Transfer Pricing for State Tax
Agenda

- What is Transfer Pricing?
- Overview of Federal Transfer Pricing Principles
- State Transfer Pricing Overview
- State Transfer Pricing Considerations
- Multistate Tax Commission ALAS Project
What is Transfer Pricing?
What is Transfer Pricing?

• Generally, transfer pricing refers to the mechanism used to establish the arm’s-length price 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 prerequisite for application of § 482 adjustment.
Overview of Federal Transfer Pricing Principles
Transfer Pricing Authority – Federal Background

• Federal landscape:
  - Codified under IRC § 482
  - 199 pages of regulations, including detailed methodologies
  - Developed body of judicial decisions and agency determinations
  - Disciplined procedures for obtaining advance approval for transfer pricing
  - As of December 31, 2013, the International Business Compliance and Transfer Pricing Practice units of the IRS’s Large Business and International Division had 1,060 cases under examination
    - The Vanguard Group, Inc. – $34.6 billion in unpaid federal taxes
Transfer Pricing Authority – Federal Background

• Transfer pricing is governed by IRC § 482 and extensive federal regulations.
  ▪ Adjustments permitted among related business if necessary to prevent evasion of taxes or to clearly reflect the income of such businesses.

• Language of IRC § 482
  ▪ In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation, is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses . . . .
Transfer Pricing Authority – Federal Background

• Existence of controlled transactions

• Best Method Rule (e.g., resale price method, cost-plus method, comparable profits method (CPM)) – Treas. Reg. 1.482-1(c)(1)

• Intercompany services: probable benefits test – Treas. Reg. 1.482-2(b)(2)(i)

• Advance pricing agreements
When do Transfer Pricing Principles Apply?

- Company A located in United States licenses trademark to Company B in France, a direct subsidiary.
  - Company A charges a 2% royalty to Company B.
- IRS challenges the transfer price of 2%.
  - Conducts transfer pricing study to support this figure.
- Company A would attempt to rebut the IRS’s study with its own economic report.
- IRS responds and suggests the price should be 7%.
- Now Company A either:
  - Challenges in court
  - Settles with the IRS
What is the Remedy?

• If the IRS determines that the transfer price of the transaction did not meet the requirements of § 482, it can:
  ▪ Propose settlement with taxpayer
  ▪ Adjust the transfer price to reflect the proper cost
  ▪ Make corollary adjustment
  ▪ Impose penalties for gross understatement of income
    ▪ Penalties can amount to 20% or 40% of the difference between the tax paid and the tax owed depending on whether certain thresholds are met
State Transfer Pricing Overview
State Transfer Pricing Overview

- State landscape varies: Used for
  - Combination
  - Expense/income adjustments or reattribution
  - Adjustments to international pricing that IRS “missed”
- Many states have specific statutes that adopt or are substantially similar to § 482.
  - States with § 482 may or may not incorporate the federal regulations promulgated under IRC § 482.
- Many states, while not specifically adopting federal § 482 language, have other statutory provisions providing the same authority.
- Nearly every state adopts some statutory regime to adjust transfer prices of intercompany transactions.
  - Notable states that do not: Delaware, New Mexico, Pennsylvania
Transfer Pricing: State vs. Federal

• No outbound “toll charge”
  ➤ See IRC § 482’s “commensurate with income” provision; see also, IRC § 367(d)

• Absence of consolidated rules (in some states)

• Availability of other state tax attacks (e.g., interest and royalty addbacks, equitable apportionment)

• No “competent authority” or APA procedures
State Transfer Pricing Adjustment Authority

• Some states directly cross reference § 482 in their transfer pricing statutory provisions.

