

## Supporting Transfer Pricing Positions and Preparing for MTC's Arms-Length Adjustment Service

WEDNESDAY, AUGUST 26, 2015, 1:00-2:50 pm Eastern

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Aug. 26, 2015

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**Supporting Transfer Pricing Positions and  
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Adjustment Service**

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# Agenda

Current landscape of state transfer pricing audits and examinations

Use of outside auditors/experts by state revenue departments in transfer pricing examinations

Multistate Tax Commission's Arms-Length Adjustment Service Program

Other state efforts to coordinate and implement transfer pricing policies

Best practices for documenting and supporting related-party transactions

# *Current landscape of state transfer pricing audits and examinations*

# Background



## Growing area of state scrutiny

- Massachusetts—27 pending appeals at ATB alone



**States concerned with pricing of any transaction between related entities—e.g., goods, services, intangibles, loans**



## Typical state challenges

- Is pricing arm's length, reasonable, other standard?
- Allocation method between states
- Additional “embedded royalty”?
- Basis for combination



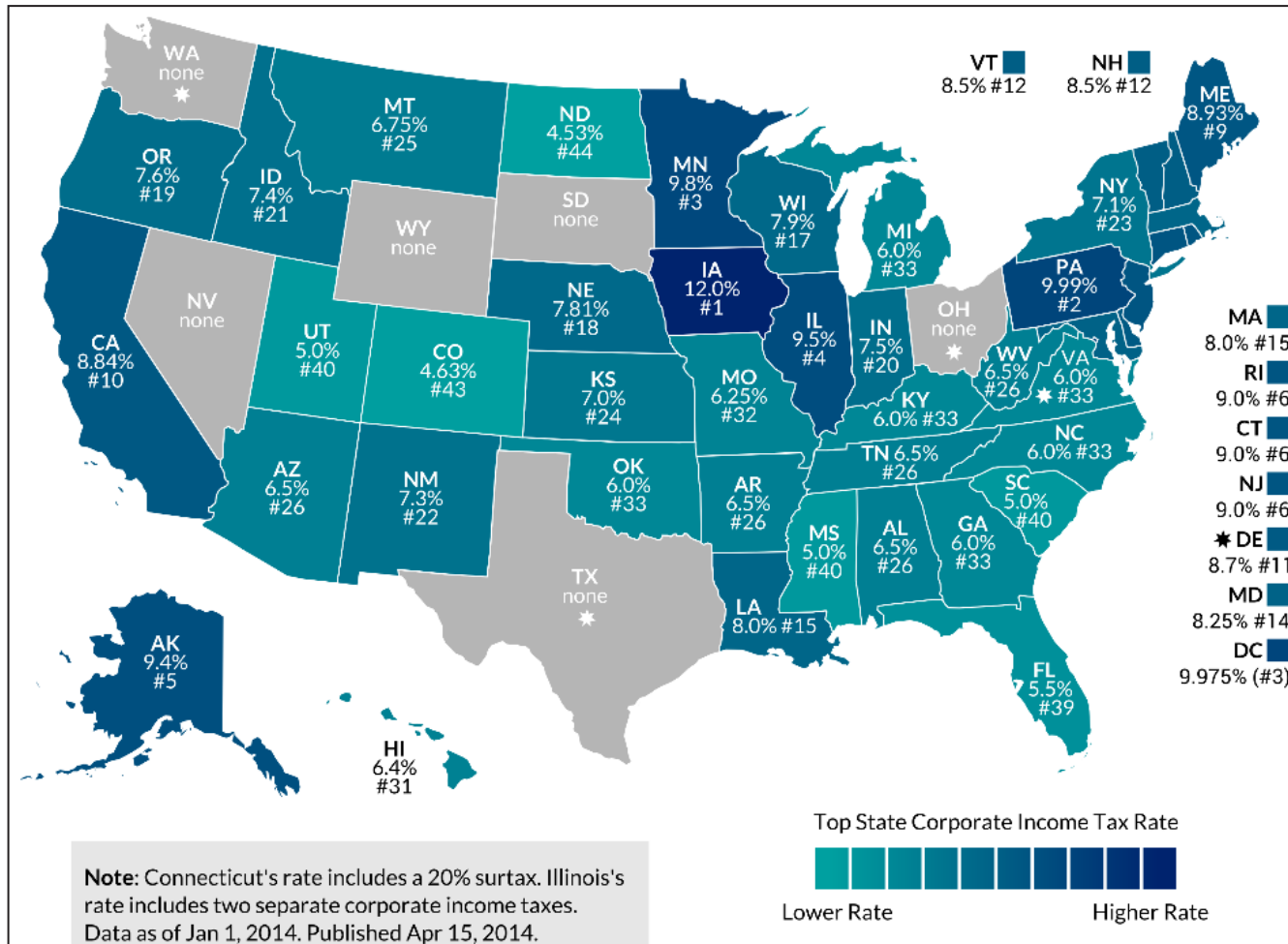
# Background—What Can Companies Put a Transfer Price On?

