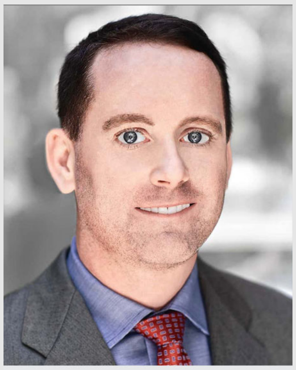
SALT Transfer Pricing — What You Need to Know: Part 2

by Doug Schwerdt, Guy Sanschagrin, and Bill Lunka



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In this two-part article, Schwerdt, Sanschagrin, and Lunka examine how transfer pricing impacts corporations in separate entity states and combined reporting states, including recent Multistate Tax Commission State Intercompany Transactions Advisory Service Committee developments, state application of section 482 as evidenced in court cases, state transfer pricing amnesty programs, and measures taxpayers should consider to prepare for state transfer pricing audits.

Following state tax court cases with rulings supporting taxpayers' application of section 482, tax authorities in separate reporting states are increasingly challenging intercompany pricing related to section 482-based statutes, rather than relying on their discretionary power to adjust income or claim transactions lack economic substance.[1] Also, states have strengthened their transfer pricing enforcement capabilities and have focused on initiatives to resolve transfer pricing cases more quickly to bolster state tax coffers and reach agreements on taxpayer transfer pricing approaches for future years. This article discusses these trends, select court cases, and measures taxpayers should consider putting in place to prepare for state transfer pricing audits.

State Application of Section 482

State transfer pricing issues often arise in separate entity reporting states because these states are concerned about the arm's-length nature of interstate transactions between related parties. Corporate groups have historically engaged in tax planning to limit the tax paid in separate reporting states. Most separate reporting states have adopted statutes to address intercompany transactions, with rules varying from conformity with section 482 to state-specific rules and language. In many cases states include addback provisions that disallow deductions for certain expenses (for example, interest, management services, royalties) paid to a related-party entity.

We examine three cases as examples of how states have applied section 482 to evaluate the appropriateness of taxpayer interstate transfer

[1] "Section 482" refers to IRC section 482 as embodied in Treas. regs. section 482-1 to 482-9.

pricing.[2] In the first two, *Rent-A-Center East*[3] (*RAC East*) and *Columbia Sportswear USA*,[4] the Indiana Department of Revenue asserted that the taxpayers' transfer pricing studies were irrelevant and not binding on state tax authorities because they concerned federal law. In both cases, the Indiana tax court ruled in support of section 482-based transfer pricing studies providing evidence of arm's-length intercompany transactions under Indiana law.[5] In the third case, *See's Candies*,[6] the Utah Supreme Court affirmed the district court and *See's* section 482-based transfer pricing study and concluded the transfer pricing was arm's length, justifying a deduction not barred under section 482 and therefore not barred under Utah Code Annotated section 59-7-113.

Rent-A-Center East

In *RAC East*, the Tax Court of Indiana determined that the DOR acted improperly when it required the company to file a combined report with two of its corporate affiliates for the 2003 tax year. RAC East argued that the DOR could not force it to file a combined return with its affiliates because its separate Indiana return fairly reflected its source income. In support of this argument, RAC East submitted a transfer pricing study conducted by an independent accounting firm showing that its intercompany transactions were conducted at arm's length.[7] The DOR explained to the court that RAC East's transfer pricing study was not relevant to the determination of whether RAC East's Indiana source income was fairly reflected on its separate return.

The court wrote, "It is undisputed that the Transfer Pricing Study established arm's-length rates for RAC East's Intercompany Transactions and that the royalty and management fee payments were consonant with the Transfer Pricing Study's rates. . . . Consequently, RAC East's 2003 separate return fairly reflected its Indiana source income. The Court, therefore, GRANTS summary judgment in favor of RAC East and AGAINST the Department." Thus, the Court rejected the DOR's argument that the taxpayer's transfer pricing study was not relevant to the distortion analysis, finding that a comparison of Indiana Tax Code section 6-3-2-2(m) with section 482 "inescapably demonstrates their similarities" and "a transfer pricing study is relevant because it can serve as an objective evidentiary method for evaluating state tax issues that may arise in cross-border transactions between related organizations." The court concluded that RAC East's 482-based transfer pricing study established arm's-length rates for RAC East's intercompany transactions and fairly reflected its Indiana source income.

