DEPARTMENT OF STATE REVENUE

02-20150117.LOF

Letter of Findings: 02-20150117
Corporate Income Tax
For the Years 2010, 2011, and 2012

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.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

Indiana Clothing Retailer was not required to reapportion its gross operating margin between itself and its related purchasing entity in order to more fairly reflect Clothing Retailer's Indiana source income; the Department's audit did not provide sufficient grounds for rejecting Clothing Retailer's transfer pricing study under which Clothing Retailer decreased its federal adjusted gross income - for Indiana apportionment purposes - by approximately 43 million dollars.

ISSUE

I. Corporate Income Tax - Fairly Reflect Indiana Source Income.

Authority: IC § 6-3-2-2; IC § 6-3-2-2(l); IC § 6-3-2-2(m); IC § 6-8.1-5-1(c); 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); Columbia Sportswear USA Corporation v. Indiana Department of State Revenue, 45 N.E.3d 888 (Ind. Tax Ct. 2015); Rent-a-Center East, Inc. v. Indiana Department of Revenue, 42 N.E.3d 1043 (Ind. Tax Ct. 2015); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, (Ind. Tax Ct. 2010); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wabash, Inc. v. Dept. of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000); 45 IAC 3.1-1-62; Treas. Reg. § 1.482; Black's Law Dictionary (4th ed. 1981).

Taxpayer argues that the Department of Revenue erred in adjusting Taxpayer and related company's gross operating margin in order to more fairly reflect Taxpayer's Indiana source income.

STATEMENT OF FACTS

Taxpayer is a multi-state clothing retailer operating eight Indiana business locations. Taxpayer files Indiana income tax returns.

Taxpayer is a subsidiary of an out-of-state company ("Parent Company"). Parent Company has multiple subsidiaries including a retail service company ("Retail Services"). Parent Company files a separate Indiana income tax return.

Retail Services negotiates with and purchases clothing inventory from various vendors. Retail Services purchases the clothing and then resells the clothing to Taxpayer; Taxpayer purchases all of the inventory sold at its Indiana retail outlets from Retail Services.

Retail Services does not file an Indiana income tax return; rather it is included in Parent Company's combined out-of-state Florida return. In that combined out-of-state return, Taxpayer and Retail Service's intercompany sales are eliminated.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's income tax returns and business records. The audit concluded that Taxpayer's reporting methodology did not fairly reflect its Indiana source income. Taxpayer disagreed with the decision and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Fairly Reflect Indiana Source Income.

DISCUSSION

The issue is whether the Department was justified in adjusting the gross operating margin of Taxpayer and Retail Services on the ground that Taxpayer's original method of allocating and reporting its income did not fairly reflect Taxpayer's Indiana source income. The Department's audit division made the adjustment pursuant to IC § 6-3-2-2(l), (m) which permits the Department to resort to alternative methods of allocating and apportioning a taxpayer's income in order to more fairly reflect the taxpayer's Indiana source income.

A. Audit Results.

The Department's audit explains that Taxpayer pays Retail Services for all of the inventory sold in Indiana and deducts those payments on its Indiana income tax returns. However, the payments which Retail Services receives from Taxpayer are not reported on the Indiana returns because Retail Services, an out-of-state company, is not required to file Indiana income tax returns. Instead, Retail Services, a subsidiary of Parent Company's group, elects to file its income tax returns on a combined basis with Parent Company. When Parent Company files the out-of-state income tax returns on a combined basis, the income is not recognized because that income is the result of intercompany sales (transactions) and is eliminated. Additionally, because Retail Services is one member of Parent Company's group for federal income tax purposes, that income is not reported in the federal income tax returns because that income is the result of intercompany sales (transactions) and therefore is eliminated; in turn, when Parent Company files its Indiana income tax returns - which incorporate federal adjusted gross income as the starting point - that income is not recognized in the corresponding Indiana returns.

Pursuant to the audit, the Department noted, "Except for the retail reporting entities (including Taxpayer), all of the other entities' income is intercompany. Thus "this income is eliminated in [] both the federal consolidated return and the [out-of-state] combined return."

The audit found Taxpayer and Retail Services "have significant intercompany inventory sales" and thus further reviewed Taxpayer's records concerning the parties' pricing payment arrangements.

The audit compared the operating margin of Taxpayer and Retail Services. ("Operating margin" is defined as the "[n]et operating income divided by sales for the period." Black's Law Dictionary 984 (4th ed. 1981)). Taxpayer's operating margin was approximately one to two percent; Retail Services' operating margin was approximately nine to twelve percent.

