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Tax Section



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2022

# ABA/IPT ADVANCED TAX SEMINARS

## ABA-IPT Advanced State Income Tax Seminar

State Transfer Pricing: Challenges, Issues and  
Opportunities for Multistate Taxpayers

March 16, 2022



# The Panel

## ***Speakers:***

Bruce Fort, Senior Counsel – Multistate Tax Commission

Kate Pascuzzi, Managing Director – BDO USA, LLP

Mark Richards, Partner – Ice Miller, LLP

## ***Moderator:***

David Hughes, Partner – HMB Legal Counsel

# Objectives

- Explain how state Departments of Revenue utilize their transfer pricing authority;
- Describe how taxpayers can defend themselves against transfer pricing adjustments;
- Identify the common issues that arise in a state transfer pricing audit;
- Discuss the role that the Multistate Commission plays in state transfer pricing developments.

# Agenda

- I. What is State Transfer Pricing?
- II. State Authority to Adjust Intercompany Transactions
- III. Current State Transfer Pricing Issues
- IV. Defending a State Transfer Pricing Audit
- V. The Role of the MTC in State Transfer Pricing Developments

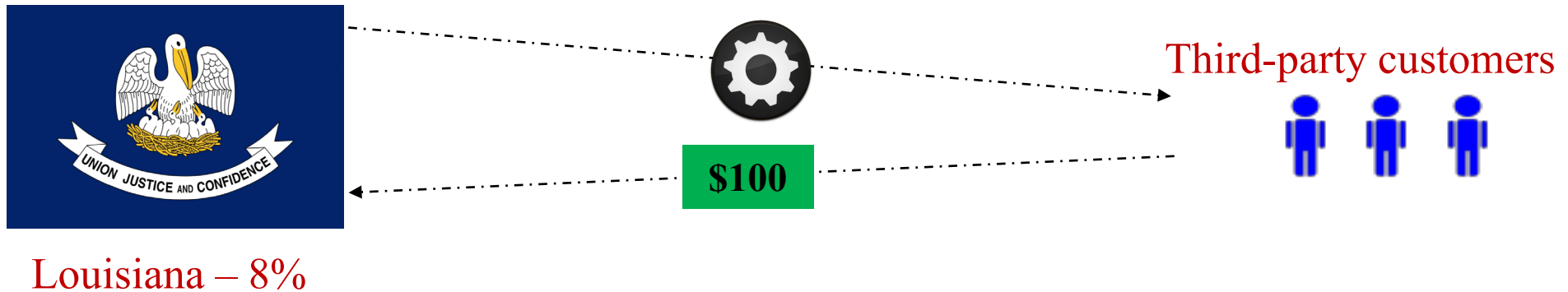
# What is State Transfer Pricing?

# State Transfer Pricing

- Absent government intervention, taxpayers could feasibly shift income and expenses between state jurisdictions to artificially lower their effective state income tax rate.
- Unregulated taxpayers can accomplish this by taking advantage of intercompany pricing at non-arm's length terms.
- If a taxpayer controls both sides of a transaction between its related businesses, it could potentially set artificially low or high prices on goods/services sold between the related businesses in different taxing jurisdictions.
- This would allow taxpayers to manipulate where their income is taxed, particularly in separate legal entity reporting states .

