

State Transfer Pricing: Are You Prepared for Increased Scrutiny?

by Michael Bryan, Andrew Fisher, Conrad Krol, and Karen Notz



Michael Bryan



Andrew Fisher



Conrad Krol



Karen Notz

Michael Bryan is a director in Deloitte Tax LLP's Washington National Tax Multistate practice. Andrew Fisher is a director in Deloitte's National Transfer Pricing practice. Conrad Krol is a director and Karen Notz is a senior manager in Deloitte's National Multistate Tax practice.

In this edition of Inside Deloitte, the authors provide an overview of intercompany transfer pricing arrangements and related state tax considerations, summarize the latest developments involving the Multistate Tax Commission's Arm's-Length Adjustment Service project, and suggest actions that taxpayers may wish to consider in developing exam-ready transfer pricing documentation.

This article does not constitute tax, legal, or other advice from Deloitte, which assumes no responsibility regarding assessing or advising the reader about tax, legal, or other consequences arising from the reader's particular situation. The authors thank Fred Paladino, Michael Paxton, and Snowden Rives for their review of this article.

Copyright 2015 Deloitte Development LLC.
All rights reserved.

Businesses operating in more than one state or country often do so through multiple corporate entities. That necessitates intercompany transfer pricing arrangements that are increasingly scrutinized by the states. Many states challenge the pricing of intercompany transactions through statutes and regulations that are similar to or that adopt Internal Revenue Code section 482. States may also negate the effect of intercompany transactions through, for example, the use of discretionary powers to adjust income, statutes requiring the addback of some intercompany payments, or the assertion of nexus principles for entities not physically present in the state.

Many states believe there is significant additional revenue that could be collected by challenging intercompany transactions. Some states have engaged outside consultants to better equip their revenue authorities for this purpose. Also, the Multistate Tax Commission is pursuing an initiative directed at developing a multistate transfer pricing service, known as the Arm's-Length Adjustment Service (ALAS) program, that, if implemented, would support state revenue authorities in their review of intercompany transactions. While the ALAS program remains under consideration, state interest in the proposed service, and in the related transfer pricing training sessions offered by the commission, suggests that states desire improved transfer pricing audit capability. Accordingly, taxpayers need to be prepared to defend state audits or assessments arising from an adjustment to intercompany charges.

In this article, we provide an overview of intercompany transfer pricing arrangements and related state tax considerations, summarize the latest developments involving the MTC's ALAS project, and suggest actions that taxpayers may wish to consider in developing exam-ready transfer pricing documentation.

I. Legal Entity Planning

Despite a U.S. economy that is rebounding from the Great Recession, nearly half of the states expect a budget

deficit for the upcoming fiscal year.¹ Faced with these shortfalls, some states have looked for tax revenue sources that are palatable to the resident constituents. As demonstrated through the number of states that within the past decade have legislatively moved to a single sales factor for state apportionment purposes, many state policymakers view the state corporate income tax as a revenue base that can grow at the cost of businesses not substantially located in their state.

Of the 44 states that impose a corporate income tax, roughly half do not mandate that a taxpayer calculate its state tax liability on a combined or consolidated basis. In these states where the default method requires a taxpayer to determine its state tax liability on a separate legal entity basis, policymakers have focused their attention on curbing actual and perceived tax planning structures that result in a corporate tax base that in their view does not fairly measure the taxpayer's activities in the state.

State income tax savings can occur when income shifts from a taxpayer operating in a separate filing state to a related entity that conducts its business activities in a different state (for example, with a lower income tax rate). State income tax savings may also occur when income shifts to a taxpayer with a lower apportionment factor percentage in a separate filing state. In some instances, even when state income tax rates are equivalent, income shifting may produce a reduction in an affiliated group's overall state tax liability due to the implications of combined and separate filing methods. Further, intercompany transactions may facilitate the use of state net operating losses and tax credits.

Transactions between entities within a corporate group can and should occur for a number of commercially justified reasons, including the acquisition of inventory, the use of intangibles, the need for short- or long-term financing, and the need for centrally provided services.

In the (now seemingly distant) past, a common arrangement was for a separate legal entity to hold an intangible asset used by related corporations. This state tax planning involved the separate legal entity being domiciled in a state such as Delaware, Nevada, or a combined return state where intercompany royalty income was favorably treated or eliminated. The separate legal entity would charge the related corporations a royalty for use of the intangible asset. The intercompany royalty payment reduced the state taxable income of the related operating corporations in separate return states. Over the years, states have, in general, negated most of the favorable state income tax results associated with this type of legal entity organization, notwithstanding that those structures were implemented for business reasons, including the protection of intangible property.

Additional tax planning approaches involving intercompany transactions to reduce the tax base in separate return

states may include a parent corporation doing business solely in a combined return state that pushes down debt to a subsidiary conducting business in separate return states. The payment of interest on the intercompany debt is eliminated in the parent corporation's state tax return but is deducted in the subsidiary's state tax returns.

