1 requires taxpayers to maintain "any records as required by the secretary of revenue or otherwise necessary for the administration of this chapter." SDCL 10-43-43.1 (2017) (emphasis added). The Department does not – nor can it – cite to any provision or other support that a taxpayer is required by the Secretary to maintain detail for a calculation that the taxpayer ultimately corrected. See Dept. Br., p. 29.

## II.

## U.S. BANK PROPERLY COMPUTED THE FEDERAL TAX DEDUCTION

To compute its Federal Tax Deduction, U.S. Bank multiplied its federal taxable income by 35% (i.e., the same method used to compute the consolidated group's total income taxes as required by the IRC described above), as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | Separate Company Tax Rate | U.S. Bank's Tax Liability |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | 35% | $ 840,313,825 |
| December 31, 2011 | $2,342,731,149 | 35% | $ 819,955,902 |
| December 31, 2012 | $4,925,219,278 | 35% | $1,723,826,747 |

AR 21-51; 52-84; 85-120. The amount of the federal tax liability attributed to U.S. Bank under this method is the exact same amount as U.S. Bank's share of the consolidated federal tax liability. Specifically, U.S. Bank's share of the consolidated group's federal taxable income was as follows:

| Tax Year Ended | U.S. Bank's Federal Taxable Income | Consolidated Group's Federal Taxable Income | %[4] |
|---|---|---|---|
| December 31, 2010 | $2,400,896,642 | $3,263,581,855 | 74% |
| December 31, 2011 | $2,342,731,149 | $3,567,245,451 | 66% |
| December 31, 2012 | $4,925,219,278 | $5,671,934,133 | 87% |

Id. Applying U.S. Bank's income percentage to the consolidated tax liability (i.e., the taxes imposed by the IRC) results in the following:

| Tax Year Ended | U.S. Bank's % | Consolidated Group's Tax Liability | U.S. Bank's Share |
|---|---|---|---|
| December 31, 2010 | 74% | $1,142,253,649 | $ 840,313,825 |
| December 31, 2011 | 66% | $1,248,535,908 | $ 819,955,902 |
| December 31, 2012 | 87% | $1,985,176,947 | $1,723,826,747 |

Id.

[4] Percentage amounts have been rounded.

It was U.S. Bank's separate company federal tax liability (i.e., U.S. Bank's share of the consolidated federal tax liability) that was deducted on its amended South Dakota Franchise Tax on Financial Institutions returns ("South Dakota Returns") for 2010 and 2011 and its original South Dakota Return for 2012. AR 150-53; 154-58; 159-63.[5]

The Department incorrectly claims that U.S. Bank's Federal Tax Deduction exceeds the consolidated federal tax liability. Dept. Br., pp. 3, 11, 21, 23, 32. However, as the foregoing demonstrates, U.S. Bank's Federal Tax Deduction is only a portion of the consolidated federal income tax liability (between 66% and 87%), which directly correlates to U.S. Bank's portion of the consolidated group's federal taxable income. The methodology used by U.S. Bank never exceeded the amount of the consolidated federal income tax liability. Therefore, the Department's attempts to discredit U.S. Bank's methodology fall flat.

### A. U.S. Bank's Methodology Complies with Federal Law

The Department incorrectly claims that U.S. Bank's methodology "runs counter to federal law." Dept. Br., p. 17. In support, the Department quotes only a portion of a Treasury Regulation. Id. However, an analysis of the entire subsection of the Treasury Regulation cited by the Department reveals the flaws in the Department's claims. Treasury Regulation Section 1.1502-75(f) provides as follows:

> (f) Inclusion of one or more corporations not members of the group . . .
>
> (2) Allocation of tax liability. In any case in which amounts have been assessed and paid upon the basis of a consolidated return and the tax liability of one or more of

[5] The calculation of the Federal Tax Deduction on the 2010 and 2011 amended South Dakota Returns included federal adjustments to taxable income and the resulting tax liability.

> the corporations included in the consolidated return is to be computed in the manner described in subparagraph (1) of this paragraph, the amounts so paid shall be allocated between the group composed of the corporations properly included in the consolidated return and each of the corporations the tax liability of which is to be computed on a separate basis (or on the basis of a consolidated return of another group) in such manner as the corporations which were included in the consolidated return may, subject to the approval of the Commissioner, agree upon or in the absence of an agreement upon the method used in allocating the tax liability of the members of the group under the provisions of section 1552(a).

