DEPARTMENT OF STATE REVENUE

02-20090805.LOF

Letter of Findings: 09-0805
Corporate Income Tax
For the Tax Years 2005-2006

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I. Adjusted Gross Income Tax–"Excessive Factoring Fees".

Authority: IC § 6-3-2-2(m); IC § 6-8.1-5-1(c); Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 63 S.Ct. 1132 (1943); Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer protests the Department of Revenue's decision that a portion of Taxpayer's factoring expenses paid to a related entity should be disallowed.

II. Tax Administration–Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a service provider operating in Indiana. As a result of an investigation, the Indiana Department of Revenue ("Department") issued proposed assessments for additional adjusted gross income tax, interest, and negligence penalties for the 2005 and 2006 tax years. In the investigation, the Department disallowed a portion of the claimed factoring expenses, which were determined to be excessive, in order to fairly represent Taxpayer's Indiana income. Taxpayer protested the assessment of tax relating to this disallowance of the "excessive factoring fees" and the imposition of the negligence penalties. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as necessary.

I. Adjusted Gross Income Tax–"Excessive Factoring Fees".

DISCUSSION

During the years at issue, Taxpayer paid factoring fees to a related entity, which was not included in Indiana income tax return filings. Taxpayer subcontracted the collection of its accounts receivable to the related entity by "factoring" its accounts receivables to the related entity. The Department disallowed a portion of the claimed factoring expenses, which were determined to be excessive, in order to fairly represent Taxpayer's Indiana income. In support of that position, the audit report cited to IC § 6-3-2-2(m) which states:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The cited statutory provision provides the Department with authority to apportion or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect Indiana income.

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." Id. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." See Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer maintains that the related entity is an operating company which actively pursues the collection of the "factored" accounts receivables for which it has charged an arm's length rate. Taxpayer asserts that the full amount charged for the "factoring fees" should be allowed as an expense.

As noted in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

While the audit report correctly noted that the claimed expenses significantly reduced the amount of the income subject to tax in Indiana, based upon the facts presented there is little to indicate that the factoring fees constituted an abusive tax avoidance scheme such that the claimed expenses did not "fairly reflect" Taxpayer's Indiana source income. In the instant case, the related entity incurs legitimate and reasonable expenses associated with the collection of the factored receivables. Based upon the facts presented, the related entity

neither loans the factoring fees back to Taxpayer, nor returns the factoring fees to Taxpayer in the form of dividends. Also, there is no indication that the related entity makes unaccounted for "interest" or other payments to Taxpayer. Therefore, in this particular case, Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of demonstrating that the Department's decision disallowing a portion of the factoring expenses is incorrect.

FINDING

Taxpayer's protest is sustained.

II. Tax Administration–Negligence Penalty.

Taxpayer requests that the Department abate the ten-percent negligence penalty.

IC § 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed.... "

While Taxpayer has demonstrated that it will not owe some of the proposed tax assessments, as discussed in Issue I, Taxpayer has not affirmatively established that its failure to pay the remaining deficiencies was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c). Therefore, the penalty assessed pursuant to IC § 6-8.1-10-2.1 shall not be abated.

FINDING

Taxpayer's protest is respectfully denied.

CONCLUSION

Taxpayer's protest to the disallowance of a portion of its "factoring fees" is sustained, as discussed in Issue I. Taxpayer's protest to the imposition of the ten-percent negligence penalty is denied.

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