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Indiana tax court finds DOR's combination powers restricted by statute

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In an unpublished opinion, the Indiana Tax Court held that the Department of State Revenue ("Department") is required to exhaust all statutory methods for determining an equitable allocation or apportionment of a taxpayer's income before forcing combination. [[AE Outfitters Retail Co v. Indiana Department of State Revenue](#), Indiana Tax Court, 10/25/11]

Background. AE Outfitters Retail Co. ("AEO") sells retail apparel through several stores located in the United States, including Indiana. At all times relevant, AEO separately reported and paid its Indiana adjusted gross income tax liability. The Department audited AEO for the tax years ending 7/31/04, 6/30/05, 7/29/06, and 8/4/07, and, determining that the separate returns did not fairly reflect its Indiana income, concluded that AEO must file on a combined basis.

The Department issued a proposed assessment based on the forced combination, which AEO timely protested. The Department issued a Letter of Findings sustaining the combined return methodology. Thereafter, AEO appealed the determination to the Tax Court.

Department's forced combination powers limited by statute. AEO argued that Ind. Code Sec. 6-3-2-2(p), as effective during the tax years at issue, required the Department to exhaust all statutory methodologies listed in Ind. Code Sec. 6-3-2-2-(l) and (m) for fairly reflecting a taxpayer's Indiana income before it may mandate combined reporting. The Department countered that it may mandate combined reporting after applying any one of the statutory methodologies.

The Court agreed with AEO, holding that the statute is not ambiguous and requires the Department to apply all of the methodologies before it may require combined reporting. Specifically, the Court noted that "the statutory language employed



plainly conveys that the Department may not require a taxpayer to file a combined tax return 'unless [it] is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to [it] by subsections (l) and (m).'"

Therefore, before the Department may force combination, it must determine whether a taxpayer's Indiana income may be fairly reflected through the application of *each* of the following methodologies:

- 1) Separate accounting;
- 2) The exclusion of any one or more factors, excepting the sales factor for tax years between January 1, 2007 and January 1, 2011;
- 3) The inclusion of any one (1) or more additional factors; or
- 4) The employment of any other reasonable method that would effectuate an equitable allocation and apportionment of the taxpayer's income. See Ind. Code Sec. 6-3-2-2(l).

PwC Observes. "This decision, along with the Tax Court's published decision in [Rent-A-Center East](#) (5/27/11), provides a strong rebuttal to the Department's practice of requiring combination in many circumstances where other adjustments available to the Department would have been appropriate, or where, in fact, no adjustment was warranted," observes Mike Ralston, State and Local Tax Director with PwC in Indianapolis. "In *Rent-A Center East*, the Court found that the Department failed to provide sufficient information that it considered alternatives to assessing tax based on a combined return. The Court now clearly states in *AE Outfitters* that the Department must apply *all* the statutory tools available before forcing combination, providing taxpayers support where they believe combination produces an inequitable result."

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