In addition, the audit compared total federal income of Taxpayer and Retail Services; Taxpayer produced between 7 and 10 percent of the federal income while Retail Services produced - during the years at issue - 63, 72, and 52 percent of the total federal income despite the fact that Taxpayer generated virtually all third-party revenue for the group. As explained in the audit report:

> Since ALL of [Retail Services'] income is from related parties and the operating margin for these . . . . entities varies significantly, it was determined that the methodology utilized by [T]axpayer to report Indiana income for [Taxpayer] did not fairly reflect the income from Indiana sources.

The audit report recognizes that Taxpayer did not agree with these findings. Taxpayer submitted for consideration its "Transfer Pricing Study" which purported to establish the proper "arms-length" pricing between Taxpayer and Retail Services. That report provided:

> [F]or the three year period FY 2007 to FY 2009, comparable retail companies earned operating margins of between 1.8 percent and 5.4 percent, with a median of 2.5 percent.

The audit rejected Taxpayer's reliance on the study in part because of the close relationship between Taxpayer and Retail Services. As explained in the audit report, "[I]f sales were made to unrelated entities, [T]axpayer would not be able to base their sales price on the unrelated entities' gross profit margin." In effect, the audit found that "gross profit margin" would have been irrelevant in determining the sales price between unrelated businesses.

In addition, the audit took issue with the "comparables" contained within the transfer pricing study.

> The pricing study looked at 181 potential comparables and selected [] twenty . . . . However, none of the selected 20 comparables sell only their own private line of clothing products and most of the entities, such as

> Dollar General, Dollar Tree, Dollarama, Tuesday Morning[,] and Family Dollar are not even considered clothing retailers. Since the pricing study does not include any reasonably similar comparables, it cannot be the determining factor for allocating intercompany sales price.

The audit report cited to "Bizstats.com" which - according to the report - indicated that the average gross profit margin for a retail clothing company was 7.24 percent. The audit report took note of the fact that Parent Company's gross profit margin for 2011 through 2013 was 7.58, 7.24, and 9.28 percent respectively.

As authority for its decision to adjust Taxpayer's reporting methodology as it did, the audit cited to IC § 6-3-2-2(l) and (m). The statute 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.

The audit report noted that "The separate accounting method was, in essence the method used by [Taxpayer] as this is [a] separate tax return. There is no additional factor that could be employed as there is no isolated or non-recurring transaction[s] that distorted the income."

In addition, the audit cited to IC § 6-3-2-2(m) which 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. (Emphasis added).

The audit found that Taxpayer met the definition of a "controlled corporation" as specified in IC § 6-3-2-2(m) because of the following factors:

- Unity of ownership as all of the companies are part of a horizontally integrated controlled group of corporations;
- Unity of use is evidenced by the various intercompany charges, and management fees;
- Unity of operations is met by the various intercompany charges, taxpayer goods purchased by the retail entities from the captive inventory company, intercompany royalty charges where the common purpose of all entities is to sell a product at retail.

The audit considered but rejected the option of requiring the parties to file a combined return. The audit, in relevant part, states:

> [One option] was to combine all of the entities since it could be argued that they are unitary. While it is true that the significant intercompany sales and costs are reflected in cost of goods sold and thus in the operating margin, there are, however, other costs that are incurred outside of the cost of goods sold that might keep this method from fairly reflecting income. It is agreed that each entity has its individual business purpose and the costs incurred by [Retail Services] to purchase goods is completely different than costs incurred by [Taxpayer] to sell at retail.

Instead, the audit chose to reallocate two of the parties' "gross operating margins." The audit concluded that reallocation of this margin would "reflect a unified, yet distinct profit." While the audit recognized that Parent

Company had established and organized distinct operating entities "to perform specific functions and [that] each corporation has its individual costs associated with those functions, the goal for the total group is to sell a product at retail." The audit chose to reallocate the gross operating margin because it "would better reduce the profit disparity between entities selling the exact same product yet recognizes the difference in the basic corporate purposes." The audit report explains the reallocation of the gross operating margin:

> The operating margin is calculated by dividing federal taxable income by sales. Total operating margin for the group was totaled and divided by 3 to yield average operating margin. That percentage was then multiplied by [Taxpayer's] annual sales to produce income subject to tax that more fairly reflects the distribution of income. When this method was employed, the result was that the average operating margin for these entities is 4.11[percent] for FY10, 4.35[percent] for CY 11 and 5.17[percent] for FY13.

