DEPARTMENT OF STATE REVENUE

02-20140599.LOF

Letter of Findings: 02-20140599
Corporate Income Tax
For the Years 2007, 2008, and 2009

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Manufacturer failed to refute the audit's decision that its various, corporate entities should report their income on a combined basis. Manufacturer's reliance on a transfer pricing study resulted in an incongruous attribution of profits derived from selling its products to Indiana customers.

ISSUE

I. Corporate Income Tax - Combined Return.

Authority: IC § 6-3-2-2; IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-3-2-2(p); IC § 6-8.1-5-1(c); Treas. Reg. § 1.482; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 3.1-1-62; Playing "The Price Is Right" With State Transfer Pricing Studies, State Tax Notes, Jan. 3, 2011.

Taxpayer argues that the Department of Revenue was without authority in its decision requiring that members of Taxpayer's unitary group file combined Indiana income tax returns and that the decision to do so was unjustified.

STATEMENT OF FACTS

Taxpayer is in the business of manufacturing consumer and industrial products. Taxpayer consists of a parent entity ("Parent") and various subsidiaries. The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns.

The audit determined that Taxpayer and certain of its subsidiaries should have reported their Indiana income on a combined basis. Taxpayer disagreed with that determination, disagreed with the resulting assessment of additional tax, and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for its protest. This Letter of Findings results.

I. Corporate Income Tax - Combined Return.

DISCUSSION

The issue is whether the Department erred in determining that Taxpayer and certain of its various operating subsidiaries should have filed combined corporate income tax returns for the years 2007, 2008, and 2009.

During 2007 and 2008, Taxpayer and its subsidiaries shared the following business structure.

- "Parent" is the parent company of two entities. The first entity is designated here as "Entity One." The second entity is designated here as "Entity Two."
- In turn, "Entity One" operates two primary subsidiaries. "Entity One" owns and operates "Subsidiary One" and "Subsidiary Two."
- "Entity One" operates a third subsidiary here designated as "Holdings."

• "Entity One" also operates and owns 99 percent of a fourth subsidiary here designated as "LLC."

• In turn, "Subsidiary One" owns the remaining one percent of "LLC."

For the years 2007 and 2008, the Department's audit required that "Entity One" and "Subsidiary One" file combined corporate income tax returns.

Taxpayer changed its business structure in 2009.

• "Parent" created another entity designated here as "Corporation."

• "Corporation" operated and owned 100 percent of three new subsidiaries here designated as "Procurement One," "Procurement Two," and "Procurement Three."

• In 2009, "Entity One" merged with "Procurement One."

For the year 2009, the Department's audit required that "Entity One," "Subsidiary One," "Corporation," and "Entity Two" file combined corporate income tax returns.

In considering Taxpayer's protest and as a threshold issue, it is the Taxpayer's responsibility to establish that the audit decision requiring it and its subsidiaries file combined returns and the consequent tax assessment is incorrect. As stated 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." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

A. Audit Findings for 2007 and 2008.

"Parent" is the "ultimate parent company of all Taxpayer's operating entities." During 2008, one of "Parent's" subsidiaries, "Entity One," filed an Indiana corporate income tax return claiming an Indiana apportionment factor of zero percent. It stopped filing Indiana returns in 2009 because it merged with "Procurement One."

Prior to 1998, "Entity One" was previously the manufacturer of Taxpayer's products. Beginning 1998, "Entity One" created a new entity, "Subsidiary One," and transferred to "Subsidiary One" all of its production assets. "Entity One" retained all of its other assets including its corporate office and the intellectual property related to the manufacture of its products.

Thereafter, "Subsidiary One" became the actual manufacturer of Taxpayer's products while "Entity One" became the sales corporation for those products. According to the audit report, "Entity One" became the procurement company for "Subsidiary One." As explained in the audit report:

> For 2008, ["Subsidiary One"] is under contract with ["Entity One"] to perform contract-manufacturing services to ["Entity One's"] customers [Taxpayer's products] using technology owned by ["Entity One"] and for the benefit of ["Entity One"].

The audit report explains "Entity One's" activities and functions.

> ["Entity One"] is a wholly-owned subsidiary of ["Parent"]. Its activities include research and development, product development, sales forecasting, direct marketing, contract negotiations, transportation . . . handling credit terms of sales, market strategy, handling long-term customer relationships, pricing, strategic planning, legal and regulatory affairs, and information technology. In addition, it owns and develops intangible property comprising customer agreements, know-how, proprietary software or processes, supplier agreements, trade secrets, and trademarks. In short, it will handle all aspects of the sale except physically manufacturing the product.

