IN THE
SUPREME COURT OF MISSOURI

No. SC86932

MIDWEST ACCEPTANCE CORPORATION,

Appellant,

v.

DIRECTOR OF REVENUE,

Respondent.

Petition For Review
From The Administrative Hearing Commission,
The Honorable June Striegel Doughty, Commissioner

REPLY BRIEF

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ARGUMENT

The Director's argument is simple, too simple. She suggests that this matter presents the same legal issue as was decided by this Court in *Wolff v. Director of Revenue*, 791 S.W.2d 390, 391 (Mo. banc 1990). While there may be great appeal in simplifying the legal issues this case brings before this Court, the new element of how the General Assembly intended the tax provisions in Chapter 148 (the Financial Institutions Tax) to interact with the provisions of Chapter 143 (the Missouri Income Tax) is simply ignored by the Director. The tax parity which the General Assembly sought to maintain between competing financial institutions cannot be ignored while interpreting a complex system of interrelated tax statutes.

The table on the following page illustrates how a hypothetical taxable income of $10,000 would be taxed to a Missouri credit institution according to the Director. This table illustrates why the Director's interpretation thwarts the General Assembly's goal of achieving tax parity among competing financial institutions. Note that even for partnerships the director allows no credit for income taxes paid by the partners against the financial institutions tax imposed upon the partnership.

Form of Entity	Entity Level Income Tax	Individual Level Income Tax	Financial Institutions Tax	Tax Credit for Income Taxes	Combined Tax Liability
Corporation	$625[1]	$0-$563	$700	$625	$700-$1,263
Partnership	$0	$600	$700	$0	$1,300
S Corporation	$0	$600[2]	$700[3]	$0[4]	$1,300[5]

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[1] Assumes the entire $10,000 is run through the tax table at the corporate income tax rate of 6.25%.

[2] For the "C" corporation the amount taxed to the shareholder is controlled by the amount of dividends distributed. In our example we assume that the maximum distribution is $9,375 which is the original $10,000 less the Missouri corporate income tax paid. The highest nominal individual income tax rate which kicks in after a taxpayer earns $9,000 is 6%. This six percent rate was applied to the maximum distribution amount to compute the highest range for the individual income tax (9,375 x 6% = $563). This maximum amount is highly unlikely since it would allow none of the profits to be reinvested in the business. The other end of the spectrum is that no individual income tax would be owed if no dividends are distributed to shareholders. For the two pass through entities it is assumed that the highest nominal individual rate of six percent applies.

[3] Assumes for each type of entity the full amount of income is applied to the tax rate of seven percent (7%).

In her brief, the Director concedes that when drafting Chapter 148 (circa 1945-1946), the Missouri General Assembly sought to create tax parity among competing financial institutions. Respondent's Brief at pages 5 and 11. The Director goes on to explain why this should not be relevant since S corporations were not introduced into the IRC until 1958, and the IRC was not adopted as the starting point for Missouri income taxation until a later time.

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[4] Per the Director's interpretation only the C corporation is entitled to a credit against its credit institutions tax for the income taxes paid on the earnings from the credit institution, and this credit is based upon the entity level tax it pays.

[5] Under the IRC, and as incorporated into §143.471, all of the earnings of an S corporation are treated as the earnings of the shareholders. Thus, the entire $10,000 of earnings of the credit institution flows through to the shareholder as taxable income on his/her individual income tax return. Similarly, for the partnership under the IRC as incorporated into §143.411, all of the earnings of the partnership are treated as earnings of the partners. Thus, the entire $10,000 of earnings of the credit institution flows through to the partners as taxable income on each partner's individual income tax return. In the case of the C corporation only that portion of corporate earnings actually distributed to the shareholders is subjected to tax. The tax upon these dividends is the double taxation element discussed in the Respondent's brief.

However, the obvious point that the Director glosses over is that partnerships did exist in 1945. In fact among the quotes from the *Wolff* case included in the Director's brief is the following: "[Missouri, like the United States, has] adopt[ed] the partnership statutes as the model for taxing the shareholders of S corporations." Respondent's Brief at page 7; *Wolff v. Director of Revenue*, 791 S.W.2d 390, 391 (Mo. banc 1990). This quote is followed by: "The S corporation . . . is colloquially known as an 'incorporated partnership.'" Respondent's Brief at page 8; *Wolff*, 791 S.W.2d at 391.

