

# South Carolina Court Upholds Combined Unitary Reporting for Company and Its Subsidiaries That Improperly Shifted Income

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Report from our correspondent Jannica Santos

The South Carolina Administrative Law Court has held that a South Carolina company - Tractor Supply Company (TSC) - improperly shifted income from TSC and a Michigan subsidiary to a Texas subsidiary by marking up the price of inventory above what the South Carolina Department of Revenue determined to be an "arm's length" price (see Note). According to the Court, the TSC was able to exclude the shifted income from its South Carolina corporate income tax return by filing as a single entity – reporting only TSC's South Carolina source income – rather than as a unitary entity in which the sales of the entire group are taken into account (*Tractor Supply Company v. South Carolina Department of Revenue*, Docket No. 19-ALJ-17-0416-CC).

In 2001, TSC was restructured to create its Michigan and Texas subsidiaries. TSC and its subsidiaries entered into a procurement agreement under which the Texas subsidiary provided inventory procurement services for TSC and the Michigan subsidiary at cost plus a 9.7% markup based on a transfer pricing study provided to TSC by PWC.

For the relevant tax years, TSC filed its South Carolina corporate income tax returns as a single entity using the separate entity reporting method (i.e. the state's default reporting method), which eliminated intercompany transactions like the 9.7% markup on inventory. Neither the Texas nor the Michigan subsidiaries filed South Carolina returns for these years.

Upon audit, the state's Department of Revenue concluded that separate entity reporting allowed TSC to minimize its South Carolina taxes by reducing income sourced to South Carolina. As a result, and because the companies operated as a unitary group, the Department determined that combined reporting was appropriate because it remedied the distortion created by separate entity filing.

In its 8 August 2023 Final Order, the South Carolina Administrative Law Court affirmed the Department's assessment, holding that:

- the 9.7% markup distorted TSC's operating income and did not reflect an arm's length transaction because after markup was applied, the Texas subsidiary accumulated about 71% of the entities' taxable income across the audit years even though TSC had approximately 80% of the sales;
- the transfer pricing study provided to TSC by PWC, on which TSC had based the markup, was flawed and unreliable, based on expert witness testimony presented by both TSC and the Department; and
- neither party presented sufficient evidence to support a transfer price (or markup on inventory) that would correct the current deficiency of the 9.7% markup and reach an arm's length result.

Determining that TSC and the two subsidiaries qualify as a unitary business, the Court held that the Department had the authority to require TSC to use combined reporting. According to the Court, combined unitary reporting is an appropriate alternative method of apportionment because it:

- corrects the income shift from TSC and the Michigan subsidiary to the Texas subsidiary as a result of the Procurement Agreement; and
- reasonably and equitably approximates the taxable net income attributable to Tractor's business activity in South Carolina.

*Note:* Under the arm's length principle, affiliated companies should charge the same prices in relation to a transaction that would be charged by independent parties under comparable circumstances.

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