The audit report sets out the "Subsidiary One's" activities and functions.

> ["Subsidiary One"] in its manufacturing operations purchases raw materials based on ["Entity One's"] existing arrangements with suppliers. ["Subsidiary One"] makes [] [products] on a contract basis based on orders from ["Entity One"]. The manufacturing process includes [manufacturing steps resulting in Taxpayer's products]. This is done using proprietary tool and die designs and selected [product] making equipment owned and developed by ["Entity One"]. ["Subsidiary One"] even pays ["Entity One"] a royalty fee for the ["Entity One's"] intellectual property it uses in the manufacturing process.

The audit found that "Subsidiary One" was under the direct control of "Entity One" and does not serve any third-party customers. The audit report cites to the agreement between "Entity One" and "Subsidiary One" in which "Customers" refers to "Entity One's" Customers.

> ["Subsidiary One"] shall manufacture the Products for Customers in such quantities as shall be required by the Customers and ["Subsidiary One"] shall devote all of its assets and employees to the manufacture of Products for Customers.

The audit concluded that "Subsidiary One" produces various products exclusively for "Entity One" employing the "technology, product specification[s], and production schedules as set forth by "Entity One." The audit report notes that "[e]ven the raw materials are purchased from supply arrangements set up by ["Entity One"].

> [G]iven any transaction, ["Entity One"] does all of the activities associated with the sales with ["Subsidiary One"] handling just the manufacturing aspect under direct control of ["Entity One"] with ["Entity One"] setting forth the price for ["Subsidiary One's"[services and [] ultimately the price for which the product is sold.

Insofar as the financial arrangement between "Entity One" and "Subsidiary One," the audit report found as follows:

> ["Subsidiary One"] collects the gross price when it "sells" the product to the customer but sends to ["Entity One"] the amount collected less its manufacturing fee. The profit reported by ["Subsidiary One"] to Indiana represents its cost plus fee and not the true profit earned from the sale. The manufacturing fee is a cost plus arrangement between ["Entity One"] and ["Subsidiary One"].
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> In 2008, on their federal return, ["Entity One"] had a gross profit of [Redacted] on sales of [Redacted] or [more than 250 percent] whereas ["Subsidiary One"] had a gross profit of [Redacted] on sales of [more than one billion dollars] or [less than five percent]. The latter was due to its cost of goods sold reflecting [] passing the profit back to ["Entity One"]. ["Entity One"] claimed to have zero nexus in Indiana even though ["Subsidiary One"] "sold" to ["Entity One's"] Indiana customers at prices specified by ["Entity One"] and manufactured to ["Entity One's"] specification.
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> . . . .
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> Clearly the actual profit from all of the sales was truly reflected on ["Entity One's] books and records [rather] than on ["Subsidiary One's"]. Even the [less than five percent] profit earned by ["Subsidiary One"] was low given industry standards which range from [percentages greater than 30 but less than 40] according to the website bizstats.com.

The audit cited to IC § 6-3-2-2(l) and IC § 6-3-2-2(m) as authority for its decision requiring that "Entity One" and "Subsidiary One" report their income on a combined basis. Before implementing that decision, the audit discussed with Taxpayer's representatives potential alternatives. However, the audit report indicates that it arrived at no satisfactory alternative with Taxpayer. The audit report explains:

> Separate accounting did not apply because this was not a situation of two distinct sources of revenue. Disallowing of expenses was not a good option because there is no one intercompany expense that could be isolated to correct distortion. This is a case of a single transaction that starts with technical development, contract negotiation, procurement of raw materials, manufacture and ends with the sale of a finished product. Since it is one unitary transaction the best approach would be to combine the companies involved to fairly reflect income. Due to the facts in this case, other alternatives such as disallowance of expenses, separate accounting and re-allocating of expenses do not work. Combination is the only approach that makes the most sense given that it allows factor relief (other methods do not) and gets to the fairest result. The [T]axpayer did not provide any alternatives after being requested to do so.

As required under IC § 6-3-2-2(l), the audit found that "Entity One" and "Subsidiary One" shared the requisite "unitary relationship." The audit report found that the unity of ownership existed because both companies were part of a "vertically integrated controlled group of corporations."