26 C.F.R. § 1.1502-75(f) (emphasis added).

First, Treasury Regulation Section 1.1502-75(f) involves the inclusion of one or more corporations that are not members of the group. Here, U.S. Bank is a member of U.S. Bancorp's consolidated group. Thus, Treasury Regulation Section 1.1502-75(f) does not apply in this case.

Second, even if the regulation did apply, subparagraph (2) provides that the allocation of the consolidated liability is based on each corporation's liability, computed on a separate basis. 26 C.F.R. § 1.1502-75(f)(2). A separate basis computation is the same method that U.S. Bank used to compute the Federal Tax Deduction. Therefore, Treasury Regulation Section 1.1502-75(f) supports U.S. Bank's methodology – not the Department's denial of U.S. Bank's methodology.

Moreover, the U.S. Tax Court's decision in Norwest Corporation actually supports U.S. Bank's methodology. The Department claims that U.S. Bank's methodology was rejected by the court in Norwest Corporation. Dept. Br., pp. 20-23. However, the Department fails to analyze the holding in that case. In analyzing the taxes imposed on a corporation that was a member of an affiliated group, the Tax Court held

that such amount was a portion of the "tax imposed on the consolidated taxable income of the affiliated group." Norwest Corp., T.C. Memo 1995-600. Here, U.S. Bank's methodology results in a portion of the tax imposed on the consolidated group – the same method approved in Norwest Corporation.

Despite the Department's arguments to the contrary, U.S. Bank's methodology for computing the Federal Tax Deduction complies with federal law.

### B. The Tax Sharing Agreement and the Department of the Treasury's Policy Statement Support U.S. Bank's Methodology

Contrary to the Department's assertions, U.S. Bank is not allocating "its tax liability based on a tax sharing agreement," nor does the Tax Sharing Agreement represent tax imposed. Dept. Br., pp. 22, 32. Notably, the Department could not cite to any page of U.S. Bank's initial brief to support this claim. See Dept. Br., p. 22.

Under the Tax Sharing Agreement, U.S. Bank's share of the consolidated federal tax liability was computed on a separate company basis (i.e., separate company federal taxable income multiplied by 35%). AR 264-72; 326. U.S. Bank used that same method to compute the Federal Tax Deduction (i.e., separate company federal taxable income multiplied by 35%) in line with how taxes are computed for federal income tax purposes. The fact that the two methods are indistinguishable demonstrates the accuracy of U.S. Bank's method to compute the Federal Tax Deduction.

Similarly, the Department of the Treasury's Policy Statement supports U.S. Bank's method of computing the Federal Tax Deduction as the methods are identical, which the Department did not refute. See Dept. Br., pp. 1-33. The Policy Statement provides that "intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it

had filed its income tax return as a separate entity." AR 429-31 (Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure, 63 Fed. Reg. 64757 (Nov. 23, 1998)). As with the Tax Sharing Agreement, the Policy Statement supports that the Federal Tax Deduction should be computed as if the financial institution filed its federal income tax return as a separate entity.

### C. The Department Failed to Provide Any Method to Compute the Deduction

The Department failed to provide any method by which to compute the Federal Tax Deduction. See Dept. Br., pp. 1-33. Instead, the Department has alleged that each taxpayer is required to determine its own methodology. See id. at 30. However, such a requirement would prevent the uniform and fair application of South Dakota tax laws as each taxpayer may have a different method for computing the deduction. See The South Dakota Taxpayers' Bill of Rights, https://dor.sd.gov/media/4qwgc4r0/taxpayerbillofrights.pdf (providing that a guiding principle of the Department is "[a]n unwavering commitment to the uniform and fair application of our tax laws") (last visited Dec. 7, 2020). This is even more so in the absence of any guidance from the Department.

The Department's failure to provide a methodology is evident by the options that the Department claims that the auditor "was left with." See Dept. Br., pp. 11, 30. According to the Department, because U.S. Bank did not detail the calculation used to compute the Federal Tax Deduction on its original South Dakota Returns for 2010 and

2011 (a calculation that U.S. Bank corrected on its amended returns),[6] the auditor only had two options: "(1) accept the methodology U.S. Bank utilized to calculate the deduction on its 2011 amended return and 2012 return . . .; or (2) deny U.S. Bank's claimed deductions." Dept. Br., p. 11; see also id. at 30.

The Department was unable to conceive of a third option whereby it applied its own method to calculate the deduction. In fact, during the course of the audit, the relevant portions of the consolidated federal income tax returns and U.S. Bank's pro forma federal income tax returns were provided to the auditors. AR 297-302; 374; 382. This is the information necessary to compute the Federal Tax Deduction.

