State Transfer Pricing: Developments & Implications

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Agenda

- State Transfer Pricing Overview
- MTC ALAS Project
- Transfer Pricing Basics
- Recent Developments in International Transfer Pricing
- State Transfer Pricing Cases
- What's Next?

State Transfer Pricing Overview

Most States Have Transfer Pricing Authority

- Many states have statutes that adopt or are substantially similar to § 482
  - States with § 482 may or may not incorporate the federal regulations

- Some states assert statutory language broader than federal § 482 authority (e.g. Virginia)

- Some states with no § 482 equivalent assert their right to adjust intercompany pricing by asserting general federal conformity or general discretionary authority

- Nearly every state adopts some statutory regime to adjust prices of intercompany transactions
  - Notable states that do not: Delaware, New Mexico, and Pennsylvania

Limited Historic Use of Transfer Pricing Authority

- Historically, few states have actively utilized 482-like authority for transfer pricing purposes

- One reason is that states rely on formulary apportionment for determining where corporate income is earned. By contrast, the U.S. and virtually every other nation in the world rely on transfer pricing for sourcing cross-border income.

- Another reason is that states have limited experience with transfer pricing and few resources trained to apply transfer pricing rules as compared with IRS or foreign taxing authorities

Other State Tax Solutions for Related Party Transactions

- States have also utilized other solutions for policing related party transactions including:
  - Assert nexus or jurisdiction to tax with regard to the related party
  - Disallow a deduction by a corporate taxpayer if the deduction was created through a transaction with a related party
  - Reverse the transaction for lacking economic substance
  - Mandatory unitary combined reporting
  - Forced combination
  - Tax Haven legislation

Increased Interest in State Transfer Pricing

- Over the last few years interest in transfer pricing has increased among the states

- In part, this is due to the global attention accorded to the problem of cross-border income taxation and to the Organization for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Project

- It is also attributable to the publicity surrounding the Multistate Tax Commission's (MTC) Arm's Length Adjustment Services (ALAS) Project

- In particular, many states with separate entity reporting have expressed interest in expanding their transfer pricing audit capabilities

MTC ALAS Project

MTC ALAS Project

- In December 2013, the MTC Executive Committee authorized the executive director to explore interest in, and if enough states expressed interest, begin the design of an Arms-Length Adjustment Services (ALAS) project
  - Participating states were Alabama, D.C., Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina

- Two components of ALAS project
  - 1. Providing/developing economic expertise
  - 2. Conducting transfer pricing audits

MTC ALAS Project

- MTC Executive Committee approved the Final Program Design on May 7, 2015, although only five states formally committed:
  - Alabama, Iowa, New Jersey, North Carolina, and Pennsylvania
  - The MTC continues to encourage other states to participate

- In December, 2015, the MTC created an ALAS Committee to continue to gather support for, and refine the design of its ALAS initiative.

- Initially the ALAS Committee will focus on information sharing and training relating to transfer pricing.

- Potential exists for state revenue agencies to be supported by external economic consulting firms in the following areas:
  - Training
  - Audit selection
  - Economic analysis
  - Litigation support

Transfer Pricing Basics

What is Transfer Pricing?

- Pricing of transactions between related entities for goods, intangible assets, services, and loans

- Designed to prevent tax avoidance among related entities by requiring pricing equivalent to prices available with an uncontrolled party
  - Transactions must (generally) be at arm's length
  - Non-arm's length intercompany transactions can impact the clear reflection of income in states where income is reported on a separate or partial combination basis
  - Tax evasion or avoidance generally not a pre-requisite for making a transfer pricing adjustment

Federal Landscape

- Transfer pricing is generally governed by:
  - Codified under IRC § 482
  - Extensive regulations, detailed methodologies
  - Developed body of judicial decisions
  - Disciplined procedures for obtaining advance approval for transfer pricing

- In the U.S.
  - Earliest statutory predecessor to § 482 was 240(d) of the Revenue Act of 1921
  - This was followed by § 45 of the Revenue Act of 1928 and by § 482 in 1954

IRC § 482 Regulations

- Key components of the IRC § 482 regulations are as follows:
  - *Arm's Length Principle* - results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances
  - *Best Method Rule* – a method that provides the most reliable measure of an arm's length result
  - *Comparability* – specific factors should be considered when determining comparability

- IRC § 482 is not self-executing. It provides the IRS discretion to make adjustments.

What are Comparable Transactions?