Columbia Sportswear USA

In *Columbia*, the DOR asserted its discretionary authority to adjust Columbia's net income tax base for the 2005, 2006, and 2007 tax years, asserting that the taxpayer's intercompany transactions distorted its Indiana source income. The DOR assessed Columbia by applying the consolidated group's profit margin to each separate legal entity. The DOR asserted that Columbia's transfer pricing studies distort its Indiana source income under the state's statutory sourcing rules[8] and do not rebut the DOR's case that its assessments are correct because:

- Indiana has neither adopted nor enacted a statute similar to IRC section 482 or its related regulations;
- the purposes of IRC section 482 — to "combat off-shore tax evasion by multi-national corporations" — is entirely different from Indiana Code section 6-3-2-2(m); and
- the transfer pricing studies contain a disclaimer, stating that they "do not reach any conclusions regarding state tax issues."

[2]While the courts in these three cases have concluded on many transfer pricing related issues, our discussion is limited to section 482-based transfer pricing documentation.

[3]*Rent-A-Center East Inc. v. Department of State Revenue*, 42 N.E.3d 1043 (Ind. T.C. 2015).

[4]*Columbia Sportswear USA Corporation v. Department of State Revenue*, 45 N.E.3d 888 (Ind. T.C. 2015).

[5]IRC section 482 and Indiana Tax Code section 6-3-2-2(m) are substantially equivalent.

[6]*State Tax Commission v. See's Candies Inc.*, 435 P.3d 147 (Utah 2018).

[7]The 2002 transfer pricing study determined arm's-length pricing for the royalties RAC East would pay RAC West and the management fees it would pay RAC Texas.

[8]Indiana Code section 6-3-2-2(a)-(k) provides that a taxpayer's business income is apportioned between Indiana and other states using a three-factor formula.

The court disposed of the DOR's first two arguments by citing its recent decision in *RAC East* and noting the strong similarity between section 482 and Indiana's statutory equivalent and that section 482's purpose of ensuring an arm's-length reflection of income between related entities is relevant to the same determination under Indiana law. Further, under Indiana Code section 6-3-2-20(d), the court wrote, "In fact, Indiana's Legislature has acknowledged the value of this arm's-length standard by expressly incorporating IRC section 482 and its associated regulations as a safe harbor from having to add back certain intercompany intangible expenses when computing an Indiana [adjusted gross income tax] liability."

The court disposed of the DOR's third argument and concluded that the purpose of the disclaimer was only to limit the accounting firm's professional responsibility. Finally, the court disallowed the DOR's adjustments and concluded that because Columbia's transfer pricing studies determined that its intercompany transactions were arm's length, its Indiana income was fairly reflected for Indiana tax purposes.

See's Candies

In a 2018 case, the Utah Supreme Court affirmed the decision of the district court, finding that the language of Utah Code 59-7-113 was ambiguous and that section 113 did not permit the income allocation that the Utah State Tax Commission had imposed on See's Candies. The court held that the district court properly used the arm's-length standard to determine that the commission improperly allocated See's income.

The commission allocated royalty payments — which See's made to an affiliated insurance company and deducted from its taxable income — back to See's as taxable income.[9] The commission argued that it had plenary authority and sole discretion to allocate income to prevent tax evasion or to make a corporation's returns clearly reflect its income. The district court decided that the allocation was inappropriate and allowed See's to take the deductions. The supreme court affirmed, holding:

- the language of Utah Code section 59-7-113, granting the commission discretionary authority is ambiguous;[10]
- the district court properly looked to the statute's federal counterpart (that is, IRC section 482 and its accompanying regulations) for guidance; and
- the district court did not err in employing the arm's-length standard — consistent with See's independent transfer pricing study prepared by an accounting firm — to determine that the commission improperly allocated See's income.

The key practical transfer pricing lesson from *See's Candies* is that IRC section 482 is ambiguous in the same ways Utah statute section 59-7-113 and Indiana Code section 6-3-2-20(d) are ambiguous. Further, many additional states have adopted statutes which are virtually identical to section 482. Therefore, multistate corporate taxpayers can generally rely on Treas. regs. 482 as transfer pricing guidance.

