Transfer Pricing Implications for State & Local Tax

GIANLUCA PITETTI  KEITH ROBINSON, PHD
KPMG  PWC

INSTITUTE FOR PROFESSIONALS IN TAXATION
2016 INCOME TAX SYMPOSIUM – TUCSON, AZ
NOVEMBER 14, 2016
Introduction

What is driving States’ increasing use of transfer pricing?
- OECD’s BEPS project
- MTC’s SITAS project

What is transfer pricing?
- Federal transfer pricing overview
- State transfer pricing overview

State Tax Issues
- State initiated vs federal flow through
- Competent authority adjustments
- Potential impacts of an adjustment
- Potential for minimizing uncertainty and inconsistency at the state level
Introduction – different taxing regimes

- **Taxation of Worldwide Income** – Tax is imposed by a country on its residents and domestic corporations on their worldwide income (U.S. and 5 other OECD countries).
  - Generally, there is a deferral of foreign source income until the parent company receives a foreign dividend.

- **Territorial Tax System** – Tax is generally imposed by a country only on income earned within the country (28 of 34 OECD countries have some form of a territorial tax system).
  - Under a territorial tax system, there is typically an exemption for 95 to 100 percent of foreign subsidiary dividends.

- **Formulary Apportionment** – Alone among sovereign governments in the world, U.S. state governments utilize a formulary apportionment system for corporate income tax purposes
  - Some states have separate entity reporting; other states have combined reporting.
  - Currently, no states have mandatory worldwide combination.
  - Traditionally, the U.S. and other nations use transfer pricing for intercompany, cross-border transactions whereas the states mainly utilize other methods.
How does state transfer pricing compare to federal?

Same issues at the state level and federal level -
- For federal purposes, tax base (net income) is sourced to where earned; for state purposes, tax base (net income) is apportioned to where earned using “rough approximation.”
- Both federal and state concerned that if transfer prices aren’t set right (too high for the buyer or too low for the seller), there may be less tax base to source, or apportion, than there should be.

Additional issue for the states -
- For the seller, the transfer price may affect nexus and apportionment, as well as tax base.
- Both the buyer and the seller, whether foreign or domestic, may have nexus and file in a state.
- If both entities have nexus in the state, or are both included in a combined group, an adjustment might not change liability and may not be pursued.

State transfer pricing adjustments may be made -
- As a flow through of a federal adjustment, or
- As a state initiated adjustment, based on state statutory authority
Examples of Intercompany Transactions

- Retailer sells goods to customers and records a (fixed) margin on its tax return after paying a management fee to Parent and paying for inventory from Purchasing Company.
- Purchasing Company sells to Retailer and reports majority of the Group’s taxable income.
- Transfer pricing study illustrates that Purchasing Company and Parent own all intangibles.
Increased Interest in State Transfer Pricing
Increased Interest in State Transfer Pricing

Organization for Economic Co-operation and Development’s (OECD) Base Erosion and Profit Shifting (BEPS) Project

- See also IRS country by country reporting (new Form 8975) disclosure form
- Broad information required on all Group affiliates

Multistate Tax Commission’s (MTC) State Intercompany Transactions Advisory Service Committee
Increasing State Focus – BEPS Background

BEPS 15-Item Action Plan

1. Identify challenges of a digital economy
2. Neutralize hybrid mismatch arrangements
3. Strengthen CFC rules
4. Limit interest deductions and other financial payments
5. Counter harmful tax practices
6. Prevent treaty abuse
7. Prevent artificial avoidance of PE status
8. Align transfer pricing with value creation – intangibles
9. Align transfer pricing with value creation – risk and capital
10. Align transfer pricing with value creation – high risk transactions
11. Establish methodologies to collect and analyze data on BEPS
12. Require disclosure of aggressive tax planning arrangements
13. Re-examine transfer pricing documentation
14. Make dispute resolution mechanisms more effective
15. Multilateral Instruments
Increasing State Focus –
BEPS Project Proposed Changes

