# Transfer Pricing Impact on State Corporate Income Tax

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# Transfer Pricing

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# Transfer Pricing: What is it?

- Transfer pricing refers to the pricing of transactions between controlled entities. For example, when a US parent (USP) sells a product to its controlled foreign corporation (CFC), IRC 482 requires USP to sell that product at an arm's length price to its CFC. Under IRC 482, controlled entities should price transactions in the same way that uncontrolled entities would under similar circumstances. This is the "arm's length standard", which means the price of the product that USP charges its CFC should be the same as it would charge to an unrelated party for the same product under similar circumstances. (IRS)

- 26 U.S. Code § 482: In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) 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. In the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

- Substantial guidance provided in IRS regulations:

# Transfer Pricing: State Tax Concerns

- States use Federal Taxable Income as a starting point in the calculation of state income tax.
- Separate-entity reporting states especially vulnerable to tax planning organizational structures and corresponding inter-company transactions
- Expensive and complicated for states to challenge
- Difficulties in using discretionary IRC 482 type powers outside of IRS guidelines

# Mandatory Unitary Combined Reporting: An easier answer?

- States seem to moving toward unitary combined reporting.
  - Currently, 27 Unitary Combined States plus D.C
  - Up from 16 states a decade ago
- West Virginia and Kentucky are the only SEATA states to require unitary combined reporting for corporate income tax
- It's a BIG HELP to address income shifting but not a complete solution.
  - Not all related companies are part of the taxpayer's unitary combined group
  - Prone to most international income shifting

# Transfer Pricing: An International Issue

- OECD/G20 Base Erosion and Profit Shifting (BEPS) project identified 15 actions which would equip governments with domestic and international instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created.

- Actions developed based on three "pillars": coherence, substance, and transparency
  - "Coherence": uniformity of international tax rules.
  - "Substance": source income appropriately based on the business' overall activity
  - "Transparency": Improve relations between business and governments by providing transparency and certainty

# Transfer Pricing: An International Issue

Transparency:

- Action 13: standardized three tier formula for transfer pricing documentation of large multinationals.
  - Global Master File: Global "overview" of a multinationals business including its supply chain, allocation of income and transfer pricing policies
  - Local File: Detailed information and analysis about the local entity's intercompany transactions and is expected to be filed with the tax authority in that jurisdiction.
  - Country-by-Country Report: Template for multinationals to report annually and for each tax jurisdiction in which they do business, which includes requirement for detailed financial and tax information relating to the global allocation of their income and taxes, among other indicators of economic activity.

# Transfer Pricing: An International Issue

OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS)

- Jurisdictions committed to the implementation of the BEPS package
- 129 members as of March 2019
- BEPS Project in its implementation phase
- Final consensus-based solution in 2020
- Underlying purpose: International jurisdictions working together to prevent improper income shifting:

How have states worked together in this area?

How can states work together more?

# States working together?

Benefits:

- Leverage personnel with technical expertise
  - Relatively few employees have this expertise within a state
  - Allows a state to benefit from a larger group of experienced personnel
- Increase productivity
  - Two states sharing transfer pricing analysis means that you can pursue twice as many transfer pricing cases.
- Decrease costs
  - Transfer pricing analysis can be complex and also expensive.
  - Spread those costs over multiple states. Taxpayer is likely doing business in most of the SEATA states.
- Enhance your staff's expertise
  - Your staff may be excellent but they will benefit from new ideas and the experience of others.
- Reduce inefficiency pursuing unsuitable transfer pricing candidates
  - Transfer pricing cannot "fix" income shifting in all circumstances

# States working together?

How can states work together?