Other common tax structures consist of intercompany charges for services, an approach often implemented to achieve economic efficiencies through operational streamlining. For example, a parent corporation or a shared services company may charge intercompany management fees to related corporations for the performance of centralized management and administrative functions.

Another common transaction structure is when a dedicated entity is responsible for selection and procurement of inventory that is then sold to a retail network operated by a separate legal entity.

Whether a legal entity structure has resulted in actual or unintentional tax planning, state policymakers have been active in closing perceived tax loopholes.

Although these corporate structures may be purposefully entered into in part to achieve income tax savings, as noted previously, these tax planning opportunities involve transactions that a related group of corporations may enter into for common business reasons, such as legally protecting intangible property (IP) from lawsuits, sharing the costs of acquisition debt, realizing economic efficiencies through eliminating functional redundancies, and increasing product margins through centralized purchasing. Many taxpayers may be able to achieve state income tax savings (or, conversely, additional tax costs) through a combination of implementing common business practices, applying a state's method of determining a corporation's income tax liability, and the choice of legal entity organization.

II. State Response to Legal Entity Planning

Whether a legal entity structure has resulted in actual or unintentional tax planning, state policymakers have been active in closing perceived tax loopholes. One method of attack has been to implement mandatory unitary combined reporting. Within the past decade, seven states have adopted combined reporting. Many state tax authorities assert that the move to combined reporting increases the tax base because the filing method negates the ability to use intercompany charges to reduce a taxpayer's profits. However, there are several factors that could decrease a taxpayer's tax base through combined reporting. One factor involves the ability of a taxpayer to include loss companies in its tax base that would otherwise be excluded. Another factor involves the ability of a taxpayer to include related corporations that

¹Christina A. Cassidy, "Nearly Half of States Expect to Confront Big Budget Gaps," *U.S. News & World Report*, May 9, 2015.

dilute the state apportionment factor and, as such, reduce the portion of the taxpayer's taxable income apportioned to the state.

These factors could be why several states that considered combined reporting during the past decade decided to continue imposing corporate income tax on a separate return basis. State legislatures have generally turned to other policies to attack perceived legal structure planning. The most common approach has been to require the addback of some intercompany royalty payments, interest expense deductions, or management fees paid by related members.

A. IRC Section 482 and State Audits

State tax authorities conduct tax audits that scrutinize intercompany transactions, potentially resulting in adjustments to the calculation of state taxable income. Regardless of a state's audit authority used to adjust a taxpayer's state taxable income, the state typically relies primarily on the arm's-length principle (as discussed in IRC section 482) to support their adjustments.

IRC section 482 requires taxpayers engaged in transactions with related parties to do so on a basis consistent with dealings between unrelated parties (that is, consistent with the arm's-length principle). When dealings between related parties are considered not to be arm's length, IRC section 482 permits an adjustment to the value of those transactions to bring the pricing in line with the arm's-length price, with a result and recalculation of the taxable income of the affected taxpayer. Specifically, IRC section 482 provides that the U.S. Treasury has the power to "distribute, apportion, or allocate gross income, deductions, credits, or allowances" between two or more organizations that are owned or controlled directly or indirectly by the same interests to prevent tax evasion or to clearly reflect the income of any of those organizations, trades, or businesses.²

A transaction between related parties will be considered arm's length if the results are the same as those for uncontrolled taxpayers engaged in the same transaction under the same circumstances.³ To support an arm's-length transaction, taxpayers rely on a transfer pricing analysis grounded in accepted economic principles. A review of independent, comparable uncontrolled transactions is at the heart of a transfer pricing analysis. The analysis may consider independent transaction values (prices), margins (gross or net), or resulting profits.⁴

Most states may try to use IRC section 482-type powers to assign income from transactions with related parties; however, the discretionary authority of the state taxing administrators varies from state to state. Some states adopt IRC section 482 by specific reference or by using federal taxable income as the starting point in determining state

taxable income. Other states provide broad discretionary powers under an IRC section 482-type statute. However, some states limit the discretionary authority to circumstances in which transactions between related parties have not been conducted at arm's length. Further, most states either have explicitly adopted the Uniform Division of Income for Tax Purposes Act statute on alternative apportionment or have a similar rule that allows the state administrative tax authority to impose alternative apportionment formulas if the standard formula does not fairly represent the taxpayer's activities in the state.

The following is a discussion of the common methods employed by states to address the intercompany transactions that states perceive as improper income shifting. These methods often, but not always, incorporate IRC section 482 principles in order to scrutinize the intercompany transactions.

B. Expense Addback Statutes

Nearly two dozen states require some sort of intercompany expense disallowance or expense addback. The reporting requirements of intercompany expense adjustment statutes vary by state, but all statutes have similar characteristics.