Select States Focus on Resolution

Some states, including Indiana, North Carolina, and Louisiana, have taken steps to resolve transfer pricing issues more quickly. Louisiana's program was announced October 26, 2021, and it began accepting taxpayer applications on November 1, 2021. Other states are observing the administration and results of these programs. Programs that promote voluntary disclosure are attractive approaches for these states because of lower administrative costs and quicker timelines to collect tax revenue.

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[9] See's, a Berkshire Hathaway subsidiary, sold its intangible property to Columbia Insurance Co., another Berkshire Hathaway subsidiary. In return, See's received shares of Columbia Insurance stock. After the sale, See's was required to pay Columbia Insurance to use the See's trade name. The commission concluded that the transaction had been structured to permit See's to improperly reduce its taxes.

[10] Utah Code section 59-7-113: "If two or more corporations (whether or not organized or doing business in this state, and whether or not affiliated) are owned or controlled directly or indirectly by the same interests, the commission is authorized to distribute, apportion, or allocate gross income or deductions between or among such corporations, if it 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 corporations."

Indiana's Transfer Pricing Group and Advance Pricing Agreements

In response to losses at the Indiana Tax Court, the DOR developed and made public a comprehensive transfer pricing initiative that includes building a dedicated transfer pricing team, contracting with an external economist and transfer pricing service provider, and using APAs to resolve transfer pricing disputes. The DOR developed its dedicated transfer pricing team in audit operations during fiscal 2018 and has since expanded it. Indiana has stated that its audit operations team "experienced significant success in the area of Transfer Pricing." Also, the DOR "Transfer Pricing team collaborated with 13 states to improve compliance, increase tax revenues and develop the specialized audit process for this complex area of tax law."[11]

Indiana allows taxpayers not currently under audit and those who have begun the audit process to request a unilateral APA related to transfer pricing issues. Unilateral APAs are binding only on the signatory state's tax authority position on that taxpayer. They do not bind any other state tax authority. An APA removes uncertainty on how the DOR will view a taxpayer's related-party transactions.

The APA process starting point is DOR review of the taxpayer's section 482 compliant transfer pricing study. The DOR will then identify areas where it reaches a different conclusion than the transfer pricing study. Areas of focus include the choice of best transfer pricing method and the appropriateness of any comparability adjustments. The DOR has identified six recurring issues with APA requests that have been difficult to resolve[12]:

A. Timeliness of comparables information.
B. Inclusion of companies outside the taxpayer's geographic area.
C. Inclusion of loss companies.
D. Inappropriate adjustments.
E. Use of methods comparing uncontrolled transactions to the controlled transactions under review.
F. Choice of Profit Level Indicator.

These issues — in particular, B, C, E, and F — point more to an Indiana preference for the comparable profits method as the best transfer pricing method than they indicate that the DOR broadly finds taxpayer applications of the CPM to be problematic.

Where agreement is reached and a taxpayer enters an APA with the DOR, the APA will apply to all open tax periods and will typically be in effect for two future audit cycles, or six years, although the term is open for discussion. The DOR completed its first APA in April 2020.[13]

North Carolina's Transfer Pricing Amnesty Program

The North Carolina DOR collected $97 million in disputed income taxes from over 100 businesses of 45 corporate groups under its voluntary corporate transfer pricing resolution initiative for resolving intercompany pricing issues, which was launched on August 1, 2020, and incentivized with tax penalty waivers. The voluntary initiative was intended to expedite the resolution of transfer pricing issues for all tax years within the statute of limitations for which the taxpayer had filed a return, subject to N.C. Gen. Stat. section 105-130.5A. This statute grants the DOR the power to redetermine a corporate taxpayer's North Carolina state net income — by way of adjusting intercompany transactions or forced combination if intercompany transaction adjustments are not adequate — if it determines that the corporation's intercompany transactions lack economic substance or are not at fair market value. Voluntary disclosure agreements are typically for undiscovered taxpayers — those not notified of an audit by a tax authority — but the DOR's amnesty program was also open to taxpayers that had already been notified of an audit, were under audit, or were in a request for review process.

Taxpayer adjustments were proposed and agreed to in record time, with taxpayer deadlines of September 15 to elect to participate and October 16 to provide required transfer pricing, tax, and financial information and documentation to the

[11] Indiana DOR, DOR FY20 Annual Report, p. 28 (2020).