  ▪ E.g., Alabama, Ala. Code § 40-2A-17
    ▪ (a) In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Commissioner of the Alabama Department of Revenue may distribute, apportion, or allocate gross income, deductions, credits, or allowances, if the Commissioner determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of Alabama income taxes or to clearly reflect the income of any such organization, trade, or business.
    ▪ (f) The Commissioner . . . shall exercise such authority in a manner consistent with this act and, to the extent applicable, 26 U.S.C. Section 482 and the rulings and regulations issued thereunder.
State Transfer Pricing Adjustment Authority

- Some states adopt an approach to transfer pricing similar to § 482 but make no direct reference to § 482.
    - “For tax periods ending before January 1, 2005, in the case of entities not required to file a consolidated or combined return under subsection (1) of this section that carried on transactions with stockholders or affiliated entities directly or indirectly, the cabinet shall adjust the net income of such entities to an amount that would result if such transactions were carried on at arm’s length.”
  - See also, Connecticut, Conn. Gen. Stat. § 12-226a; District of Columbia (addressed on following slide).
State Transfer Pricing Adjustment Authority

- In D.C., taxpayers either file separate returns or report on a nexus combined basis.
- § 47-1810.03. Distribution, apportionment, or allocation of income or deductions between or among organizations, trades, or businesses.
  - The Mayor is authorized to distribute, apportion, or allocate gross income or deductions between or among related businesses, whenever in his opinion such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such businesses.
State Transfer Pricing Adjustment Authority

• Some states assert statutory language broader than federal § 482 authority.
    - When any corporation liable to taxation . . . conducts the business of such corporation in such manner as either directly or indirectly to benefit the members or stockholders of the corporation . . . by either buying or selling its products or the goods or commodities in which it deals at more or less than a fair price which might be obtained therefor, or when such a corporation sells its products, goods or commodities to another corporation or acquires and disposes of the products, goods or commodities of another corporation in such manner as to create a loss or improper taxable income, and such other corporation . . . controls or is controlled by the corporation liable to taxation under this chapter, the Department may require such facts as it deems necessary for the proper computation provided by this chapter and may for the purpose determine the amount which shall be deemed to be the Virginia taxable income of the business of such corporation for the taxable year . . .
State Transfer Pricing Adjustment Authority

- Some states with no § 482 equivalent (or some lesser authority) nonetheless assert the right to adjust intercompany pricing by asserting general federal conformity or general discretionary powers.
- For example, Maryland asserted this in 1999.
    - General federal conformity did not instill in the Comptroller the same discretionary authority granted to the IRS in § 482
    - MD Comptroller had no power to make transfer pricing adjustments in the absence of federal adjustments
  - In 2003, Maryland enacted broader § 482 equivalent power
Indiana

Rent-A-Center, Inc. v. Department of Revenue, 2015 STT 176-17 (Sept. 10, 2015)

Indiana Tax Court held that Rent-A-Center East, Inc. (RAC East) did not have to file a combined return with its out-of-state affiliates Rent-A-Center West, Inc. (RAC West) and Rent-A-Center Texas LP (RAC Texas) because the record did not show that RAC 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.

Indiana DOR had assessed $513,272 in additional income tax assessments after concluding on audit that RAC East could not file a separate tax return. Instead, the audit applied an alternative apportionment to include RAC West and RAC Texas.

Case was decided on remand from the Indiana Supreme Court.
State Transfer Pricing Authority – Combined Reporting

- New York historically applied IRC § 482 to determine whether affiliate transactions are distortive, justifying forced combined reporting as well as for when a taxpayer requests to file on a combined basis.
  - In *Hallmark Marketing Corporation*, an administrative law judge ruled that the taxpayer, a marketing company, could not be required by the Division of Taxation to file its 1999 corporate franchise tax report on a combined basis with its parent, a manufacturer of greeting cards.
  - The Tax Appeals Tribunal affirmed, holding that while the words of NYCRR § 6-2.5(a) standing alone might lend themselves to other interpretations, it is clear from the case law that it is necessary to find distortion, and not merely the existence of substantial intercorporate transactions, in order to require the filing of a combined report. *In the Matter of the Petition of Hallmark Marketing Corporation for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1999*, 819956, 07/19/2007.
State Transfer Pricing Authority – Combined Reporting

• South Carolina

  ▪ In Media General Communications, three communications companies, which comprised a unitary group, were allowed to use the combined entity apportionment method to apportion their income and determine their South Carolina corporate income tax liability for the years at issue. The Department of Revenue used the separate entity apportionment method to calculate the taxpayers’ corporate income taxes, which were based on income earned from intangible assets used in South Carolina.

