Transfer Pricing Litigation in the District of Columbia

by Nancy Cook and Eric Cook

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In this article, the authors discuss *Microsoft* and *BP*, two recent transfer pricing cases in the District of Columbia in which they served as subject matter experts. They defend their use of a profits-based pricing method for evaluating the arm's-length nature of the taxpayers' intercompany transactions, arguing that under that method, there is no requirement that related-party transactions be separated from unrelated-party transactions.

Introduction

Over the past decade, we have served as subject matter experts in more than 75 audits involving IRC section 482 and have attended more than 35 informal taxpayer conferences with audit staff from various states and the District of Columbia. Most cases settled, but a few in the District resulted in litigation.

We developed the economic analyses used by the District's Office of Tax and Revenue (OTR) to make assessments that have resulted in litigation. Two cases have concluded: The Office of Administrative Hearings (OAH) *Microsoft* case was decided in 2012,[1] and the D.C. Superior Court *BP Products North America* case settled in 2014.[2]

In *Microsoft*, an administrative law judge granted the taxpayer's motion for summary judgment without a trial. In its motion, Microsoft argued that we should have segregated its controlled transactions from its uncontrolled transactions in performing our analysis under the comparable profits method.

In his order granting the taxpayer's motion, ALJ Paul B. Handy pointed out that Chainbridge selected the CPM under the regulations for section 482, which requires the analyst, to the extent possible, to compare controlled transactions between the tested party and its affiliated businesses against uncontrolled, arm's-length transactions with third parties.

In the D.C. Superior Court, BP filed a motion for summary judgment that relied heavily on *Microsoft*. Superior Court Judge John M. Campbell denied the motion, and just days before trial was to begin, the case was settled in favor of the District.

During the hearing on BP's motion for summary judgment, Campbell said he didn't think *Microsoft* controlled the case before him, adding that while *Microsoft* provided guidance, it didn't necessarily indicate how *BP* should be resolved.

At the end of the day, we are left with an ALJ decision granting a taxpayer's motion for summary judgment in the OAH and a case settled in favor of the District in superior court with no written opinion. The OTR decided not to appeal *Microsoft* and to await resolution of *BP* in superior court. In *Microsoft*, the ALJ cited our failure to segregate related-party transactions from unrelated-party transactions as cause for granting the taxpayer's motion. In *BP*, Campbell indicated that *Microsoft* would not control, and all parties speaking at the hearing on BP's summary judgment motion agreed that *Microsoft* did not set legal precedent in *BP*.

We have not publicly spoken about either case, particularly when one seemed to rely so heavily on the other. However, now that both cases have concluded, we believe we might shed some light on the topic from our perspective as subject matter experts. We are not attorneys and therefore cannot comment on the precedential or non-precedential nature of *Microsoft*, although we believe that it sets no legal precedent. Rather, we briefly discuss some technical transfer pricing issues, including applying section 482 in the states and the District and the aggregation of transactions in *Microsoft* and *BP*.

We believe that in both *Microsoft* and *BP,* we appropriately applied section 482. In both cases, we selected a profits-based (not a transactions-based) pricing method to evaluate the arm's-length nature of the taxpayer's (tested party's) intercompany transactions. Under that profits-based method, there is no regulatory requirement that related-party transactions be separated from unrelated-party transactions. In fact, in both *Microsoft* and *BP,* it would have

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[1] *Microsoft Corp. Inc. v. Office of Tax and Revenue*, No. 2010-OTR-00012 (OAH 2012).

[2] *BP Products North America Inc. v. District of Columbia*, No. 2011-CVT-10619 (D.C. Super. Ct. 2014).

been mathematically impossible to segregate the tested party's controlled transactions from its uncontrolled transactions for purposes of computing a profit level indicator (PLI) under the CPM.

Applying Section 482 in the States and the District

One definition of the term "transfer price" in a business economics context is the amount charged by one segment of an organization for products or services that it supplies to, or receives from, another segment of the same organization. Corporate CFOs and tax directors are faced with a dilemma because they must maximize profits reported to corporate owners and minimize profits reported to tax authorities.

On the corporate side, transfer pricing methods may be used to "set" intercompany prices for tax purposes. On the government side, those methods are used to "test" the arm's-length nature of intercompany transactions. In theory, if transfer pricing practitioners are doing a proper job, a similar result should be reached on both sides.