## Just about anything:

- **Goods**
- **Services**
  - **Marketing, management, treasury, and accounting functions**
- **Loans/Debt**
- **Intangibles**
  - **Royalties paid for licenses and trademarks**

# Why is transfer pricing a growing area of state scrutiny?

## Different States Have Different Corporate Tax Rates



## Why is transfer pricing a growing area of state scrutiny?

- May have no impact at federal level between members of consolidated group, and thus, not draw IRS scrutiny
- Unitary combination often excludes intercompany receipts
- Application of powers on the books rather than enacting a new tax.

# Current State Transfer Pricing (“TP”) Environment

- **482 Powers:** Growing number of states are exercising § 482 like power to adjust income/apportionment to more accurately reflect the taxpayer’s activities.
  - States look to § 482 guidance, but believe they are not limited to federal rules/ OECD guidelines.
    - **NJ TAM (2012):** NJ issued TAM acknowledging the IRS’ Advance Pricing Agreement (“APA”) Program, but stating that NJ has authority to examine the APAs and challenge their underlying assumptions and interpretations in determining a taxpayer’s entire net income.
  - States lack expertise & resources to perform proper TP analyses.
    - Handful of states with auditors trained on § 482 principles.

# Current State Transfer Pricing Environment

- **482 Powers:**

- States lack expertise & resources (cont.)
  - Approaches to TP are oftentimes questionable, inconsistently applied, and discordant across states.
  - Analysis shortcuts – industry average benchmark returns (vs. profit earned on intercompany transactions / conflicting with § 482 guidance against use of industry benchmarks).
  - Use of external consultants – e.g., Chainbridge (use of ‘black box’ TP studies).

# Current State Transfer Pricing Environment

State Challenge:	<i>Typical Approach for Calculating Adjustment:</i>
External Transfer Pricing Consultant	Adjust taxpayer profitability to the median or a value within the benchmark range.
Industry Averages	Adjust profitability of taxpayer in jurisdiction to the median or mean of the industry average.
Combined Reporting	Intercompany transactions eliminated in consolidation. Many separate company states are requiring combination based upon broad discretionary authority. Via legislation or forced under audit.
Addback Statutes	Requires preparer to add back certain categories of intercompany expenses in calculating taxable income, unless exception is met. Some exceptions require arms length pricing. Addback may also be imposed on embedded royalties.
Assert Nexus	Assert nexus of related party, particularly intangible holding companies based upon economic nexus.

# Current State Transfer Pricing Environment

- **Types of transactions under scrutiny:**
  - IRC § 351 non-recognition transfers between related domestic companies that result in income-producing assets moved to low-tax states (e.g., transfer IP from high tax state to low).
  - Intercompany transactions: product sales, intangibles transfers, services, loans, insurance premiums.
  - Intercompany transactions between group and related parties outside of group (e.g., foreign related parties or 80/20 companies, captive insurance companies, non-unitary affiliates).

## Examples of scrutiny taxpayers are encountering at state level

- **Connecticut** – Products, Services, Management Fees
- **DC** – Products, Services, Management Fees, Loans, Royalties, Foreign
- **Florida** – Services, Management Fees, Loans, Royalties
- **Georgia** – Products, Services, Management Fees, Loans, Royalties, Foreign
- **Massachusetts** - Products, Services, Management Fees, Loans, Royalties, Foreign
- **New Jersey** - Products, Services, Management Fees, Loans, Royalties, Foreign
- **New York** - Products, Services, Management Fees, Loans, Foreign
- **Pennsylvania** – Royalties
- **Wisconsin** - Products, Services, Management Fees, Loans, Royalties



*Use of outside auditors/experts by state  
revenue departments in transfer pricing  
examinations*

