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South Carolina Legislature Reinforces Separate Reporting Regime, Slapping Department on the Wrist

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Last week, South Carolina Governor McMaster signed into law Act No. 113 in a much needed reproach to the Department of Revenue's aggressive attempts to undermine the state's separate reporting regime for apportioning corporate income. While the law creates a new paradigm for how and in what manner the state or taxpayer may obtain alternative apportionment, the objective was clear: to restrict the Department's ability to require combined reporting when invoking alternative apportionment. Under the new law, the Department may require combined reporting only if it determines that an affiliated group's intercompany transactions lack economic substance or are not at fair market value, and it must provide a detailed written statement of its findings justifying combined reporting. Additionally, and perhaps most importantly, if the Department concludes that a combined return is required in order to fairly represent a taxpayer's business activity in the state, the Department may not unilaterally exclude unitary members from the combined group.

The Act, which takes effect March 11, 2024, and applies to all open tax periods excluding assessments under judicial review by the South Carolina ALC, Court of Appeals, or Supreme Court, has been a long time coming. Passed unanimously by both the House and Senate, the Act is a clear repudiation of South Carolina Revenue Ruling No. 15-5 (6/12/2015), which has frequently been invoked by the Department to require combined reporting, not where a taxpayer's transfer pricing studies fail to support the arm's length nature of intercompany transactions, but simply where a unitary business exists and not all members file in the state. That policy recently came to a head in *Tractor Supply Co. v. Dep't of Rev.*, Dkt. No. 19-ALJ-17-0416-CC. In that case, the ALJ determined that intercompany transactions were not at arm's length (despite a transfer pricing study that concluded the opposite) and that combined reporting was a reasonable alternative to the statutory framework to fairly represent the taxpayer's business activity in the state. While that decision involved a thorough discussion of the facts and evidence in the case, the ALJ was dismissive of the fact that the Department was using executive fiat to undermine the state's separate reporting regime. In fact, the ALJ specifically said, "I do not find Petitioner established that the Department is using Revenue Ruling #15-5 to systematically target unitary businesses for combined unitary reporting without regard to the factual determination required to impose alternative apportionment."

Both the South Carolina House and Senate obviously disagreed with the ALJ's finding in this regard, and for good reason. The assertion that the Department was blindly requiring unitary businesses to file combined tax returns without regard to the facts was not just anecdotal- the Department *has* systematically targeted unitary businesses operating in the state since it issued Revenue Ruling No. 15-5. The fiscal impact statement all but proves this. It states that the Department reported that approximately $138,000,000 has been generated in the last 3 to 4 years from 53 audits of companies.

Of course, many entities reporting in South Carolina may be parts of unitary groups that generate only losses. Call us cynics, but we suspect the Department has not required combination of those groups. The Department's strategy appears to have been to cherry-pick taxpayers for combined reporting; the Department targeted unitary businesses with out-of-state income for combined reporting (some of the largest in the country), but not those unitary businesses with out-of-state losses. This allowed the Department all the revenue benefits of combined reporting, but none of the revenue losses.

More broadly, Act No. 113 may provide some hope to taxpayers confronting similar challenges in other states. Recently, other separate reporting states have aggressively targeted unitary structures in a variety of ways. While South Carolina required combined reporting, others have audited the taxpayer's transfer pricing studies despite limited audit capabilities in that respect or taken another creative approach to broaden the tax base. Some states may use an "embedded royalty" add back approach, while others may simply say the out-of-state entities lack economic substance. There have been many iterations of this, but the ultimate goal is often the same – to target unitary businesses operating in the state with the goal of undermining the statutory separate reporting paradigm. We've seen these issues arise in Alabama, Georgia, Louisiana, Indiana, Maryland, New Jersey and North Carolina.

Many of these states have seen proposed legislation for combined reporting come and go without passing. Taxpayers have reasonably pointed to these failed proposals as evidence that the separate reporting rules should be presumed to fairly reflect a business's operations in the state, absent reliable evidence to the contrary. The tax departments in these states have often disregarded this argument. South Carolina's legislation, however, goes a step further and functions as a direct repudiation of the Department's efforts to target unitary businesses. Maybe the willingness of the South Carolina legislature to pass Act No. 113 will make other state departments think twice before being as aggressive in their audits of intercompany transactions. If not, perhaps Act No. 113 will become model legislation for other similarly situated states.

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