



Multistate Tax Commission: Arm's Length Adjustment Conference

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Agenda

- 1) Introducing RoyaltyStat® Three-in-One™
- 2) Challenges and solutions to improve State tax compliance related to intercompany transactions
- 3) Opportunities offered by RoyaltyStat to implement transfer pricing rules and controls
- 4) Major strengths: pre-audit, audit, and post-audit analytical tools, and expert advise
- 5) Database offering, transfer pricing training and consulting

Three-in-One™

RoyaltyStat offers three premier online databases to support transfer pricing analysis involving the transfer of tangible goods, the provision of services, and the transfer (sale or license) of intangibles:

- 1) Proprietary license agreements database, including over 17,000 full-text agreements with disclosed royalty rates. Data fields are extracted and standardized.
- 2) Global company financials database licensed from S&P Capital IQ Compustat, including over 46,300 worldwide companies. This database is integrated with user-friendly transfer pricing tools.
- 3) Annual reports database, with over 300,000 current and historical annual reports from publicly traded companies worldwide.

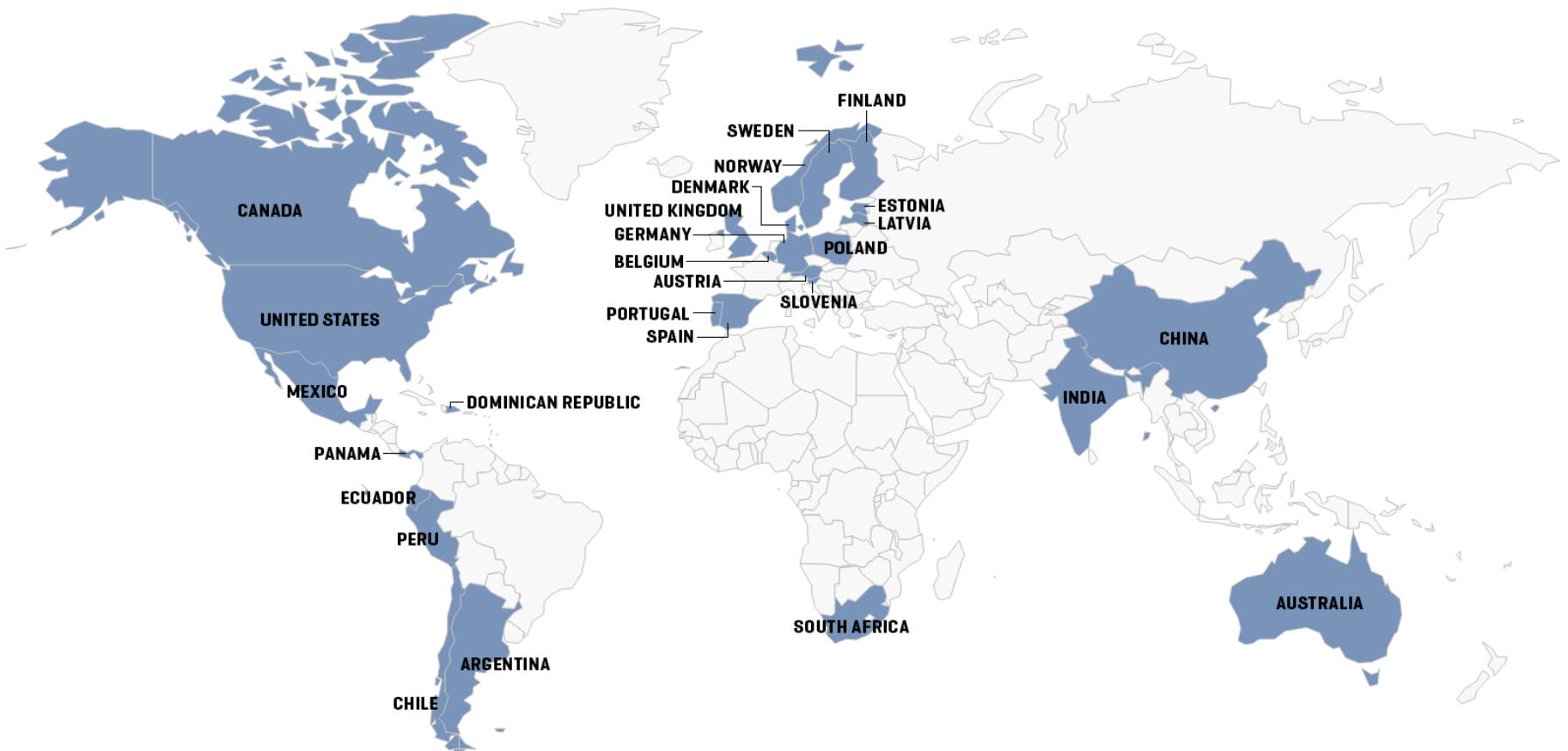
The three databases are updated every business day.