- OECD regulations and § 482 both provide set of methodologies for comparing third party transactions with related party transactions
- Methods may vary depending on the type of transaction
- Transactional based methods – compare actual prices or gross margin earned on third party transactions (internal and external)
- Profit based methods – compare profits earned by comparable companies (e.g., markup on services)

Key Intercompany Transactions Subject to Transfer Pricing

- Transfer and licensing of intangible assets
- Providing and charging for common services
- Financing
- Factoring accounts receivables
- Sale of tangible goods that contain a trademark or other intangible
- Purchase and resale of tangible goods

Transfer Pricing Analysis: Key Elements

- Reviewing intercompany agreements and course of conduct to accurately identify and isolate intercompany transactions
  - This can be time consuming
  - Documentation is key
- Determining the relative functions performed, risks assumed and assets employed by the respective related taxpayers
- Selecting the best method to test the results of the intercompany transactions
- Reviewing comparables to calculate an arm's length range of results
  - Documenting rejected comparables can be meaningful
- Comparing the taxpayers' actual results to calculated arm's length range
  - Monitor results, evaluate arrangements at meaningful intervals

Recent Developments in International Transfer Pricing

OECD BEPS Initiative

- In February 2013, the OECD and G20 created a 15 point Action Plan to address Base Erosion and Profit Shifting (BEPS)
- The two year process has included OECD and G20 countries as well as input from developing countries through regional tax organizations
- The participating countries represent over 90 percent of global GDP
- On October 5, 2015, a 2,000 page comprehensive package was released with final reports on the 15 Action Items
- The OECD action steps represent the most fundamental change to international tax rules in decades

Action Item	Solely Focused on Transfer Pricing
Action 1 – Address the tax challenges of the digital economy	
Action 2 – Neutralize the effects of hybrid mismatch arrangements	
Action 3 – Strengthen CFC rules	
Action 4 – Limit base erosion via interest deductions and other financial payments	
Action 5 – Counter harmful tax practices more effectively, taking into account transparency and substance	
Action 6 – Prevent treaty abuse	
Action 7 – Prevent the artificial avoidance of PE status	
Action 8 – Assure that transfer pricing outcomes are in line with value creation: intangibles	✓
Action 9 – Assure that transfer pricing outcomes are in line with value creation: risks and capital	✓
Action 10 – Assure that transfer pricing outcomes are in line with value creation: other high-risk transactions	✓
Action 11 – Establish methodologies to collect and analyze data on BEPS and the actions to address it	
Action 12 – Require taxpayers to disclose their aggressive tax planning arrangements	
Action 13 – Re-examine transfer pricing documentation	✓
Action 14 – Make dispute resolution mechanisms more effective	
Action 15 – Develop a multilateral instrument	

Transfer Pricing – Specific Action Items

- Actions 8-10 – Aligning Transfer Pricing Outcomes with Value Creation
  - Intangibles
  - Low-Value Adding Services
  - Cost Contribution Arrangements
  - Commodity Transactions
  - Scope of Work for Guidance on Profit Split Method

- Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting
  - Country-by-Country Report
  - Master File
  - Local File

- What constitutes “value creation”?

State Transfer Pricing Cases

Authority to Adjust Income - District of Columbia

- *Microsoft Corp. v. Office of Tax and Revenue*, 2010-OTR-00012 (2012)
  - Controversial methodology relied upon by several states to assess corporate taxpayers for transfer pricing violations was ruled invalid by a D.C. ALJ
  - OTR and Chainbridge argued that they could aggregate all of Microsoft's transactions because "Microsoft has engaged in thousands of controlled transactions with over 100 affiliated businesses"— basically arguing that it was too difficult to follow the regulations
  - The D.C. court found "the fact that Microsoft has 100 or even 2,000 affiliates does not address the question of why there was no effort to isolate the controlled transactions." The Judge noted that this aggregation of all intercompany transactions is a "significant error" because the relevant profit level ratio may be quite different for different types of transactions

Authority to Adjust Income - District of Columbia

- *Hess Corp./Shell Oil Co./Exxon Mobil Oil Corp. v. Office of Tax and Revenue*
  - Consolidated taxpayers are claiming that collateral estoppel precludes OTR from litigating whether an assessment supported by the Chainbridge transfer pricing methodology is proper
  - D.C. is arguing that it should not be barred from litigating these matters after it chose to withdraw its appeal in *Microsoft*
  - D.C. is arguing that it should not be precluded from defending the methodology forever because of one ruling claiming that it cannot appeal every adverse opinion because of limited resources
  - D.C. argues that non-mutual collateral estoppel is inoperable against the federal government and should apply to the District as well

