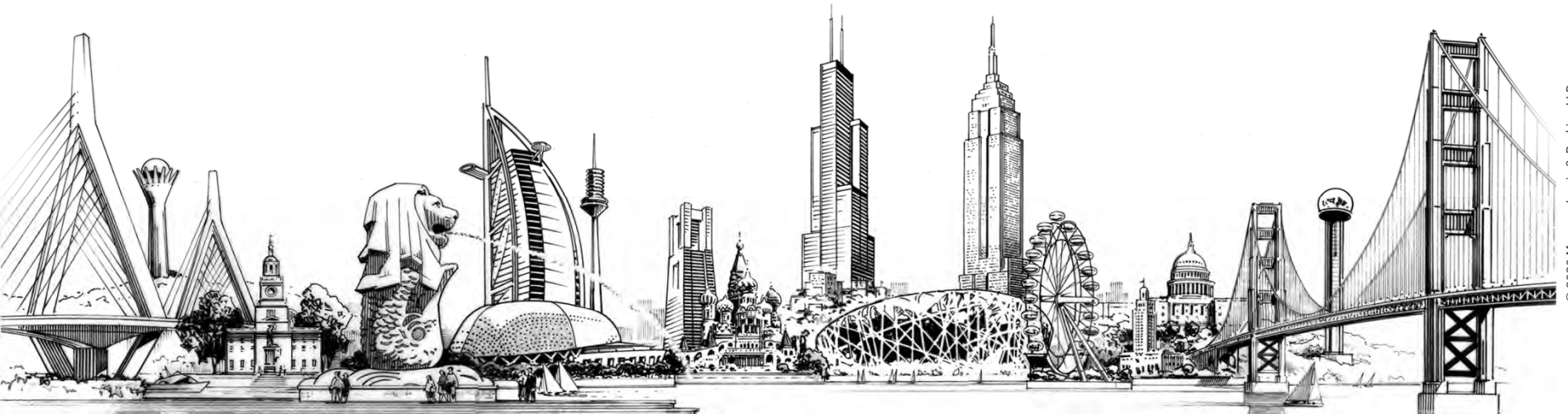


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STATE TRANSFER PRICING ENFORCEMENT

State Efforts and Taxpayer Best Practices
May 28, 2020

Presenters: Jenny Austin, Adam Beckerink, Tom Linguanti, Saul Mezei, Matt Mock, Sanford Stark, Justin Cupples, Colleen Redden, and Terrell Ussing



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Today's Presenters:



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Agenda

- What is transfer pricing? How does it apply to state income tax filings?
- Historical approach to state transfer pricing
- Future of state transfer pricing
- Roundtable Discussion

Transfer Pricing for Federal Tax Purposes

What is Transfer Pricing?