  ▪ The taxpayers contended that this did not fairly represent their business activities in the state and petitioned for the use of combined entity apportionment methodology. Although the Department agreed that the combined entity apportionment method fairly represented the taxpayers’ business activities in the state, it declined the petition on the grounds that it lacked authority to allow or require use of the method.
State Transfer Pricing Authority – Combined Reporting

South Carolina (cont’d)

- The plain language of the statute, which allows the use of “any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income” when the general allocation and apportionment methods do not fairly represent the taxpayer’s in-state business activities, authorizes the Department to use the combined entity apportionment method.

- In this case, the Department never recalculated the taxpayers’ income using any other alternative method and also stipulated that the combined entity apportionment method resulted in a fair computing of the taxpayers’ business activities in the state. Consequently, the Department was ordered to apply the combined entity apportionment method to the tax period at issue and was allowed to use any other appropriate alternative method for future tax years. Media General Communications v. S.C. Department of Revenue, 694 S.E. 2d. 525 (2010).
State Transfer Pricing Authority – Adjust Income

• To adjust income/expense
  – *IDC Research Inc.* (Mass. ATB 2009)
    – Taxpayer, parent corporation, operated at a loss during audit years.
    – Commissioner imputed additional income to taxpayer pursuant to § 482 authority, asserting prices charged for services were not at arm’s length.
      – Commissioner believed company should “break even” – based all adjustments solely on this belief.
    – Board found Commissioner improperly applied § 482 rules.
      – Proof of arm’s-length pricing sufficient;
      – Some activities not the type subject to § 482 rules; and
      – Commissioner’s adjustments based on no substantive or comparative data. Overall expenses not appropriate basis for § 482 adjustments.
State Transfer Pricing Authority – Adjust Income

- **District of Columbia**
  - D.C. has dealt with transfer pricing issues before.
  - In *Microsoft Corp. v. Office of Tax and Revenue*, the controversial methodology relied upon by several states to assess corporate taxpayers for transfer pricing violations was ruled invalid by a D.C. Administrative Law Judge (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 was a “significant error” because the relevant profit level ratio may be quite different for different types of transactions. *Microsoft Corp. v. Office of Tax and Revenue*, 2010-OTR-00012 (2012).
State Transfer Pricing Considerations
State Transfer Pricing – Intercompany Transaction Considerations

- Consistency with international cross-border transactions
- A practical approach to accounting for intercompany transactions
- Policies/procedures for documentation
Litigation Considerations

• Selection of experts
• Business purpose considerations
• Documents and evidence
Multistate Tax Commission
ALAS Project
Arm’s-Length Adjustment Service (ALAS) Project Background

• States recognized that there are significant issues related to transfer pricing at the state level. Many states lack the expertise and resources/flexibility to staff the function.
  - MTC could develop staff with the expertise for complex subject matter
  - Share cost among interested/affected states
  - States would also benefit from expert case support

• Origin
  - MTC meeting in D.C. – 2013
  - Other historical discussions with MTC never achieved critical mass

• Current Participants
  - Alabama, Iowa, Kentucky, New Jersey, North Carolina, and Pennsylvania
ALAS Project Background

- Dan Bucks, former MTC Executive Director, is the “project facilitator”
- Dan Bucks role
  - Outside consultant
  - Previously with Montana DOR and MTC
  - Coordinate and facilitate the initial design
- State’s roles
  - Funding through supplemental MTC dues
  - Case nomination
  - Issue identification
    - Initial document collection and review
    - APAs
    - Assessment
    - Other end-stage case handling with MTC support
- Two components of MTC Project
  - Providing/developing economic expertise
  - Conducting transfer pricing audits
Economic Expertise – Why?

• Some states have not developed the expertise to address transfer pricing issues.

• Some states have identified the lack of financial resources as a reason why they have not recruited skilled personnel for this subject matter.

• Some states have hired firms to conduct transfer pricing studies in the past (e.g., New Jersey, D.C.).
ALAS Program Design

• The Project Committee has identified the following goals of the program design:
  ▪ Transfer pricing analysis
  ▪ Training
  ▪ Information exchange
  ▪ Case resolution and litigation support services
  ▪ Optional joint audits
What Will it Cost?

- What will the program cost to the states?
  - Estimated four-year total cost is $7,833,000, assuming 10 states join the program
  - Two general components to the cost:
    - General services
      - Roughly 1/3 of the cost
    - Transfer pricing analysis
      - Two additional subsets:
        - Pre-analysis technical review
        - Economic analysis
Questions?
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