B. Taxpayer's Response.

At the outset, Taxpayer challenges the audit's statement that Taxpayer's operating margin was one to two percent while Retail Services' operating margin was approximately nine to twelve percent. Taxpayer responds:

> The auditor is using a measure of federal taxable income, not operating margin. The operating margin for Taxpayer is 2.3[percent]-3.2[percent] and the operating margin for Retail Services is 11[percent] to 14[percent].

Taxpayer argues that the Department failed to provide "support for its conclusion that the Transfer Pricing Study should be rejected." As explained by Taxpayer:

> In short, the Audit Report fails to show in any way why the Transfer Pricing Study is flawed, why [Taxpayer's] Indiana source income is understated, and why the Audit Report's alternative method is justified.

Taxpayer maintains that the Transfer Pricing Study's reliance on "comparables" is both recognized and authoritative.

> The [Comparable Profits Method] is one of the six specified analysis methods identified under Treas. Reg. § 1.482-3 and is widely used. The Transfer Pricing Study applied this method consistent with Treas. Reg. § 1.482-5, focusing on operating margin, one of the profit level indicators specifically identified in [Treas. Reg.] § 1.482-5 and one commonly used. The Study selected operating margin as the appropriate profit level indicator as it was determined to be the most reliable measure of income at arm's length in accordance with "best method rule" of Treas. Reg. § 1.482-1(c). Thus, use of profit margin as a means to determine an arm's length price is entirely consistent with federal regulations on the issue.

Taxpayer also challenges the audit's generalization that the entities considered in the Transfer Pricing Study have the same goal of selling clothing at retail.

> That conclusion, however, ignores the unique activities, resources, and risks employed or borne by [Retail Services], [Taxpayer], and [second retailer]–the very factors the Transfer Pricing Study took into consideration and that are required to be considered under federal law. And because the Audit Report's calculations used tax figures, it failed to take into consideration the entities' unique tax attributes that may distort the entities' true operating margin. Regardless of these infirmities, however, it is entirely reasonable for [Retail Services] to have a higher profit margin since it is the entity that creates nearly all of the value. [Retail Services] handles nearly all aspects of the process that creates [Taxpayer's] unique products, including choices of pattern, prints, construction, design specifications, fabric, finishes and color, and it also oversees the manufacturing and quality control process. While the value added by [Taxpayer] and [second retailer]–the store experience and customer service–is important, that value does not compare to the value created by [Retail Services]–the value of the product itself.

Taxpayer argues that the audit report lacks "any credible analysis, argument, or evidence supporting [its] rejection of the Transfer Pricing Study, and [lacks] any legitimate analysis, argument, or evidence supporting the Report's alternative calculation . . . ." Taxpayer states that the audit report incorrectly "dismissed the Transfer Pricing Study and its methodology as unreliable and then uses the exact same methodology inserting different amounts, and then justifies the result by referencing a figure found on an unsubstantiated website that clearly identifies its figures as applying to small businesses, not billion dollar businesses like the [Parent Company's] family."

C. Hearing Analysis.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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).

In challenging the Department's decision, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the 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, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

Taxpayer cites to Wabash, Inc. v. Dept. of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000) for the proposition that the Department here has the burden of establishing that "Taxpayer's Indiana source income is not fairly stated." ("Having raised this issue, the Department bears the burden of proving that [the taxpayer's] Indiana income does not fairly reflect Indiana-sourced income.") Id. at 624. The Department must respectfully disagree that the Department here is required to retrace the audit's steps and establish anew that the audit's decision was correct. At this administrative level, IC § 6-8.1-5-1(c) imposes on Taxpayer the requirement to establish that the audit's assessment was wrong. Rent-a-Center, 963 NE.2d at 466.

The Department's regulation, 45 IAC 3.1-1-62, emphasizes that alternative reporting is warranted only in "unique and nonrecurring" 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).

The Indiana Tax Court addressed the relevance of a transfer pricing study in Rent-a-Center East, Inc. v. Indiana Department of Revenue, 42 N.E.3d 1043 (Ind. Tax Ct. 2015). In that case, the petitioner challenged the Department's decision requiring it to file a combined return. Id. at 1045. The Department had disregarded the petitioner's transfer pricing study because the transfer pricing study "concern[ed] financial accounting, not tax, [] it concern[ed] federal, not Indiana law, [] it [had] no binding effect on state tax authorities, [] other jurisdictions have rejected similar studies, and [the study] is flawed." Id. at 1049.

The court found the petitioner's transfer pricing study relevant because I.R.C. § 482 studies are not written solely to address federal tax evasion. Id. at 1050-51. In some cases, the court explained, the study may be drafted to "clearly reflect the income of related organizations." Id. at 1050-51.