# Contract Auditors

- Most arrangements with contract auditors are contingent fee based (14-16% of collection), which is controversial within the tax community as many believe this arrangement encourages abuse.
- Contract auditors historically used in a multitude of states (CT, AL, DC, LA, KY, and NJ).
- Goal = pressure to settle.
- May 2012: Microsoft / DC: Administrative Law Judge (“ALJ”) finds transfer pricing methods used by Chainbridge to identify \$2.75M “useless in analyzing arm’s length nature of Microsoft’s IC transactions (reviewed total company operating margin vs. segmented analysis to review intercompany transactions).
- DC’s position has been that the Microsoft ruling did not have precedential value for other taxpayers, and renewed its contract with Chainbridge.

## Contract Auditors (cont'd) – good news?

- NJ Director of Taxation terminated multi-million dollar contract that involved performing transfer pricing analysis citing taxpayer resistance.
- Kentucky's Department of Revenue declined to renew its contract for transfer pricing audit assistance even though no assessments were issued and no taxes had been collected that would have resulted in contingency fees being paid.
- Will recent developments lead to reduced reliance on contract auditors or a fixed fee arrangement?
- Summary judgment for 3 additional taxpayers in DC.
- DC Office of Administrative Hearings ("OAH") recently appealed summary judgments.
- MTC Deputy Executive Director Greg Matson said on Jun. 16, 2015 the Multistate Tax Compact does not allow contingent fee arrangements. ALAS will be cost basis only.

# *Multistate Tax Commission's Arms-Length Adjustment Service Program*

# Multistate Tax Commission (“MTC”)

- MTC’s aim is to (i) develop recommended uniform state tax policies; and (ii) encourage compliance & consistency in enforcement through Joint Audit Program.
- February 2013: Income & Franchise Tax Uniformity Subcommittee drafts memo addressing states’ authority to reallocate income & deductions, and suggests uniformity in applying Section 482 power.
- TEI responds to memo stating opposition to the proposed project.
- March 2013: MTC decides not to pursue uniformity project.
- May 2013: NJ challenges MTC to consider a proposal to create a dedicated multistate transfer pricing audit program.
- April 2014: MTC announces aim to create advisory board of state tax directors to draft model state TP audit program due December 2014 with final design for submission to Executive Committee / Commission by July 2015.

# Multistate Tax Commission

- Multitude of states offered support to fund the development phase (separate entity & combined states).
  - States involved include: Alabama, D.C., Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, North Carolina.
  - One state (PA, RI, or IA) appears to have joined MTC audit program in anticipation of this program.
- MTC's Arm's Length Adjustment Services ("ALAS") program expected to comprise 3 types of services:
  - Pre-audit services: analysis and audit selection, training services, and transfer pricing development.
  - Audit services: including economic services.
  - Post-audit services: including legal assistance with litigation, and expert witness and economic services.
- Some practitioners believe that the MTC should allow taxpayers to address pricing issues on the "front end" akin to IRS Advance Pricing and Mutual Agreement Program.

# Multistate Tax Commission

- On October 6-7, 2014, MTC interviewed 7 boutique transfer pricing firms.
- MTC issued “Updated Draft Design for an MTC Arm’s Length Adjustment Service” (“Updated MTC Draft Design”) on October 30, 2014.
- Updated MTC Draft Design estimates \$25 million annually in added revenue.
- Estimates costs of new MTC audit program of \$2 million annually.
- Actively recruiting states to commit to cover costs.
- Also, actively recruiting a few transfer pricing experienced professionals.
- Updated MTC Draft Design does not include framework. Will auditors follow Section 482 given lack of uniformity between the states?
- ALAS program was scheduled to start with 10 member states on May 7, 2015

# Multistate Tax Commission

- On May 7, 2015, draft design approved as final. Design includes:
  - Transfer pricing analysis and reports from economists working with MTC auditors. Investigate comparables and business purpose.
  - Training state auditors on how to identify issues, what information to request, and how to conduct non-economic analysis
  - Litigation support, including appeals strategy and expert witnesses
  - Voluntary disclosure period, suggested as Jul.-Dec. 2016
  - Optional joint audits under MTC joint audit program
    - Practitioners have said that MTC joint audits are inefficient because the practitioners need to educate MTC auditors about state rules. Then, when the MTC auditors submit their recommendations to the state, the practitioners need to educate the state about the facts and their client.
  - ALAS also thinking about offering APAs, authority to reconcile competing state adjustments, and written guidance for what evidence would be sufficient at audit to support transfer prices



