

State Transfer Pricing: A Deeper Dive

July 14, 2021

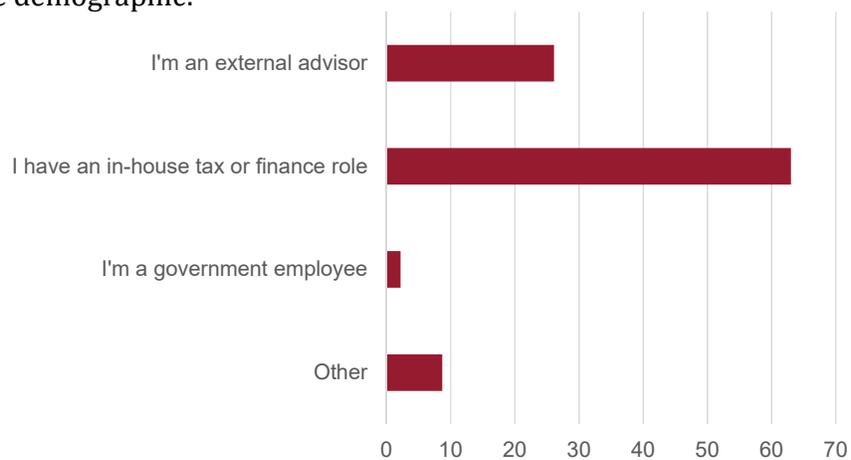
Matthew Frank, Partner
&
David A. Fruchtman, Partner
Chair, Step toe's National State and Local Tax Practice

Poll Question

1. Audience demographic:
 - a. I'm an external advisor
 - b. I have an in-house tax or finance role
 - c. I'm a government employee
 - d. Other

Poll Question Results – Audience Demographic

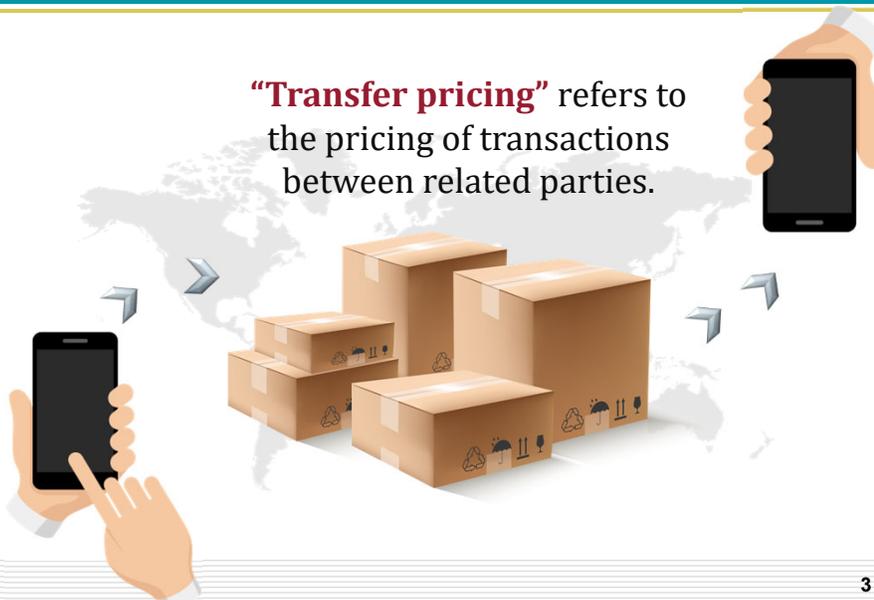
1. Audience demographic:



Transfer Pricing

Introduction

“Transfer pricing” refers to the pricing of transactions between related parties.



Transfer Pricing

Introduction

“Transfer pricing” is not a pejorative term, although sometimes used as such.

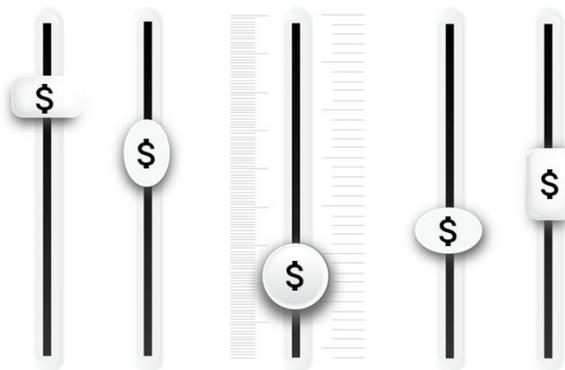
“Transfer pricing” is just the setting of prices, a commercial and tax imperative.