Pennsylvania recently enacted an intercompany expense addback statute. For tax years beginning after December 31, 2014, taxpayers generally may not deduct intangible or interest expenses and costs paid or accrued to an affiliated entity.⁵ However, if the affiliated entity is subject to tax on the corresponding intangible or interest item in any U.S. state or possession, a tax credit against the taxpayer's Pennsylvania liability is provided.⁶ Also, Pennsylvania's statute contains exceptions to the required expense addback if specific conditions are met, including:

- the intercompany transaction is with an affiliated entity domiciled in a foreign nation that has a comprehensive tax treaty with the United States;⁷
- the intercompany transaction is with an affiliated entity that directly or indirectly paid or accrued intangible or interest expenses to an unrelated party;⁸ or
- the intercompany transaction did not have as the principal purpose the avoidance of Pennsylvania tax and was done at arm's-length rates and terms.⁹

Thus, the ability for a taxpayer to support a valid business purpose for the intercompany intangible or interest charge exists, and that the charge was made on arm's-length terms is important to meeting a valid exception to the Pennsylvania addback statute.

⁵72 Pa. Stat. Ann. section 7401(3)(t)(1).

⁶*Id.*

⁷72 Pa. Stat. Ann. section 7401(3)(t)(3).

⁸72 Pa. Stat. Ann. section 7401(3)(t)(4).

⁹72 Pa. Stat. Ann. section 7401(3)(t)(2). Note that in addition to the specific expense addback requirement, Pennsylvania may deny a deduction related to a fraudulent or sham transaction. 72 Pa. Stat. Ann. section 7401(3)(t)(1).

²IRC section 482.

³Treas. reg. section 1.482-1(b)(1).

⁴Treas. reg. section 1.482-3.

North Carolina also requires a corporation to add back direct and indirect royalty payments received by related members for use of intangible property in the state.¹⁰ North Carolina has also enacted a broad intercompany addback statute that requires a corporation to add payments to or charges by a parent, subsidiary, or affiliated corporation in excess of fair compensation in all intercompany transactions of any kind.¹¹ A regulation provides that IRC section 482 standards are used to determine whether or not transactions between members of an affiliated group were made at fair market value.¹² The state regulation explains that the existence of a transfer pricing study is not by itself sufficient to establish that a transaction was made at FMV.¹³ Rather, the North Carolina Department of Revenue is required to consider all facts and circumstances relative to the transactions and apply federal or state case law developed under IRC section 482 and its regulations to determine whether the transactions were made at FMV.¹⁴

Thus, although North Carolina's addback statute encompasses more than intercompany intangible and interest expenses, both the Pennsylvania and North Carolina expense addback requirement exceptions anticipate that the taxpayer will have a valid transfer pricing analysis to support a position to deduct intercompany intangible and interest expenses.¹⁵

Intercompany expense disallowance or expense addback requirements are relatively new tax rules and, as such, there are few taxpayer challenges to the application of the statutes that have resulted in a published judicial decision. However, a recent example highlighting the need to review the exceptions provided by a state in its addback statute arose within *Wendy's International Inc. v. Virginia Department of Taxation*. In *Wendy's*, the taxpayer successfully defended its interpretation of one of the safe harbor provisions in Virginia's intercompany intangible expense addback statute.¹⁶ Virginia requires the addback of some intangible expenses and costs but allows an exception to the addback requirement when the related member derives at least one-third of its gross revenue from the licensing of intangible property to parties that are not related members, and the transaction giving rise to the intercompany expenses was made at rates

and terms comparable to rates and terms agreed to with unrelated parties for the licensing of intangible property.¹⁷

The taxpayer in *Wendy's* was a fast-food restaurant franchiser (*Wendy's*) that licensed trademarks and trade names through a disregarded limited liability company that was formed by a *Wendy's*-owned captive insurance company. LLC licensed to *Wendy's* the right to use the trademarks and trade names owned by LLC at a royalty of 3 percent of *Wendy's* gross sales. Under the legal agreement, *Wendy's* granted sublicenses to its franchisees' restaurants to use the trademarks and trade names and its operating systems for 4 percent of the gross sales of the franchisee's restaurant. *Wendy's* filed a refund claim for the addback of the royalties paid to LLC under the position that *Wendy's* qualified for the safe harbor provision because LLC derived at least one-third of its gross revenue from the licensing of intangible property to unrelated parties.¹⁸ The department argued that the safe harbor provision did not apply because LLC had to directly license the trademarks and trade names to the franchisees instead of indirectly through *Wendy's*.¹⁹ The court disagreed and, applying principles of statutory construction, reasoned that no direct connection between the related member and the unrelated member is required for the safe harbor provision to apply.²⁰ Thus, *Wendy's* could deduct the royalties paid to LLC because LLC derived at least one-third of its gross revenue from unrelated franchisees, albeit indirectly through *Wendy's*, and the *Wendy's* royalties paid to LLC were made at comparable rates and terms as the license agreements with the unrelated members (franchisees).²¹