> The unity of use is evidenced by the various intercompany services (such as contract manufacturing by [Subsidiary One] for [Entity One] and management services by [Entity One] to [Subsidiary One] and fees for the above services and fees for the use of trademarks and processes owned by [Entity One] and paid by [Subsidiary One] to [Entity One]. Unity of operations is met by the various intercompany services between the entities which are manufacturing, marketing, distributing and selling [products] and [product components].
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> . . . .
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> ["Subsidiary One"] is clearly not independent; in reality, it is simply a branch of ["Entity One"]. ["Entity One"] even performs all management activities including tax, treasury, accounting, legal [] for ["Subsidiary One"] for which ["Subsidiary One"] pays ["Entity One"] a fee under a management services contract between the two companies.

For the years 2007 and 2008, the audit concluded that - as reported - the originally filed separate returns did not fairly reflect "Entity One's" Indiana source income. The separate filing limited income reported by "Subsidiary One" to a minimal amount "since the profit is stripped from the sale and remitted to [Entity One] but not reported to Indiana." As reported, "Entity One" claimed to have zero nexus in Indiana even though "Subsidiary One" sold to "Entity One's" Indiana customers at prices determined by "Entity One" and manufactured to "Entity One's" specifications.

The audit proposed to combine "Entity One" and "Subsidiary One" pursuant to IC § 6-3-2-2(l) and IC § 6-3-2-2(m).

B. Audit Findings for 2009.

Taxpayer underwent a corporate restructuring effective the year 2009. Previously inactive "Corporation" was revived and given control of three, newly-organized single member LLCs. Those three LLCs are here designated as, "Procurement One," "Procurement Two," and "Procurement Three." For reporting purposes, the three LLCs were disregarded. None of the three procurement LLCs filed Indiana corporate income tax returns.

The auditor requested copies of agreements between the three procurement entities, "Entity One," and "Subsidiary One." According to the audit report, the auditor was told that "none existed" and the only available and relevant governing document was a third-party authored transfer pricing study. However, the audit discounted the value and relevance of the transfer pricing study because it "only serves to meet IRC Section 482 requirements and not for any state income purpose." The audit report states:

> The transfer pricing study establishes many responsibilities between companies for which there is no specific charge - only an arbitrary percentage of profit which is to cover all intercompany transactions. One profit percentage cannot cover all day-to-day operations and therefore there are expenses in both corporations that are not charged and therefore distort income. It is also distortive that [] two of the three manufacturing companies operate at a loss and one has a profit . . . . It is not economic reality that a manufacturer would sell their product at a loss so the company selling his product would make substantial profits. Therefore the pricing structure does not fairly reflect income. (Emphasis added).

Having arrived at the conclusion that separate Indiana reporting did not fairly reflect the 2009 income derived from conducting business in Indiana and selling its products to Indiana customers, the audit discussed with Taxpayer various alternatives to correct that perceived distortion. According to the audit report:

> Separate accounting did not apply because this was not a situation of two distinct sources of revenue. Disallowing of expenses was not a good option because there is no one intercompany expense that could be isolated to correct distortion. This is a case of a single transaction that starts with technical development, contract negotiation, procurement of raw materials, manufacture, and ends with the sale of a finished product. Since it is one unitary transaction the best approach would be to combine the companies involved to fairly reflect income. Due to the facts in this case, other alternatives such as disallowance of expenses, separate accounting, and re-allocating of expenses do not work. Combination is the only approach that makes the most sense given that it allows factor relief (other methods do not) and it gets to the fairest result.

The audit noted that discussions with Taxpayer's representative about the audit concerns did not yield any results. "The [T]axpayer did not provide any alternatives after being requested to do so. We explored with the [T]axpayer and found wanting all other alternatives."

Again, relying on the provisions contained in IC § 6-3-2-2(l) and IC § 6-3-2-2(m), the income of "Subsidiary One," "Entity One," "Holdings," and "Entity Two" was combined for the purpose of reporting Taxpayer's 2009 income.

C. Taxpayer's Response.

Taxpayer disagrees on various grounds with the Department's decision requiring it to file combined returns for 2007, 2008, and 2009.

Taxpayer asserts that IC § 6-3-2-2 - under which the Department exercised authority to require the combined filing - is constitutionally flawed. According to Taxpayer, IC § 6-3-2-2 improperly "permits Indiana to tax an out of state non-unitary company that engages in activity that distorts the income of an in-state company even if the out of state company has no nexus with Indiana." In Taxpayer's view, IC § 6-3-2-2 "has the potential to exceed Constitutional boundaries of Due Process and the Commerce Clause by allowing taxing jurisdiction over a non-unitary affiliate with no nexus in the state."