The point is that for Missouri income tax purposes and for Missouri financial institutions tax purposes, partnerships and S corporations are taxed alike. Thus, the argument that S corporations did not exist at the time Chapter 148 was created loses its potency when one considers that partnerships, an identical business organization for Missouri tax purposes, did exist and were taken into consideration in the enactment of Missouri's tax laws for financial institutions.

To equalize the tax burden upon credit institutions formed as partnerships the General Assembly intended such partnerships to receive a credit for the income taxes paid by the individual partners against their entity level Missouri credit institutions tax.[6] This was the only means of achieving tax parity for

[6] Or alternatively, a credit must have been contemplated similar to the one which banks now receive via section § 148.031, RSMo.

financial institutions organized as partnerships, which the Director concedes that the General Assembly intended.

The table in this brief starkly illustrates that the Director imposes a higher combined rate of income and financial institutions tax upon both partnerships and S corporations than she imposes upon financial institutions organized as C corporations.[7] This result is clearly at odds with the General Assembly's intention

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[7] The amount of additional tax imposed upon flow through entities ranges from a low of 2.84 % (1300-1,273 = 37; 37/1300 = 2.84%) to a high of 46.15% (1300 – 700 = 600; 600/1300 = 46.15%). Note that the low end of the range (2.84%) would require the corporation to pay out the entire $9,375 as a dividend to its shareholders. In reality this is not possible because the federal government would impose an income tax on these earnings of approximately thirty-four percent (34%). Inclusive of the federal income tax and the Missouri income tax, the amount available for a dividend to shareholders is reduced from $10,000 to $5,975 (34% + 6.25% = 40.25%; 10,000 – 40.25% = $5,975). Hence, the "real" maximum amount available for distribution to shareholders $5,975 would only generate $358.50 of Missouri individual income tax (assuming the maximum six percent rate) for the shareholders. This further reduces the overall combined taxation for C corporations to a maximum of $1,058.50 ($700 + 358.50 = $1,058.50). This means the range of extra taxation imposed on partnerships and S

to create tax parity among competing financial institutions. While the Director suggests this over taxation may be ignored since S corporations were nonexistent when Chapter 148 was created, she conveniently ignores the fact that partnerships did exist at the time, and for purposes of the taxes in question in the instant case are taxed identically by the Director.

MAC believes that the General Assembly did take into account pass through entities when Chapter 148 was enacted and that it intended partnerships to enjoy tax parity with other financial institutions. Hence, the General Assembly intended that partnerships receive a tax credit against their financial institutions tax liability for the income taxes paid by their shareholders.[8] As the Director taxes S corporations identically to partnerships, it is disingenuous for the Director to assert that the General Assembly could not have contemplated the tax treatment of S corporations in 1946. While this statement is literally true, the tax treatment of pass through entities was certainly considered.

As the Director concedes that the General Assembly intended to create tax parity among competing financial institutions, including partnerships, the Director should allow tax credits to partnerships to equalize their tax treatment vis-à-vis

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corporations is really 18.58% (1,300 – 1058.5 = 241.5; 241.5/1300 = 18.58%) to 46.15%, an even greater disparity than shown in the table.

[8] See footnote #1 *supra*.

"C" corporations. As "S" corporations are taxed identically to partnerships, these same tax credits should be extended to "S" corporations.

CONCLUSION

The Administrative Hearing Commission erred when if failed to allow Petitioner a credit against its Missouri credit institutions tax for either the income taxes paid by its shareholders attributable to the income they received from the Petitioner or, alternatively, the Missouri corporate income taxes Petitioner would have paid had it been organized as a "C" corporation rather than as an "S" Corporation.

Respectfully submitted,

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Certification of Service and of Compliance with Rule 84.06(b) and 84.06(c)

The undersigned hereby certifies that on November ____, 2005 on true and correct copy of the foregoing brief, and one disk containing the foregoing brief were mailed postage prepaid to:

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The Undersigned further certifies that the foregoing brief complies with the limitations contained in Rule Number 84.06(b), and that this brief contains 1,485 words. The undersigned further certifies that the labeled disk filed contemporaneously with the hard copies of this brief has been scanned for viruses and is virus-free.

____
Daniel J. Cook