C. Nexus

Nexus is an area that has seen important developments in recent years. In *Quill*, the U.S. Supreme Court concluded that physical presence in the jurisdiction is not required to establish the necessary connection under the due process clause alone. Instead, there only needs to be some definite link between the taxpayer and the state.²² In *Quill*, in the context of sales and use taxation, the Supreme Court held that substantial nexus for purposes of the commerce clause exists only if a corporation has a nontrivial physical presence in a state.²³ States have taken various positions on whether "physical presence" is also a requirement in the context of

¹⁰N.C. Gen. Stat. sections 105-130.5(a)(14), 105-130.7A(a).

¹¹N.C. Gen. Stat. section 105-130.5(a)(9).

¹²17 N.C. Admin. Code 5F.0301(a).

¹³17 N.C. Admin. Code 5F.0301(c).

¹⁴17 N.C. Admin. Code 5F.0301(a)-(b).

¹⁵N.C. Gen. Stat. section 105-130.5A(a)-(b) also provides the North Carolina DOR broad discretion to adjust the net income of a corporation by adjusting intercompany transactions or requiring a filing of a combined tax report if the intercompany transactions lack economic substance or are not at FMV.

¹⁶*Wendy's Int'l Inc. v. Va. Dep't of Taxation*, 84 Va. Cir. 398, 400 (2012).

¹⁷Va. Code Ann. section 58.1-402(B)(8)(a).

¹⁸*Wendy's*, 84 Va. Cir. 398-399 (2012).

¹⁹*Id.*

²⁰*Id.* at 400.

²¹Virginia legislatively changed the law as a result of *Wendy's* and did so retroactively. HB 5001, CH 1, 2014 Acts of Assembly 5.11 (language only) section 3-5.11 Intangible Holding Company Addback.

²²*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

²³*Id.* at 309 (holding that the presence of licensed software copied on floppy diskettes and provided to customers within the taxing state was insufficient to satisfy the due process clause's physical presence requirement).

net-income-based taxes for purposes of establishing substantial nexus. This has resulted in another common method used by states to address income shifting intercompany transactions — namely, the state’s assertion of an economic presence nexus theory based on the exploitation of a state’s marketplace for profit. In recent years, several states, including California, Colorado, Connecticut, Michigan, New York, Ohio, Tennessee, and Washington, have adopted a “bright-line” receipts factor presence standard in which a taxpayer is deemed to establish nexus for purposes of a state income tax if the taxpayer’s gross receipts from the state’s marketplace exceed an established threshold.²⁴ Under this standard, nexus is created regardless of whether the taxpayer has a physical presence in that state.

While these concepts have broader applications, as applied to legal entity restructuring, states have successfully attacked intangible property holding company structures similar to that in *Geoffrey Inc. v. South Carolina Tax Commission*.²⁵ In *Geoffrey*, the taxpayer’s parent company transferred IP to an out-of-state intangible property holding company subsidiary, which then licensed the IP back to the parent in exchange for a royalty. The court found that the licensing of IP to the parent in the state and receipt of income from the licensing created nexus for the intangible property holding company without physical presence.²⁶

ConAgra Brands Inc. v. Comptroller of the Treasury is one of the most recent decisions to assert nexus over an intangible licensing company.²⁷ In this Maryland Tax Court decision, the taxpayer, ConAgra Brands Inc., was created to hold the intangible property including trademarks that were previously held by its parent company and other affiliated subsidiaries. ConAgra Brands licensed the trademarks back to its parent and other subsidiaries in return for royalty income. This allowed ConAgra Brands’ affiliated subsidiaries with nexus in Maryland to have a royalty deduction on their Maryland corporate income tax returns. ConAgra Brands also licensed the trademarks to third-party corporations and was engaged in activity beyond the mere licensing of intangibles. All profits were effectively transferred back to

its parent company by “annual payments called ‘cost of capital’ payments and through other internal financing arrangements.”²⁸

In its opinion, the court wrote that a “subsidiary must have economic substance as a separate entity from its parent to avoid nexus and taxation.”²⁹ The court determined that ConAgra Brands was required to file in Maryland because it could not have functioned as a corporate entity without the support services it received from the corporate affiliate.³⁰ Among other findings, the court determined that the functional source of ConAgra Brands’ income was the ideas and discoveries generated by the corporate parent and that ConAgra Brands relied on the corporate parent’s personnel, office space, and corporate services.³¹ These determinations led the court to conclude that ConAgra Brands’ income is produced from the parent’s business in Maryland, which establishes nexus sufficient to justify taxation.³²