Taxpayer also argues that it has now been impermissibly placed it in a position to refute the audit's conclusion that its originally filed tax reporting distorted its Indiana source income. Taxpayer cites to Rent-a-Center, 963 N.E.2d at 466-67, for the proposition that, having submitted a written protest, it is now incumbent upon the Department to prove that its originally filed tax returns did not fairly reflect its Indiana source income.

> [T]he state is assessing tax on the mere allegation of distortion, and demanding that [Taxpayer] prove otherwise. By bypassing the required findings of distortion and lack of remedy, and moving directly to combination, the state has effectively removed the statutory protections intended by the legislature to prevent overreaching by the state.

Taxpayer maintains that the audit exaggerated "what a reasonable expectation of profit in the [product] industry . . ." and that its transfer pricing study establishes a more reasonable and appropriate level of profitability in its product manufacturing business. According to Taxpayer, its transfer pricing study properly and accurately gauges its profitability based on the risks and functionality of each of its subsidiaries and that the entities' inter-divisional operating agreements are "legally binding operating agreement[s]" and properly delineate each of the parties' separate risks and functions. According to Taxpayer:

> The transfer pricing study takes each separate entity, assumes the risks it bears and functions it performs, and attributes to it an appropriate amount of arm[']s length profit. Since [Entity One] is entirely outside of Indiana, it has the effect of allocating the appropriate level profit to instate and out of state activities.

Taxpayer asserts that the transfer pricing study was prepared by a "reputable third party" and is "uncontroverted and unchallenged . . . ." As a result, Taxpayer concludes that "there is no distortion in the income reported to Indiana, and hence there is no need to move ["Subsidiary One"] off the standard formula of apportionment."

D. Hearing Analysis.

"Entity One" originally filed Indiana tax returns for 2007, 2008, and 2009 return showing an Indiana apportionment factor of "zero."

"Subsidiary One" originally filed 2007, 2008, and 2009 returns indicating an Indiana apportionment factor of greater than zero for each year.

The audit concluded that - as claimed on its separate filings - the income reported did not "fairly reflect" the income Taxpayer derived from doing business in Indiana and that a combined filing of its various entities - as described in Parts B and C above - more accurately reflected the group's Indiana source income.

The audit arrived at its decision requiring a "combined filing" based in part on authority found at IC § 6-3-2-2(l). IC § 6-3-2-2(l) states in relevant part:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require,

in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

(2) for a taxable year beginning before January l, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;

(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or

(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (m) 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.

IC § 6-3-2-2(m) authorizes the department to resort to alternative methods of reporting income:

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.

IC § 6-3-2-2(p) states that requiring a taxpayer to file a combined return is warranted only if necessary to "fairly" reflect the taxpayer's Indiana income.

Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

The Department's regulation, 45 IAC 3.1-1-62, emphasizes that alternative reporting is warranted only in out-of-the-ordinary or even extreme circumstances.

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37-45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results. (Emphasis added).

1. Constitutionality.

Taxpayer has a fundamental disagreement with the statutory provisions contained in IC § 6-3-2-2(l) and IC § 6-3-2-2(p) on the ground that the provisions are constitutionally deficient on their face in that the statutes exceed "Constitutional boundaries of Due Process and the Commerce Clause . . . ." However, the Department does not consider the administrative process the appropriate means by which to challenge the constitutionality of Indiana tax statutes. IC § IC § 6-8.1-5-1(c) requires that Taxpayer establish that the assessment imposed pursuant to IC § 6-3-2-2(l) and (m) is "wrong." The Department concludes that resolution of the contested assessment lies within the four-corners of the imposition statutes and questions related to any purported constitutional deficiency of those statutes are best addressed elsewhere.

2. Burden of Proof.

Taxpayer cites to Rent-A-Center, 963 N.E.2d at 466-67 for the proposition that the Department has failed to meet its burden of establishing that separate company reporting did not fairly reflect Taxpayer's Indiana source income.

