

BEFORE THE IOWA DEPARTMENT OF REVENUE
HOOVER STATE OFFICE BUILDING
DES MOINES, IOWA

IN THE MATTER OF

Peoples Savings Bank
106 S. 2nd Street
Montezuma, Iowa 50171

FRANCHISE TAX

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DECLARATORY ORDER

DOCKET NO.: 207171

Pursuant to a Petition for Declaratory Order (“Petition”) filed with the Iowa Department of Revenue (“Department”) by Peoples Savings Bank (“Petitioner”), and in accordance with Iowa Code (“Code”) section 17A.9 and Iowa Administrative Code rule 701—7.24, the Director issues the following order.

I. FACTS

The findings of fact are based on the Petition submitted to the Department.

Petitioner is an Iowa chartered bank that is 100% owned by Arendt’s, Inc. of Montezuma, Iowa (“Arendt’s”). Petition, p. 4 (Aug. 10, 2022). Arendt’s elected to be taxed as an S corporation for federal and Iowa income tax purposes. *Id.* Arendt’s also made the election for their wholly-owned subsidiary, Petitioner, to be taxed as a qualified subchapter S subsidiary (“QSub”). *Id.* Petitioner is a financial institution subject to Iowa franchise tax. *Id.* Arendt’s is not a financial institution and is not subject to Iowa franchise tax. *Id.*

Arendt’s entered into a stock purchase agreement with Lynn H. Fuller and Thomas J. Fuller to sell 100% of Petitioner’s stock. Petition, p. 4. The closing of this sale is expected to happen in late 2022. *Id.* Arendt’s anticipates it will realize a gain from the sale of Petitioner’s

stock. *Id.* Petitioner is asking whether the gain realized by Arendt’s should be included in the Petitioner’s calculation of net income for franchise tax purposes. *Id.* at 5.

II. ISSUES PRESENTED

The Petition presents a single issue: whether a gain realized by a parent S corporation for the sale of stock of a QSub that is a financial institution should be included in the calculation of net income of the QSub for franchise tax purposes.

III. STANDARD OF REVIEW

A. Declaratory Orders and the Iowa Administrative Procedures Act

Iowa’s Administrative Procedure Act (“IAPA”) was enacted “to provide a minimum procedural code for the operation of all state agencies when they take action affecting the rights and duties of the public.” Iowa Code § 17A.1(2) (2022). Under the IAPA, “[a]ny person may petition an agency for a declaratory order as to the applicability to specified circumstances of a statute, rule, or order within the primary jurisdiction of the agency.” *Id.* § 17A.9(1)(a). The IAPA also describes agency rights and responsibilities with respect to declaratory order proceedings. *Id.* § 17A.9(1)(b)–(8).

The purpose of a declaratory order is to provide a “generally available means for persons to obtain reliable information about agency administered law as it applies to their particular circumstances.” *Sierra Club Iowa Chapter v. Iowa Dep’t of Transp.*, 832 N.W.2d 636, 647 (2013) (citing ARTHUR EARL BONFIELD, AMENDMENTS TO IOWA ADMINISTRATIVE PROCEDURE ACT, REPORT ON SELECTED PROVISIONS TO IOWA STATE BAR ASSOCIATION AND IOWA STATE GOVERNMENT 1–8 (1998)). Declaratory orders are not contested cases that “entitle[] parties affected by the agency action to an adversarial hearing” in order to “adjudicate disputed facts pertaining to particular individuals in specific circumstances.” *Greenwood Manor v. Iowa Dep’t*

of *Pub. Health, State Health Facilities Council*, 641 N.W.2d 823, 834 (Iowa 2002); *see also* Iowa Code § 17A.12. Instead, the IAPA “contemplates declaratory rulings by administrative agencies on purely hypothetical sets of facts.” *City of Des Moines v. Pub. Emp. Rels. Bd.*, 275 N.W.2d 753, 758 (Iowa 1979). As such, “[t]he procedure established by section 17A.9 allows persons to seek formal opinions on the effect of future transactions and arrange their affairs accordingly.” *Bennett v. Iowa Dep’t of Nat. Res.*, 573 N.W.2d 25, 26 (Iowa 1997). Declaratory orders issued by an administrative agency do, however, have “the same status and binding effect as any final order issued in a contested case proceeding.” Iowa Code § 17A.9(7).

Pursuant to Iowa Code section 17A.9(2), the Department adopted Iowa Administrative Code rule 701—7.24, which outlines department-specific rules governing declaratory orders. The Department’s rule governing declaratory orders is consistent with this understanding of the role of declaratory orders in administrative procedure. *See* Iowa Admin. Code r. 701—7.24 (2022).