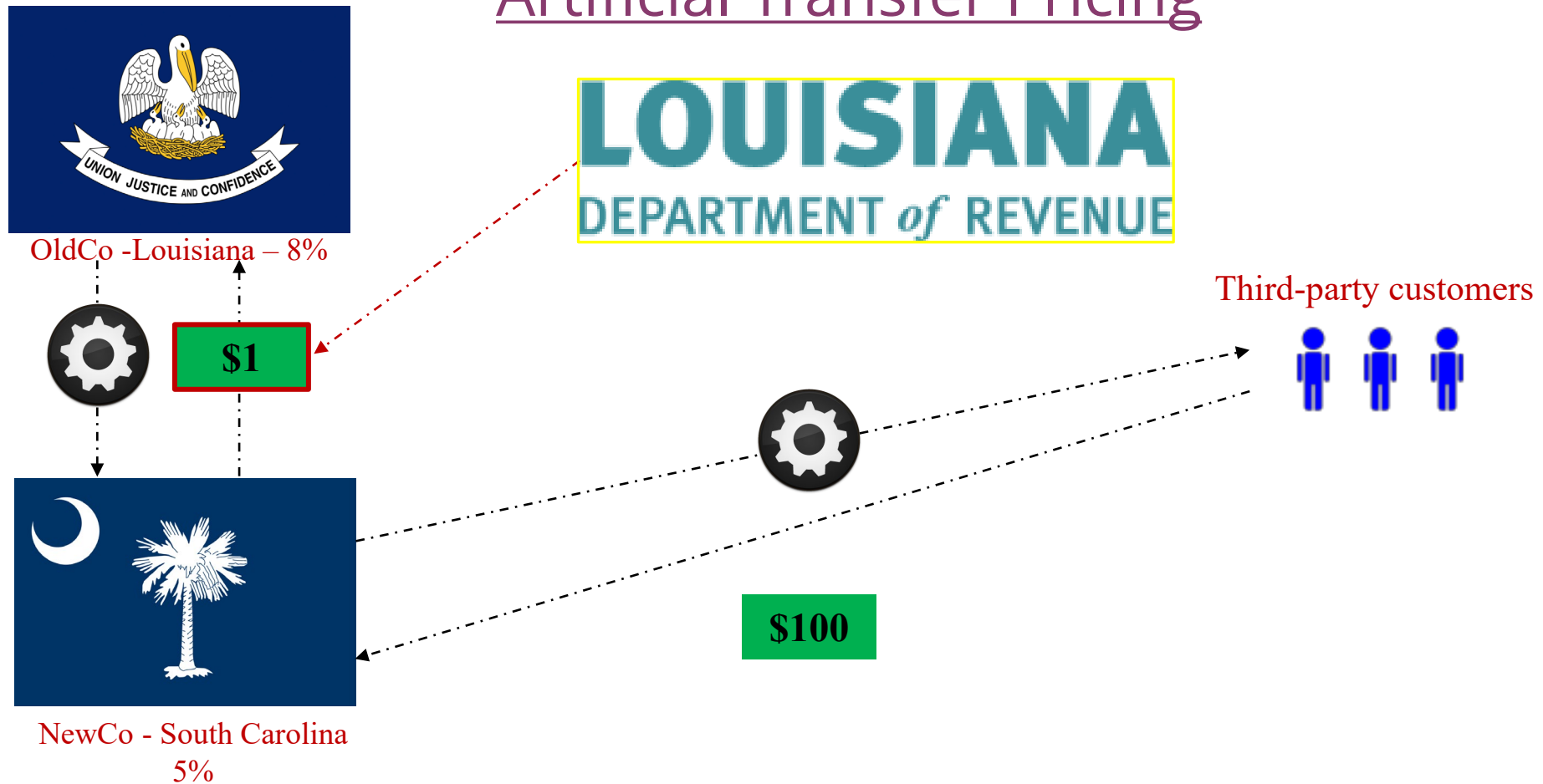
# State Transfer Pricing Example

## Market Pricing



# State Transfer Pricing Example

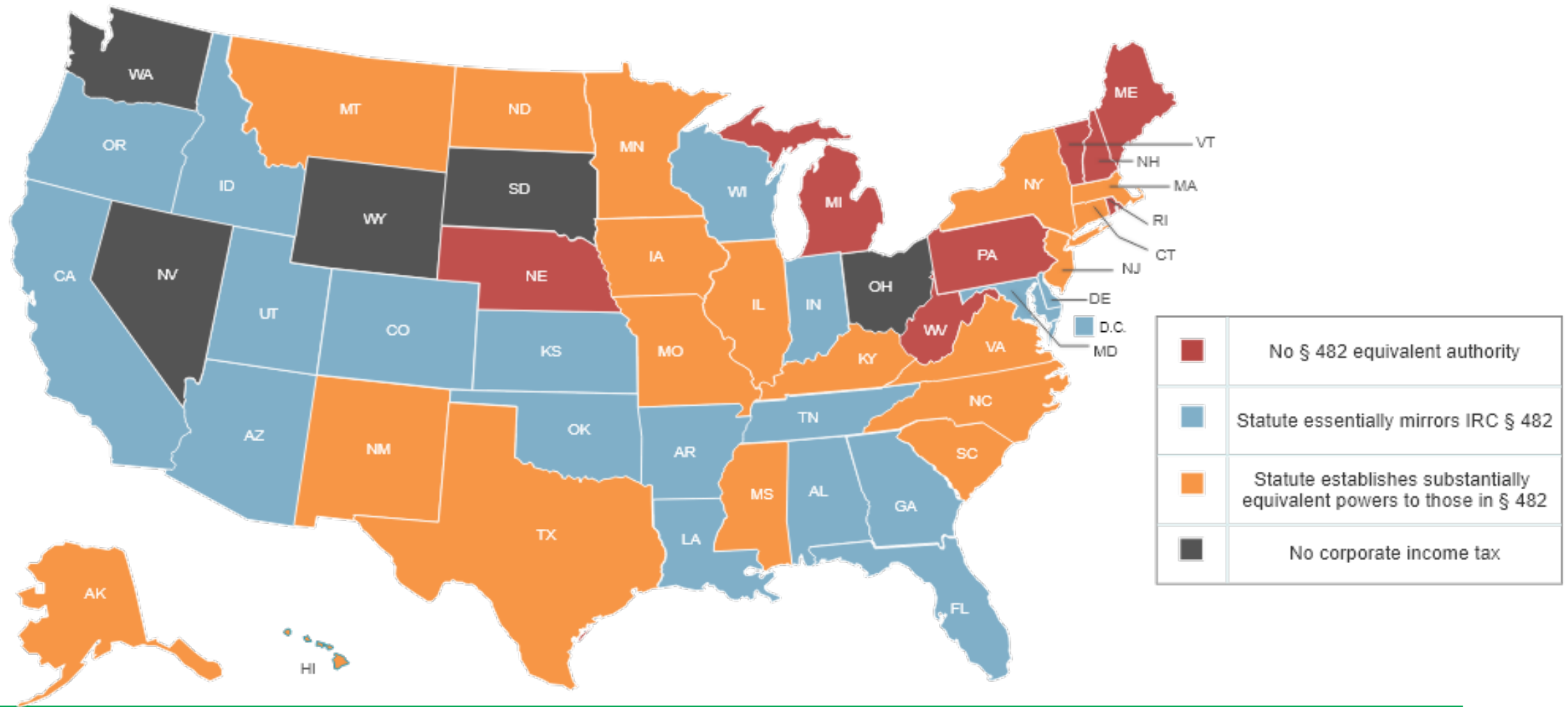
## Artificial Transfer Pricing





# State Authority to Adjust Intercompany Transactions

## State Transfer Pricing Authority



# State Authority to Reallocate Income and Expenses Among Related Parties (State “IRC 482” Powers)

- Many states have some form of 482 authority. Some refer to obtaining a picture of “true income” and some refer to adjustments to “fairly reflect” income;
- **Fair reflection of income statutes**— 26 states— similar or identical to IRC 482;
- Commonly used now in Southeastern states (separate entity filing) as basis for transfer pricing programs.
- **Fair profits/true income standard**: has the benefit of not being identical to federal 482 statute;
- **Lack of fair consideration statutes**: probably intended for sales tax transactions;
- **Improper accounting statutes**: probably of limited value in challenging corporate transactions.

# Do States Without Reallocation Statutes Have Inherent Authority By Virtue of adoption of Federal Taxable Income as Starting Point for Base Income?

- States have authority to audit “above the line” to separately calculate federal taxable income.
- Many times, the disallowance of a deduction arising from an intercompany transaction involving intangible property or management fees could be classified as a disallowance of expenses as not being “ordinary and necessary” under IRC 162.
- Use of federal 482 authority should be similar; an integral aspect of the computation of federal (and hence state) taxable income.
- But See: *Comptroller v. Gannett*, 741 A.2d 1130 (Md. 1999)(no inherent Sec. 482 authority).

# Incorporating 26 C.F.R. 1.482 Regulations into State Practices

- Numerous 1.482 regulations have analogs to other tax principles and problems, including interest expense deductions, economic substance, matching principle.
- Economic substance: 1.482-1(d) provides that in evaluating comparability of transactions, the economic substance of the parties' arrangements must be considered.
- Interest Expense: 1-482-2(a): includes procedures for adjusting inter-company interest but only for *bona fide* loans. Read in conjunction with IRC 385.
- These regulations may prove helpful in states where courts have rejected economic substance theory.