“The Internal Revenue Service ... claimed enormous sums of back tax from [the company] after alleging it **engaged in so-called “transfer-pricing”** - a practice designed to ensure a company's tax liability falls in countries where the tax regime is more favourable.”

The Daily Telegraph (London), page 3, Sept. 12, 2006.

Transfer Pricing

Introduction



Tax authorities may adjust prices for tax purposes to align with the tax authority view of:

a fair / reasonable / arm's length price,

to achieve true / clear reflection of income.

Transfer Pricing

Introduction

“**Transfer pricing**” adjustments are made on a **No Fault** basis.



Taxpayer motive
not relevant.



Overall tax savings
not relevant.



Good faith is
not a defense.

See, e.g., N.J.A.C. 18:7-5.10(b) (absence of a tax avoidance motive “is not a consideration”)

Transfer Pricing

Introduction

All Transactions in scope.

Transactions may involve:

- Performance of services
- Transfer (sale, license, or mere use) of intangible property
- Transfer of tangible goods
- Financial transactions, e.g., loans and guarantees



Taxes involved are not
limited to income taxes

Transfer Pricing

Introduction

Tax authorities can raise *a lot* of money by adjusting the transfer prices of controlled group members to increase the income of their local affiliates.



Multinational corporations identify transfer pricing as their #1 tax risk.

Transfer Pricing

Introduction

“I can just sit back and say it appeared to me that 20 percent net profit on an operation such as this was reasonable. I figured if the taxpayer were willing to accept it, I thought we would be getting away with a very good deal, and, if not, he would prove otherwise.”

IRS Agent, American Terrazzo Strip Co. v. Comm’r, 56 T.C. 961, 971 n.7 (1971)



Transfer Pricing

Recent example of transfer pricing stakes



US Tax Court decision
November 2020 re
2007-2009 tax years.

Court upheld bulk of adjustment for increased trademark royalties.

With interest, Coca-Cola faces liability (tax and interest) for all years of some \$12 billion. Penalties would have been imposed except for a prior closing agreement.

Transfer Pricing

State transfer pricing activity

TAX NOTES STATE, APRIL 6, 2020

**States Aggressively Contracting
With Transfer Pricing Experts**



4 Things To Know About State Transfer Pricing Efforts In 2021

Law360 (January 29, 2021, 6:35 PM EST)

Poll Question

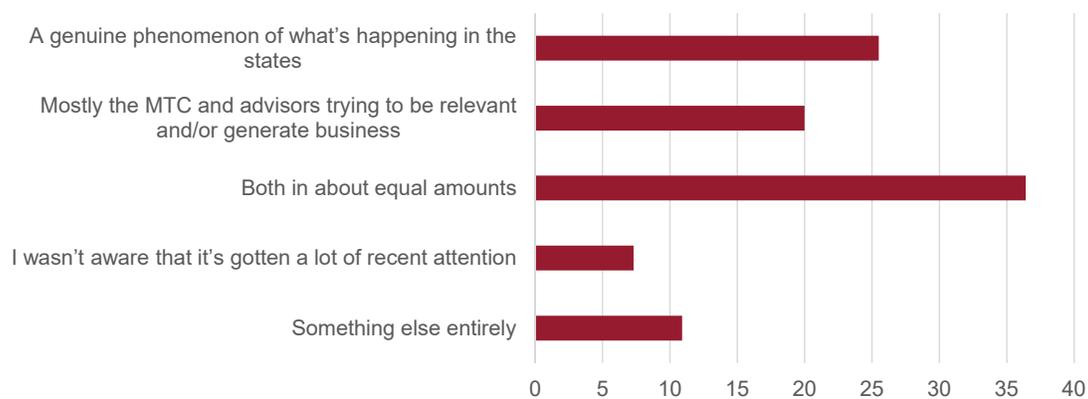
2. I think all the recent attention on state transfer pricing reflects
- a. A genuine phenomenon of what's happening in the states,
 - b. Mostly the MTC and advisors trying to be relevant and/or generate business,
 - c. Both in about equal amounts,
 - d. I wasn't aware that it's gotten a lot of recent attention,
 - e. Something else entirely.

