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INDIANA STUDYING SWITCH TO MANDATORY COMBINED REPORTING FOR MULTI-STATE AND MULTI-NATIONAL BUSINESSES

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Indiana is a separate return state for income tax filing purposes, and has been since the Indiana adjusted gross income tax was first enacted into law in 1963. Now, over half a century later, that may change.

Back in the 1980s, when Indiana was courting companies headquartered in Japan and looking to invest in facilities in the United States, many of those potential investors were concerned about the tax policy of the states with respect to taxing the income of multi-national companies. At that time, several other states had moved to "mandatory combined reporting," which requires the inclusion of companies in a state's income tax return that do not conduct business in that state themselves, if that state believes that the company is part of a single "unitary" enterprise along with affiliates which conduct business in that state. The United States Supreme Court had recently approved California's application of worldwide mandatory combined reporting for a unitary group in *Container Corp. v. Franchise Tax Bd*., 463 U.S. 159 (1983).

In order to help position Indiana to attract these investors, then Governor Robert Orr of Indiana published a letter, dated February 23, 1984, which included the following statements:

> ***"I wish to make Indiana's position absolutely clear… It has not been and is not now, Indiana's policy to require combined reporting of taxpayers conducting unitary businesses… Indiana is known for its favorable business climate. I am much more interested in improving that climate than I am in broadening our tax base. I believe the adoption of a policy of requiring the combined reporting method for a unitary business would be extremely detrimental to Indiana's future economic growth."***

For more than 30 years since that letter was issued, Indiana has remained, at least officially, a non-mandatory combined return state for reporting and paying Indiana adjusted gross income tax. There have been concerns, however, that Indiana's position has been significantly eroded over the last several years through the frequent number of audits in which the Indiana Department of Revenue has taken the position that a taxpayer should be required to file a combined return and include its out-of-state affiliates in order to "fairly reflect" Indiana source income.

The Department's rationale has been based on its claim that Indiana Code § 6-3-2-2 authorizes the Department to deviate from the statutory allocation and apportionment formula and force a taxpayer to file a combined return if the Department determines that the taxpayer's filing method does not "fairly reflect income derived from sources within Indiana," and that the Department's determination is presumptively correct under Indiana Code § 6-8.1-5-1. The Indiana Adjusted Gross Income Tax Act when enacted was modeled after the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and Indiana Code § 6-3-2-2 reflects the provisions contained in Section 18 of UDITPA.

The Indiana Tax Court recently dealt the Department two setbacks on this subject in *Rent-A-Center East, Inc. v. Indiana Dep't of State Revenue,* 42 N.E.3d 1043 (Ind. Tax Ct. 2015) and *Columbia Sportswear USA Corporation v. Indiana Dep't of State Revenue*, 2015 WL 9263882 (Dec. 18, 2015). Each case involved a company engaging in transactions with affiliates, with the pricing based on a third party transfer pricing study. In each case, the company with Indiana income filed a separate return, and on audit the Department determined the return as filed did not fairly reflect Indiana income, disregarded the transfer pricing studies, and adjusted the company's Indiana adjusted gross income (forced combination, in *Rent-A-Center*). The Tax Court held that the evidence, including the unrebutted transfer pricing studies, established that the transactions occurred at arm's length rates and fairly reflected Indiana source income and, as a result, rejected the Department's adjustments. The Department has sought review of both cases to the Indiana Supreme Court. *Rent-A-Center East, Inc. v. Indiana Dep't of State Revenue,* 49T10-0612-TA-00106 (Nov. 13, 2015); *Columbia Sportswear USA Corporation v. Indiana Dep't of State Revenue*, 49T10-1104-TA-00032 (Jan. 19, 2016).