Section 482 has its legislative beginnings in the Revenue Act of 1918.[3] For U.S. tax purposes, section 482 indicates that intercompany transfer prices should be set according to the arm's-length principle — that is, for tax purposes, intercompany prices should be set as if the related parties were operating on an unrelated basis. U.S. Treasury regulations provide guidance for the application of section 482.

Many states and the District of Columbia have statutory language either identical or similar to section 482. Some states have broad authority to allocate income and deductions, and very few have no authority to allocate income and deductions. Many states have the legal authority to use the federal regulations guiding the application of section 482.

According to Treas. reg. section 1.482-3, the arm's-length amount charged in a controlled transfer of tangible property must be determined under one of six methods. A similar set of methods applies to the provision of intercompany services. Of the six methods, three are transactions based, two are profit based, and one is unspecified.

The CPM is a profits-based method, not a transactions-based method. There is no hierarchy of pricing methods under the regulations.

According to Treas. reg. section 1.482-1, when evaluating the arm's-length nature of controlled transactions, a functional analysis must be performed, and adherence to the best-method rule is mandatory. Broadly speaking, the regulations guide the application of the CPM, under which:

- a tested party is selected;
- a PLI is selected;
- comparables companies are selected;
- an interquartile range of PLIs for the comparable firms is established;
- a comparison is made between the tested party's PLI and the interquartile range of PLIs for the possible comparable companies; and
- if the tested party's PLI is below the bottom observation of the interquartile range of PLIs for the possible comparable companies, an adjustment to the tested party's income may be warranted.

How common is the CPM as compared with other transfer pricing methods? It was by far the most common pricing method used for transfers of both tangible and intangible property in IRS advance pricing agreements executed in 2012.[4]

Aggregation of Transactions in *Microsoft*

Under Treas. reg. section 1.482-5(b)(1):

> Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transactions is available (relevant business activity). To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions.

As he said in *Microsoft*, Handy believed that we had not properly segregated the tested party's financial data that solely related to controlled transactions, which he called "a fatal error." According to Handy, we analyzed Microsoft's profit-to-cost ratio for the 2002 tax year and compared that ratio with the profit-to-cost ratios of comparable companies. However, he said, we included all of Microsoft's income without narrowing our analysis to "controlled transactions between Microsoft and its affiliated businesses, in violation of federal standards for transfer pricing analysis."

We were puzzled by Handy's reference to a PLI (the profit-to-cost ratio) that we did not use. In performing our analysis, we relied on the ratio of operating profit to sales (operating profit margin). We do not agree with Handy that it is a violation of federal standards for transfer pricing analysis to include all of the taxpayer's income in the analysis, which we have been doing for quite some time now.

Further, Handy noted that Microsoft asserted in its motion that 98 to 99 percent of its transactions were conducted with third parties, saying:

> When I asked Microsoft at the hearing to clarify where this percentage came from and what it means, Microsoft withdrew the assertion, stating that this was a figure provided by its expert. . . . I make no finding as to this fact. The pertinent fact, which OTR has conceded, is that Chainbridge analyzed all of Microsoft's

[3] Robert N. Lent, "New Importance for Section 482 of the Internal Revenue Code," 7 *Wm. & Mary L. Rev.* 345 (1966).

[4] IRS, "Announcement and Report Concerning Advance Pricing Agreements" (Mar. 25, 2013).

> income together and that this income included many transactions between Microsoft and unaffiliated third parties. This fact is sufficient to establish that the analysis was arbitrary when focusing on the inquiry required by 26 C.F.R. sections 1.482-1 and 1.482-5.

We believe Handy was referring to sales as opposed to transactions. Whether 98 percent or 99 percent of Microsoft's sales were conducted with third parties is immaterial. The following example should clarify.

We evaluate the arm's-length nature of a grocery store chain's intercompany transactions using the CPM. In this case, 100 percent of the chain's sales are to unrelated parties. From an income statement perspective, the related-party transactions for the chain fall into the categories of both cost of goods sold and operating expenses. To compute an operating profit margin for the chain, cost of goods sold and operating expenses are subtracted from total sales.

Here, the most narrowly defined business activity containing the controlled transactions is the taxpayer taken as a whole. How could one compute an operating profit margin for the chain by simply carving out the related-party transactions? There are no related-party sales, only related-party costs. Every sale the chain makes covers the cost of inputs that are sourced from both related and unrelated parties. The same argument could be made regarding Microsoft because the sales price of every piece of software it sells covers the cost of inputs used to produce that piece of software. Those inputs are sourced from both related and unrelated parties.