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Poll Question Results

2. I think all the recent attention on state transfer pricing reflects:



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State transfer pricing climate

State transfer pricing enforcement revenue estimates

FTA (2015)	\$20 billion a year
Tax Notes article (June 2021)	\$2.7 billion/year for Northeastern States
Daily Tax Report (Aug. 2020)	TP enforcement “could double or triple tax collections from large multistate corporate taxpayers”

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MTC / SITUS Initiatives



MULTISTATE TAX COMMISSION

State Intercompany Transactions Advisory Service
(SITAS)

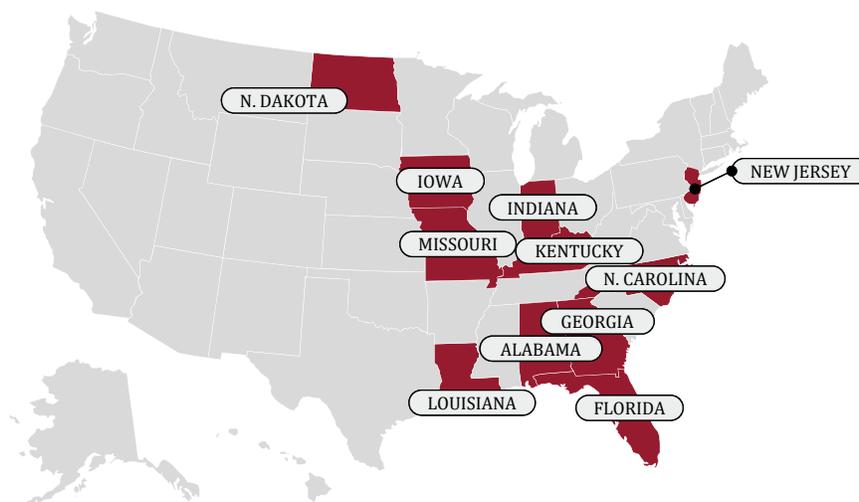
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MTC / SITUS Initiatives



SITAS March 2021 meeting.

24 participants from 11 states,
plus 10 persons from the MTC.



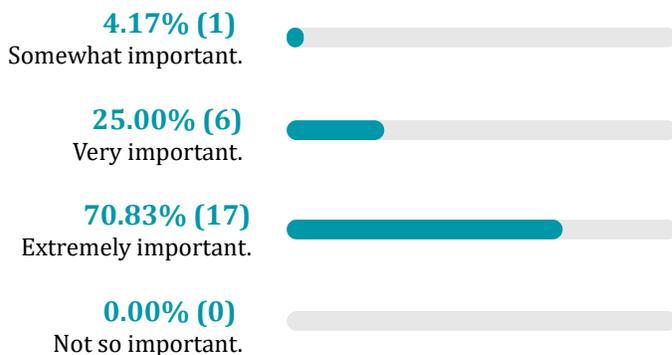
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MTC / SITUS Initiatives



SITAS poll question, March 2021:

How important do you think it is for states to work together to address improper income shifting by multinational / multistate corporations?



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MTC / SITUS Initiatives



**SITAS committee meeting
July 13, 2021**



Transfer Pricing

Sample state transfer pricing statutes

Most States have transfer pricing legislation

Some track the federal statute (IRC § 482).

Some differ materially.

Need to focus on text of specific State statute.



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State transfer pricing standards

Guidance sometimes sparse

“[A Department of Revenue official] believed that the Department refused to provide guidelines to the public because taxpayers would restructure their transactions to fall outside the guidelines. If the Department published guidelines to taxpayers, it ‘would be like handing a gun to the guy that is about to rob us.’ [T]he Department ... worked actively to conceal the standards its decision makers were using”

Delhaize America, Inc., N.C. 2011

Transfer Pricing

State transfer pricing remedies

- Income and deduction adjustments
- Forced combination
- Sham / disregard treatment
- Adjustments to / deviations from apportionment formulas
- Other discretionary adjustments



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State transfer pricing remedies

