The Collision of Formulary Apportionment and Transfer Pricing

COST Pacific Northwest Regional State Tax Seminar

December 7, 2017

Todd Lard
Partner

Ted Friedman
Associate
Agenda

– Apportionment
  • Introduction
  • Key issues
  • Recent developments

– Transfer Pricing
  • Introduction
  • Key issues
  • Recent developments
  • Contract auditors
  • MTC’s SITAS project
  • So what’s next?

– Takeaways
Apportionment
Introduction
Apportionment Introduction

- A state may tax a “fair share” of profits earned from activity conducted within its borders using apportionment. *Underwood Typewriter v. Chamberlain*, 254 U.S. 113 (1920).

- States have significant leeway in adopting an apportionment formula; however, the apportionment method selected by a state cannot be arbitrary and must not produce unreasonable results. *Hans Rees’ Sons v. North Carolina*, 283 U.S. 123 (1931).

- State apportionment methodologies vary
  - UDITPA’s three-factor formula uses property, payroll, sales
  - Other (single, double or triple-weighted factors)
  - Why the emphasis on the sales factor?
Apportionment
Key Issues
Key Issues

— Sales factor issues
  • Sales, other than sales of TPP
    • Costs of performance sourcing
      • What approach applies?
        • Transactional approach
        • Operational approach
    • Income-producing activities
      • What are the income-producing activities?
      • Whose activities?
    • Costs
      • What are the relevant costs?
        • Direct costs
        • Indirect costs
  • Market sourcing
    • What/where/who is the market?

— Alternative apportionment
  • Does distortion exist?
  • Is the proposed alternative method reasonable?
  • Did moving party satisfy burden? What is the burden?
Apportionment
Recent Developments
Oregon – Sales Factor (Sales of Online Classes)

Apollo Educ. Grp. Inc. v. Or. Dep’t of Revenue,
TC-MD 150352C (Or. T.C. Aug. 24, 2017)

— The Oregon Tax Court upheld the Department’s sourcing methodology, which sourced receipts from sales of online educational services based only on “faculty cost data” from a corporation’s cost study.

— “A taxpayer’s income-producing activity ... is the activity the taxpayer obliges itself to perform when it accepts money from a customer. It is the service the taxpayer’s customer has a right to expect.”
  • The court found that the corporation’s IPA was “the provision of a course section.”

— “Direct costs of an income-producing activity are ‘incremental costs.’”
  • The court found that the corporation’s “only direct costs for providing course sections were faculty costs.”
Indiana – Sales Factor (Sales of Online Classes)

Univ. of Phoenix, Inc. v. Ind. Dep’t of State Revenue, No. 49T10-1411-TA-00065 (Ind. T.C. Nov. 30, 2017)

— The Indiana Tax Court held that the Department incorrectly sourced a corporation’s revenue according to the location of its market, rather than the location of the costs of its income-producing activities.

— According to the court, Indiana’s COP sourcing statute “sources a taxpayer’s revenue to the Indiana numerator based on the seller’s acts: the performance of acts from the perspective of sales, thus, the seller, not from the view of the buyer or consumer - to generate income.”
  • “Accordingly, income producing activities are not limited to what those students directly pay for, as the Department urges, but encompass acts a seller directly engaged in with the purpose to generate revenue.”

— The corporation was not required to use a transaction-by-transaction approach as the basis of its cost study.
South Carolina – Sales Factor (Subscription Receipts)

**DIRECTV Inc. v. S.C. Dep’t of Revenue**, No. 2015-001509  

- The South Carolina Court of Appeals found that a corporation’s sole income-producing activity related to its South Carolina customer subscription receipts was the delivery of its satellite signal to those customers. The court held that all of the corporation’s South Carolina customer subscription receipts were properly sourced to the state due to the location of its satellite signal delivery.

- The court found the proper burden of proof (“preponderance of evidence”) was applied to DIRECTV.

