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SALT Transfer Pricing — What You Need to Know: Part 1

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In this two-part article, Schwerdt, Sanschagrin, and Lunka examine how transfer pricing affects corporations in separate entity states and combined reporting states.

When the subject of transfer pricing arises, most finance and tax professionals think of international transfer pricing. Transfer pricing, however, can play an important role in state and local tax. Corporations and their advisers must understand when transfer pricing is relevant from a state corporate income tax perspective. In part 1 of this article, we examine:

- Three major reporting methods available to states under formulary-apportioned corporate tax reporting: separate reporting, combined reporting, and consolidated reporting.
- The effect of transfer pricing on different reporting methods.
- The latest Multistate Tax Commission[1] transfer pricing developments.

In part 2, we will discuss:

- State tax authority mechanisms for adjusting taxpayer income and the shift from use of discretionary powers to enforcing and challenging the application of the arm's-length standard.[2]
- How states have recently strengthened their transfer pricing enforcement capabilities and are focusing efforts on promptly and cost-effectively resolving transfer pricing cases to bolster state tax coffers.
- How companies can prepare for state transfer pricing audits.

State Apportionment of Corporate Income

As with different countries internationally, it is important to understand the different corporate income tax reporting methods for states and the District of Columbia.[3] The starting point for the three major reporting methods is an understanding of state corporate income formulary apportionment.[4] Wisconsin, which in 1911 became the first state to adopt the corporate income tax, applied apportionment with a formula based on a Wisconsin corporation's share of its multistate corporate group's sales, property, and manufacturing cost.[5] By the 1930s, most states had adopted apportionment, with the three-factor gross receipts, property, and payroll formula becoming the standard formula.

[1]The MTC is an intergovernmental state tax agency that seeks to address the efficient administration of state tax laws that apply to multistate and multinational enterprises.

[2]Tax authority discretionary powers include non-arm's-length-standard-based powers such as forced combination, affiliated group disallowances or addbacks, disallowing intercompany transactions, and so forth.

[3]In this article, the term "states" includes the District of Columbia.

[4]In this article, the term "apportionment" refers to U.S. state corporate income formulary apportionment.

[5]Joann Martens Weiner, "Formulary Apportionment and Group Taxation in the European Union: Insights From the United States and Canada," Taxation Papers 8, Directorate General Taxation and Customs Union, European Commission (revised Mar. 2005).

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Table 1. Virginia Income Apportionment Example

	Taxpayer Information		Factors		
			Property	Payroll	Sales
	i	ii	iii	iv	v
A	Virginia		$3,000	$1,000	$30,000
B	Total U.S.		$10,000	$5,000	$100,000
C	**Ratio (A/B)**		**0.30**	**0.20**	**0.30**
D	Weight (Double-Weighted Sales)		25%	25%	50%
E	Total U.S. Income	$8,000			
F	**Virginia Apportioned Income (C*D*E)**		**$600**	**$400**	**$1,200**
G	**Total Virginia Income (iiiF + ivF + vF)**	**$2,200**			

Apportionment methods used today by most states typically apply up to three factors to estimate state corporate income. Sales, property, and payroll are commonly considered the corporate income-producing factors. The sales factor generally includes gross receipts less returns and allowances from the sale of goods or products and gross receipts for services, interest, dividends, rentals, royalties, capital gains, and other business income (nonbusiness income is excluded). According to the Federation of Tax Administrators,[6] as of January 1, 2021, 27 states use single sales factor apportionment, meaning that state income is apportioned by multiplying total U.S. income by the state's percentage of total U.S. income. Six states double-weight the sales factor (that is, three-factor apportionment with sales double-weighted), three double-weight sales in certain cases, and Tennessee triple weights sales. Some states deviate from a uniform application of apportionment formulas. For example, Mississippi uses special formulas or three-factor apportionment for certain industries or types of companies and single sales factor apportionment for all other taxpayers (primarily retailers, wholesalers, service companies, and lessors).