State approach: Allow or Deny



Forced combination /
Economic Substance

Federal approach: Calibration



Income and deduction
adjustments

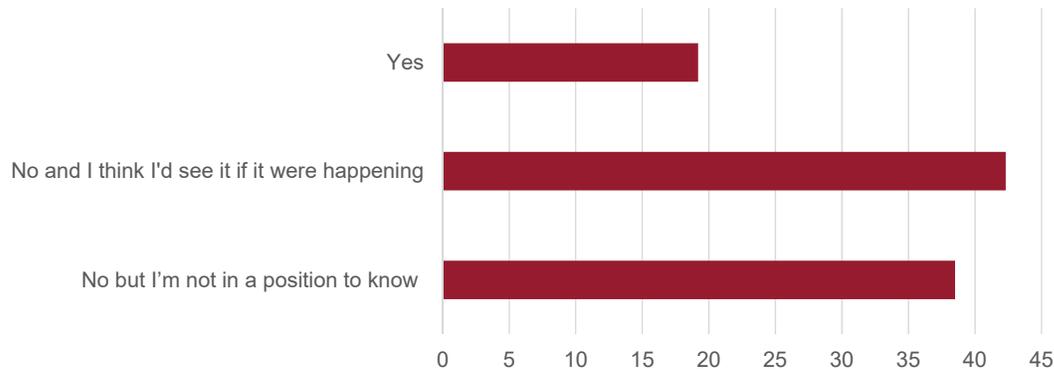
Poll Question

3. I have experience where a state tax authority made a partial adjustment to achieve an arm's length result rather than simply adding an item of income or denying an item of expense in full:

- a. Yes,
- b. No and I think I'd see it if it were happening
- c. No but I'm not in a position to know

Poll Question Results

3. I have experience where a state tax authority made a partial adjustment to achieve an arm's length result rather than simply adding an item of income or denying an item of expense in full:



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State transfer pricing standards

Some state tax authorities assert broad “plenary” authority, not constrained by federal standards.



“The Commission argued that it had plenary authority to allocate income whenever it, in its sole discretion, believed it was necessary to prevent tax evasion or to make a corporation's returns clearly reflect its income.”

See's Candies, Utah 2018.

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State transfer pricing standards

Courts have pushed back, insisting on some standard.



Carpenter Technology Corp. v. Commissioner, 47 Conn. Supp. 122; 779 A.2d 239 (CT 2000) (“The court disagrees with the commissioner that he has unfettered discretionary powers....”)

Utah State Tax Comm’n v. See’s Candies, Inc., 2018 UT 57; 435 P.3d 147 (UT 2018) (Commission “authority is not unlimited.... [W]e do not [agree] ... that the Legislature intended the Commission to exercise its ... discretion untethered to any identifiable standard”).

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State transfer pricing standards

Arm’s Length standard may or may not drive result.



State can act even if pricing is arm’s length.

E.g., *Wurlitzer Co.*, N.Y. 1974

Delhaize America Inc., N.C. 2011

State can act only where pricing not arm’s length.

E.g., *Blackmon*, Georgia 1972

See’s Candies, Utah 2018

Transfer Pricing

Dispute Avoidance, Management, and Resolution

Transfer Pricing

Transfer pricing dispute management



Documentation needs to support economic substance and arm's length pricing.

Secondary documentation, e.g., internal agreements, essential.

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Transfer pricing studies

TP documentation



Assemble the information



Document it



Present it persuasively

be thoughtful

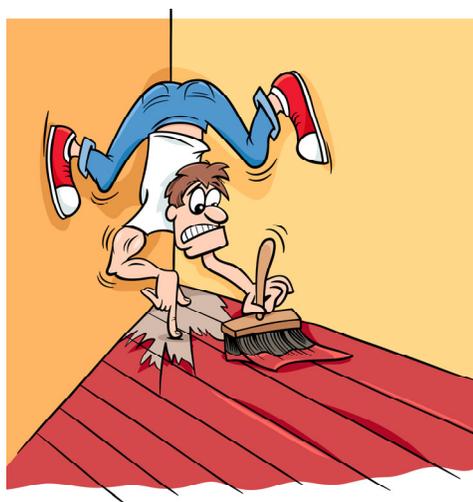
be nimble / anticipate change

be efficient

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Transfer pricing studies

And avoid this ...



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Transfer pricing studies

Documentation affords opportunity to frame the transfer pricing discussion

Choice of transactions



Choice of Time Frame



Choice of method and choice of comparables

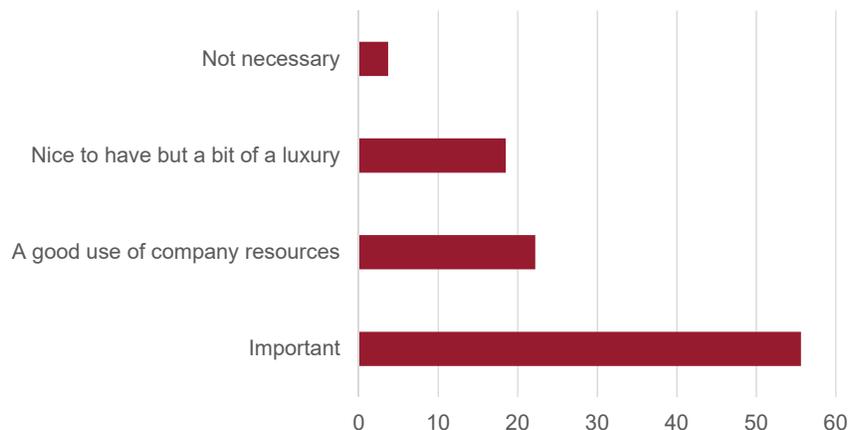


Poll Question

4. I think having transfer pricing studies available for state tax purposes is
- a. Not necessary
 - b. Nice to have but a bit of a luxury
 - c. A good use of company resources
 - d. Important