- The court affirmed the ALC’s assessment of underpayment penalties because there was no reasonable cause for DIRECTV’s underpayment.
Texas – Sales Factor (Receipts from Services)

– The Comptroller ruled that receipts from risk and fraud prevention services are sourced to the customer’s location.
  • Texas sources service receipts to the location where services are performed.
  • The Comptroller interprets where services are performed based on the location of the “end-product act,” which, under the Comptroller’s view, does not include “non-receipt producing, albeit essential, support activities.”

– The Comptroller found that the end-product act is the taxpayer’s response to service requests, which are provided at customer locations.
California – Sales Factor (Non-Marketing Services)


— The Franchise Tax Board reaffirmed its 2015 position that receipts from non-marketing services should be sourced to California to the extent that a taxpayer’s direct customers receive service benefits in California.

— The FTB found that non-marketing administration services provided by the taxpayer were taxable based on the location of the company’s direct customers and not the locations of the customer’s customers.
New York – Sales Factor (Receipts from Services)


– The Administrative Law Judge (ALJ) determined that online litigation support services receipts are “services” and are allocated to the location where the services were performed, which were outside of New York.


– The ALJ determined that a taxpayer’s electronic bill payment and presentation receipts constitute service receipts and not “other business receipts,” and are properly sourced where the service is performed.
Virginia – Alt. Apportionment (Rejected; COP Upheld)


— The Virginia Circuit Court (Arlington County) held in favor of the Department of Taxation’s use of the statutory COP method to apportion income from the sales of subscription-based services because use of the COP method did not lead to inequitable results and was not unconstitutional.

  • The court found that under the COP method, most of the taxpayer’s sales originated in Virginia and were attributable to the state.

— The court rejected the corporation’s request for alternative apportionment using market-based sourcing and characterized the request as “arbitrary.”
Colorado – Alt. Apportionment (Improper)


— A Colorado district court found that despite lacking any physical presence in state, a subsidiary that managed a company’s brands had substantial nexus in Colorado because its IP licenses were used there.

— However, the Department of Revenue’s use of its alternative apportionment authority to exclude the subsidiary’s substantial out-of-state property and payroll from apportionment factors was unreasonable.
Minnesota – Alt. Apportionment (Struck Down)


- The Minnesota Tax Court found that the Commissioner could not invoke alternative apportionment to include interest income and intangible property in the apportionment factor of LLCs subject to the general apportionment formula, which excludes these items from the factors. The taxpayer’s lawful business structure could not be disregarded.

  • The taxpayer created two LLCs to conduct business in Minnesota, which defines a “financial institution” as a “corporation.” The taxpayer excluded the LLCs’ interest income under the general apportionment rules and avoided the LLC interest income inclusion rules applicable to financial institutions.

- On appeal with the Minnesota Supreme Court.

- In a special legislative session, the Minnesota Legislature amended the definition of a “financial institution” to include both “corporations” and “other business entities” effective after December 31, 2016.
South Carolina – Alt. Apportionment (Burden Not Met)


- The South Carolina Court of Appeals determined that a corporation could utilize the state’s standard three-factor apportionment formula, and rejected a challenge by the Department of Revenue to require alternative apportionment based on the argument that the statutory method used by the corporation was distortive.

- The party seeking to use an alternative apportionment method “bears the burden of proving by a preponderance of the evidence that (1) the statutory formula does not fairly represent the taxpayer’s business activity in South Carolina and (2) its alternative accounting method is reasonable.”
Transfer Pricing
Introduction
Transfer Pricing Overview
What is Transfer Pricing?

– Transfer pricing is the pricing of transactions between related entities for goods, intangible assets, services and loans.

– It’s designed to prevent tax avoidance among related entities by requiring pricing that places controlled transactions on par with transactions between unrelated parties.

– Transactions generally must be at arm’s length.
  • Uses “comparables” for arm’s length standard because identical transactions are usually not available.