# Other State Authority to Adjust Intercompany Transactions

- Expense add back statutes
- Forced combination

# Current State Transfer Pricing Issues

# Audit Theories/Approaches to intercompany transactions

“Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”

Judge Learned Hand, *Gregory v. Helvering*, 69 F.2d 809, 810 (2<sup>nd</sup> Cir. 1934)

“Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible; Everybody does so; rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands; taxes are enforced extractions; not voluntary contributions. To demand more in the name of morals is mere cant.”

Judge Learned Hand, *Comm’r v. Newman*, 159 F.2d 848, 851 (2<sup>nd</sup> Cir. 1947) dissenting opinion.

“The hardest thing in the world to understand is income taxes.”

Albert Einstein

“Make sure you pay your income taxes; otherwise, you can get in a lot of trouble.”

Richard M. Nixon



# Audit Theories/Approaches to intercompany transactions

- Common law doctrinal qualifiers:
  - Substance over form: *Indiana Dep't of State Revenue v. Belterra Resort Indiana, LLC*, 935 N.E.2d 174 (Ind. 2010).
  - Sham transaction/lack of valid business purpose/lack of economic substance. IN Letter of Findings #02-20120140.
- Assertions of economic nexus: IN Letter of Findings #06-0033; *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993).
  - Indiana's adoption of income tax nexus "to the fullest extent" of the U.S. Constitution
  - Public Law 86-272 developments: is a website sufficient to defeat immunity conferred by statute?
  - Future nexus claims with market based sourcing of services (MBS)? Cf., *Robinson v. Jeopardy Productions*, 315 So.3d 273 (La. App. 2020).

# Audit Theories/Approaches to intercompany transactions

- Statutory:
  - UDITPA type alternative apportionment statutes (failure to fairly reflect state income – “distortion”):
    - Deny deductions: IN Letter of Findings #06-0169; #06-0411; #10-0430.
    - Forced combination: IN Letter of Findings #01-0132; #02-20120008; #02-20130641.
  - Related party add-back statutes, such as:
    - Intangible (royalty) expense: Ind. Code § 6-3-2-20
      - Concerns with embedded royalties
    - Interest and rent expense: Ind. Code § 6-3-2-20 (intangible expenses and interest)

# Audit Theories/Approaches to intercompany transactions

- Statutory
  - State statutory equivalents to IRC § 482:
    - Transfer Pricing Goal: Clearly reflect income by putting related (controlled) party transactions “on a tax parity” with unrelated (uncontrolled) party transactions. Treas. Reg. §1.482-1(a)(1).
    - Standard: Taxpayer dealing at arm’s length with an uncontrolled taxpayer. Treas. Reg. §1.482-1(b)(1).
    - Expansion to sales tax (California)

# Audit Theories/Approaches to intercompany transactions

- Litigation
  - *Rent-A-Center East Inc. v. Indiana Dep't of State Revenue*, 42 N.E.3d 1043 (Ind. Tax Ct. 2015)
    - Intercompany royalties and management fees, with pricing based on 482 studies
    - Department forced combination, disregarding 482 studies as “irrelevant”
    - Holding: Forced combination improper

# Audit Theories/Approaches to intercompany transactions

- *Columbia Sportswear USA Corp. v. Indiana Dep't of State Revenue*, 45 N.E.3d 888 (Ind. Tax Ct. 2015)
  - Intercompany product sales, with pricing based on 482 studies
  - Department adjusted the taxpayer's Indiana tax base
  - Holding: Department adjustments improper: failing to provide evidence to combat 482 studies and unreasonable (attributing over 99% of profits to one entity)
- *E.I. Dupont de Nemours & Co. v. Indiana Dep't of State Revenue*, 79 N.E.3d 1016 (Ind. Tax Ct. 2017)
  - Department's disallowance of interest expense deductions held improper.
  - Tax Court cites IRC § 482, *Rent-A-Center* and *Columbia Sportswear*.

# Use of Consultants, Information Sharing and Specialized Training

- Use of Consultants:
  - Training
    - Education or Indoctrination?
    - Economics or legal?
    - Legitimate or false sense of expertise?
  - Audits
    - Legal advisors or outsourced member of auditor/appeals team?
    - Undue reliance/influence?
    - Fee agreements
- Information Exchange Agreements:
  - Legal considerations
  - Policy/relationship considerations

# Recent State Initiatives

# Indiana Transfer Pricing Initiatives

- Audits - Shift from ignoring to addressing transfer pricing studies:
  - Department's claimed "subject matter experts" or "SMEs"
  - Confidentiality concerns with disclosures to outside consultants
    - Consultant's data base of nonpublic information
- APA Program
  - No application fee
  - Available with or without a current audit