Poll Question Results

4. I think having transfer pricing studies available for state tax purposes is:



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Transfer Pricing

Common transfer pricing areas of focus



Royalties paid for use of company trademark (or other IP)

Rent-A-Center East, Inc. v. Indiana Department of State Revenue, 42 N.E.3d 1043 (2015)
(trademark royalties; tax authority sought to force combination)

Utah State Tax Comm'n v. See's Candies, Inc., 2018 UT 57; 435 P.3d 147 (2018)
(trademark royalty paid by See's Candies to affiliate that owned the See's mark.)

Sherwin-Williams Co. v. Tax Appeals Tribunal, 12 A.D.3d 112 (N.Y. App. 2004)
(trademark royalties; tax authority sought to force combination)

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Common transfer pricing areas of focus



Intercompany loans

E.I. DuPont de Nemours v. Indiana Department of State Revenue, 79 N.E.3d 1016 (2017) (interest deduction disallowed on the ground that interest rate was too high, and transaction was a sham; court held for taxpayer)

Carpenter Technology Corp. v. Commissioner, 47 Conn. Supp. 122; 779 A.2d 239 (2000) (disallowed interest deduction on ground that transaction was a sham; court held for taxpayer)

Transfer Pricing

Common transfer pricing areas of focus



Sale or lease of goods

R.O.P. Aviation, Inc. v. Director, No. 1323-2018, NJ Tax (May 27, 2021) (lease of aircraft)

McNamara v. Tube-Alloy Corp., 583 So. 2d 930 (1991) (all income of subsidiary attributed to parent; sale of tubular product used in petroleum industry; court held for taxpayer finding that transactions were priced at arm's length).



Management services

Rent-A-Center East, Inc. v. Indiana Department of State Revenue, 42 N.E.3d 1043 (2015) (management fees)

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Transfer pricing dispute management



Intercompany loans – key issues

- Debt versus equity
- Amount of debt (whether it was “arm’s length” amount)
- Interest rate setting and role of affiliation
- Prepayment options

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Transfer pricing dispute management



Intercompany loans – key steps

- Anticipate dispute
- Draft agreements thoughtfully, e.g., w/r/t interest rate resets, prepayment conditions, covenants
- Have statement of policy and rationale
 - For loan
 - For structure (loan terms)
 - For pricing
- Address affiliation impact on credit standing

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TP Dispute Management

Expect internet searches ...



Expect interviews ...



Prepare your witnesses ...



Enlist the business experts ...



Tax authority is hard pressed to dispute judgment of seasoned business experts

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Advance Pricing Agreements

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State transfer pricing litigation -- lengthy

Tax Years at Issue	Year Decided	Case (and State)
1996-2003	2019	Conagra Foods (Maryland)
1999-2007	2018	See's Candies (Utah)
2000-2005	2017	Oracle Corp. (Colorado)
2006-2007	2017	E.I. DuPont de Nemours (Indiana)
2003	2015	Rent-A-Center East (Indiana)
2005-2007	2015	Columbia Sportswear (Indiana)

Transfer Pricing

Transfer pricing dispute management



Advance Pricing Agreements



APAs defined

An agreement with the tax authority that if company follows agreed pricing method, no adjustment will be made.

Written agreement; typically, good for 5+ year term, subject to renewal.

IRS APA program just completed its 30th year.

Indiana has announced State APA program; other States have expressed interest.