– A tax evasion or avoidance motive is generally not a prerequisite for application of an IRC § 482 adjustment.
Transfer Pricing Overview
Key Intercompany Transactions Subject to Transfer Pricing

- Transfer and licensing of intangible assets
- Providing and charging for common services
- Financing
- Factoring accounts receivables
- Purchase and resale of tangible goods
Transfer Pricing Overview
Federal Landscape

Transfer pricing is generally governed by:
- IRC § 482;
- Extensive regulations, detailed methodologies;
- Developed body of judicial decisions; and
- Disciplined procedures for obtaining advance approval for transfer pricing.
Transfer Pricing
Key Issues
Overview of State Transfer Pricing Issues
State Use of Transfer Pricing Authority

— Many states have statutes that adopt or are substantially similar to IRC § 482.
  • States with an IRC § 482 equivalent statute may or may not incorporate the federal regulations.

— Some states assert statutory language broader than IRC § 482 authority.

— Some states with no IRC § 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
Overview of State Transfer Pricing Issues

State Use of Transfer Pricing Authority

Historically, few states have actively utilized IRC § 482 equivalent authority

- States rely on formulary apportionment for determining where corporate income is earned. By contrast, the United States and virtually every other nation rely on transfer pricing for sourcing cross-border income.

- States have limited experience with transfer pricing and few resources trained to apply transfer pricing rules as compared with the IRS or foreign taxing authorities.

States have also utilized other solutions for policing related party transactions.

- E.g., asserting nexus, addback provisions, etc.

Rather than engaging in a substantive pricing analysis, states are increasingly either:

- Disregarding intercompany transactions; or
- Disallowing 100% of tax outcome by arguing that the transactions are per se distortive.
Overview of State Transfer Pricing Issues

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 OECD Base Erosion and Profit Shifting (BEPS) project.

— It is also attributable to the publicity surrounding the Multistate Tax Commission’s (MTC) State Intercompany Transaction Advisory Service (SITAS) project.

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

• Non-arm’s length intercompany transactions can impact the clear reflection of income in separate entity or partial combination reporting states.
Transfer Pricing
Recent Developments
Colorado – Transfer Pricing Developments


– The Court of Appeals held that a corporation was not required to include a domestic subsidiary holding company (with no property or payroll) in its Colorado combined corporate income tax returns because the subsidiary was not “includible” under Colorado’s combined reporting regime.

– The Department cannot rely on its 482-type statute to include the subsidiary or otherwise tax a portion of its income.


– Same result as *Oracle*
Indiana – Transfer Pricing Developments

Rent-A-Center East, Inc. v. Ind. Dep’t of State Revenue, 42 N.E.3d 1043 (Ind. T.C. 2015)

— The court rejected combination as an alternative apportionment methodology and rejected the Department’s claim that R-A-C’s income would be distorted unless it filed a combined return with two affiliates.

— The court relied in part on an IRC § 482 transfer pricing study and the parties’ stipulation of valid business purposes.

Columbia Sportswear USA Corp. v. Ind. Dep’t of State Revenue, 45 N.E.3d 888 (Ind. T.C. 2015)

— 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.
Indiana – Transfer Pricing Developments
Letter of Findings, No. 02-20150171 (Ind. Dep’t of State Revenue Aug. 31, 2016)

— The Department equalized the operating margin between a retail entity that filed in Indiana (1%-2%) and an out-of-state retail services entity (9%-12%) to allocate additional income to the Indiana taxpayer.

— The Department acquiesced to the Tax Court’s position regarding the relevancy of transfer pricing studies discussed in Rent-A-Center East and Columbia.
  • “… the Department agrees that the audit cannot set aside Taxpayer’s transfer pricing study on the grounds cited when it required Taxpayer to reapportion the gross operating margin between itself and Retail Services.”
Transfer Pricing
Contract Auditors
Transfer Pricing – Contract Auditors
Should They Be Used?

— Some arrangements with contract auditors are contingent fee based.
  • Does this encourage abuse?

— Contract auditors historically used in a multitude of states (e.g., CT, AL, DC, LA and NJ).

— Pressure to settle.