# Multistate Tax Commission

- By scheduled start date, only 6 states joined ALAS
  - AL, IA, KY, NJ, NC, PA
- ALAS membership was budgeted to \$200k annually for costs, based on 10 states joining. Did not start with fewer than 10 states.
- ALAS's revised conservative estimate is that it will generate \$110M in assessments over 4 years
- Some states involved in the ALAS advisory group did not join ALAS because of budget issues
- MTC is looking for 10 states to begin, continues to court state participation
- Pushed start date back to July 2015
- By July 2015, still only 6 members
- MTC continues to solicit states to participate

# *Case studies in state efforts to coordinate and implement transfer pricing policies*

# Massachusetts—Litigation Issues

## Industry-wide metrics

- *TAP Pharmaceuticals, Inc. v. Commissioner*
- *Andersen Windows, Inc. v. Commissioner*

## Berry ratio

- *Sigma-Aldrich, Inc. v. Commissioner*

## Reliance on third-party studies

- *Zimmer US, Inc. v. Commissioner*

## Transfer pricing plus embedded royalty adjustment

- *PepsiCo, Inc. & Affiliates v. Commissioner*

# Massachusetts—Other Issues at Audit

- Price set by federal regulation
- Adjustment to G/L accounts including purchases from third-parties
- Intercompany transactions with no-markup
- Selective or arbitrary pricing analysis
- Misapplication of sham transaction doctrine to transfer pricing adjustment
- Adjustments greater than effect under combined reporting

# Massachusetts—Audit and Litigation Strategies

## Arguments for Audit and Appeal

- Look to IRC § 482
- Can you argue for *increased* price? (e.g., no mark-up under IRC 482)
- Does Department have authority for adjustment for specific industry? *E.g., Tenneco Inc. v. Comm'r*
- What is impact of Department method on later years (even outside audit period)?
- Apply Department positions in other appeals

## Settlement Options?

- Appellate Tax Board
- Mediation program and expedited settlement

# District of Columbia—Microsoft

- *Microsoft Corp. v. Office of Tax and Revenue*
  - Transfer pricing audit conducted by Chainbridge Software
  - Taxpayer files for summary judgment arguing Chainbridge method:
    - (1) Violates IRC 482 regulations
    - (2) Fails to properly reconcile tax accounting with financial statement accounting
  - Taxpayer victory at Office of Administrative Hearings—no appeal

# District of Columbia—What's Next

- *BP Products North America Inc. v. District of Columbia*
  - Bench ruling denies taxpayer motion for summary judgment.
  - Parties reach settlement.
- *Shell, Hess, and Exxon*: Court rules for taxpayer citing non-mutual offensive collateral estoppel.
  - Appeal on issue of collateral estoppel.
  - City argues that it is not bound by prior OAH decisions.
- Several appeals in the pipeline as of August 2015

# Pennsylvania

- Starting point is federal taxable income.
- No transfer pricing adjustment powers.
- But see *Werner Co*, BF&R Dckt. 1319954.
  - BF&R refuses to honor third-party transfer pricing study regarding intangibles using sham transaction principles.
- Addback for tax years beginning January 1, 2015.



## Georgia—Expansive view of transfer pricing authority

- Georgia has authority to adjust taxable income if taxpayer has arbitrarily shifted income to an affiliate.
  - Ga. Stat. Ann § 48-7-58; Reg 560-7-8-.07.
- Department’s view: this authority can be used as a “catch-all” for making audit adjustments between affiliates. See Corporate Income Tax Group Audit Training Manual.

# Georgia—Limits on Department authority

- Principles to determine whether shifting of income is arbitrary
  - Whether affiliates are dealing under arm’s-length terms or transactions result in a fair profit.
  - If it is an “acceptable way of doing business,” then it is not arbitrary.
  - High burden to prove arbitrary shifting of income to an affiliate.
    - See *Blackmon v. Campbell Sales Co.*, 189 S.E.2d 474 (Ga. Ct. App. 1972); *Aaron Rents Inc. v. Collins*, 1994 WL 16848473 (Ga. Super. 1994).

