Indiana –Factoring fee expense disallowed when circular flow of funds exists

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In brief

In a recent Letter of Findings, an Indiana corporate income taxpayer was required to add back certain factoring fee expenses when calculating its corporate income tax. The Letter of Findings concluded that the related finance entity returned such factoring fees to the taxpayer in the form of tax free dividends and/or intercompany loans. The circular flow of funds between the taxpayer and the finance entity supported the Department's determination to disallow a portion of the factoring fee expenses in order to fairly reflect the taxpayer's Indiana income. [Indiana Letter of Findings 02-20120612 (11/27/13)]

In detail

Facts

Taxpayer paid fees to a related factoring entity (RFE), which was not included in Taxpayer's consolidated Indiana income tax return, to 'factor' or collect its accounts receivable. A portion of Taxpayer's receivable factoring expense comes back to Taxpayer in the form of dividends and loans by RFE.

The Department disallowed over $57 million of factoring fee expenses that Taxpayer paid to RFE. The $57 million represented the portion of factoring fees exceeding RFE's expenses in providing the factoring services to Taxpayer.

Department may adjust taxable income when income is not fairly reflected

Indiana does not have a specific addback for factoring expenses. However, Indiana Code Sections 6-3-2-2(l) and (m) provide that if the standard apportionment and allocation formulas do not fairly reflect a taxpayer's Indiana income, then the Department may depart from the standard formulas and use alternate methods to fairly reflect and report the taxpayer's Indiana-source income. The statutes and regulations direct the Department to approach making adjustments to fairly reflect the taxpayer's income on a case-by-case basis based on the facts and information available to the Department.

Taxpayer asserted that Indiana's alternative apportionment regime only allows for adjustments to a taxpayer's *apportionment*, not adjustments to a taxpayer's *income*. The Letter of Findings (LOF) concluded that the Department's authority extends to 'other adjustments' to arrive at a taxpayer's Indiana income – including the disallowance of expense deductions.

Circular flow of funds contributes to income not fairly reflected

Taxpayer argued not including factoring fees paid to RFE in its Indiana income tax return fairly reflected its activities in Indiana. Taxpayer emphasized that RFE was an operating company that collected

Taxpayer's accounts receivable for an arm's-length rate based upon a transfer pricing study.

The Department asserted a specific transaction's arm's-length status alone does not determine whether or not the substance of Taxpayer's overall company structure, intercompany transactions, and consolidated group's deductions fairly reflect a taxpayer's consolidated group's Indiana adjusted gross income. Additionally, the Department argued that Taxpayer's factoring arrangement created a distortion "without a corresponding benefit to the whole organization (such as liquidity and cheaper interest rates)."

The LOF concluded that the substance of Taxpayer's overall company structure and intercompany transactions resulted in RFE returning money back to Taxpayer in the form of tax-free dividends and/or intercompany loans. This 'circular flow of funds' had the effect of shifting a substantial portion of the taxpayer's Indiana-source income outside the state. Accordingly, the LOF determined that it was appropriate for the Department to disallow a portion of the factoring expenses in order to fairly reflect Taxpayer's Indiana income.

Contrast with prior LOF

Taxpayer argued that its position was supported by Letter of Findings 09-0805 (7/1/10), which concluded that a taxpayer was allowed to deducted similar factoring expenses. The LOF found that the following facts from Letter of Findings 09-0805 differentiated it from Taxpayer's situation:

- there was no evidence of a circular flow of funds between the taxpayer and its related factoring entity
- the related entity neither loaned the factoring fees back to the taxpayer, nor returned the factoring fees to the taxpayer in the form of dividends
- there was no indication that the related entity made unaccounted interest or other payments to the taxpayer.

The takeaway

While the Department's attempt to distinguish the fact pattern in this LOF from that in Letter of Findings 09-0805 is not wholly persuasive, the contrast in facts between the two should provide Indiana taxpayers with some guidance regarding facts under which factoring expenses may be acceptable to the Department. The Department may be more likely to conclude that such expenses do not support a fair reflection of taxpayer's Indiana income and, accordingly, disallow a portion of the expenses when such payments may be considered to be part of a "circular flow of funds." The LOF also suggests that a taxpayer may need to show some overarching business purpose to the related company factoring.

Let's talk

If you have any questions regarding the Letter of Findings, please contact:

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