Taxpayer believes that it has made a facially sufficient argument that its originally filed returns were correct and that the Department has now failed to refute that argument. The Department rejects Taxpayer's application and reliance on the Indiana Supreme Court's decision in Rent-A-Center. In that case, the issue was whether the Tax Court properly required the Department to meet its burden under Ind. Trial Rule 56(c) of demonstrating that it was entitled to summary judgment as a matter of law. Id. at 466. The administrative protest filed by Taxpayer is not governed by the Indiana Trial rules and the "burden of proof" does not shift to the Department once Taxpayer sets out in its protest an argument challenging the assessment. As noted in the supreme court's decision, "Significantly, the General Assembly has provided that '[t]he 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.'" Id. (Emphasis in original).

3. Transfer Pricing Study.

The Department's audit discounted the relevance and accuracy of Taxpayer's transfer pricing study concluding that the study resorted to "an arbitrary percentage of profit . . . cover[ing] all intercompany transactions." According to the audit report, "One profit percentage cannot cover all day-to-day operations and therefore there are expenses in both corporations that are not charged and therefore distort income."

Taxpayer disagrees and relies heavily on its transfer pricing study concluding that it properly reported its income on a separate company basis. As Taxpayer explains, the transfer pricing study "establishes arms length compensation that appropriately apportions income inside and outside the state" and establishes that "there is no distortion to the income of ["Subsidiary One"] reported to Indiana." According to Taxpayer, "The Department has simply ignored these facts and made a bald, unsupported statement that the income of ["Subsidiary One"] in Indiana is distorted" and that the "legal documentation and the financial analysis in the form of comprehensive, contemporaneous and uncontroverted transfer pricing documentation presented by [Taxpayer] prove otherwise."

Taxpayer's transfer pricing study states:

> The § 482 regulations require that transfer prices within a controlled group must be "consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances (arm's length result)."

The accounting firm which prepared the study included a caveat within the study.

> While [accounting firm] believes that the conclusions in this report are consistent with the relevant provisions of IRC § 482, as amended, the regulations thereunder, and the judicial and administrative interpretations, thereof, there can be no guarantee that tax authorities will agree.

In this regards, the transfer pricing study's preceding caveat is correct. Transfer pricing studies are not Indiana-approved vehicles for justifying tax expenses through controlled party profits. Recitation in a transfer pricing study of the "arm's length" nature of its intercompany transactions does not necessarily imbue the study with authority to justify profit margins. An analysis conducted in accordance with the Treasury Regulations issued under § 482 of the Internal Revenue Code (Treas. Reg. § 1.482) does not apply to Indiana's adjusted gross income tax. The federal "arm's length" rules pertaining to international controlled transfers are intended to discourage U.S. companies from diverting profits to off-shore tax havens by requiring those companies to charge their foreign affiliates the same "arm's length" prices economic competitors are charged. As noted in Playing "The Price Is Right" With State Transfer Pricing Studies, State Tax Notes, Jan. 3, 2011, at 23, 27, "The reasons for requiring transfer pricing studies in international tax controversies are inappropriate in the multistate tax context."

At the heart of this dispute is Taxpayer's transfer pricing study by which Taxpayer invites the Department to concentrate on the economic principles underlying that study; However the Department does not agree that the transfer pricing study is the linchpin upon which the matter is resolved. Under IC § 6-3-2-2, the Department does not have to limit its inquiry to whether the Taxpayer's transfer pricing study establishes arm's length costs even if the Department were to agree that the transfer pricing study accurately weighs the risks, rewards, responsibilities of the parties. Instead the Department is obligated to broadly evaluate the totality of the circumstances to determine whether Taxpayer's income derived from its Indiana business activities is fairly reflected and reported.

The Department has no quarrel with general issues relating to Taxpayer's I.R.C. § 482 study and whether or not the transfer pricing properly or accurately addressed the federal income tax issues implicated by that study. Issues relating to federal questions are best addressed by Taxpayer and the federal authorities responsible for enforcing the Internal Revenue Code. However, the intercompany relationships between "Entity One" and "Subsidiary One" raised a legitimate question as to whether or not the Taxpayer's original reporting of its Indiana source income was or was not unduly affected by the method by which it reported the income received from selling products to Indiana customers. As explained in the audit report:

> ["Subsidiary One"] collects the gross price when it "sells" the product to the customer but sends to ["Entity One"] the amount collected less its manufacturing fee. The profit reported by ["Subsidiary One"] to Indiana represents its cost plus fee and the true profit earned from the sale[s].