The court held that - in the summary judgment context - the relevance of any transfer pricing study will "depend[] on whether it tends to prove or disprove that [petitioner's] use of a separate return fairly reflected its Indiana source income . . . ." Id. at 1051.

Finally, the court rejected the Department's contention that other courts have "found arm's length pricing irrelevant in determining whether the income of a taxpayer that operates as a unitary business and engages in intercompany transactions with its affiliates is fairly reflected on a separate return." Id.

The Tax Court concluded that the Department "ha[d] not provided any . . . explanation, factual basis, or precedential or persuasive legal authority to support [its] claim." Id. at 1052.

In this instance, the Department's audit discounted the relevance and accuracy of Taxpayer's transfer pricing study concluding that "the determination that the amounts charged are reasonable and are at arms' length assumes that the **purchasing** entity would realize an operating margin of between 2.1 and 7.3. However, if sales were made to unrelated entities [T]axpayer would not be able to base their sales price on the unrelated entities' gross profit margin." (**Emphasis in original**).

Taxpayer disagrees and relies primarily on the accuracy and relevance of its transfer pricing study. According to Taxpayer, the "Comparable Profits Method" employed in the study "is a widely used, federally approved transfer pricing method . . . ."

The Transfer Pricing Study itself states:

> Our report is limited only to establishing the arm's length range of prices such that the Client's transfer pricing practices for the tax year ending January 31, 2010 for the Covered Transaction could be considered consistent with results that would have been achieved by independent parties dealing at arm's length and in conformance with the Regulations promulgated under IRC § 482.

The study explains the relevance of the study in regards to state tax issues:

> The Company has not requested us to consider, and we have not considered, any other state and local tax issues other than transfer pricing; any non-income tax issues; or any federal or foreign income tax issues. Accordingly, we do not reach any conclusions regarding any other state and local tax issues other than transfer pricing . . . .

In addition, the study states that its conclusions:

> [R]epresent our transfer pricing conclusions only and should not be taken as an assurance of the ultimate tax treatment. The advice is not binding on the state tax authorities, and there can be no comfort that the state tax authorities would not take positions contrary to such advice and would not be successful in sustaining such contrary positions. However, should the state tax authorities challenge the state and local income tax treatment of the issues discussed, the advice reflects our assessment of the merits.

However, the Tax Court in Columbia Sportswear USA Corporation v. Indiana Department of State Revenue, 45 N.E.3d 888, 898 (Ind. Tax Ct. 2015), transfer denied, ___ N.E.3d ___ (Ind. May 12, 2016) was not persuaded that similar cautionary, disclaimers in the petitioner's transfer pricing study at issue in that case.

The Department recognizes that Taxpayer and Retail Services contribute different degrees of value to the transactions entered into between Taxpayer and its customers. However, the "value" of the clothing is ultimately determined by the retail customer who chooses to purchase an item of clothing and pay Taxpayer the designated price for that item.

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.

The Department acknowledges that the intercompany relationships between Taxpayer and Retail Services raised a legitimate question as to whether or not 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:

> [I]f sales were made to unrelated entities, [T]axpayer would not be able to base their sales price on the unrelated entities' gross profit margin;
>
> None of the selected 20 comparables sell only their own private line of clothing products and most of the entities . . . are not even considered clothing retailers. Since the pricing study does not include any reasonably similar comparables, it cannot be the determining factor for allocating intercompany sales price[s].

The audit reasonably concluded that the allocation of income as determined in the study appeared weighted in such a way as to unduly minimize Taxpayer's Indiana tax exposure. However, in reviewing that conclusion and in light of the recent Tax Court's Rent-a-Center and Columbia Sportswear decisions, the Department is prepared to agree with Taxpayer's contention that the audit did not address with sufficient specificity the perceived shortcomings in that study. In addition, the audit did not establish the "reasonableness" of its decision to reallocate the parties' "gross operating margin." See Columbia Sportswear, 45 N.E.3d at 899.

The Tax Court has found that application of the Department's authority to require an alternate, equitable apportionment of income under either IC § 6-3-2-2(l), (m) is "ambiguous" and that such ambiguities are to "be resolved against the Department." Id. Given that low standard, the Department agrees that the audit cannot aside Taxpayer's transfer pricing study on the grounds cited when it required Taxpayer to reapportion the gross operating margin between itself and Retail Services.

FINDING

Taxpayer's protest is sustained.

Posted: 08/31/2016 by Legislative Services Agency
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