Income Apportionment Example: Virginia

The taxable income of a corporation is apportioned to Virginia by multiplying the corporate group's total U.S. income by a fraction, "the numerator of which is the property factor plus the payroll factor, plus twice the sales factor, and the denominator of which is four; however, where the sales factor does not exist, the denominator of the fraction shall be the number of existing factors and where the sales factor exists but the payroll factor or the property factor does not exist, the denominator of the fraction shall be the number of existing factors plus one."[7] In a nutshell, the Virginia apportionment formula is termed "double-weighted sales." Table 1 contains an income apportionment example with step-by-step calculations using Virginia's double-weighted sales apportionment formula.

State Reporting Methods

There are three major alternatives available to states under formulary-apportioned corporate tax reporting: separate reporting, combined reporting, and consolidated reporting. States set a requirement for one type of filing and often allow taxpayers to elect and petition to file using an alternate reporting method.

[6] Federation of Tax Administrators, "State Apportionment of Corporate Income (Formulas for Tax Year 2021 — as of January 1, 2021)."

[7] Va. Code Ann. section 58.1-408(A).

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Separate Reporting

Separate reporting requires that each corporation file a separate return, regardless of whether it is part of an affiliated or consolidated group. Separate filers report federal income, deductions, apportionment, and tax liability at the separate-entity level. Separate reporting is based on a premise — supported by the arm's-length standard — that a corporation's state taxable income can be accurately isolated even if it is reported separately from its affiliated entities. In this article, separate reporting states are those that require or statutorily permit an affiliated group of taxpayer entities to elect separate reporting.

If separate reporting is an option for a large multistate taxpayer, then in many cases the taxpayer will have structured itself to make separate filing more tax advantageous than other filing options. This structuring involves alignment of the affiliated entities' functions, risks, and assets — especially ownership of intangible property — with the best (transfer pricing) method[8] and the selection of comparables. From a taxpayer's point of view, a disadvantage of separate filing in some cases is the inability to offset income from profitable affiliates with losses at other related affiliates. Therefore, for SALT transfer pricing purposes, any state that requires or permits separate reporting is a separate reporting state, of which there are 17.

Combined Reporting

A combined return is an income tax return filed for the unitary group of an affiliated group[9] of corporations. The includable corporation must meet a test of unity. While there is not a bright-line definition of a unitary business, and the determination is fact-dependent and state-specific, the MTC has defined a unitary business as "a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts."[10] States may tax income on a combined basis if there is a sufficient unitary connection to the out-of-state activities it seeks to tax. This unitary connection must be sufficient under the Constitution's due process[11] and commerce clauses.[12] Twenty-nine states are generally considered combined reporting states.

Most combined reporting states include only corporations organized in the United States in the combined group. Some states require worldwide combined reporting unless a water's-edge election is made.[13] These states include California, Idaho, Montana, New Mexico, and North Dakota. Alaska requires worldwide combined reporting for corporations that produce oil or gas in the state, or that transport oil and gas by pipeline.

Consolidated Reporting

Consolidated reporting does not have a uniform definition across all states. A consolidated return is either 1) a state return that reflects the separately computed state taxable incomes of related corporations, or 2) a state return that calculates the group's apportionable business income based on the federal consolidated return regulations.[14] Entities in a consolidated return must have a common parent, and most states require 80 percent ownership — a requirement consistent with federal consolidated rules. In states that follow the federal consolidated return, the return requirements may apply either to members of the federal consolidated group that have specified ties to the state or to all members of the group whether or not they have nexus.

[8] Treas. regs. section 1-482-1(c) defines and discusses the best method rule and determining the best method.

[9] Section 1504(a) contains the definition of an affiliated group.

[10] Multistate Tax Commission Model Statute for Combined Reporting, Section 1. Definitions, as approved by the MTC Aug. 17, 2006, and amended July 29, 2011.