Databases & Consulting

- 1) Customized database: RoyaltyStat has capabilities to develop specialty databases or extract information according to specific requirements.
- 2) Training: RoyaltyStat does online and onsite training and provides technical assistance in designing search strategies and using economic & statistical tools for transfer pricing and intangible valuation.
- 3) Consulting: Participation in all phases of audit cycle, including risk assessment, checking and preparing transfer pricing documentation, and providing litigation support and expert testimony.
- 4) Tax authorities, and accounting, consulting and law firms in the United States and foreign countries use RoyaltyStat.

Tax Authorities Trust RoyaltyStat

Transfer pricing training conducted for several tax authorities worldwide.



Purpose of Transfer Pricing Audit

For tax administrations, transfer pricing audits serve to ensure:

- 1) Tax parity between controlled and uncontrolled taxpayers.
- 2) Taxpayers report “true” (arm’s length) taxable income.
- 3) Prevent tax base erosion and profit shifting.

See BEPS Action Plan: <http://www.oecd.org/ctp/BEPSActionPlan.pdf>.

Challenges to Improve State Tax Compliance

- 1) States adopt disparate approaches to transfer pricing adjustments.
- 2) Disparate paradigms: Arm's length defined in terms of comparable transactions (difficult to enforce), formulary apportionment, and safe harbors (*e.g.*, limit deductions for tax purpose). Which paradigm to adopt?
- 3) States may not have enacted specific transfer pricing statutes, such as the federal Internal Revenue Code ("IRC") § 482 and its regulations.
- 4) Risk of the State tax authority being found "arbitrary, capricious and unreasonable" by DTA or tax courts (*as seen in Microsoft Corp. v. District of Columbia Office of Tax and Revenue.*)