Further, the examples in Treas. reg. section 1.482-5(e) guiding the application of the CPM do not support the segmentation of controlled transactions from uncontrolled transactions. In Example 1, which involves a wholesale distributor selling solely to unrelated parties, the tested party's net operating profit is computed using total sales, total costs of goods sold, and total operating expenses — not segmented sales, costs of goods sold, and operating expenses. In Example 2, the same tested party's operating profit is compared with the operating profits of comparables using the operating profit-to-sales ratio (also determined using total sales, total cost of goods sold, and total operating expenses). In Example 5, which illustrates an adjustment to operating assets and operating profit for differences in accounts receivable, both the tested party and the uncontrolled comparables' total operating assets and total operating profit are used to perform the analysis. In Example 6, which involves an adjustment to operating profit to account for differences in accounts payable, the total operating profit of both the tested party and the uncontrolled comparables is increased to reflect interest expense imputed to accounts payable. Those examples do not use, or suggest the need for, the segmentation of transactions in any fashion.

BP

BP's motion in the D.C. Superior Court relied heavily on *Microsoft*, but during the April 2013 hearing, Campbell, BP counsel James McBride, and District counsel Eli Wood all agreed that *Microsoft* should not have binding authority in *BP*:

> Campbell: Oh, you guys didn't mention *Microsoft*. I'm not sure if you think that's . . . because it has . . . no binding authority, correct?
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> McBride: That's correct.
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> Campbell: No binding authority because you think it has no persuasive authority at all?
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> Wood: Yes, your Honor. We believe *Microsoft* as you pointed out is not binding authority here. . . . We would expect the court to make its own determination by looking at the law and applying the facts in this case . . . and make its own individual trial court determination as opposed to relying on decision of an administrative trial court.[5]

Regarding the aggregation of transactions, Campbell and McBride discussed whether the issues in *BP* and *Microsoft* were the same:

> Campbell: Handy's decision as an example of an adjudicator finding that such a methodology on the facts of some case which — Microsoft's case is per se kind of you can't do it this way.
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> McBride: Absolutely.
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> Campbell: And your case — and your facts are — your company's posture is comparable to Microsoft's?
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> McBride: In the words of counsel, it's exactly the same. So the question goes to the methodology. And yes, our facts are comparable.[6]

Campbell's statement that "you can't do it this way" refers to how we performed the computation of the net operating margin for our CPM analysis (as in *Microsoft*) — using total sales, total cost of goods sold, and total operating expenses for the taxpayer, not related-party sales, related-party cost of goods sold, and related-party operating expenses. Campbell then asked whether it comes down to an argument that there was a more narrowly identifiable business activity, saying, "Is that the crux of it?"[7]

District counsel Daniel Rezneck argued that BP's own expert agreed that a more narrow definition of the tested party in *BP* was not possible. BP refines crude oil purchased from both related and unrelated parties to produce every gallon of gasoline that is sold to consumers. Once the gasoline is produced, it is not possible to separate the

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[5] *Supra* note 2, at 6-7.
[6] *Id.* at 17.
[7] *Id.* at 7.

related-party crude oil from the unrelated-party crude oil because it has been commingled with every gallon of gasoline BP produces:

> Rezneck: On this question about aggregation . . . I would like to cite what their own expert conceded on his deposition. And he said — and this is in our Exhibit I, pages 175 and 176. He conceded that all the purchases of crude oil by the petitioner here from whatever source are co-mingled to produce the required products for resale. And likewise he conceded that one hundred percent of all sales [of] finished products are attributable to both controlled and uncontrolled transactions.[8]

Rezneck said there clearly was evidence — even from BP's own expert — to show that aggregation was proper. According to that expert, the most narrowly defined relevant business activity was the taxpayer itself, taken as a whole. Thus, the correct computation of operating profit is equal to total sales minus total cost of goods sold minus total operating expenses.

Campbell twice asked BP counsel how the relevant business activity might be more narrowly defined. On both occasions, BP's counsel could not explain how to come up with a more narrow definition of the tested party other than the taxpayer itself.