Indiana is another state where the tax authority appears to follow a broad interpretation of substantial nexus. The Indiana Tax Court held in 2013 that the corporate income tax uses a physical presence standard for establishing nexus.³³ The Indiana DOR, however, reasoned in 2014 that royalties earned by a Delaware intangible holding company through licensing agreements with two Indiana affiliates that allowed those affiliates the right to use the IP in connection with the manufacture or sale of goods in the state established a business situs in the state. In asserting that the licensing agreements allowed the Delaware intangible holding company to exploit its IP in Indiana, the DOR determined that the state could subject the economic benefit, the royalty payments, to Indiana’s corporate income tax. In its decision, the department relied on the sales factor sourcing rules to determine where the income-producing activity occurred and concluded that these activities did not occur in Delaware, where the IP is managed, but in Indiana, where the royalties are earned when the goods are manufactured and sold.³⁴

²⁴Cal. Rev. & Tax. Code section 23101; Col. Rev. Stat. section 39-22-301(1)(d); Colo. Code Regs. section 39-22-301.1; Conn. Gen. Stat. section 12-216a(a); Mich. Comp. Laws section 206.621(1); N.Y. Tax Law section 209.1.(a) and (b); Ohio Rev. Code Ann. section 5751.01(H) and (I), and Commercial Activity Tax Information Release CT 2005-02 (Ohio Dept. of Taxn., Sept. 2005); Tenn. Code Ann. section 67-4-2004 (as added by HB 0644, 2015 Leg., 109th Gen. Assemb., Reg. Sess., Tenn. May 20, 2015; effective for tax years beginning on or after January 1, 2016); Wash. Rev. Code sections 82.04.066 and 82.04.067, and Wash. Admin. Code section 458-20-19405.

²⁵*Geoffrey Inc. v. S.C. Tax Comm’n*, 313 S.C. 15 (1993), cert. denied, 114 U.S. 550 (1993).

²⁶313 S.C. at 23.

²⁷*ConAgra Brands Inc. v. Comptroller of the Treasury*, No. 09-IN-OO-0150 (Md. Tax Ct., Feb. 24, 2015).

²⁸*Id.* at 10-11.

²⁹*Id.* at 12.

³⁰*Id.* at 11-12.

³¹*Id.* at 11.

³²*Id.* at 12. In contrast to the Maryland opinion, the West Virginia Supreme Court of Appeals held on the same facts in *Griffith v. ConAgra Brands Inc.*, 229 W.Va. 190 (W.Va. 2012), that the licensing activities of ConAgra Brands did not satisfy the “purposeful direction” condition under the due process clause and ConAgra Brands did not meet the “significant economic presence” requirement under the commerce clause, and as such, did not have substantial nexus with West Virginia. 229 W.Va. at 200.

³³*United Parcel Service v. Dep’t of Revenue*, 995 N.E.2d 20, 23 (Ind. Tax Ct. 2013).

³⁴Indiana Department of Revenue, Letter of Findings No. 02-20140072 (Jun. 25, 2014).

D. Sham Transaction/Economic Substance

The federal tax judicial doctrines of sham transaction and economic substance have become more prevalent for attacking intercompany transactions. Courts have long applied these doctrines in determining, for federal income tax purposes, whether a corporation should be respected as a separate taxable entity or disregarded because the legal entity lacks economic activities and exists as a vehicle to achieve tax savings.³⁵ The application of the sham transaction, economic substance, and similar tax avoidance doctrines by the states has resulted in differing interpretations of the meaning of these principles. These doctrines have also sometimes been used interchangeably to deny an affiliate the benefit of an intercompany deduction. For example, these doctrines have been used to justify disregarding the legal entity receiving the payment, denying the expense amount paid to the tax avoidance entity, or effectively eliminating the intercompany expense by requiring the filing of a combined or consolidated return. The following is an example of how two states have reached different conclusions regarding application of the sham transaction or economic substance doctrine to intercompany royalty deductions.

The federal tax judicial doctrines of sham transaction and economic substance have become more prevalent for attacking intercompany transactions.

In *Sherwin-Williams Co. v. Commissioner of Revenue*, the Supreme Judicial Court of Massachusetts allowed as a deduction the royalties paid by the parent corporation, Sherwin-Williams, to related subsidiaries for the use of trade names, trademarks, and service marks (marks).³⁶ The commissioner of revenue had denied the deduction because the transfer of the marks to newly formed subsidiaries and then the licensing back of those marks to the operating corporations was a sham and could be disregarded under the sham transaction doctrine. In applying the doctrine in the context of a reorganization, the court explained that a taxpayer can demonstrate that the transaction is real if the “reorganization results in ‘a viable business entity,’ that is one which is ‘formed for a substantial business purpose or actually engages in substantive business activity.’”³⁷ The court further stated that “whether a transaction that results in tax benefits is real, such that it ought to be respected for taxing purposes, depends on whether it has had practical economic effects