Solutions to Improve State Tax Compliance

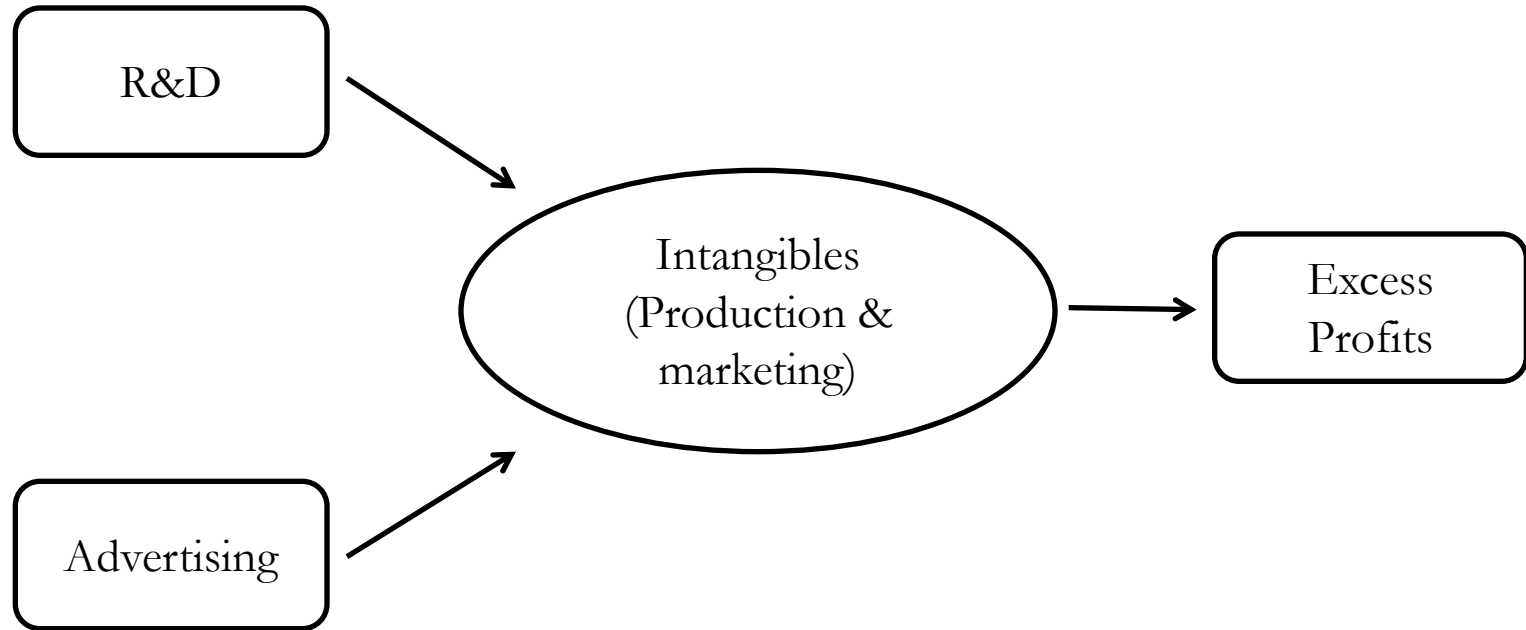
- 1) Establish clear and simple rules for transfer pricing adjustments.
- 2) Common paradigm: Adopt consistent approaches for transfer pricing audit and adjustments. *E.g.*, general use of safe harbors or formulary apportionment.
- 3) Economic substance: Consider business purpose and economic substance of the intercompany transactions, taking into account functions performed (value-added), contractual terms and risks assumed by multistate entities.

Solutions to Improve State Tax Compliance

- 4) Use safe harbors for less complex transactions. This measure would increase simplicity and certainty for both taxpayers and tax administration, and also increase efficiency of audit cycles. *E.g.*, safe harbors have been implemented in the U.S. covering “low-margin services” (Treasury Regulations (“Treas. Reg.”) (§ 1.482-9(b)), and Loans and Advances (§ 1.482-2(a)(2)(iii)(B))); Australia (outbound services with annual cost lower than AUD \$500k); Mexico (*maquiladora* program); Brazil (safe harbors for exports).