[11] U.S. Const. Amend. V, XIV.

[12] U.S. Const. Art. I, section 8, cl.3.

[13] Water's-edge reporting excludes the income and apportionment factors of unitary group affiliates that are incorporated in a foreign country or that conduct most of their business outside the United States.

[14] Reg. section 1.1502-75.

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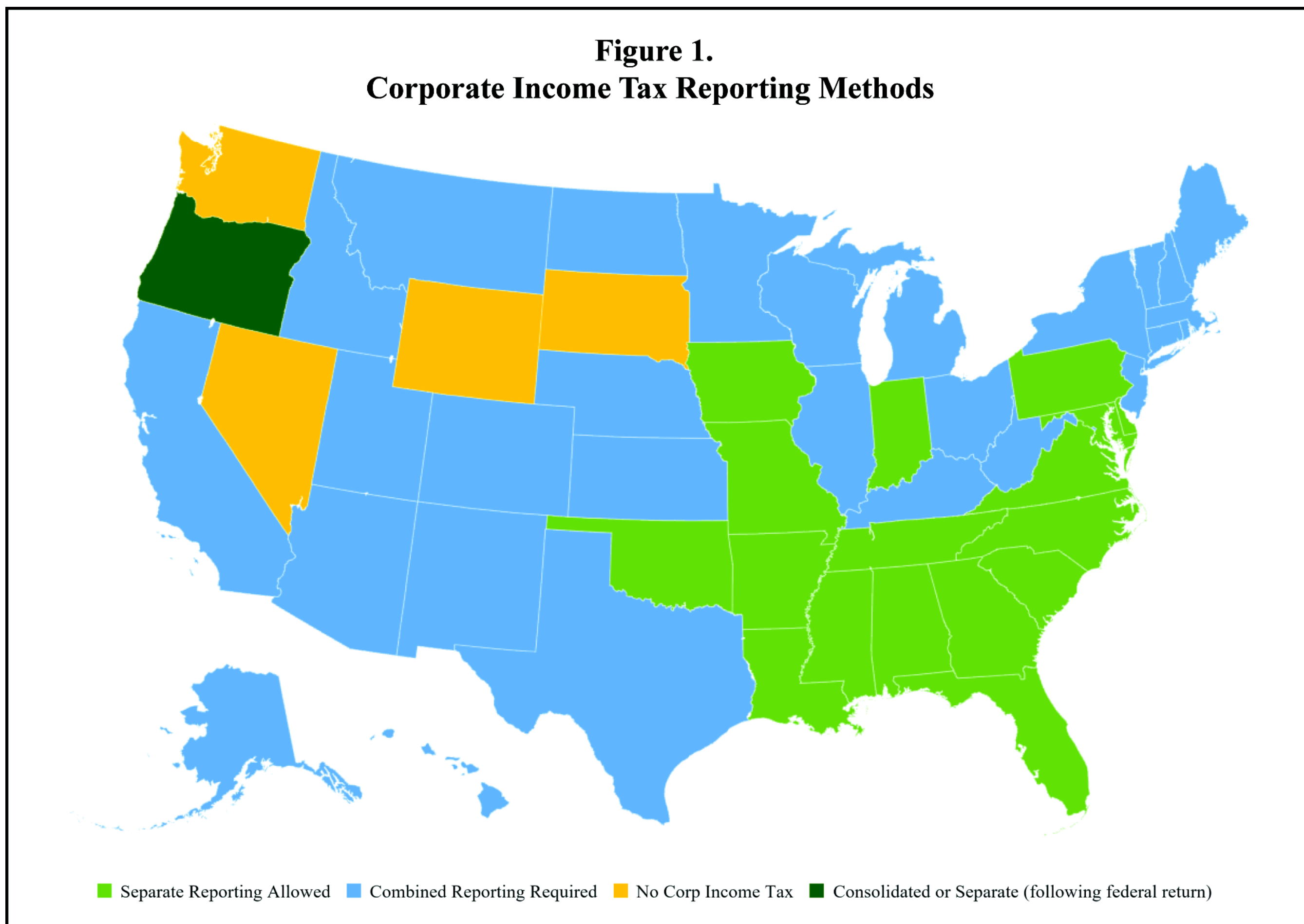

The map in Figure 1 illustrates the general designated reporting method for each state. This map only provides a general representation of reporting methods among the states. Ultimately, the appropriate reporting method for a taxpayer is based on the underlying facts and circumstances and the detailed rules of each state.