beyond the creation of those tax benefits.”³⁸ Further, the court wrote, “tax motivation is irrelevant where a business reorganization results in the creation of a viable business entity engaged in substantive business activity rather than in a ‘bald and mischievous fiction.’”³⁹ The court cited the subsidiaries’ entry into genuine obligations with unrelated third parties for use of the marks, the subsidiaries’ investment of the royalties with third parties, and the substantial sums of liabilities paid to third parties and the parent corporation to maintain, manage, and defend the marks as evidence of economic substance or substantive business activity.⁴⁰ Thus, the court concluded that the state “erred when it found that the transfer and the licensing back transactions between Sherwin-Williams and its subsidiaries were without economic substance and therefore a sham.”⁴¹

In contrast, the New York State Tax Appeals Tribunal decided, on essentially the same facts, that the Sherwin-Williams intangible holding companies and the resulting licensing of the marks had no economic substance or valid business purpose because the transactions were “inherently illogical.”⁴² The tribunal determined that Sherwin-Williams acted as the subsidiaries’ service provider for the marks, which demonstrated that the functions of Sherwin-Williams had not changed after the formation of the intangible holding companies and thus, the only obvious benefit of the transaction was to successfully avoid taxes.⁴³ The tribunal also found persuasive the argument that “there would be serious economic risk in any business arrangement which separates the responsibility for marks and brand management from those in a company who work with the branded products on a daily basis and have actual knowledge of the brands, customer requirements, customer expectations and corporate capabilities.”⁴⁴ Further, the tribunal concluded that it was proper to require Sherwin-Williams and the subsidiaries to file a combined report because in addition to the lack of economic substance, the independent, professional appraisal report valued the marks too high, and a subsequent transfer pricing report was flawed because the set of comparables excluded companies with significant intangibles.⁴⁵

³⁸ *Id.* at 516.

³⁹ *Id.* at 518-519.

⁴⁰ *Id.* at 517-518.

⁴¹ *Id.* at 508. Also in this decision, the commissioner alternatively asserted that the royalty payments should be eliminated because they were not made at arm’s length and distorted the actual income of the taxpayer. The court, however, was satisfied that the royalty payments were arm’s-length transactions based on an independent, professional appraisal report that valued the marks and recommended a range of royalty rates. *Id.* at 508, 521-522.

⁴² *Matter of Sherwin-Williams Co.*, DTA No. 816712 (N.Y. Tax App. Trib., June 5, 2003).

⁴³ *Id.* at 170.

⁴⁴ *Id.* at 168-169.

⁴⁵ *Id.* at 172, 177.

³⁵ See *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943); *National Investors Corp. v. Hoey*, 144 F.2d 466 (1944); *Shaw Construction Co. v. Commissioner*, 35 T.C. 1102 (1961); *William B. Strong v. Commissioner*, 66 T.C. 12 (1976), *aff’d without publishing opinion*, 553 F.2d 94 (2d Cir. 1977).

³⁶ *Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E.2d 504, 508 (Mass. 2002).

³⁷ *Id.* at 515.

E. Transfer Pricing Scrutiny

An early case addressing the use of IRC section 482 principles to assess state intercompany transactions was *Matter of Tropicana Products Sales Inc.*⁴⁶ In that case, the New York State Tax Appeals Tribunal concluded that the taxpayer failed to rebut the presumption of distortion resulting from substantial intercorporate transactions.⁴⁷ The intercorporate transactions were not governed by an intercompany agreement, and the transfer pricing study provided was prepared three years after the taxpayer received its notice of deficiency.⁴⁸ Also, the tribunal determined that the comparable set of companies used in the transfer pricing study was flawed.⁴⁹ In rendering its decision, the tribunal explained that under Treas. reg. section 1.482-1(d)(1), “comparability of transactions and circumstances must be evaluated considering all factors which could affect prices or profits including functions, contractual terms, risks, economic conditions and property or services.”⁵⁰ Further, the “uncontrolled transaction need not be identical, only sufficiently similar so that it can render a reliable measure of an arm’s length result.”⁵¹ The state analyzed the comparables used in the report and determined there were enough material differences between the comparable companies and the taxpayer that the difference affected the measure of an arm’s-length rate.⁵² Some of the material differences included the use of a start-up company, a purchasing co-op that may not be maximizing profits, and the selection of companies conducting business in different geographic regions.⁵³

In contrast, the taxpayer in *Hallmark Marketing Corp.* was able to rebut the presumption of distortion by demonstrating that the intercompany transactions were at arm’s length.⁵⁴ The New York State Tax Appeals Tribunal determined the transfer pricing report was “sound and thoroughly prepared” and consistent with the IRC section 482 regulations.⁵⁵ In its decision, the tribunal noted that there is flexibility in choosing the method under the section 482 regulations.⁵⁶ In selecting the method, “the two primary factors to be considered are the degree of comparability

⁴⁶*Matter of Tropicana Products Sales Inc.*, DTA No. 815253 (N.Y. Tax App. Trib., June 12, 2000).