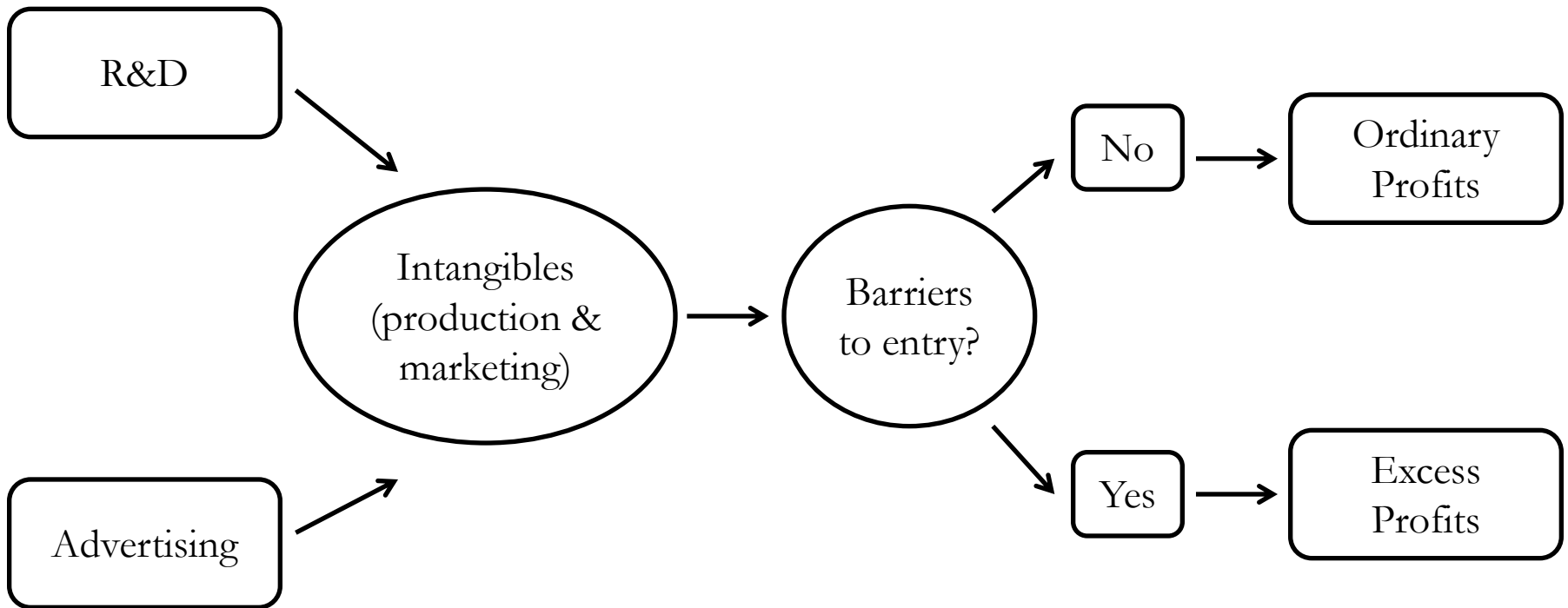
- 5) Avoid profit shifting by realigning the location of profits with the location of economic activities and value-added creation, as aimed by the BEPS project.

Theory 1: Intangibles and Profitability



The link between intangibles and excess profits may not be direct (may be mediated by barriers to entry and market concentration).

Theory 2: Market Structure and Profitability



The link between intangibles and excess profits is mediated by barriers to entry (market concentration).

Databases for Audit Screening

- 1) Company financials and “material contract” (agreement) databases can be used for audit screening and tax adjustments.
- 2) Audit examiners must first check for the existence of Comparable Uncontrolled Prices (CUP) or independent competitors to be used as comparables.
- 3) A key principle for audit screening is that a controlled taxpayer cannot hide in the distribution tails of the Operating Profit Margin (“OPM”), Operating Profit Markup (“Markup”) or royalty rates of uncontrolled taxpayers.

Pre-Audit: Identify Transfer Pricing Violations

Using OPM as an example, audit screening techniques to identify potential transfer pricing violations can be established as follows:

- 1) Calculate the OPM of uncontrolled companies with positive revenue and positive operating profit in the industry of the taxpayer.
- 2) Calculate Tukey's low outlier limit using the formula $Q1 - (1.5 \times IQR)$, where IQR ($Q3 - Q1$) is the interquartile range.
- 3) If an inbound taxpayer has an OPM lower than Tukey's low outlier limit of uncontrolled companies, the taxpayer can be subject to further audit scrutiny depending on the size of the case. This is a simple method of allocating limited audit resources.

Transfer Pricing Adjustments

In addition to audit screening, RoyaltyStat's company financials and agreement databases can be used to support tax adjustments. Taxpayers identified for further audit scrutiny may be subject to the following transfer pricing analysis:

- 1) Potential violations may reflect:
 - a) Mispricing COGS (excess purchases; acquiring obsolete inventory).
 - b) Excess OPEX (management fees, royalties, advertising; mismatch of expenses and revenue).
 - c) Excess interest expenses because the interest rate is mispriced or intercompany loans are excessive (thin-capitalization);
 - d) Net Operating Losses (NOL) carried forward from prior transfer pricing violations may be disallowed.

Transfer Pricing Adjustments

- 2) Find comparables to the taxpayer (tested party) with respect to the property transferred, functions performed (industry), and geographic market (country or region).
- 3) Use the selected comparables to determine an arm's length range of consideration, including OPM, Markup, royalty rates, etc.; or use a specified OPM safe harbor.