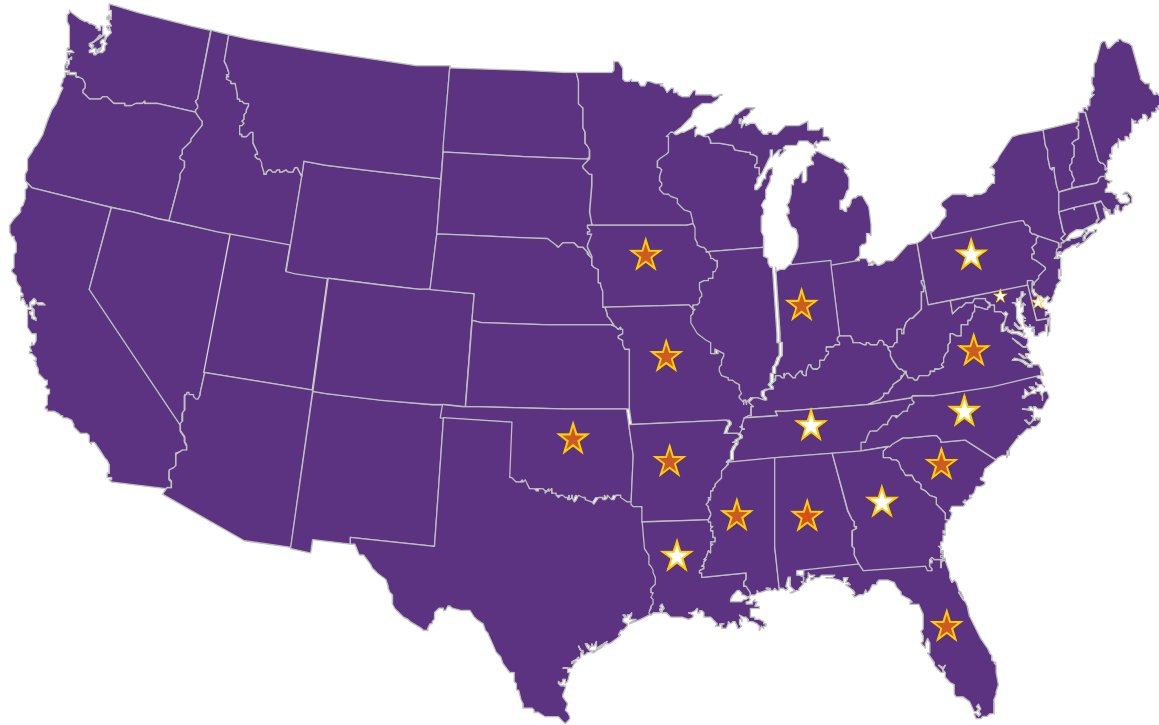
- IRC § 482 authorizes the IRS to “distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”
- Price cross-border transactions between controlled parties in parity with transactions between uncontrolled parties. 26 CFR § 1.482-1.
- Achieved through application of the “arm’s length standard.”

State Context

Where does transfer pricing apply in the state income tax context?

- Transfer pricing is in play for separate return filing states.
 - Intercompany transactions are eliminated in consolidated or combined returns.
 - However, combined states may review transactions between related domestic and foreign entities especially in water's-edge filings where intercompany transactions are not eliminated.

Separate Return States - The below states are generally as "Separate Return" states. However there may be special circumstances where a combined or consolidated return is required.



★ Denotes election or request to file on a combined or consolidated basis available.

HISTORICAL APPROACH TO STATE TRANSFER PRICING

**TOOLS AVAILABLE TO
STATES AND THEIR SUCCESS**

Tools Available to the States

- Forced Combination
- Alternative Apportionment
- Related Party Expense Addback
- Nexus Assertion
- State codified IRC § 482 language

Forced Combination

- State has statutory authority to require taxpayer to file on a combined basis on audit.
 - North Carolina; N.C. Gen. Stat. § 105-130.5A(b).
 - *Walmart Stores East, Inc. v. Hinton*, 676 S.E.2d 634 (Ct. App. 2009)
 - *Delhaize America, Inc v. Lay*, 731 S.E.2d 486 (Ct. App. 2012).

Alternative Apportionment Statute

Department of Revenue may have authority to require taxpayers to use an alternative apportionment methodology.

Indiana Code § 6-3-2-2(I)

- *Rent-A-Center East Inc. v. Indiana Dep't. of State Revenue*, 42 N.E.3d 1043 (Ind. Tax Court 2015).
- *E.I. Dupont de Nemours and Company v. Indiana Dep't. of State Revenue*, 79 N.E.3d 1016 (Ind. Tax Court 2017).

Related Party Expense Addback

State requires taxpayers to add back amounts paid to related party in computation of state taxable income.

- Alabama Code § 40-18-35
- Georgia Code § 48-7-28.3(b)

Nexus Assertion

State may assert nexus on out-of-state related party requiring out-of-state related party to file an income tax return.

- Economic Nexus Thresholds
- Imputed Intangible
- Nexus assertion does not always create an unfavorable result depending on state sourcing rules.

Codified IRC § 482

States have codified the language of IRC § 482 in state statute

- Utah Code § 59-7-113
- Indiana Code § 6-3-2-2

Taxpayers Push back Against Novel State Arguments

- States have faced resistance to their novel approaches to transfer pricing.
- Taxpayers have succeeded in arguing the state lacked evidence to support claims that separate returns do not reflect taxpayer income or that transactions lack economic substance.
- *E.I. Dupont de Nemours and Company v. Indiana Dep't. of State Revenue*, 79 N.E.3d 1016 (Ind. Tax Court 2017).
- State revenue authorities have also been required to adhere to transfer pricing rules and practice when applying the state versions of IRC § 482.