In 2008, this arrangement resulted in "Entity One" - which reported "zero" Indiana apportionment - earning more than 250 percent profit on its product sales whereas "Subsidiary One" had less than five percent profit which what is used as a basis for reporting its Indiana sales. Transfer pricing study or not, the results on their face appear skewed in such a way as to minimize Taxpayer's Indiana tax exposure. The inequity in Taxpayer's reporting method is not made more equitable by its transfer pricing study. Indeed, no such study can automatically relieve the Department of its responsibility to independently evaluate and determine the fairness of a person's given reporting method. Instead of giving transfer pricing studies the force of an un-rebuttable trump card, transfer pricing studies should be viewed as one of the many items of evidence the Department may consider in determining whether any entities' reporting method fairly reflects the person's Indiana business activities. To rule that a transfer pricing study by itself overrides every other consideration that could be taken into account places too much weight on such studies and too little weight on equally relevant factors. The entire set of facts should be evaluated and no one factor should be declared more dispositive than any other.

Taxpayer points out the statutory requirements before the Department may require it to file combined Indiana income tax returns for the members of its unitary group. In order to meet that statutory threshold, the Department must: (1) show that the standard apportionment and allocation provisions do not fairly reflect a taxpayer's Indiana source income; (2) establish that the affected taxpayer is unitary with the corporation or corporations the Department seeks to include in the combined return with the taxpayer; (3) must show that it is unable to fairly reflect the taxpayer's Indiana source income using any other method allowable under IC § 6-3-2-2(l), (m). In addition, IC § 6-3-2-2(p) requires that the Department exhaust all other methods to address any alleged distortion before it may require that a taxpayer file a combined return.

As required under IC § 6-3-2-2(l), the audit considered various alternatives short of requiring that "Subsidiary One" file a combined return with the "Entity One" and Taxpayer's other entities. The audit considered the following:

- Separate accounting;

- Disallowing expenses;

- Reallocating expenses.

The audit rejected the alternatives for the reasons cited in parts "A" and "B" above. In each case, Taxpayer declined to offer its own alternatives but stood by its ground that the transfer pricing study justified its original method of filing separately.

E. Conclusion.

Taxpayer is a large, sophisticated company, entitled to structure its business affairs in any manner it sees fit, to enter into any internal financial arrangements it deems appropriate, determine its own internal risks and rewards, and to pursue any tax advantage attendant upon the management of its business affairs. However, in determining the nature of Taxpayer's business transactions and the resultant tax consequences, the Department considers "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992), aff'd 639 N.E.2d 264 (Ind. 1994). The issue here is whether Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that the audit's decision requiring it file a combined return and consequent assessment was "wrong."

Taxpayer is in the business of selling products to customers including customers located in Indiana. It does so by virtue of a corporate structure by which it internally attributes "profits" obtained from selling those products. That attribution of profits is determined by reference to a transfer pricing study relevant primarily in resolving federal international tax controversies. In this case, the profit disparity, as illustrated in its 2008 federal return, is a stark representation of the disparity. The entity which was designated as receiving a more than 250 percent profit on its product sales claimed to have "zero" Indiana nexus while the entity which concedes to having Indiana nexus was designated as receiving less than 5 percent profit on those same sales. This disparity falls squarely within what the Department's regulation describes as an "incongruous result[]" (45 IAC 3.1-1-62) fully justifying the audit's decision seeking an alternative method to more fairly represent income received from doing business within the state.

The audit raised legitimate concerns that the Taxpayer's original reporting of its Indiana income was inherently distortive and proceeded through the requisite steps in arriving at a methodology, fully authorized under Indiana law, to more accurately reflect that income.

The audit met the requirements set out at IC § 6-3-2-2(l), (m), (p) before determining that "Entity One" and "Subsidiary One" in 2007 and 2008 - and in 2009 along with "Holdings" and "Entity Two" - report their income on a combined basis. The audit justifiably found, and Taxpayer does not reasonably disagree, that the parties shared a unitary relationship. As required under IC § 6-3-2-2(l)(4), the audit considered and then discarded "other method(s) to effectuate an equitable allocation and apportionment of the taxpayer's income" before resorting to the combined reporting requirement.

Taxpayer challenged the audit's conclusion but has failed to meet its burden under IC § 6-8.1-5-1(c) of establishing that the assessment was "wrong." For these and other reasons cited in the audit report, the Department finds that the decision requiring the entities file a combined return fully justified.

FINDING

Taxpayer's protest is respectfully denied.

Posted: 07/29/2015 by Legislative Services Agency
An html version of this document.