The State of Indiana has achieved notable gains in recent years in improving Indiana's tax system and as a result enhanced Indiana's reputation for having a favorable tax climate. In 2014, Governor Pence held a "Tax Summit" designed to generate ideas for simplifying Indiana's tax system and otherwise further enhancing Indiana's tax climate in order to retain and attract business investment in Indiana. Following that summit, the Indiana Legislature eliminated many procedural inconsistencies which had been traps for the unwary, reduced the aggregate number of deviations from federal taxable income, and eliminated certain unfair tax policies, most notably the throwback rule, just to name a few of the Legislature's many accomplishments. As a result of these and other improvements in Indiana tax policy over the last decade, Indiana has climbed in the published rankings of state tax climates.

Given the consistent efforts over last several years to make Indiana's tax policy more attractive in order to cultivate business investments in Indiana, many were caught by surprise when Senate Bill 323 was introduced early in January 2016 during the current session of the Indiana Legislature. The bill was introduced in the Senate Tax and Fiscal Policy Committee (Tax Policy Committee) and, as originally introduced, Senate Bill 323 would have mandated combined reporting for companies doing business in Indiana. If combined reporting was implemented in Indiana, Indiana would join roughly one-half of the states that mandate combined reporting**.** *Survey of State Tax Departments*, Special Rep. Multistate Tax Report (BNA), Apr. 24, 2015, at S-266-S-273. COST has published a position paper that opposes mandatory combined reporting and lists many of what COST believes are its detrimental effects. Moreover, Senate Bill 323 was based on the Multistate Tax Commission Model Act for mandatory combined reporting, which many believe to be extremely unattractive to multistate and multi-national businesses.

Proponents of the bill note that it was intended to apply any resulting increases in tax revenues to the acceleration of the corporate income tax rate reduction (which was previously enacted). They also believe that mandatory combined reporting would enable the Indiana Department of Revenue to avoid transfer pricing issues and close tax avoidance loopholes.

Many concerns have been expressed by the business community, and listing all of them is beyond the scope of this article. This bill would undoubtedly be a tax increase in the short term. However, the extent of the tax increase is unknown, as the State has been unable to assign a fiscal impact other than "indeterminable." There are concerns that this fundamental change in longstanding tax policy could have a severe and adverse impact on Indiana's business development efforts and the perception of Indiana as a state with an attractive tax policy climate, which could actually lead to a reduction in tax revenue for the State in the long run, among the other detrimental effects of a reduction in business investment in the state.

The proposed legislation was complex and its reach very broad. In addition to the overarching tax policy concerns regarding mandatory combined reporting, there are many concerns regarding specific provisions within the bill. Many of the provisions were vague and subjective, which, among other things, could create reporting uncertainty, added tax return preparation expense, increased audit risks and costs, and more disputes. The transition from a separate return system to a mandatory combined reporting system would also appear to add significant administrative costs for the Department, as the training of personnel alone would be a big undertaking. COST presented a letter expressing its opposition to Senate Bill 323, and others testified, or were available to testify, in opposition to Senate Bill 323.

As a practical matter, this is a short session for the Indiana Legislature which would have made it extremely challenging for the Legislature to find the time to thoroughly consider the concerns which have been expressed both for and against this bill. After hearing concerns from the business community, on January 26, 2016, the Senate Tax and Fiscal Policy Committee passed an amendment to the bill to send it to the Legislative Services Agency ("LSA") for study. LSA was instructed to conduct its study and submit its report before October 1, 2016 to the legislative council and to the interim study committee on fiscal policy.

While it appears that Indiana will not make this decision this session, the LSA study may impact the likelihood of the issue arising during the 2017 legislative session, which will be a long session and budget year. While LSA may not solicit input from the business community, LSA could be hard pressed to ignore unsolicited input from businesses wanting to provide information and express concerns in order to influence LSA's conclusions. This fall is the Indiana gubernatorial election, and as a result the 2017 budget session will take place *after* that election. The outcome of that election, as well as the timing of the 2017 session occurring post-election, could influence how this potentially substantial change in Indiana tax policy plays out. The introduction of this bill generated significant interest in the Indiana business community over the last few weeks, and that could be the precursor to a heavy debate next session.