— New Jersey Director of Taxation terminated multi-million dollar contract that involved performing transfer pricing analysis citing taxpayer resistance.
Transfer Pricing – Contract Auditors
Mississippi – Authority to Hire Third-Party Experts

- S.B. 2973 authorizes the Department of Revenue to hire third-party consultants to help the Department with transfer pricing cases effective July 1, 2017.

- Use of third-party auditors is not unique, but Mississippi is the only state that will pay on a contingency basis.
  - The bill appropriated up to $1 million to fund those contingency contracts for the current fiscal year ending June 30, 2018.
  - The Department issued an RFP for potential contractors to examine transfer pricing and underreported cash sales.
    - The scope of services includes providing audit leads, performing audit and legal analysis, drafting IDRs, preparing formal transfer pricing reports, providing expert witnesses, and training Department employees.
    - It appears that the Department is only committing to a capped $250,000 contingent fee for the transfer pricing contract.
Transfer Pricing
MTC’s SITAS Project
Transfer Pricing – MTC’s SITAS Project

- A committee of the MTC developed a transfer pricing program that would be available to the states.

- The MTC Executive Committee approved the Final Program Design in May 2015, originally called Arm’s-Length Adjustment Services (ALAS); subsequently rebranded to State Intercompany Transactions Advisory Service (SITAS) in August 2016.

- Recent transfer pricing cases have been cited as a reason for a multistate program.

- SITAS is designed to:
  (1) Provide training for state staff to identify distorting intercompany transactions; and
  (2) Provide third-party support to combat transfer pricing studies provided by taxpayers.
Transfer Pricing – MTC’s SITAS Project

— The program was designed to launch with the support of 10 states, although only five states have signed on.  
  • Alabama, Iowa, New Jersey, North Carolina and Pennsylvania

— SITAS now functions as an informal vehicle to facilitate state cooperation collaboration.  
  • SITAS encourages ad hoc cooperation among states.  
  • States working among themselves to address issues.
Transfer Pricing
So What’s Next?
So What’s Next?
Outlook of State Transfer Pricing

– 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?

– How will BEPS/international transfer pricing initiatives impact state treatment of intercompany transactions?

– Will states’ efforts rely on contingency auditors?

– Will interest in transfer pricing be displaced by other policing solutions, e.g., tax haven legislation, addback legislation, worldwide combination, etc.?

– What’s the impact of SITAS?
Takeaways
Takeaways
Preparing for a State Transfer Pricing Analysis

— Review intercompany agreements and course of conduct to accurately identify and isolate intercompany transactions.
  • This can be time consuming, but documentation is key.

— Determine the relative functions performed, risks assumed and assets employed by the respective related taxpayers.

— Select the best method to test the results of the intercompany transactions.

— Review comparables to calculate an arm’s length range of results.

— Compare the taxpayers’ actual results to calculated arm’s length range.
  • Monitor results and evaluate arrangements at meaningful intervals.
Takeaways
The State Taxing Authority Wants to Adjust, Now What?

— Under what legal authority is the state taxing authority proposing an adjustment?
  • IRC § 482 equivalent statute?
  • Addback statute?
  • Discretionary adjustment authority?

— Is the state’s statute identical to, similar to, or directly references IRC § 482?
  • If not, what is the standard for an adjustment or assessment?
    • Arm’s length price?
    • Fair price?
    • Clear reflection of income?

— If the statute permits a state taxing authority to act, what types of adjustment does the statute permit?

— Consider opportunities for settlement.
Questions?
Connect with us!
Download the Eversheds Sutherland SALT Shaker app today

Be sure to also submit your pet through our app to be featured as Pet of the Month!

- Apple App Store
- Google Play
- Amazon Appstore

@ESsaltlaw
Contact us

**Todd Lard**
Partner
202.383.0909
ToddLard@eversheds-sutherland.com
700 Sixth Street, NW
Suite 700
Washington, DC 20001-3980
202.383.0100

**Ted Friedman**
Associate
202.383.0829
TedFriedman@eversheds-sutherland.com
700 Sixth Street, NW
Suite 700
Washington, DC 20001-3980
202.383.0100

stateandlocaltax.com