Campbell asked Rezneck why he should not rely on Handy's opinion in *Microsoft*:

> Campbell: Would somebody tell me why I should not, you know, learn at the feet of Judge Handy? . . . He seems to be the one guy who — who says doing it this way is wrong.
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> Rezneck: I will be glad to try to do that for your Honor. Because the petitioner here seems to rely almost entirely as far as I can see on the Handy decision in the Office of Administrative Hearing[s]. But *Microsoft* is a different case and a different tribunal and it's full of . . . distinctions [in] areas of both fact and law.
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> Regulation section 5(b)(1) provides [that] to the extent possible profit level indicators [are] to be applied solely to the tested party's financial data, that it is related to controlled transactions. That calls for an individualized inquiry unique to each case. And while the ALJ and Microsoft mentioned that standard, he cited the regulation. He made no effort to apply it.
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> Second point was that he quoted the statement from the regulations, this is 5(c)(3) . . . if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers. It may not be possible to apply the profit level indicator solely [to] the financial data related to the controlled transactions. That standard which we agree is an applicable standard has several factual inquiries and issues built into it. He made no effort to apply that standard. He cited it.
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> But in this case . . . we have purchases of crude oil by petitioners from both controlled and uncontrolled suppliers. They refine it and then they sell refined products to both controlled and uncontrolled purchasers. And the intermingling — the co-mingling is testified to by their own witness as to both ends of it; at the purchase end and the sale end. . . . And it means that aggregation was . . . the only proper method that could be used . . . in view of the co-mingling which is admitted to have taken place.
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> I want to point out . . . some of the flaws both factually and legally in the *Microsoft* opinion. . . . The *Microsoft* opinion mis-cites the key regulations.
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> The opinion also in *Microsoft* repeatedly states that the District experts there who are the same ones as here, applied a profits to costs ratio as the profit level indicator. There are 23 references in the *Microsoft* opinion to the profits to costs ratio. Every one of them is incorrect because the experts here applied a profits to sales ratio and that's different. They did it there, they did it here.
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> With all respect your Honor, the opinion — the ALJ opinion in *Microsoft* is sloppy and it shouldn't be followed here.
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> Campbell: I am having trouble concluding that this is an issue susceptible to summary judgment. I'm having trouble concluding that this is a question of law that can be resolved at this stage of the record.
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> It does not seem to me — it seems to me that the questions you're raising about whether they should have done it this way are quintessentially factual questions that may even turn on questions about what was available during discovery and the interaction between the parties that was part of the discovery. And that it really is going to come down to was this the best method. Was this the right way to do it, the best method. And did they do this method having chosen it assuming it was acceptable, did they do it right.
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> And, you know, with all respect I don't think that the *Microsoft* case, that decision is going to control this decision. I hear what you're saying that at least it's some guidance. And I agree in an area where there isn't any it's something. But sometimes guidance just

[8]*Id.* at 18 and 19.

> helps to illustrate what the issues are rather than what the proper resolution of them is. And I think that's the way it's going to go.[9]

The trial was scheduled for the week of February 10, 2014, but BP and the District settled on January 28, 2014, for $581,600 (the District's initial assessment was $722,585).

During the case, BP argued that an adjustment should be made to our comparables to account for the higher profitability of comparables involved in oil and gas exploration and development. (BP Products North America Inc. does not engage in exploration and development.) We agreed and produced a second report that adjusted the profitability of comparables engaged in oil and gas exploration and development, which reduced the assessment from $722,585 to $581,600. This was documented during the hearing as follows:

> Rezneck: The third point on those challenges that they make to the assessment to the use of comparable companies — with other companies, I would point out that our experts were extremely sensitive to that. And when petitioner raised that issue as to whether the comparables were really comparable, our experts went back and took a lengthy look at that and rendered a whole new second report in which they reduced the assessment to take account of that. And the assessment started I think $722,000 and it ended up at about $580,000. In other words, they made substantial adjustments based on the arguments that were being made.[10]

On April 1 Maria Koklanaris reported that Ted Gest, spokesman for the Office of the Attorney General, said the District had achieved a favorable outcome. "By resolving the tax liability at $581,600, which exactly corresponds to the calculation of the District's experts in the Superior Court, the District achieved the same result as was likely if it successfully defended the methodology underlying its assessment at trial," he said.[11]

Conclusion

We believe that in both *Microsoft* and *BP,* we appropriately applied section 482. In both cases, we used a profits-based (not a transactions-based) pricing method to evaluate the arm's-length nature of the taxpayer's (tested party's) intercompany transactions. Under the profits-based method, there is no regulatory requirement that related-party transactions be separated from unrelated-party transactions. In both *Microsoft* and *BP*, it would have been mathematically impossible to segregate the tested party's controlled transactions from its uncontrolled transactions for purposes of computing a PLI under the CPM. ✰

[9] *Id.* at 35-38 and 41-42.

[10] *Id.* at 20.

[11] Koklanaris, "District to Refund $140,000 in BP Transfer Pricing Case," *State Tax Notes*, Apr. 7, 2014, p. 15.