Oregon does not fit squarely into the separate or combined reporting designations. In Oregon, if a unitary corporation filed a consolidated federal return, along with at least one affiliated corporation in the same unitary business group, and at least one of the affiliated corporations was doing business in Oregon or had Oregon-source income, then it is required to file a consolidated (water's edge) return in Oregon, based on the federal return.

Correspondingly, if an Oregon corporation doing business in Oregon or with income from an Oregon source filed a separate federal return, then it is required to file a separate Oregon return. A corporation subject to Oregon taxation is also required to file a separate Oregon return if it was included in a consolidated federal return but was not unitary with any of the other affiliates.

Elective Reporting Methods

Three separate reporting states allow taxpayers to elect combined reporting, and nine separate reporting states allow taxpayers to elect consolidated reporting (two of the nine allow separate, combined, or consolidated reporting). These elections allow taxpayers to use the reporting method that best reflects their business functions, assets, and risks in a state.

Virginia's statutory language on electing separate, combined, or consolidated returns for affiliated companies is typical and illustrative of other separate reporting states: "Corporations which are affiliated within the meaning of §58.1-302 may, for any taxable year, file separate returns, file a combined return or file a consolidated return

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of net income for the purpose of this chapter, and the taxes thereunder shall be computed and determined upon the basis of the type of return filed. Following an election to file on a separate, consolidated, or combined basis all returns thereafter filed shall be upon the same basis unless permission to change is granted by the Department."[15]

Why Domestic Transfer Pricing Is Important in the United States

U.S. domestic transactions can affect state tax liabilities, particularly for taxpayers in separate reporting states that file separate returns for each in-state corporation and treat intercompany transactions as if they occur between unrelated entities. Whereas intercompany transactions are eliminated in combined and consolidated returns, since separate reporting generally starts with a corporation's federal income calculated on a separate-company basis, the taxpayer's separate-company taxable income will be affected by the pricing of transactions between the taxpayer and any domestic or foreign affiliate. State tax authorities may review transactions between related domestic and foreign entities, particularly in water's-edge filings in which intercompany transactions are not eliminated.

Combined reporting states may be concerned with transfer pricing on transactions with affiliates that are excluded from the combined group. For instance, transfer pricing issues can arise in states that have domestic combination or water's-edge combined reporting when they have transactions with affiliate entities located in foreign countries. Transfer pricing issues can also arise when there are transactions between two or more unitary groups that are owned by a common owner. Also, both domestic and international transfer pricing can affect the state-specified apportionment of corporate income formulas. For example, since in-state sales are generally included in the numerator of the fraction that is used to apportion taxable income among the various states, the pricing of sales between related entities in different jurisdictions will affect the calculation of the sales apportionment formula.

[15] Va. Code Ann. section 58.1-442(A).

Many separate reporting states have statutes that either adopt IRC section 482 or contain language that is substantially similar to it. As a result, multistate taxpayers and tax authorities of states that have adopted IRC section 482-like statutes often rely on the arm's-length standard embodied in Treasury regs. section 482.[16] In this article, section 482 refers to IRC section 482 and Treas. regs. section 482, which is the official federal interpretation of it. The key aspect of transfer pricing under section 482 is ensuring that the value exchanged in related-party transactions is the same as it would be for unrelated parties conducting the same transaction on an arm's-length basis.