Current Litigation – Indiana

- *Rent-A-Center East, Inc. v. Ind. Dep't of Revenue*, No. 49T10-0612-TA-00106 (Ind. Tax Ct. Sept. 10, 2015)
  - Indiana Tax Court rejected the Department's long-standing position that transfer pricing studies are not relevant to whether a separate return fairly reflects Indiana source income because Indiana's transfer pricing statute mirrors the language of § 482
  - Indiana Tax Court held that Rent-A-Center East, Inc. did not have to file a combined return with its out-of-state affiliates Rent-A-Center West and Rent-A-Center Texas because the record did not show that Rent-A-Center East engaged in any tax avoidance measures and its intercompany transactions were at arm's length rates as determined by an independent transfer pricing study

- *Columbia Sportswear USA Corp., v. Ind. Dep't of Revenue*, No. 49T10-1104-TA-00032 (Ind. Tax Ct. Dec. 18, 2015)
  - Indiana Tax Court concluded that because Columbia's transfer pricing studies demonstrated that its intercompany transactions were conducted at arm's length rates, its Indiana income was fairly reflected for purposes of Indiana's transfer pricing statute

Current Litigation – Indiana

- Ind. Dep't of Revenue, Ltr. of Findings No. 02-20130155 (Feb. 26, 2014)
  - The Department determined that forced combination of an out-of-state company and its subsidiary was appropriate because its transfer pricing study was insufficient to establish that its intercompany transactions were at arm's length

- Ind. Dep't of Revenue, Ltr. of Findings No. 02-20130641 (posted Feb. 25, 2015)
  - The Department determined that forced combination of an Indiana taxpayer, its wholly owned disregarded entity and its out-of-state parent company was appropriate because the parent company increased the costs of goods sold for intercompany sales to the disregarded entity by 80%
  - The Department rejected the taxpayer's transfer pricing study for support of the intercompany transactions reasoning that "transfer pricing studies are not Indiana-approved vehicles for justifying tax expenses through controlled party profits," and noted the "arms-length" prices in the study had not been revised in over 30 years
    - The Department, however, relied on the transfer pricing study to further justify its decision to force combined reporting

- Ind. Dep't of Revenue, Ltr. of Findings No. 02-20120310 (July 1, 2013)
  - The Department denied a taxpayer's deductions for certain intercompany payments to a subsidiary management company claiming the deductions did not reflect the taxpayer's economic realities even though the parties had executed an intercompany agreement based on a federal income tax transfer pricing study

Other State Transfer Pricing Cases

- Alabama
  - *Dravo Corp. v. Ala. Dep't of Revenue*, No. CORP. 96-418 (Admin. Law Div. 2002) (discussing the Commissioner's authority to forcibly combine companies under Ala. Code § 40-2A-17(a))
- Connecticut
  - *Carpenter Tech. Corp. v. Dep't of Revenue Serv.*, 47 Conn. Supp. 122 (2000) (Commissioner did not have discretion to disallow interest deduction because the loans had economic substance and business purpose, and the arrangement did not inaccurately reflect income)
- Georgia
  - *Aaron Rents, Inc. v. Collins*, No. D-96025 (Fulton Cty. Super. Ct. June 27, 1994) (Department had high burden to prove arbitrary shifting of income to an affiliate)

Other State Transfer Pricing Cases

- Minnesota
  - *HMN Fin. v. Comm'r of Revenue*, 782 N.W.2d 558 (Minn. 2010) (the Commissioner lacked authority to disregard a taxpayer's captive REIT structure under several discretionary provisions when the taxpayer organized its business in compliance with the relevant statutes even though the taxpayer was motivated solely by a desire to reduce its taxes)
- New York
  - *Matter of Hallmark Marketing Corp.*, DTA No. 819956 (N.Y. Tax App. Trib. 2007) (the Division of Taxation could not force an in-state subsidiary to file its franchise tax return on a combined basis with its out-of-state parent company because the subsidiary showed that its transactions with its parent company were at arm's length and its transfer pricing study reasonably applied § 482 principles)
- New York City
  - *Matter of Astoria Financial Corp. & Affiliates*, TAT(E)10-35(BT) (N.Y.C. Tax App. Trib. 2016) (an in-state parent company was not required to include its out-of-state passive investment subsidiary in its New York City banking corporation tax return because the subsidiary was found to have business purpose apart from tax benefits and economic substance, and conducted its transactions with its in-state parent company at arm's length)

What’s Next?

What’s Next?

- Are the states going to follow through with developing resources dedicated to transfer pricing?
- Separate return vs. consolidated/combined return states; variance in approaches:
  - What is the impact for consolidated/combined return states?
- To what extent will states’ efforts be enhanced by information sharing from the IRS?
- Will states efforts rely on contingency auditors?
- Will interest in transfer pricing be displaced by other state tax solutions (e.g. tax haven legislation; add-back legislation; worldwide combination)?

Questions?

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