States held to IRC § 482 Principles

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

The Utah Supreme Court affirmed the district court's application of IRC § 482 standards to the state's similar statute.

- See's Candies argued its licensing transactions with an affiliate were priced at arm's length in line with IRC § 482 principles.
- The Utah Supreme Court, affirming the district court, found the language of Utah Code § 59-7-113 was almost identical to IRC § 482, thus the arm's length standard applied.
- Based on expert testimony, the district court found the transaction withstood IRC § 482 arm's length standard, and therefore withstood Utah Code § 59-7-113.

FUTURE OF STATE TRANSFER PRICING

STATES' NEW APPROACH TO TRANSFER PRICING

States Build Up Audit Arsenal

With recent losses in state courts, states are approaching transfer pricing by looking to transfer pricing economists and professionals.

- In its annual report, the Indiana Department of Revenue described its dedicated transfer pricing group which works with thirteen other states.
- Alabama, North Carolina, and Louisiana have contracts with transfer pricing consulting firm RoyaltyStat LLC.
- Massachusetts has retained outside counsel and economists, including former U.S. Treasury and IRS counsel.
- Connecticut has hired two firms to provide transfer pricing training to its personnel.

Multistate Tax Commission Support

- The Multistate Tax Commission (MTC) created a transfer pricing committee, the State Intercompany Transactions Advisory Service (SITAS), to provide transfer pricing training to state auditors.
- While the MTC effort has not garnered widespread support, states have continued to push forward with measures to increase their transfer pricing audit capabilities.
- Sixteen states participated in MTC's transfer pricing training in March 2019.

How to Defend Your Transactions

- Document all intercompany transactions.
- Maintain up to date, reliable transfer pricing studies.
- Use transfer pricing experts.

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ROUNDTABLE DISCUSSION

Morgan Lewis State Tax Experts



Matthew S. Mock advises clients on state and local tax litigation and planning, regularly representing them in all stages of state and local tax controversies, including transfer pricing issues. Matt is often called on to counsel on audits, protests before state administrative agencies, and appeals to state courts. He also advises multinational companies on the state and local tax aspects of corporate restructurings and transactions.



Adam Beckerink represents multinational corporations, in tax disputes and litigation with revenue authorities throughout the United States, including transfer pricing issues. Through both litigation and settlement, he has resolved difficult state tax matters before administrative appeal boards, tax tribunals, and courts in Illinois and throughout the United States. He also counsels on multistate and federal tax planning, and the tax aspects of mergers and acquisitions.

Morgan Lewis State Tax Experts



Justin D. Cupples has assisted clients with transfer pricing issues in a variety of contexts. He has represented taxpayers before various state revenue agencies and courts. Justin has also counseled clients with restructurings in which intercompany transactions and related transfer pricing plays a role. Prior to joining Morgan Lewis, Justin worked as a senior tax manager for a Big 4 accounting firm where he implemented a number of structures for clients with intercompany transactions.



Colleen M. Redden advises clients on state and local tax matters. Her practice includes corporate income tax, sales and use tax, gross receipts tax, and other miscellaneous taxes. She has experience with implementing and defending headquarter company structures which include intercompany transactions and related transfer pricing issues. Colleen helps clients with tax strategy projects as well as controversy engagements. Prior to joining Morgan Lewis, Colleen worked as a senior associate at a Big 4 accounting firm.

Morgan Lewis Transfer Pricing Experts



Thomas V. Linguanti represents clients in complex tax controversies and tax litigation. He assists clients in determining the appropriate strategy in disputes with the US Internal Revenue Service during audit, alternative dispute resolution proceedings, and trial and appellate litigation. He has represented clients in transfer pricing matters for nearly three decades. He has written extensively on transfer pricing and has been named to several Chambers USA lists as a tax controversy expert.



Jenny Austin concentrates her practice on federal tax controversy and litigation, working across all industries, with a particular focus on matters involving significant intellectual property interests, including medical device, pharmaceutical, and technology companies. Jenny advises US taxpayers with respect to international tax implications of offshore operations, and handles matters involving transfer pricing, including cross-border transfer pricing of tangible and intangible assets and intellectual property, services, and cost sharing arrangements. She also has experience with transfer pricing issues at the state level.