Historically, states have placed less emphasis on compliance with section 482 when auditing affiliated interstate transactions and have often used their discretionary power to adjust income. Common practices include combined reporting,[17] disallowance or addback provisions requiring certain payments to related entities to be added back to the tax base,[18] alternate apportionment methods, and claiming transactions lack economic substance. However, during the past decade, many states have increasingly focused on the application of section 482.

MTC and SITAS

The MTC's State Intercompany Transactions Advisory Service Committee (SITAS) was started in 2014 and before November 2016 was known as the Arm's Length Adjustment Service Committee (ALAS).[19] ALAS completed its initial program design in 2015, but the MTC did not receive adequate commitments from the states to fund and establish the program.[20] ALAS program goals

[16] *See* reg. sections 1.482-1 to 1.482-9.

[17] For example, North Carolina has statutory authority to require taxpayers to file on a combined basis on audit.

[18] For example, Georgia requires taxpayers to add back captive REIT expense and intangible property and related interest expense paid to related parties in the computation of state taxable income.

[19] Unless otherwise indicated, all commentary in this section is sourced from the MTC State Intercompany Transactions Advisory Service, 2021.

[20] Each charter state needed to commit to invest about $200,000 during the project's four-year rollout period, assuming 10 states committed to participate ($2 million total). However, only Alabama, Iowa, New Jersey, North Carolina, and Pennsylvania committed financially to becoming charter members of ALAS.

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included providing participating states with transfer pricing training, information exchange agreements between states, cost-effective analysis of taxpayer transfer pricing studies through a combination of in-house MTC economists and hired third-party consulting firms, audit assistance and expanded coverage of transfer pricing issues, and case resolution and litigation support services.

SITAS 2021 Meetings

SITAS did not hold an official meeting for over four years until it met via videoconference on March 23, 2021. SITAS met a second time on July 13, 2021. On March 23, SITAS Chair Krystal Bolton[21] hosted representatives from state revenue agencies (Alabama, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Missouri, New Jersey, North Carolina, and North Dakota); media; accounting practitioners; legal practitioners; taxpayers[22] including Chevron, ConocoPhillips, Entergy, and Pfizer; organizations including the Council On State Taxation, Financial Institutions State Tax Coalition, and MultiState; and members of the public to overview the history of SITAS and to present the results of a multistate interest survey regarding intercompany transactions and transfer pricing.

During the second portion of the meeting, Bolton overviewed the responses of the 24 representatives of 11 states who responded to a SITAS committee survey. The survey was sent to state representatives included on the SITAS contact list, and a link was provided in the March 2021 MTC newsletter. The survey results showed that most states were interested in training opportunities, information exchange and audit collaboration, and improved communication and coordination regarding transfer pricing. The survey responses indicated that responding states do not believe they are working together effectively in these areas. Notably:

- Seventeen respondents (71 percent) were interested in SITAS facilitation of information exchange and audit collaboration.
- Seventeen respondents indicated it would be extremely valuable to exchange information with members of other states.
- Twenty-two respondents (92 percent) were interested in training to "identify intercompany transactions prone to improper income shifting."
- Twelve respondents (50 percent) were interested in receiving "information about vendors providing transfer pricing support."

The March 23 SITAS meeting concluded with the committee members expressing interest in learning about advance pricing agreement process development in other states and the possibility of an informational session. The July 13 SITAS meeting consisted of reviewing the proposed SITAS charter and the revised SITAS Participation Commitment and Exchange of Information Agreement. When reviewing the results, Bolton referenced the agreement and suggested that states wishing to participate in an informational session should review and send a signed agreement to Holly Coon, director of the MTC Joint Audit Program. While no states had signed the SITAS agreement, some responding representatives indicated that it was under review in their agencies, and others indicated it would be signed soon. The meeting ended with notice that the next SITAS meeting would be scheduled after state agencies submit signed agreements.