- Action Items 8-10 modify important elements of transfer pricing rules but maintain commitment to arm’s length standard
  - No “special measures” deviating from arm’s length standard
- Particular focus on intangibles and risk
  - Development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE functions)
  - Entitlement to intangible-related return
  - Role of contracts
- Where does “value creation” occur?
Increasing State Focus –
BEPS Project Proposed Changes

- Action Item 13 creates a new format for Taxpayer’s transfer pricing documentation
  - Master File (provides broad information on a company)
  - Local File (provides more specific information on a specific affiliate)
  - CbCr Report (disclosure form for specific data on all affiliates)

- Designed to provide similar information to all relevant tax authorities

- The U.S., however, did not change format of its transfer pricing documentation to the Master File and Local File (but did adopt the CbCr disclosures, i.e., Form 8975)
MTC Transfer Pricing Project – What is it?

What is the MTC?

Program objectives —
  ◦ Training
  ◦ Economic analysis, recommendations, testimony
  ◦ Information exchange on transfer pricing practices of taxpayers
  ◦ Optional Joint Audits (through Joint Audit Program)
  ◦ Other state support

Other Program features —
  ◦ Early voluntary disclosure program
  ◦ “Advanced Pricing Agreements” through existing ADR process
MTC Project – Where is it now?

<table>
<thead>
<tr>
<th>Alabama</th>
<th>Kentucky</th>
<th>North Carolina</th>
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<tr>
<td>Iowa</td>
<td>New Jersey</td>
<td>Pennsylvania</td>
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Five states committed —
Currently, not enough states to fully launch program (7-10 needed)
Meanwhile, effects of training and information exchanges being felt.

- Litigation support
- Inventory of issues in separate entity states (also applies to combined states)
- Information exchange of proprietary taxpayer information related to transfer pricing matters
MTC Project – where is it going?

Is it necessary and/or beneficial?

Will it work?

Challenges in implementation and operation?

Will it be used in combined as well as separate reporting states (e.g. outside water’s-edge)?
Increasing State Focus - Perspectives

Positive
- Looking at reasonableness of price, rather than transaction itself
- Improved sophistication, consistency, and certainty
- Help reduce potential for conflicting adjustments with other states

Not Positive
- The burden on taxpayers of heightened review, increased litigation
- Will states accept federal transfer pricing studies, or are state level studies required?
- Litigation in the District of Columbia
  - *Microsoft Corp., Inc. v. Office of Tax and Revenue*, Case No. 2010-OTR-00012
- Increased potential for conflict with federal interpretations
- Are there ways to address some of these issues?
Federal Transfer Pricing Overview
Authority

Federal landscape
- Codified under IRC § 482 and Treas. Reg. 1.482
- Extensive regulations, detailed methodologies
- Developed body of judicial decisions
- Disciplined procedures for obtaining advance approval for transfer pricing
- Transactions between affiliated entities can be adjusted to “arm’s length” if necessary to prevent evasion of taxes or to clearly reflect the income of such businesses

Statutory language
- 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...
Key Features

Arm’s length principle (Treas. Reg. 1.482-1(b))

Best method rule (Treas. Reg. 1.482-1(c))

Comparability factors (Treas. Reg. 1.482-1(d))

Specified methodology approaches for:

- Tangible property transactions (e.g., comparable profits method)
- Intangible property transactions (e.g., comparable uncontrolled transaction method)
- Intercompany services transactions (e.g., services cost method)

Potential for transfer pricing rulings with IRS and other (foreign) tax authorities

- Advance Pricing Agreements (Rev. Proc. 2015-41)
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 arm’s-length price
- Make corollary adjustment
- Impose penalties for gross understatement of income (under § 6662)

Penalties can be 20% or 40% of the difference between the tax paid and the tax owed depending on whether certain thresholds are met

- Existence of formal annual transfer pricing documentation provides 100% penalty relief
State Transfer Pricing Overview
State Initiated Adjustments

Nearly every state has some statutory authority to adjust transfer prices.