Morgan Lewis Transfer Pricing Experts



Sanford W. Stark focuses on federal tax controversy and litigation. He counsels on a range of complex domestic and international issues, including a substantial emphasis on transfer pricing. Sanford's transfer pricing experience includes significant focus on identifying and valuing intangible property, and further includes transfer pricing planning and internal restructurings. Sanford is a member of the Bloomberg BNA Transfer Pricing Advisory Board, and he teaches "Survey of Transfer Pricing" as an adjunct professor in the Graduate Tax Program of Georgetown University Law Center. Sanford is the co-author of "Transfer Pricing: Litigation Strategy and Tactics", *BNA Tax Management Portfolio*, 893 T.M. (2010).



Saul Mezei represents clients at all stages of federal tax controversy, from audit and administrative appeals to trial and judicial appeals. Saul focuses on all aspects of international transfer pricing, with an emphasis on issues relating to intangibles. Saul is an adjunct professor in the Graduate Tax Program at the Georgetown University Law Center, where he currently teaches "Survey of Transfer Pricing" He is the co-author of "Transfer Pricing: Litigation Strategy and Tactics," *BNA Tax Management Portfolio*, 893 T.M. (forthcoming).

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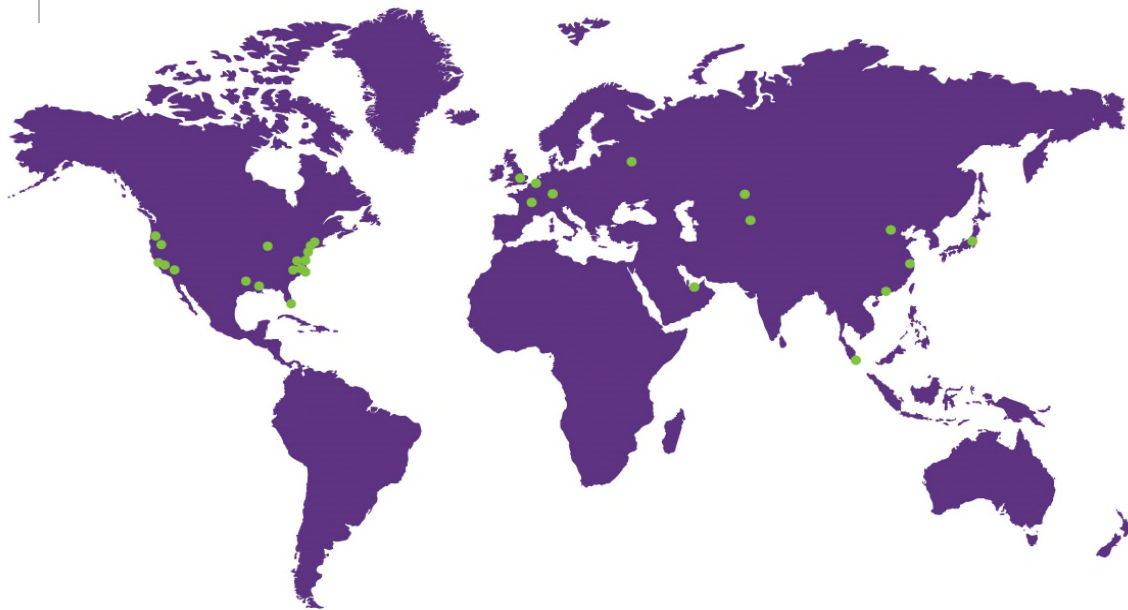
C. Terrell Ussing concentrates his practice in the area of tax controversy and litigation, representing clients in all phases of tax controversy, from audit to litigation. He counsels multinational corporations on a range of complex domestic and international tax issues, with a particular emphasis on transfer pricing. Terrell's transfer pricing experience focuses on hard-to-value intangible property and further includes sophisticated transfer-pricing planning and risk assessment at the federal and international level and state level where the federal transfer-pricing principles apply. He was a critical member of the trial teams representing Amazon.com and The Coca-Cola Company in their multi-billion-dollar transfer-pricing litigations before the US Tax Court.

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