The Tightrope of Acceptable Intercompany Transactions

by Brian Strahle

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It's again the time to look back and reflect on what we did or didn't accomplish in the prior year and to develop goals or resolutions for the new year.

Accounting and law firms publish an annual review of state tax issues and try to forecast what will happen next year. It is said that imitation is the sincerest form of flattery. If that's true, there is a lot of flattery going on in the state tax world: Trends in that arena tend to start with tax policies or changes adopted by one state that other states then implement.

This is also the time when one tax year ends and another begins. The books close and taxpayers begin to gather information to file the prior year's tax returns. Provision, planning, compliance, and controversy — the cycle continues year after year. One trend that will never cease is the need to comply with multistate taxation and minimize the taxes resulting from a company's business transactions and operations. Tax departments at both large and small companies must continually resolve the past, comply with the present, and plan for the future. Sometimes that tax planning works, and sometimes it doesn't.

The Tightrope

An Indiana taxpayer paid factoring fees to a related entity that was not included in its Indiana income tax return. The taxpayer subcontracted the collection of its accounts receivable to the related entity by factoring the accounts to the entity. According to the taxpayer, the entity charged an arm's-length rate based on a transfer pricing study prepared in accordance with IRC section 482 and related regulations. An independent third party prepared the study, and the factoring fees reported on the federal returns fell within the range of acceptable prices listed in the study. A portion of the receivable factoring expense that the taxpayer paid came back to it as dividends and loans from the related entity.

After an audit investigation, the Indiana Department of Revenue disallowed more than $57 million of the factoring fees the taxpayer paid to the related entity, which represented the portion of the fees paid to the entity that exceeded its expenses for providing the factoring services. The DOR argued that the taxpayer group, as an economic entity, did not achieve any business or operational advantage that it did not have before the taxpayer started factoring its receivables. The in-house factoring did not result in lower financing costs, the most common reason for factoring. The same departments, such as accounting, credit and collection, and customer service, that existed before the receivable factoring was put in place still existed. However, the functions became part of the operations of the related entity, which didn't file in Indiana. Thus, the major benefit of the factoring operations was the minimization of state income tax. According to the DOR, that distorted the reported Indiana adjusted gross income without benefiting the whole organization. The factoring entity reported more income than all other entities in the consolidated group, including the taxpayer, which is supposed to be the most dominant entity.

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In Indiana Letter of Findings 02-20120612, the DOR said corporate form will normally be respected unless the form is a sham or unreal. The DOR relied on the fact that courts have been consistent in holding that tax avoidance in and of itself is not a valid business purpose. It also relied on IC section 6-3-2-2(m) to distribute, apportion, or allocate income derived from sources in Indiana among organizations, trades, or businesses to fairly reflect income. According to the DOR, the regulations allow it to use any method to equitably allocate and apportion a taxpayer's income.

Working Without a Net

The taxpayer argued that the independently prepared transfer pricing study provided enough support for the state to accept the intercompany transactions. However, the DOR stated in its letter of findings that the arm's-length status of a transaction, considered in isolation, is not relevant to whether the substance of a taxpayer's overall company structure, intercompany transactions, and consolidated group's deductions fairly reflect a taxpayer's consolidated group's taxable Indiana income. According to

the DOR, the problem was that the transfer pricing study was performed to analyze the arm's-length status of the transactions for federal, not state, tax purposes. In fact, the transfer pricing study itself asserted it was not performed for state tax purposes and should not be used by the taxpayer as advice for state tax purposes.

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Perhaps the most troublesome issue for the taxpayer was that a portion of the receivable factoring expense it paid came back to it as dividends and loans. The Indiana DOR has routinely provided guidance in letters of findings regarding the circular flow of funds between related parties, such as (i) when a taxpayer makes intercompany payments and takes expenses for those payments but cannot explain the nature and substance of the underlying agreement and transactions[1]; (ii) when the deduction of royalty and interest expenses are part of a continual circular flow of money between related entities — with the result of shifting taxable income to out-of-state entities that then return nontaxable income to the Indiana entities, calling into question the need for the transactions and resulting in an unfair reflection of the income earned from Indiana sources[2]; and (iii) when the payment of royalties results in an intercompany circular flow of money that serves no commercial business purpose.[3]

The taxpayer argued that its position should be sustained because the business purpose and substance of the related factoring entity were substantially similar to that of the factoring company described in Letter of Findings 02-20090805. However, the DOR argued that the taxpayers' situations were not factually similar because there was no evidence that the other taxpayer had a circular flow of funds in the form of either loans or dividends. Letter of Findings 02-20090805 simply stated that the facts presented little to indicate that the factoring fees constituted an abusive tax avoidance scheme even though the claimed expenses significantly reduced the income subject to Indiana tax. In fact, the DOR held in Letter of Findings 02-20090805 that the related entity incurred legitimate and reasonable expenses associated with the collection of the factored receivables.

In this case, the DOR did request additional documentation regarding the circular flow of funds, but the taxpayer did not provide it. Thus, the DOR held it had legitimate concerns that the taxpayer exploited the company's structure and the intercompany transactions to shift a substantial portion of its Indiana income outside the state.

Balancing Act

A related factoring entity can withstand audit scrutiny, but taxpayers should take proper steps to support the path to acceptance. Although each state differs, the lessons from the Indiana letters of findings can be used to substantiate the validity of the transactions. First, taxpayers should have a business or operational purpose for the creation of related entities when large intercompany transactions will occur. Second, taxpayers should realize some type of business benefit, such as liquidity or lower interest rates, for the whole organization as a result of the new entity or structure. Third, taxpayers should not rely on federal transfer pricing studies to substantiate state tax consequences of intercompany transactions. Lastly, taxpayers should avoid the circular flow of funds between related parties.

Tax planning is each taxpayer's right and obligation, but finding the balance between what is and isn't acceptable is like walking a tightrope. As the Indiana letters of finding show, finding the balance is difficult, but not impossible. ✰

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[1]Indiana Letter of Finding 02-20030423.
[2]Indiana Letter of Finding 02-20090945.
[3]Indiana Letter of Finding 02-20100494.