⁴⁷*Id.* at 70.

⁴⁸*Id.* at 70-71.

⁴⁹*Id.* at 84.

⁵⁰*Id.* at 76.

⁵¹*Id.*

⁵²*Id.* at 77-86.

⁵³*Id.* See *Matter of Lowe’s Home Centers*, DTA No. 818411 (N.Y. Tax App. Trib., Sept. 30, 2004) for a similar determination in which the taxpayer could not rebut the presumption of distortion because of a flawed transfer pricing study.

⁵⁴*Matter of Hallmark Marketing Corp.*, DTA No. 819956 (N.Y. Tax App. Trib., Jan. 26, 2006).

⁵⁵*Id.* at 81.

⁵⁶*Id.* at 76-77.

between the controlled transaction and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis.”⁵⁷

The Indiana DOR recently required the forced combination of an Indiana corporate income taxpayer that included a disregarded distribution entity and a parent corporation.⁵⁸ The distribution entity made wholesale sales of consumer products produced by the parent corporation’s manufacturing subsidiaries. Indiana pointed to several facts as evidence that the taxpayer’s business was not an “independent operation,” including that the transfer pricing study was prepared before the taxpayer’s business structure was established. Also, the transfer pricing study supported an intercompany rate equal to the prices paid 30 years earlier. As such, the transfer pricing study could not support the taxpayer’s current business activities.

III. Recent State Transfer Pricing Audit Activities

Some jurisdictions, including the District of Columbia and New Jersey, engaged third-party contractors to provide transfer pricing analyses. Regarding the District, taxpayers have challenged, and continue to challenge, the District’s methods, with several cases under appeal. As these methods have come under greater scrutiny, state interest in forming a unified transfer pricing audit program has increased.

IV. MTC Initiative

In a meeting of the MTC Executive Committee on May 9, 2013, Michael Bryan, while in his position as the director of the New Jersey Division of Taxation, requested that the MTC consider the creation of a dedicated transfer pricing audit program. Bryan reasoned that such a program would allow states to address their concerns about domestic and international transfer pricing noncompliance by supplementing state audit staff with seasoned transfer pricing professionals centralized within the MTC Joint Audit Program. Bryan also asserted that addressing transfer pricing issues within the program could result in a more consistent and defensible work product and that MTC personnel could provide end-stage audit assistance, including appeals and litigation support. Bryan cautioned that if an MTC transfer pricing audit program was not created, a possible alternative would be for states to cooperate and form coalitions using existing information sharing agreements to address the potential noncompliance in this area.

On March 13, 2014, the MTC announced its plan to develop the ALAS project, a state transfer pricing audit program that would enable participating states to pool resources to secure economic expertise to support arm’s-length issues on audit, administrative appeals, and litigation. An advisory group was formed to lay out a conceptual

⁵⁷*Id.* at 76.

⁵⁸Indiana DOR, Letter of Findings No. 02-20130641 (Feb. 25, 2015).

framework of the project.⁵⁹ In the meetings and teleconferences that followed, there were discussions regarding the relevance of the project to different state tax regimes. During the December 12, 2014, meeting of the MTC Executive Committee, Dan Bucks,⁶⁰ the ALAS project facilitator, indicated that the project would be important in analyzing transfer pricing studies in separate company reporting states; analyses would not be limited to U.S. borders; and states could be better positioned to analyze and adjust the pricing in cross-border transactions.

States have not typically challenged international related-party transactions on transfer pricing grounds. However, as international tax structures come under increasing scrutiny from various authorities at the international level (for example, the base erosion and profit-shifting project of the OECD), some states have taken action.⁶¹ For instance, several states have in recent years begun enacting “tax haven” provisions that bring into a combined report the tax base of a foreign entity doing business in some overseas jurisdictions.⁶² Some states have also increased challenges to U.S.-foreign intercompany debt structures that otherwise passed IRS muster.

In addition to extending the use of ALAS to international transfer pricing issues, Bucks proposed at the December 12 meeting that ALAS resources could also be used in conducting unitary relationship analyses to determine the members of a combined reporting group. Previous discussions have also highlighted the potential uses of transfer pricing as a component of state intercompany addback statutes, where transfer pricing could be used to identify indirect or embedded royalties.

