



District of Columbia

State and Local Transfer Pricing

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Introduction to Transfer Pricing

- Generally, transfer pricing laws allow taxing authorities to adjust allocations of income and deductions between related entities when such adjustments are required to properly reflect income or to prevent the evasion of tax
- Transfer pricing adjusts prices charged between related parties to reflect arm's length results
- Unchecked by such transfer pricing adjustments, commonly owned or controlled entities could determine prices charged among themselves to reduce overall taxation of the group
- Tax evasion is not a prerequisite for a IRC § 482 adjustment



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Federal Transfer Pricing

- Transfer pricing is governed by IRC § 482 and extensive transfer pricing regulations, which detail the methods by which transfer pricing analysis is undertaken
- I.R.C. § 482 provides:

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.



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Federal Transfer Pricing

- Key Components of the Transfer Pricing Regulations
 - **Best Method Rule**: transfer pricing method under “the facts and circumstances,” provides the most reliable measure of arm’s length result
 - The comparable uncontrolled price method (“CUP”);
 - The resale price method;
 - The cost plus method;
 - The comparable profits method;
 - The profit split method; and
 - Unspecified methods.
 - **Comparability**: adjustments are made when applying transfer pricing methods, consider differences between controlled (interrelated) and uncontrolled (third party) transactions



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State Transfer Pricing Statutes

- Many states have adopted statutes that are identical or substantially similar to the federal transfer pricing statute in § 482
- Other states have statutory authority to adjust intercompany prices, without adopting the federal statutory language
- The District of Columbia has a transfer pricing statute that is nearly identical to I.R.C. § 482, D.C. Official Code § 47-1810.03, which states:

In any of 2 or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the District, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Mayor is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, whenever in his opinion 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.



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Microsoft v. OTR (OAH-2012)

- Taxpayer challenged OTR's transfer pricing analysis, conducted by a contractor, claiming that the Comparable Profits Method was misapplied
 - Aggregation of intercompany transactions
 - Separation of controlled and uncontrolled transactions
- Summary motion was granted in favor of the taxpayer, Office of Administrative Hearing's ALJ held that OTR's application of the transfer pricing methodology was arbitrary and capricious
- OTR appealed the decision to the DC Court of Appeals but withdrew the appeal upon settlement of the case



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BP Products North America-2013

- D.C. Superior Court
- Taxpayer sought refund and filed motion for summary judgment
- Court denied motion for summary judgment
 - Selection of most narrowly identifiable business activity incorporating controlled transactions “is a factual question”
 - Arguments in motion for summary judgment are essentially fact-based
- *BP Products North America* is in direct contrast to *Microsoft* decision



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Exxon v. OTR, et al: Procedural History

- Taxpayers challenged transfer pricing assessment issued against it by OTR, using analysis from Chainbridge
- Taxpayers argued that methodology used was identical to that considered in *Microsoft* and argued for the application of collateral estoppel on the basis of the *Microsoft* decision
- Office of Administrative Hearings ALJ ordered OTR to respond only to collateral estoppel argument, and granted summary motion on that ground
- OTR appealed decision to the DC Court of Appeals, where the case was remanded for further briefing on the collateral estoppel issue
- A new OAH judge denied the taxpayer's motion for summary judgment on the collateral estoppel grounds, and ordered OTR to respond to taxpayer's substantive arguments in the motion for summary judgment



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Exxon v. OTR, et al: Substantive Arguments

- The taxpayers challenged the assessments in the *Exxon* and related cases (*Shell* and *Hess*) on the same grounds as in *Microsoft*
 - Aggregation of intercompany transactions
 - Separation of controlled and uncontrolled transactions
- OTR argued transfer pricing is inherently fact-based, material facts were in dispute, and the motion for summary judgment was inappropriate
 - Facts required to determine whether or not the comparable profits method had been properly applied
 - Expert testimony provided by OTR had not been contradicted by evidence presented by taxpayers



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Exxon v. OTR, et al: Decision and Result

- OAH ALJ agreed with OTR and denied taxpayers' motions for summary judgment
- The facts on the record were not sufficient to grant summary motion in favor of the taxpayers
- OAH ALJ found that petitioners did not establish that any of the analyses were arbitrary, capricious, and unreasonable as a matter of law
- The ALJ encouraged the taxpayers and the OTR to “exhaust all settlement possibilities”
- All cases ultimately settled-*ExxonMobil*, *Shell*, *Hess*, *AT&T*, *Eli Lilly*, *Pfizer*, *Ahold*, and *Honeywell*



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Transfer Pricing Litigation Concerns

- Reliability of transfer pricing reports
- Facts and circumstances nature of transfer pricing
- Burden of proof
- Selection and use of testifying experts



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Other State Transfer Pricing Cases

- *Utah State Tax Comm'n v. See's Candies, Inc., Utah, No. 20160910-SC*
- *Columbia Sportswear USA Corp. v. Indiana Department of State Revenue, Indiana Tax Court, No. 49T10-1104-TA-00032 (Dec. 18, 2015)*
- *In the Matter of the Petition of HMC-New York Inc., N.Y.C. Tax App. Trib., No. TAT(H)14-15(GC) (Apr. 27, 2017)*



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Other State Audit Tools

- Related-party addback statutes require addback or disallowance of related-party transactions
- Assert alternative apportionment
- State laws and courts can apply judicially created anti-abuse doctrines to ensure proper reporting of state income taxes
 - Economic substance; substance-over-form; sham transaction; step transaction
- Combined reporting



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Combined Reporting

- Mandatory combined reporting for members of a unitary group can lessen transfer pricing issues by eliminating intercompany transactions
- Does not eliminate all transfer pricing issues, as some entities may fall outside of the combined group
 - Water's Edge Reporting
 - Insurance Companies
 - QHTCs



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Branch Banking & Trust Co. v. OTR

- OTR assessed the taxpayer based on an audit conducted by the MTC, by which it concluded that the income of seven subsidiaries should be combined with the parent's because the subsidiaries had no business purpose other than tax avoidance
 - On the taxpayer's motion for summary judgment, the OAH held that the taxpayers did not satisfy the burden of proof that the subsidiaries had economic substance (i.e. a non-tax business purpose and the objective possibility of generating profits, other than from tax avoidance) despite the taxpayer acquiring most of the subsidiaries, rather than creating them
 - Also, the OAH held that OTR had the authority to combine related entities "when needed to achieve a fair reflection of business activity within the District of Columbia."
- The case ended with a settlement prior to an evidentiary hearing



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Questions?