Notable states that do not have statutory regime:
- Delaware,
- New Mexico,
- Pennsylvania
State Authority to Initiate Adjustment Varies

“Express” § 482 adoption

Similar, but no direct reference to §482
- E.g., “… 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.” (Kentucky, Ky. Rev. Stat. Ann. § 141.205(9); See also, Connecticut, Conn. Gen. Stat. § 12-226a; District of Columbia (addressed on following slide)

More general authority to adjust
- E.g., “… 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.” (D.C. Code § 47-1810.03.)

Broader authority than federal
- E.g., “…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 . . . ”(Va. Code Ann. § 58.1-446)

Some assert authority through general federal conformity or general discretionary power
- E.g., Maryland Comptroller of the Treasury v. Gannett Co. Inc., 356 Md. 699 (1999);
State remedies under these statutes vary. Some assert –

- Combination
- Expense/Income adjustments or reattribution
- Adjustments to international pricing that IRS “missed”
Recent Cases


◦ *Dravo Corp. v. Ala. Dep’t of Rev.*, No. CORP. 96-418 (Admin. Law Div. 2002)

◦ *HMN Financial v. Comm. of Rev.*, 782 N.W.2d 558 (Minn. 2010)
State Authority - Alternative Approaches

- Assert nexus or jurisdiction over a related party
- Disallow expense deduction by taxpayer
- Reverse/disregard the transaction for lacking economic substance/business purpose/sham
- Assert alternative apportionment
- Combine or de-combine
- Impute interest
State Tax Issues
Issues
State Initiated vs. Federal Flowthrough

Unlike federal level, both parties to transaction may be impacted
◦ Domestic affiliates that each have nexus (state level adjustment)
◦ Foreign and domestic affiliate that each have nexus (federal or state adjustment)

Flow through of a federal level adjustment to a different state group
◦ Federal consolidated group
◦ State separate entity or combined group

When is a federal adjustment a “final determination” for State RAR purposes?
◦ Federal APA agreements?
◦ Competent authority determinations?
Issues
Competent Authority

Will the state “allow” an amended return?
◦ Will generally require an amended return within a specific number of days for any year where there is an amended federal return, even if otherwise outside the SOL.

Will the state accept the IRS’s settlement decision?
◦ Not necessarily. Typically do, and would probably not reject lightly. But several have taken the position they are not required to follow federal.
◦ *National Grid U.S.A. Services Co., Inc. v. Commissioner of Revenue*, 14-P-1861.

What remedy does the US taxpayer have if it faces double taxation because the state does not accept the IRS’s settlement decision?
◦ States may take the position taxpayer is not entitled to any remedy unless Congress has specifically provided otherwise since states are not bound by federal treaties (*Barclays Bank v. Franchise Tax Board*).
◦ MTC suggests its ADR program could be used as state “competent authority.” Program is entirely voluntary for states as well as taxpayers, however.
Issues
Competent Authority

IRS may allow “telescoping” of the settlement years into one year – will state accept?

State filing may be limited or subjected to offset in various ways.

- Many limit adjustments to those that relate directly to the impetus for the federal change. So, a change in transfer pricing could justify (require) a change in the state tax base and a change in the sales factor of the state apportionment formula.
- Some (e.g., NJ), tax base change would flow through but not the sales factor change.
- Some (e.g. NY) state could raise unrelated issues to offset a federal reduction.
- Some simply treat the year of a federal change as an open year, so that both the state and the taxpayer could raise unrelated issues, and not just as an offset.
Issues
Applicable to Both State Initiated and Federal Flow Through

Could impact several aspects of state tax
- Economic nexus (for factor presence states)
- Tax base
  - Income, expenses, add-back
  - Separate vs combined reporting states
- Apportionment
  - The selling affiliate vs. the buying affiliate
  - Sales factor
    - numerator and denominator amount, throwback
    - numerator sourcing
  - Separate vs. combined reporting states
- Sales tax implications? VAT implications?
Potential for minimizing uncertainty?

State APAs?

State competent authority?

Safe harbors?

Guidance re what information will be sufficient on audit?
Thank you

Questions?