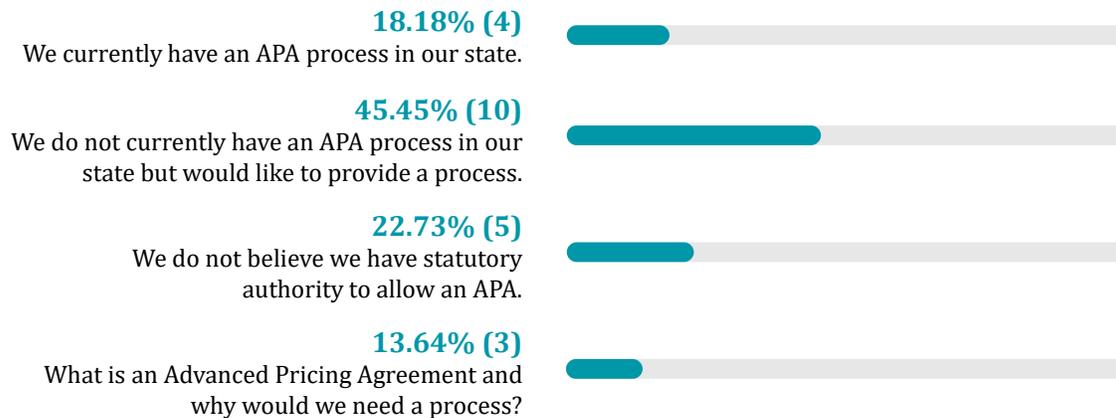
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Transfer pricing dispute management



Question from SITAS March 2021 meeting re APAs:

What statement best describes your state's position on APAs?



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Transfer pricing dispute management



APA benefits

CERTAINTY

plus

- Mechanism to resolve prior years
- May afford flexibility re timing of income
- Avoid cost of defending an exam

Poll Question

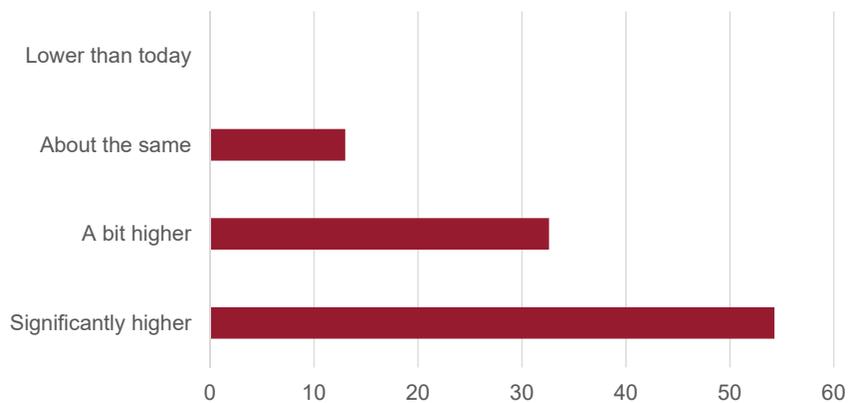
5. 5 years from now, I expect the level of transfer pricing enforcement at the state level to be:
- a. Lower than today
 - b. About the same
 - c. A bit higher
 - d. Significantly higher

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Poll Question Results

5. 5 years from now, I expect the level of transfer pricing enforcement at the state level to be:



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Questions???



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Matthew Frank

 mfrank@step toe.com +1 202 429 8014 (office)
+1 203 856 6666 (mobile)

Matthew Frank has more than 30 years of experience in litigation, tax controversy, and transfer pricing. He has held high level positions in government service, as an in-house tax executive, as an advisor, and as an academic.

Matt joined Steptoe in 2020 from a Big 4 firm where he was a Principal and focused on transfer pricing dispute resolution. Prior to that, Matt was in-house at General Electric Company (GE) for nine years (2008-2017) as Senior Tax Counsel, Transfer Pricing, where he was the global leader for GE's transfer pricing exams, controversies, and public policy matters. Matt joined GE after five years at the IRS (2003-2008) where he served as the Director of the US Advance Pricing Agreement program.

You can read Matthew's full firm biography [here](#).

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David A. Fruchtman

Chair, Steptoe's national state and local tax practice



 dfruchtman@steptoe.com

 +1 202 429 6415

David Fruchtman provides state and local tax planning and controversy advice. His representations involve almost all subnational taxes for businesses and individuals, including income, franchise, sales, use, real property transfer, and a variety of other state and local taxes. His clients include public and privately held heavy equipment manufacturers, marketing companies, travel lodging providers, and vehicle rental companies, as well as mid-sized retailers and other businesses.

David's tax planning work includes tax efficient structuring of businesses and transactions, and regularly requires working with tax authorities to obtain favorable guidance, as circumstances require. He advises foreign companies expanding into the United States, and his experience includes assisting an American affiliate of an Israeli company in one of Wall Street's most successful IPOs of 2010.

You can read David's full firm biography [here](#).

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