- State Intercompany Transactions Advisory Service (SITAS)
  - Formerly Arm's-Length Adjustment Service (ALAS)
  - Group of states requested the MTC's assistance to address improper income shifting
  - Program design currently lacks sufficient state support
  - More information available on www.mtc.gov.
  - MTC still active in supporting state efforts including training coordination- 16 states participated in transfer pricing training in March 2019
- Monthly teleconference
  - More states creating a transfer pricing program within their states.
  - Some states have mobilized around RoyaltyStat
  - Informal round table discussions
- Support from management a necessity
  - Coordination is currently unstructured
  - Ensure appropriate employees are properly authorized to send and receive tax information from fellow states


# Auditing Intercompany Transactions

Information Requested

Richard Gilbert, CPA
Director Examination Division
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# Review Goals

- Determine if transactions lack economic substance or are not at fair market value.

- Findings could result in the elimination or adjustment to the transactions.

# Defining Economic Substance

**Economic substance** is a doctrine in the tax law of the United States under which a transaction must have both a **substantial purpose** aside from reduction of tax liability and an **economic effect** aside from the tax effect in order to be considered valid.

- Contemporaneous Documentation
- The objective economic impact

# Economic Substance Documents Requested

- B & D Minutes discussing and approving change
- What were the expected benefits
- List of assets transferred
- Change in business operation of assets
- Related agreements

# Defining Fair Market Value

*Fair market value* (FMV) is the price that property would sell for on the open *market*. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.

- Correct price ≠ Economic Substance. A transaction may have appropriate arm's length pricing but be completely tax motivated.

# FMV Documents Requested

- Diagram detailing the transaction flow
  - Cradle to Grave
- Transfer Price Study
  - Target Company
  - Comparable Companies
    - Adjustments made to comparable
  - Risk Assumed
    - Functions performed by each company

# Transfer Pricing State Audit

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**RoyaltyStat**

# Agenda

1) Transfer pricing audit techniques:
   a) Review of Taxpayer transfer pricing report;
   b) Analyses of financial statements;
   c) Comparability analysis;
   d) De-engineer asset-based adjustments.

2) Capacity building: unraveling the mystery of "complex" tax structures;

3) What lies ahead?

# Transfer Pricing Audit Techniques

1) Review transfer pricing report(s) produced by Taxpayer for years under audit and identify:

   a) Related party transactions;
   b) Tested party;
   c) Comparables;
   d) Transfer pricing method;
   e) Profit (level) indicator ("PLI");
   f) Adjustments to PLI.

# Transfer Pricing Audit Techniques (cont.)

2) Review Taxpayer's (audited) book financials: income statements, balance sheet and accounting footnotes. In the absence of book financials, determine operating profit (before or after depreciation) per book from M3 schedules of IRS Form 1120.

3) Review comparables and reject companies that are foreign incorporated, show incomplete financials or report operating losses.

4) Review asset-based adjustments and subject them to economic and statistical testing. See 26 CFR § 1.482-1(d)(2)(*Standards of Comparability*) "If there are material differences between the controlled and uncontrolled transactions, adjustments *must* be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to *improve the reliability* of the results." (emphases added)

# Audit Capacity Building

RoyaltyStat works with several State DOR training and assisting auditors, appeals officers and tax counsel to:

1) Review Taxpayer transfer pricing reports;
2) Analyze comparables;
3) Determine operating (taxable) income per book from M3 schedules;
4) Select appropriate profit indicator;
5) Determine arm's length range of selected profit indicator;
6) Evaluate Taxpayer position.

# What Lies Ahead?

1) Taxpayers engage in State income tax planning using transfer pricing mechanisms to shift profits (taxable income) from entities in separate reporting States.

2) Taxpayer's assumption that State DOR is incapable to evaluate vehicles of profit shifting is no longer tenable. *Déjà vu* DEMPE (assisting owner of intangibles per 26 CFR § 1.482-4(f)(4)(*Contribution to the value intangible of property owned by another*).

3) Expect quality of Taxpayer transfer pricing reports to improve. State DOR advance capacity building should encourage voluntary compliance.

"Give me honorable enemies rather than ambitious ones, and I'll sleep more easily by night." — George R.R. Martin, *A Game of Thrones* (*A Song of Ice and Fire*).

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