B. *Statutory Construction and Interpretation of Tax Statutes*

Generally, when interpreting a statute, the Department begins by “examin[ing] the language of the statute and determin[ing] whether it is ambiguous.” *Kay-Decker v. Iowa State Bd. of Tax Review*, 857 N.W.2d 216, 223 (Iowa 2014) (citing *Rolfe State Bank v. Gunderson*, 794 N.W.2d 561, 564 (Iowa 2011)). If the statute’s language is unambiguous, the express language in the statute is controlling. *Id.* (citing *Rolfe State Bank*, 794 N.W.2d at 564). “If, however, the statute is ambiguous,” the Department’s interpretation will seek to effectuate the legislature’s intent. *Id.* (citing *Rolfe State Bank*, 794 N.W.2d at 564). A statute “must [be] read . . . as a whole and give[n] ‘its plain and obvious meaning, a sensible and logical construction.’” *Id.* (quoting *Hamilton v. City of Urbandale*, 291 N.W.2d 15, 17 (Iowa 1980)). When ascertaining the

meaning of undefined words in a statute, the Department may look to the words' ordinary usage, dictionary definitions, use in similar statutes, and court rulings to aid in its interpretation. *Id.* (citing *Gardin v. Long Beach Mortg. Co.*, 661 N.W.2d 193, 197 (Iowa 2003)).

IV. APPLICABLE LAW

A. Net Income for Franchise Tax

Franchise tax is imposed in Iowa on financial institutions for the privilege of doing business in the state. Iowa Code § 422.60(1). It is measured by net income which is calculated in the same way corporation net income is calculated under Iowa Code section 422.35 with certain adjustments. *Id.* § 422.61(3). One of those adjustments is:

Where a financial institution as defined in section 581 of the Internal Revenue Code is not subject to income tax and the shareholders of the financial institution are taxed on the financial institution's income under the provisions of the Internal Revenue Code, such tax treatment shall be disregarded and the financial institution shall compute its net income for franchise tax purposes in the same manner. . . as a financial institution that is subject to or liable for federal income tax under the Internal Revenue Code.

Id. § 422.61(3)(g).

B. Treatment of S Corporations Under Iowa Law

“Where a corporation is not subject to income tax and the stockholders of such corporation are taxed on the corporation's income under the provisions of the Internal Revenue Code, the same tax treatment shall apply to such corporation and such stockholders for Iowa income tax purposes.” Iowa Code § 422.36(5). The Department's rule also provides that

[c]ertain corporations and other types of entities, which are taxable as corporations for federal purposes, may by federal election and qualification have a portion or all of their income taxable to the shareholders or beneficiaries. Generally, the state of Iowa follows the federal provisions (with adjustments provided by Iowa law) for determining the amount and to whom the income is taxable.

Iowa Admin. Code r. 701—501.1(5).¹ In other words, corporations that are not subject to federal income tax because their income is passed through to shareholders, such as S corporations, are also not subject to Iowa corporation income tax.

Iowa also follows federal treatment of QSubs. The Department’s rule provides “[t]o the extent that, for federal income tax purposes, the incomes and expenses of the [QSubs] are combined with the parent’s income and expenses, they must be combined for Iowa purposes.” *Id.*

C. Treatment of the Sale of a QSub

A corporation that has elected to be taxed as an S corporation for federal tax purposes that owns 100% of the stock of another corporation can make an election to have such corporation treated as a QSub. IRC § 1361(b)(3). A QSub is not treated as a separate corporation and all “assets, liabilities, and items of income, deduction, and credit of a [QSub] shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.” IRC § 1361(b)(3)(A).

There are several ways an election to be a QSub can be terminated. The election can be terminated if the parent S corporation no longer owns 100% of the stock of the QSub. If the termination is caused by the sale of stock of the QSub the sale will be treated as if “the sale were a sale of an undivided interest in the assets of such corporation . . . , and the sale were followed by an acquisition by such corporation of all of its assets. . . .” IRC § 1361(b)(3)(C)(ii).

The federal regulation explains that “[i]f a QSub election terminates . . . , the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the

¹ Formerly Iowa Admin. Code r. 701—52.1(5).

new corporation.” Treas. Reg. § 1.1361-5(b). The regulation further clarifies with examples.

Example 9 is particularly applicable to the factual scenario presented by Petitioner; it states, in relevant part:

X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. Z, an unrelated C corporation, acquires 100 percent of the stock of Y. The deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of Y to Z, followed by Z's transfer of these assets to the capital of Y in exchange for Y stock.

Treas. Reg. § 1.1361-5(b) Ex. 9.

V. ANALYSIS

A. Petitioner's Calculation of Net Income

As stated above, Arendt's is the parent corporation of Petitioner and it is not a financial institution. Petitioner is a financial institution. Arendt's has elected to be taxed as an S corporation for federal tax purposes. Petition, p. 4. Arendt's has also elected to have Petitioner treated as a QSub of Arendt's for federal income tax purposes. *Id.*

For state income tax purposes, Iowa follows federal treatment of S corporations and QSubs. *See* Iowa Code § 422.36(5); Iowa Admin. Code r. 701—501.1(5). For federal tax purposes, S corporations are not subject to income tax. IRC § 1363. The income of an S corporation is passed through to the shareholders and the shareholders are taxed on their distributive share of the income. *See* IRC § 1366. QSubs are also not taxed on their income and as a result of their status as a QSub their income is treated as income of the parent S corporation. IRC § 1361(b)(3)(A)(ii). Therefore, being a QSub means for federal and Iowa income tax purposes, Petitioner is a disregarded entity and all of its income and activity is reported on Arendt's income tax return.