On May 7, 2015, the executive committee passed a motion to accept the final design of ALAS. The design had been submitted to 48 states during February 2015. The MTC received responses from 31 states, many declining participation in the program. Six states have committed to ALAS: Alabama, Iowa, Kentucky, New Jersey, North Carolina, and Pennsylvania. The final design of ALAS includes the following core concepts:

- **Transfer Pricing Analysis.** When there is a taxpayer-provided transfer pricing report, the MTC would hire or contract with economists for economic review of the report, and the MTC would use its auditors to perform noneconomic analysis of the report, such as checking for calculation errors or the absence of a business purpose and selecting comparables.
- **Training.** Train auditors in related areas, including how to identify issues, what information to obtain from taxpayers, how to obtain that information, and how to conduct noneconomic analysis noted above.⁶³
- **Information Exchange.** ALAS would provide for tax authority exchange of taxpayer information related to transfer pricing issues and sharing of information for conducting joint audits.
- **Case Resolution and Litigation Support.** These activities include assisting states on strategies for appeals and litigation and providing expert witnesses in litigation and other similar activities. The design also anticipates a voluntary disclosure period to be implemented during the developmental stage, which may occur during July to December 2016.
- **Optional Joint Audits.** The plan envisions ALAS as a component of the MTC’s existing joint audit program.

Although the final program design of ALAS has been accepted by the executive committee, it remains to be seen whether the MTC will be able to attract enough states to fund the program toward implementation.⁶⁴ The potential cost of ALAS is estimated at \$2 million per year. However, Bucks asserted that the preliminary estimate of a \$25 million annual benefit from ALAS was conservative. MTC Deputy Executive Director Greg Matson noted in his presentation to the executive committee that several states said they “couldn’t commit at this time.” However, Matson said those states described themselves as “very interested” and said they “want to keep an eye on” the program. The MTC intends the final design to be submitted to the full MTC for ratification during its annual meeting in Spokane, Washington, on July 29.

V. Audit Preparation

Although the full scope and implications of the MTC transfer pricing program are unclear at this time, it is evident from the ALAS development meetings that some states have a growing interest in cooperating to more effectively address interstate and international transfer pricing issues. Also,

⁵⁹The advisory group was made up of representatives from Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina.

⁶⁰Bucks was formerly the MTC executive director and Montana director of revenue.

⁶¹*National Grid USA Service Co. v. Commissioner*, No. ATB 2014-630, Mass. App. Tax Bd. (2014) (decision upholding assessments denying a domestic taxpayer’s interest deductions for payments under deferred subscription agreements with foreign entities because those agreements did not qualify as true debt in the absence of an unconditional obligation to repay).

⁶²See, e.g., Alaska Stat. section 43.20.145(a)(5); D.C. Code Ann. section 47-1810.07(a)(2)(F)(i); Mont. Code Ann. section 15-31-322(f); Or. Rev. Stat. section 317.715(2); R.I. Stat. 44-11-4.1(d); W. Va. Code section 11-24-13f(a)(7).

⁶³The MTC has already begun training efforts. On March 31 and April 1, staff from the taxing authorities in Alabama, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, New Jersey, North Carolina, and Pennsylvania attended a transfer pricing training program conducted by the MTC in North Carolina.

⁶⁴On May 19, 2015, Greg Matson said on a webcast that the “MTC won’t launch the program until at least nine or ten states sign on as charter — and paying — members.”

state taxing authorities are likely to continue to conduct transfer pricing audits and may explore various approaches to enhance their transfer pricing audit capabilities as demonstrated by the MTC-sponsored transfer pricing programs already underway. In the interim, taxpayers may wish to prepare exam-ready transfer pricing documentation addressing state-specific concerns. Taxpayers may also review existing transfer pricing studies to determine whether an update is advisable, given changes to the taxpayer's business activities or whether those studies need to be adapted to take into account state laws, such as statutory expense addback rules and penalty provisions. If a transfer pricing study has never been completed, a taxpayer should strongly consider obtaining a study, even if the report is prepared post-transaction. The study may be useful in an audit or in determining potential issues with current filing positions. Taxpayers should also follow through with corporate formalities associated with intercompany arrangements.

VI. Conclusion

Taxpayers often operate through multiple legal entities that enter into intercompany transactions, requiring a determination of the proper pricing for those transactions. As states increase their intercompany transaction audit activities, prudent taxpayers will be proactive in reviewing the business operations of their affiliates to verify the existence of economic substance, including the ability of an affiliate to operate as a viable business entity in fulfillment of its business purpose. Diligent taxpayers will also revisit the documentation to support intercompany pricing, including the relevancy of the transfer pricing report to the taxpayer's current business operations and the comparables relied on to determine the arm's-length rates. These activities may help taxpayers address concerns in advance of state audit activities that focus on intercompany transactions. ☆

*Come for tax news.
Leave with tax wisdom.*

Tax Analysts offers more than just the latest tax news headlines. Our online dailies and weekly print publications include commentary and insight from many of the most-respected minds in the tax field, including Lee Sheppard and Martin Sullivan.

To stay smart, visit taxanalysts.com.

taxanalysts[®]

Tax Notes Today[®] ▲ State Tax Today[®] ▲ Worldwide Tax Daily[®]