[12] Indiana DOR, Advanced Pricing Agreement Program (Sept. 2020).

[13] Amy Hamilton, "Indiana to Scrutinize Transfer Pricing Studies, Offer APAs," *Tax Notes Today State*, July 13, 2020.

DOR. Then, within 31 days of receipt the DOR promised to review and propose an adjustment, which the taxpayer had the opportunity to offer modifications or adjustments to, but agreement needed to be reached by the end of 15 days. The DOR incentivized agreement by waiving penalties for any agreed upon issues. While approximately 96 percent of taxpayers in the amnesty program reached agreement with the DOR, the program did not affect the statutory appeal rights of taxpayers that failed to reach agreement.

Louisiana's Transfer Pricing Managed Audit Program

The Louisiana DOR announced the Louisiana Transfer Pricing Managed Audit Program on October 26, 2021, in Revenue Information Bulletin No. 21-029. The program is a voluntary initiative aimed at creating "an efficient and expedited resolution for corporate tax audits when transfer pricing issues exist" and providing "certainty and uniformity to taxpayers on the resolution of transfer pricing issues for open audit periods and a defined period of future tax years." The program is for the 2021 tax year, open audit periods (regardless of whether the taxpayer is currently under audit), and up to four future tax years. The potential for agreement on transfer pricing approaches for up to four future tax years is unique compared with North Carolina's otherwise similar 2020 amnesty program and this aspect resembles APA programs.

In addition to an expedited audit and certainty on Louisiana intercompany transactions, benefits to taxpayers participating in the program include a waiver of penalties that would otherwise be due based on the results of the program and abatement of up to 180 days of delinquency interest during the managed audit period.[14]

Taxpayers can apply for the program between November 1, 2021, and April 30, 2022. Taxpayer program eligibility requirements include:

- history of voluntary DOR compliance (or recent incorporation);
- attestation of available time and resources to dedicate to participation in the program;
- suitable intercompany transaction records; and
- a reasonable expectation of the ability to pay resulting program tax liabilities.

The DOR will approve or deny applications within 15 days of request. Taxpayers approved for the program must sign a managed audit agreement and will then be supervised by an assigned field audit income tax representative. The agreement specifies the period to be audited and the procedure to be followed and is signed by an authorized representative of the DOR secretary and the taxpayer. Taxpayer program participants can (with power of attorney) appoint a representative such as a transfer pricing consultant. Accepted taxpayers or their representatives must submit documentation to the audit representative within 30 days, including:

- the last three years of federal tax returns;
- a list of all intercompany transactions by type, amount, and entity, including journal entries;
- transfer pricing studies;
- any transfer pricing-related agreements with the IRS;
- legal entity organizational chart(s);
- generally accepted accounting principles financial statements for all parties to intercompany transactions (if available); and
- other information requested by the DOR, such as invoices or accounting records.

The audit representative will review the documentation provided and issue a written determination of either the DOR agreement with the taxpayer's transfer pricing studies or the disagreement and an adjustment and tax due. Then the taxpayer will have 30 days to accept the determination or "offer modifications or adjustments." All program-managed audits must be closed by June 30, 2022.

Preparing for State Transfer Pricing Audits

The COVID-19 recession and the long road to recovery from it has lowered state tax revenue and increased relief expenditures, straining states'

[14] Penalties and interest can be assessed if the audit or information reviewed by the DOR discloses fraud or willful evasion of the tax. La. Rev. Stat. title 47 section 1541 D.(4).

budgets and bringing domestic intercompany transactions into focus as a means of raising additional revenue through better enforcement and without necessarily needing to raise tax rates. Taxpayers with significant domestic intercompany transactions involving separate entity reporting states should prepare for increased tax authority scrutiny and audits. Taxpayers should determine the materiality of their U.S. domestic intercompany transactions, prepare state transfer pricing documentation, and ensure transactions with affiliates across state lines are conducted at arm's length.

Transfer pricing documentation provides the factual and analytical support that a taxpayer's related-party transactions are consistent with the arm's-length standard. Following court decisions in *RAC East*, *Columbia*, and *See's*, taxpayers in states that have section 482-like statutes are typically best served by following the guidance in section 482 when determining and documenting their domestic transfer pricing practices.