Financial institutions are required to pay a franchise tax in Iowa based on net income. Iowa Code § 422.60. Net income is calculated in the same manner as the net income of a corporation under Iowa Code section 422.35 with some adjustments. *Id.* § 422.61(3). When a financial institution is not subject to federal income taxes and the shareholders of the financial institution are taxed on the income, “such tax treatment shall be disregarded” and the financial institution’s net income shall be calculated as though it is subject to federal income taxes. *Id.* § 422.61(3)(g); *see also* Iowa Admin. Code r. 701—602.21.² As stated above, Petitioner is a QSub so it is not subject to federal income tax. Petitioner is also a financial institution, so it is subject to franchise tax in Iowa. This means that Petitioner is required to calculate its net income for franchise tax purposes as if it were subject to federal income tax instead of its income passing through to its shareholder. In other words, Petitioner is required to calculate its net income at the entity level separately from the net income of Arendt’s for the purposes of franchise tax.

B. Treatment of Sale of Petitioner

Arendt’s has entered into a purchase agreement to sell 100% of the stock of Petitioner and the sale is expected to close by the end of the year. Petition, p. 4. Arendt’s expects to realize a gain on the sale of Petitioner’s stock. *Id.* The issue submitted by the Petitioner is whether this gain would be included in Petitioner’s net income calculation for franchise tax purposes. *Id.* at 5. The desired answer of Petitioner is that it would not be included in net income. *Id.*

One of the requirements for a parent S corporation to elect to treat its subsidiary as a QSub is the parent must own 100% of the stock of the subsidiary. IRC § 1361(b)(3)(B)(i). Under federal law, when a QSub treatment is terminated by reason of selling stock the sale is treated “as if the

² Formerly Iowa Admin. Code r. 701—59.21.

sale were a sale of undivided interest in the assets of such corporation . . . , and the sale were followed by an acquisition by such corporation of all of its assets. . . .” IRC § 1361(b)(3)(C)(ii). Additionally, the QSub is “treated as a new corporation acquiring all of its assets. . . immediately before the termination from the S corporation parent in exchange for stock of the new corporation.” Treas. Reg. § 1.1361-5(b). When Arendt’s sells Petitioner it will terminate the QSub status of Petitioner. The sale is a sale of stock so the QSub status of Petitioner would be terminated by reason of sale of stock. Under this scenario, the sale will be treated under federal law as though it were a sale of the assets of Petitioner and Petitioner would be treated as a new corporation acquiring all of its assets right before termination.

As mentioned above, Arendt’s is selling 100% of Petitioner’s stock. A similar factual scenario is explained in an example in the federal regulation describing when a parent S corporation sells 100% percent of the stock of the QSub, the deemed formation of the QSub as a new corporation is disregarded for federal tax purposes. Treas. Reg. § 1.1361-5(b) Ex. 9. The transaction is treated as though the assets of the QSub are being transferred to the purchaser instead of a sale of stock. *Id.* Because Arendt’s is selling 100% of Petitioner’s stock, the deemed formation of Petitioner as a new corporation would be disregarded for federal income tax purposes and the transaction would be treated as a transfer of assets. The gain realized by this transfer of assets would be realized by Arendt’s.

The Code and Department rules instruct that federal tax treatment of passing through income to shareholders should be disregarded for franchise tax purposes and the net income should be calculated as if the pass-through entity were subject to federal income tax. Iowa Code § 422.61(3)(g). Disregarding the tax treatment of passing through the income to the shareholders does not change who should realize a gain in the facts presented by Petitioner. In the scenario

described by Petitioner, the sale of Petitioner's stock would be treated as a transfer of assets and Petitioner's status as a new corporation following the sale would be disregarded for federal income tax purposes. Therefore, any gain associated with the transfer of assets would be realized by the parent corporation not by Petitioner. This treatment would not change for Iowa purposes. If there is no gain from this transaction realized by the Petitioner for federal income tax purposes then there would be no gain to be included in the net income calculation of Petitioner for Iowa franchise tax purposes.

ORDER

THEREFORE, based on the facts presented, foregoing reasoning, and applicable provisions of law, the Director finds that Petitioner would not include any gain realized by the parent corporation from the sale of Petitioner's stock in the calculation of net income pursuant to Iowa Code section 422.61(3).

Done at Des Moines, Iowa on this 18 day of November, 2022.

IOWA DEPARTMENT OF REVENUE

BY



Kraig Paulsen, Director