# Indiana Transfer Pricing Initiatives

- Documentation:
  - Transfer Pricing Studies
  - Three years of federal returns
  - Organizational charts
  - A summary of all intercompany transactions by type, amount, and entity
  - GAAP financial statements for each party to a controlled transaction
  - Other records as needed

# Indiana Transfer Pricing Initiatives

- Listed areas of potential differences:
  - The choice of best method
  - The choice of the tested party
  - The profit level indicator chosen and the basis for the choice
  - The search method for comparable companies
  - The appropriateness of any adjustments

# Indiana Transfer Pricing Initiatives

- Typical issues listed:
  - Timeliness of comparables information
  - Inclusion of companies outside the taxpayer's geographic area
  - Inclusion of loss companies
  - Inappropriate adjustments
  - Use of methods comparing uncontrolled and controlled transactions
  - Choice of profit level indicator

# Indiana Transfer Pricing Initiatives

- Unilateral (Indiana only) agreement.
- Open years plus two three-year audit cycles
- Confidentiality provisions
- Certainty – but at what cost?
- Goal: Appropriate outcome or raise revenue?

# Federal APA Cancellation Standards

- *Eaton Corp. v. Commissioner*
  - Eaton and the IRS executed two APAs.
  - Eaton made certain inadvertent calculation errors in implementing the APAs. It disclosed and self corrected the errors.
  - IRS “cancelled” both APAs, made adjustments and imposed penalties.
  - Tax Court called the APA cancellation an “abuse of discretion.”
  - On Appeal to the Sixth Circuit.
    - Eaton’s opening brief: “No rational company would engage in months or even years of costly investigation knowing that all that work would be thrown away if it happened to make some fixable math mistakes.”
- At issue is interpretation of IRS’s APA cancellation policy under Rev. Proc. 2015-41.
  - In its 2021-2022 Priority Guidance Plan, Treasury announced an update to the Rev. Proc., including “guidance on the administration of executed advance pricing agreements.”

# North Carolina Voluntary Corporate Transfer Pricing Resolution Initiative

- Old news:
  - Ran from began August 1 through December 1, 2020.
  - DOR reported approximately \$114 million in collections.
- Benefits:
  - The Department would waive penalties for any agreed upon issue.
- Program steps:
  - By October 16, 2020, participants were required to submit “all required transfer pricing, tax, and financial information and documentation.”
  - Within 31 days of receipt, the Department would provide a proposed adjustment.
  - Participant had 15 days to accept or offer modifications.

# Louisiana Transfer Pricing Managed Audit Program

- Benefits:
  - No penalty will be assessed on any tax due relating to the managed audit findings.
  - Delinquency interest that accrues during the “managed audit period” will be abated, not to exceed 180 days.
    - “Managed audit period” is the period from: (i) acceptance into the program; and (ii) LDR’s notice of tax due.
- Eligible taxpayers:
  - History of voluntarily tax compliance with LDR.
  - Taxpayer must certify it has available time and resources to dedicate to the program.
  - Reasonable expectation of ability to pay an expected liability.
  - Available and suitable records concerning Intercompany Transactions.
  - Taxpayer may already be under audit, appeals, etc.

# Louisiana Transfer Pricing Managed Audit Program

- Submit within 30 days of acceptance into the program:
  - Easy:
    - Complete federal tax returns for the last three years.
    - Transfer pricing studies, including comparable methods used and any agreements from the IRS.
    - Organizational charts reflecting each subsidiary and its relationship to the parent company.
  - Hard:
    - List of all Intercompany Transactions by type, amount, and entity, including journal entries.
    - Financial statements on a GAAP basis for each party to an Intercompany Transaction (alternatives if GAAP unavailable).
  - ...is this even possible??:
    - Other invoices, checks, accounting records, or other documents or information, if requested by LDR, to determine the correct amount of tax.



# Louisiana Transfer Pricing Managed Audit Program

- Program steps:
  - Taxpayers are assigned a Field Audit Income Tax (“FAIT”) Representative.
  - FAIT rep will issue a written determination on whether LDR agrees or disagrees with taxpayer’s methodology [note here, unlike NC, no specific time period for determination].
  - Taxpayer has 30 days to accept or offer modifications.
- Program Dates:
  - Apply on or before April 30, 2022.
  - Audit must be closed by June 30, 2022.
- How else is this different than North Carolina’s 2020 program??
  - Louisiana will allow for prospective agreements.