# *Best practices for documenting and supporting related-party transactions*

# Common Documentation Requirements Worldwide

- Detailed company overview
  - Functional Analysis
- A comprehensive description of the global organizational and management structure
- A description of the controlled transactions and related policies
- Intercompany transactions supported by the documentation
  - Tangible Property
  - Intangible Property
  - Services
  - Financial Transactions (loans, guarantees)

# Common Documentation Requirements Worldwide

- Demonstration that transfer prices conform to arm's length principles
- Supporting documents (invoices, intercompany agreements)
- Financials (income statement, balance sheet)
  - Legal entity, business unit, product line
- Transaction Records (books and records, workpapers, product flows, invoicing and payment)

# Common Documentation – Problems

- Incorrect method of analysis given functions and risks
  - Default to a CPM/TNMM analysis when internal comparables not examined
  - Improper application of a method
  - Documentation relies on data that can not be verified by tax authorities
- Undocumented transactions
  - Example: transfer of services or intangibles without compensation
- Inconsistent use of method or policy among related parties
- Not updating the transfer pricing methodology to reflect changes in operations, industry and general economic conditions
- Inconsistencies in policy, documentation and intercompany agreements

# Best Practices

- **Conduct functional analysis early in the development of transfer pricing policy**
  - Discussions with domestic and foreign management
  - Gain an understanding of key functions, risks, and intangibles
  - Identify available transactional comparables
  - Discussion of future orientation to anticipate where the business is heading
  - Develop contacts within the business who proactively alert tax/finance to business changes and issues
  - Gain perspectives on audit experience and key lessons learned

# Best Practices

- **Form a strong cross-functional team**
  - **Tax**
    - Often the driver of the overall process
  - **Accounting and Finance**
    - Provides data and implements intercompany prices
  - **Operations**
    - Key links to business operations and strategy, intercompany activity
  - **Legal**
    - Drafts and executes intercompany agreements
  - **Auditors**
    - Both Internal and external audit represents key stakeholders; keep informed throughout process



# Implementation

- Process to implement and monitor intercompany pricing
- Mechanism to determine and execute appropriate adjustments
- Solid controls around procedures
  - Policy manual to discuss policies and implementation procedures
  - Useful for internal audit, Sarbanes-Oxley compliance
- Align intercompany agreements

# Intercompany Agreements

- **Intercompany agreements should include**
  - Flexible pricing language
  - Clearly described functions, risks, and benefits
  - Consistency with invoices and transfer pricing report documentation
  - Avoid terminology associated with “allocations” in services analyses
- **Implement and continually update intercompany agreements**
  - Use as a guide and support for intercompany transactions
  - Timing is important to validating your intercompany transactions
  - Agreements should provide flexibility in renewal terms

# Global Transfer Pricing Cycle



## Plan & Forecast

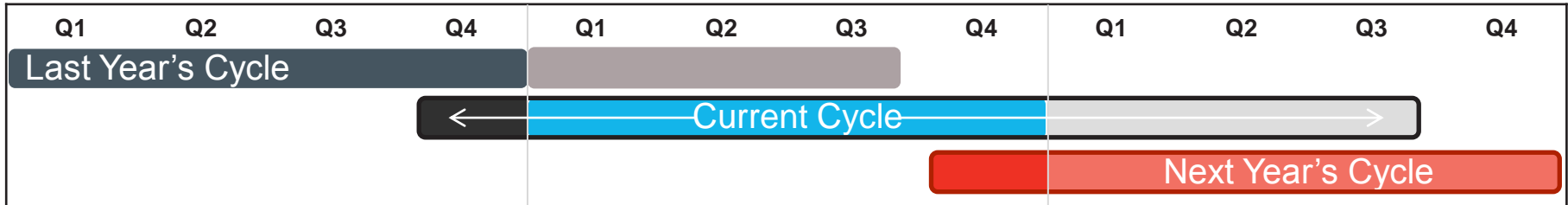
## Monitor

## Comply

- Develop budgets and forecasts
- Integrate new transactions
- Update I/C agreements
- Integrate changes to standard costs

- Perform self-auditing processes
- Monitor transfer prices in real-time
- Perform periodic true-ups
- Estimate EOY year TP adjustments
- Revisit customs and other indirect tax considerations

- Book final adjustments
- Review final statutory financial statements
- Calculate cost sharing percentages, if any
- Satisfy documentation requirements



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