Further, the Department now directly contradicts the testimony of its own auditor. See Dept. Br., p. 29. The auditor testified that "U.S. Bank should be allowed some type of deduction." AR 366; see also AR 382 (stating that it was the auditor's "recommendation" that U.S. Bank be entitled to some amount of the Federal Tax Deduction). However, the Department now claims that "[t]he Department agrees that a deduction would have been available to U.S. Bank if it would have shown that it fit squarely within the plain language of the deduction." Dept. Br., p. 29. Yet, the

[6] The South Dakota Returns do not include a location to provide detail of the calculation of the Federal Tax Deduction, nor do the returns require that such detail be otherwise included with the return. See AR 136-41; 142-47; 159-63.

Department does not provide any analysis as to how U.S. Bank does not fit squarely within the Federal Tax Deduction as was conceded by its own auditor.[7]

The Department inaccurately alleges that "U.S. Bank has provided no statute, rule, or authority that would support its position in this proceeding." Dept. Br., p. 32. As the foregoing and its original brief demonstrate, U.S. Bank has provided ample support for its position. In fact, U.S. Bank established that under the plain language of the statute, the Federal Tax Deduction applies to "[t]axes imposed" (i.e., a portion of the consolidated federal income tax liability before application of credits and cash payments). Further, U.S. Bank established that its methodology for computing the Federal Tax Deduction (i.e., as if a separate federal return had been filed) is proper. Therefore, the Department's claims are meritless.

## CONCLUSION

Federal income taxes are imposed on U.S. Bank. Even the Department's auditor concedes that U.S. Bank is entitled to the Federal Tax Deduction. Further, U.S. Bank has established that its methodology for computing the Federal Tax Deduction was proper.

For all of the foregoing reasons and the reasons stated in its initial brief, U.S. Bank prays that the Court reverse the Circuit Court and conclude that U.S. Bank is entitled to a refund for 2010 and 2011 and no additional tax is due for 2012.

---

[7] Based on the testimony of the Department's auditor, the Department should have calculated a Federal Tax Deduction for U.S. Bank. If the Department believes that "[t]axes imposed" are the amount reflected on Schedule J, Line 11 of the federal consolidated return as it argues (see Dept. Br., pp. 17, 31), then the Department should at least have calculated a deduction for U.S. Bank based on its percentage of the consolidated group's Schedule J Line 11 amount (e.g., 74% of $524,920,206 for the tax year ended December 31, 2010, 66% of $617,186,234 for the tax year ended December 31, 2011 and 87% of $981,865,059 for the tax year ended December 31, 2012).

Dated: December __, 2020 By: s/ Justin L. Bell
One of its Attorneys

Craig B. Fields
Nicole L. Johnson
BLANK ROME LLP
1271 Avenue of the Americas
New York, New York 10020
(212) 885-5000

Justin L. Bell
MAY, ADAM, GERDES & THOMPSON LLP
503 S. Pierre St.
Pierre, South Dakota 57501
(605) 224-8803

ATTORNEYS FOR APPELLANT
U.S. BANK NATIONAL ASSOCIATION

## CERTIFICATE OF SERVICE

The undersigned hereby certifies that two true copies of the Reply Brief of Appellant in the above-entitled action was duly served upon John T. Richter by being hand-delivered on the ____ day of December, 2020, to the following named person at his last known address as follows:

John T. Richter
Attorney at Law
South Dakota Department of Revenue
445 East Capitol Avenue
Pierre, SD 57501-3185

The undersigned further certifies that fifteen (15) copies of the Reply Brief of Appellant in the above-entitled action were hand-delivered to Ms. Shirley A. Jameson-Fergel, Clerk of the Supreme Court, State Capitol, 500 East Capitol, Pierre, SD 57501 on the date above written.

_____
JUSTIN L. BELL

## CERTIFICATE OF COMPLIANCE

Justin L. Bell, attorney for Appellant, hereby certifies that the foregoing Reply Brief of Appellant complies with the type volume limitation imposed by SDCL 15-26A-66(b)(4). Proportionally spaced typeface Times New Roman has been used. Reply Brief of Appellant, exclusive of the table of contents, table of authorities, jurisdictional statement, statement of legal issues, any addendum materials, and any certificates of counsel, contains 3,607 words and does not exceed 16 pages. Microsoft Word processing software has been used.

Dated this ____ day of December, 2020.

_____
JUSTIN L. BELL