# Recent State Transfer Pricing Cases

# *Utah State Tax Comm. v. See's Candies, Inc.*, 435 P.3d 147 (Utah 2018)

See's Candies transferred intangible property to a related party insurance company—Columbia Ins. Co.—in a non-recognition transaction under IRC Sec. 351 in 1997;

Columbia charged significant royalties for use of trademarks, but could not be included on Utah's combined filing report;

Utah did not challenge economic substance of 1997 transaction or arms-length price of royalty charged;

Utah argued that state 482 statute gave it authority to disallow royalty deduction based on state concepts of fair profits—including add-back statutes;

Court holds legislature intended to apply state statute under federal IRC 482 and arms-length standards; failure to challenge transfer price was therefore fatal.

Could Utah have made a case under Treas. Reg. 1.482-1(f)(iii)?

# Georgia - *Trader Joe's East, Inc. v. Riley*

- Georgia DOR challenged Trader Joe's transfer prices on purchases of services, administrative services and intellectual property licenses.
- Georgia statute allows the Commissioner to make adjustments if a taxpayer engages in transactions with related parties in a way that distorts net income.
- Unlike many states, Georgia's statute does not repeat nor reference the federal statute. Does this provide the DOR more leeway?

# Tractor Supply Co. v. S. C. Dep't of Revenue

- Tractor Supply Co. of Texas, LP (“TSC of Texas”) and Tractor Supply Co. of Michigan (“TSC of Mich”) are subsidiaries of Tractor Supply
- TSC of Texas manufactured goods and sold them to Tractor Supply pursuant to an Inventory Procurement Agreement, with the price determined by a 482 study.
- Tractor Supply and TSC of Mich. entered into a Master Shared Services Agreement.
- S.C. Dep't of Revenue applied forced combination.
- Case pending before the S.C. Admin. Law Court.

# Cola-Cola Co. v. Comm'r (Federal)

- Coke and the IRS had a 1996 closing agreement to settle a transfer pricing examination.
  - Established “10-50-50” methodology for pricing royalties on intangibles (trademarks, product formulas) paid by foreign “supply points”.
  - Closing agreement covered 1987-1995.
  - Coke continued to rely on the agreement after 1995. The closing agreement had no roll-forward provision and was not an APA.
  - The IRS did not challenge the methodology until 2015, proposed a significant adjustment.
- IRS argued royalty payments were too low (i.e., too much taxable income left outside of the US) and did not meet an arm’s-length standard.
- November 2020 – Tax Court ruled in favor of the Commissioner; October 2021 – Tax Court denied reconsideration.
- Per its 2021 Form 10-K:
  - “The Company intends to assert its claims on appeal and vigorously defend its position.”
  - “The Company’s conclusion that it is more likely than not the Company’s tax positions will ultimately be sustained on appeal is unchanged as of December 31, 2021.”
- Takeaways:
  - Do not rely on old agreements.
  - Consider Transfer Pricing from a logical perspective.

# Defending a State Transfer Pricing Audit

# Transfer Pricing Exam Defense

- Transfer Pricing exam defense begins well before the examination.
- Audit yourself.
  - Are you aware of income and expense apportionment flowing into the federal consolidated group?
  - Are you aware of all domestic intercompany transactions?
  - Are your domestic transactions legally documented?
  - Are your domestic transfer prices logical?
- Document your findings.
  - Know that documentation will likely be reviewed by an auditor.
  - If you don't understand it, the auditor won't understand it.
- Update documentation regularly and following major organizational and industry events.



# The Role of the MTC in State Transfer Pricing Developments

- The MTC proposed an ambitious program in 2014 to develop a multistate transfer pricing program with specialized auditors, economists and lawyers called the “Arms-Length Adjustment Services (ALAS).
- Nine states agreed to initial framework but could not obtain necessary commitments for multi-year funding from legislatures;
- Several outside contractors submitted proposals for training and support services; some contractors eventually signed contracts directly with states;
- 2016: MTC changes program to “State Intercompany Transactions Advisory Service to reflect:
- Changed role to providing training and advisory services and information exchange platform;
- Changed focus to range of remedies available to states, not just arms-length pricing.

## For more information

- *Speakers*

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**Questions?**