Transfer pricing documentation consists of both principal documents (typically in the form of the transfer pricing study itself) and supporting documents. Intercompany transaction legal agreements often provide an important component of supporting documentation. The agreements should be in place to address related-party transactions (sale of goods, provision of services, royalties, loans, and so forth) outlining the applicable fee or rate and terms and conditions that apply to the transactions.

Several states are in the early stages of APA program development. State APAs are generally founded on section 482-compliant documentation. Taxpayers should weigh the pros and cons of pursuing APAs. Advantages for taxpayers who enter an APA include certainty of transfer pricing outcome and efficient use of tax department resources (for example, reallocation of resources from audits to higher value-added tax planning).

While the taxpayer benefits of an APA can be substantial, there are potential downsides to consider. First, taxpayers should consider the potentially high upfront cost of an APA and the time it can take to get an APA approved and finalized. The upfront cost of an APA will vary greatly between taxpayers who are prepared for a transfer pricing audit (namely, those who have section 482 compliant contemporaneous transfer pricing documentation) and taxpayers who have not adequately invested in transfer pricing planning and documentation. Second, state APAs carry the risk of double taxation[15] because of their unilateral nature and the lack of a formalized interstate competent authority process like the U.S. competent authority[16] mutual agreement procedure.[17] If another state in which the multistate corporate group operates does not agree to the APA's terms, then there is risk of double taxation. Third, changes to the business operations during the APA coverage period may render its terms outdated. As such, APAs are generally more suitable for companies that are stable and do not anticipate mergers, acquisitions, or other significant changes to their value chains or intangible assets. Finally, when a taxpayer requests an APA proactively rather than when under audit, the APA application process itself — which includes disclosure of confidential details on intercompany transactions and the same tax records as are required for an audit — often leads to an audit in cases where the taxpayer and the DOR do not reach agreement on and finalize an APA, potentially providing the DOR with early audit stage advantages it otherwise would not have had. While this listing of drawbacks to APAs is numerous, it is not meant to discourage taxpayers from pursuing one; often the APA benefits of tax certainty and more efficient use of tax department resources outweighs the potential downside.

The state APA landscape is quickly broadening, and requirements are in flux, as evidenced by Louisiana's new managed audit program that aims to free up tax resources,

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[15] Double taxation arises when taxes are imposed in two or more states on the same taxpayer regarding the same taxable income or capital — that is, when income is taxable in the source state and in the recipient's state of residence. Non-APA intercompany transactions supported by section 482-compliant transfer pricing documentation are also at risk of double taxation.

[16] Competent authorities are tax authority offices responsible for treaty matters. "U.S. competent authority" includes the Advance Pricing & Mutual Agreement Program, which is responsible for transfer pricing cases at the federal level.

[17] MAP is established by income tax treaties to relieve double taxation.

provide tax certainty, and optionally provide DOR agreement on transfer pricing for up to four future tax years. Eligible taxpayers can proactively resolve potential transfer pricing audit issues in Louisiana's program versus reactionary and more prolonged traditional audit defense.[18] Taxpayers who could benefit from an APA should remain current with developments such as APA availability in states and requirements to reach agreement on advance pricing with states. Early-stage APA-like programs may not necessarily be named as such but similarly would cover how taxpayer intercompany income is to be reported. Often such agreements originate in audit settlements. Multistate corporate taxpayers should also watch for additional MTC State Intercompany Transactions Advisory Service program developments such as the next scheduled meeting and increased participation in interstate tax authority collaboration.

In addition to having contemporaneous transfer pricing documentation, multistate taxpayers should prepare for audits by considering the following points that often need to be supportably addressed by the company during an audit:

- background and business reasons for the intercompany transactions (for example, rationale for entering the controlled transactions, value drivers, and whether the intercompany transaction is associated with a change in functions, assets, or risks);
- persons responsible for structuring the intercompany transactions;
- how the transfer pricing report preparer gained knowledge for the functional analysis of each controlled party; and
- total profits or losses associated with each controlled transaction and each controlled party's share of the total profits or losses.
- Ultimately, taxpayers that are prepared with contemporaneous, section 482-compliant documentation supporting the arm's-length nature of their intercompany transactions will be in the best position to defend against state transfer pricing audits. ■

[18] *See also* WTP Advisors, "Starting Today: Louisiana's Transfer Pricing Managed Audit Program" (Nov. 2, 2021).