

Indiana disallows portion of related party management fee deduction that is unrelated to management company's actual expenses

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In brief

In a recent Letter of Findings, the Indiana Department of Revenue disallowed a portion of management fees composed of 'residual profits' that were paid to an affiliated company. The Department determined that the taxpayer's deduction for fees paid in excess of the affiliate's actual expenses (which were returned to the taxpayer as dividends) did not result in a fair reflection of the taxpayer's Indiana income. Indiana taxpayers should be aware that the state exercised its IRC sec. 482-like powers to disallow a portion of a taxpayer's related company management fee expense. [[Indiana Letter of Findings, Indiana Department of Revenue, No. 02-20120310](#), (7/31/13)]

In detail

Facts

In 2008 Taxpayer transferred its executive and certain clerical and management functions to a newly formed Management Company. Taxpayer paid management fees to Management Company, which were comprised of: (1) reimbursement of expenses incurred by Management Company, (2) an additional markup relating to such expenses, and (3) payment of profits (referred to as 'residual profits').

For the tax years 2008 through 2010, Taxpayer claimed a deduction for the expense

reimbursement, markup, and profits it paid Management Company. On audit, the Department allowed the deduction measured by expense reimbursement and markup, but denied the deduction for the payment of profits.

Deduction in excess of actual expenses disallowed when part of a circular flow of funds

On audit, the Department disallowed the residual profit deduction element of the management fee under its authority to allocate income between and among businesses in order to fairly reflect income derived from the state. Taxpayer

argued that such IRC sec. 482-type adjustment powers should be restricted if the deduction in question relates to a transaction determined to be arm's length under IRC sec. 482 standards. Taxpayer offered transfer pricing studies to support that residual profits paid to Management Company were at arm's length.

The Letter of Findings (LOF) found the transfer pricing studies unpersuasive. The LOF acknowledged that a circular flow of funds existed because Management Company provided Taxpayer a dividend (which was not subject to tax)

equal to the portion of the management fee that exceeded its expenses. The LOF recognized that Taxpayer received a management fee deduction that exceeded its 'real-world cost' because of the fee that was returned to Taxpayer in the form of a dividend.

The LOF found that Taxpayer's deduction relating to residual profits "did not reflect the economic realities of its operations or of Management Company's operations." The Department did not dispute the legitimate business expenses paid to Management Company relating to costs in providing services to Taxpayer, plus a markup. However, "to permit a deduction in excess of

those expenses when that excess will be simply returned to Taxpayer does not reflect the real-world income of Taxpayer." Accordingly, the LOF upheld the Department's disallowance of the excess expense element (i.e., the residual profits) of Taxpayer's management fee.

Estimated tax penalty waived, taxpayer acted in good-faith

As a result of the disallowed deduction, the Department imposed a 10% penalty for insufficient estimated tax payments. The LOF reasoned that Taxpayer made estimated payments based on a legally reasonable and good-faith position. The Department waived the 10% penalty, sustaining Taxpayer's protest.

The takeaway

The LOF provides two insights for Indiana taxpayers. First, the LOF may provide Indiana taxpayers some support that management fees relating to expense reimbursement, with a markup, are valid deductible business expenses. However, the LOF did not explore the reasonableness of the markup charge. Second, Indiana taxpayers with similar arrangements should be aware that the Department may exercise its IRC sec. 482-type authority to disallow deductions relating to management fees that are in excess of actual costs with a certain markup.

Let's talk

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