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Transfer Pricing

Indiana Must Accept Transfer Pricing Studies, Court Says

By Dolores W. Gregory

Jan. 5 — Two recent rulings in Indiana could reverse a long-standing practice of the state's tax authority to reject transfer pricing studies submitted by taxpayers challenging income adjustments in the state, practitioners say.

"These are significant decisions, important decisions," Mark Richards, a partner with Ice Miller LLP in Indianapolis told Bloomberg BNA (*Columbia Sportswear USA Corp. v. Dep't of State Revenue*, Ind. T.C., No. 49T10-1104-TA-00032, *order on cross-motions for summary judgment*, 12/18/15; *Rent-A-Center East Inc. v. Dep't of State Revenue*, Ind. T.C., No. 49T10-0612-TA-00106, *order on cross-motions for summary judgment*, 9/10/15).

For large taxpayers with related-party income, the Indiana State Department of Revenue has relied on a state statute, Indiana Code Section 6-3-2-2(m), to challenge intercompany transactions, he said.

BNA Snapshot

Development: Indiana must accept transfer pricing studies as evidence taxpayer sourced income properly to state.

Details: Tax court rejects revenue department's argument that Section 482 is irrelevant, unrelated to state statute authorizing reallocation of income in cases of distortion.

'Fairly Reflect.'

The statute authorizes the state tax director to reallocate or reapportion income from Indiana sources to more "fairly reflect" a company's earnings in the state.

"Oftentimes, taxpayers will have transfer pricing studies to try to justify the pricing on those intercompany transactions," Richards said Jan. 6. The state "has consistently ignored transfer pricing studies, and the court has clearly said they can't do that."

Jonathan Feldman, a partner with Sutherland Asbill & Brennan LLP in Atlanta, told Bloomberg BNA in a Jan. 5 interview that he also believes the rulings could be a game-changer in Indiana.

Indiana's Section 6-3-2-2(m) is almost identical in wording to Internal Revenue Code Section 482, Feldman said, yet the state has tried to argue that the statutes are so dissimilar that any transfer pricing study done in compliance with federal Section 482 regulations should be disregarded as irrelevant.

"We've seen other states trying to do the same thing," Feldman said. "The states closely scrutinize intercompany transactions, and they want to have the broadest authority to do reallocations or combinations or disallowances—whatever they want to do."

Distorted Income

In *Columbia Sportswear*, the Indiana Tax Court overturned a $950,000 assessment against an Oregon-based seller and distributor of sporting and hiking apparel and equipment for tax years 2005-07, rejecting the revenue department's finding that the company's transactions with affiliates had distorted its income in the state.

In *Rent-A-Center*, the court determined that the state acted improperly when it required a rent-to-own retailer to file a combined report with two of its corporate affiliates for the 2003 tax year. The state had claimed that the taxpayer's income was distorted because of royalties paid to one affiliate and management fees paid to another, and that the company owed an additional $513,272 in tax, penalties and interest (178 DTR K-3, 9/15/15).

Under Indiana law, the state taxes the portion of a corporation's adjusted gross income derived from sources within the state. Each corporation with Indiana adjusted gross income must report its tax liability on a separate-company basis, relying on an apportionment formula based on its property, payroll and sales in the state.

The calculation begins with federal taxable income, to which the taxpayer makes certain adjustments under Indiana Section 6-3-1-3.5(b). Once the tax base is determined, a taxpayer doing business in more than one state must calculate the portion of its adjusted gross income derived from sources in Indiana.

To do so, the taxpayer applies the allocation and apportionment rules under the code.

In effect, Richards explained, Section 6-3-1-3.5(b) "establishes the pie," and Section 6-3-2-2(a)-(k) determines Indiana's "piece of the pie."

Claim of Distortion

In *Rent-A-Center*, the taxpayer argued that the state couldn't force it to file a combined return with its affiliates because its separate return fairly reflected its source income. In support of this argument, it submitted a transfer pricing study showing that its intercompany transactions were conducted at arm's length.

Similarly, Columbia's parent company, Columbia Sportswear Co. Inc. (CSC) hired an accounting firm to prepare transfer pricing studies to determine arm's-length pricing for transactions between Columbia, CSC and another affiliate, Mountain Hardwear Inc., for tax years 2005-07.

In both cases, the state said the transfer pricing studies were irrelevant, primarily because they concerned a federal law. In *Rent-A-Center*, the state maintained that the transfer pricing studies weren't binding on state tax authorities. In *Columbia Sportswear*, the state argued that the purpose of the federal statute was entirely different from that of Section 6-3-2-2(m), even though the language of the two statutes is virtually identical.

The court rejected those arguments.

No Evidence of Tax Avoidance

In *Rent-A-Center*, the court found no evidence that the taxpayer had engaged in improper tax avoidance. Rather, the court wrote, “it is undisputed that the Transfer Pricing Study established arm's-length rates for RAC East's Intercompany Transactions and that the royalty and management fee payments were consonant with the Transfer Pricing Study's rates.”

Said Feldman: “Courts that do a good analysis see that the legislative intent of enacting that statute is to mirror Section 482.”

Even though the Indiana Legislature gave the tax director authority to reallocate income in cases where intercompany transactions were improperly priced, he said, it wasn't the Legislature's intent to give the department free reign to disregard any intercompany transaction at all.

“When there is an intercompany transaction, it needs to be valued at arm's length,” Feldman said. “The state can challenge the transfer pricing study, but they can't just ignore it completely.”

Columbia Sportswear incorporated the court's conclusions from *Rent-A-Center*, but also found that the state had improperly relied on the state statute to recalculate the tax base.

There was no evidence that the standard sourcing rules had failed to fairly represent the taxpayer's Indiana source income, the court said, but even if it had, the state's adjustments were still improper, because they were unreasonable. In making the adjustments to Columbia's Indiana income, the state had attributed nearly all of the consolidated group's gross income to a single entity, “out of all appropriate proportion to business activities in the state.”

According to Richards, the auditors were relying on the Section 6-3-2-2 regulations not just to expand Indiana's share of the base—but to expand the base itself.

“The department was wrong, and they've been doing it for a long time. But the tax court called them on it,” he said.

“It's going to be interesting to see if the department appeals or if, alternatively, they go to the Legislature to try to get additional authority.”

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For More Information

Text of the order on *Rent-A-Center* is at http://src.bna.com/bTG.

Text of the order on *Columbia Sportswear* is at http://src.bna.com/bTH.

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