SITAS 2021 Charter

On August 5, 2021, SITAS was officially formed under a draft charter approved by the SITAS Executive Committee.[23] The charter states SITAS's responsibilities in one sentence: "The SITAS Committee provides support to states seeking to address tax base erosion of income-based taxes due to inter-company transactions." The charter establishes membership, voting,

[21] Bolton is assistant director of the Louisiana DOR's field audit income tax division.

[22] Formal corporate taxpayer representation or attendance by employees as members of the general public.

[23] MTC, "DRAFT Charter for the State Intercompany Transactions Advisory Service (SITAS) Committee" (2021).

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and governance duties of the participating states.

A quorum is established at SITAS meetings by the number of member states in attendance. State employees attending a meeting may participate and can offer motions or amendments; however, in any matter requiring a vote, each signatory state is entitled to only one vote. The SITAS chair can limit who may vote on a motion when it affects some signatory states and not others. SITAS meets at the call of the chair and holds periodic meetings that are open to the public.

SITAS activities for participating states include providing training sessions and seminars on transfer pricing, audit techniques, tax compliance, litigation affecting multiple states, and other aspects of state tax. SITAS will convene for informational sessions to discuss legal and legislative developments and to share information (including confidential taxpayer information), expertise, and advice. Informational sessions are conducted under established exchange procedures.

SITAS committee membership is composed of a designated representative of each of the signatory states to the SITAS information exchange agreement. The agreement is designed to allow participating states to provide mutual assistance with audit, compliance, enforcement, and litigation activities to recoup billions of tax dollars purportedly lost to non-arm's-length or otherwise noncompliant transfer pricing practices of large multistate corporations.

SITAS 2021 Information Exchange Agreement

The SITAS information exchange agreement, which was made final in March 2021, establishes how states will share confidential taxpayer information related to transfer pricing with other states. It permits signatory states to exchange tax returns, audit reports, nexus questionnaires, and other related workpapers. Article IV, section 1 of the agreement also permits states to share "proprietary taxpayer information," including "information on intercompany pricing decisions, intellectual property values and profits, comparable industry profits, risk factors, capital costs, employee compensation, division and subsidiary profits, salaries and benefits, overhead charges, interest charges, transfer pricing reports and recommendations, comparable profits, charges, royalty rates, investment decisions, business location decisions, transfers of personnel, transfers of property, collection and enforcement activities, responses to interrogatories, [and] depositions."[24]

Under IRC section 6103(d), the SITAS agreement does not apply to information received directly from the IRS unless the IRS authorizes the exchange. Also, any information the disclosure of which would violate state or federal law or be detrimental to the administration of the tax laws of any signatory state is not subject to exchange. Each signatory state reserves the right to make the determination whether information is subject to exchange. Once the SITAS agreement has been executed by the participating states, the member representatives of those states can use the next SITAS meeting to identify and discuss specific taxpayers with potentially distortive transfer pricing arrangements.

Conclusion

Transfer pricing's importance is growing in states, especially in separate reporting states. Major recent developments include a reawakening of SITAS, which held meetings in March and July 2021 — its first meetings since 2016. A large majority of states participating in the meetings expressed interest in transfer pricing information exchange and audit collaboration between states, and training opportunities to better identify intercompany transactions to target in audits. Signing of the SITAS information exchange agreement by participating states is the next step to move SITAS forward from ideas and plans to establishing a consortium of states with real teeth.

In part 2 of this article, we will highlight how state tax authorities are increasingly

[24]MTC, "[Final] State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement" (2021).

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applying section 482-based statutes when challenging taxpayer intercompany pricing following recent tax court case rulings in support of section 482. We discuss how states have strengthened their transfer pricing enforcement capabilities and how some states have focused on initiatives to quickly resolve transfer pricing cases and reach agreements with taxpayers on transfer pricing approaches for future years via APAs. Finally, we provide takeaways on what taxpayers can do to prepare for state transfer pricing audits. ■

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