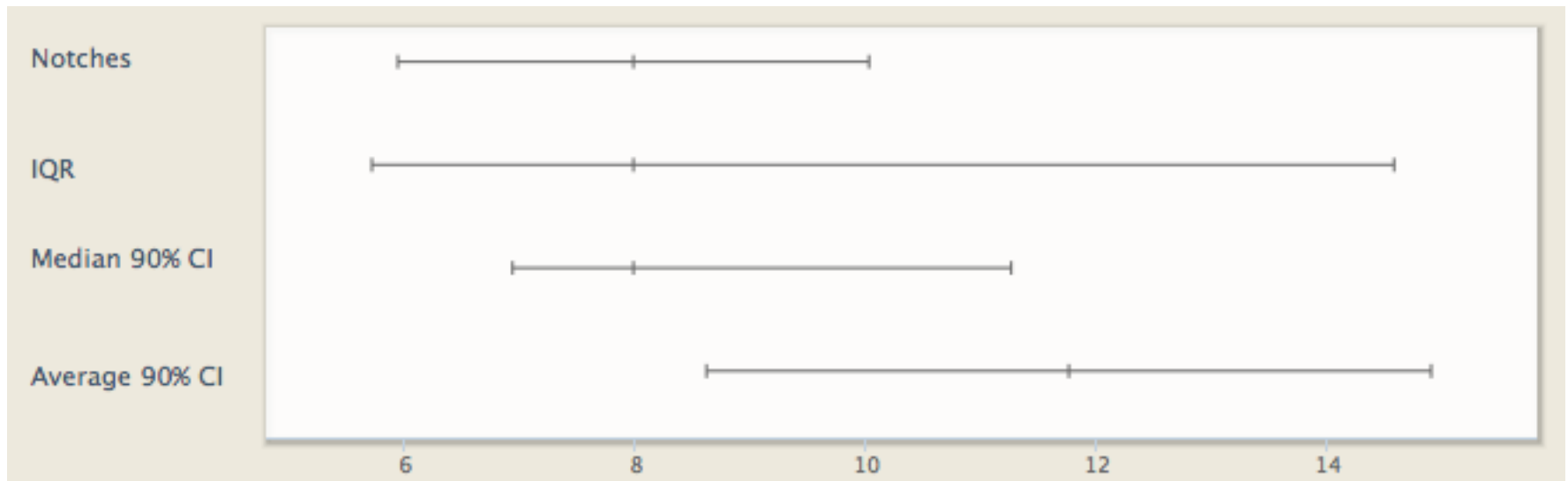
Use of Statistical Intervals in Transfer Pricing

Treas. Regs. § 482 and the OECD *Transfer Pricing Guidelines* (“OECD Guidelines”) state that the IQR provides an acceptable measure of the arm’s length range. However, a different statistical interval may be used if it provides a more reliable measure of the arm’s length range. See Treas. Regs. § 1.485-1(e)(2)(iii)(B) and OECD Guidelines, ¶ 3.57.

The IQR is adopted by several tax authorities disregarding the fact that it is wider than other statistical intervals. As a result, the arm’s length range defined by the IQR may be impractical (wide lasso).

Several Statistical Intervals

RoyaltyStat produces several online statistical intervals from selected comparable companies or agreements. Audit examiners may compare these different statistical intervals to determine the most reliable arm's length range.



Notches are the limits of a range or interval around the median. The width of the notches is proportional to the interquartile range (IQR) of the sample, and inversely proportional to the square root of the sample size (count of observations). The upper and lower limits of the notches are $\text{Median} \pm 1.58 \text{ IQR}/\text{SQRT}(\text{Count})$. See Robert McGill, John Tukey, Wayne Larsen, “Variations of Box Plots,” *The American Statistician*, Vol. 32, No. 1 (Feb., 1978), pp. 12-16. URL: <http://www.jstor.org/stable/2683468>.

Source of Comparables

- 1) Databases to benchmark transfer of tangible goods and services:
 - a) Standard & Poor's Capital IQ Compustat.
 - b) Mergent (*ex* Moody's).

- 2) Databases to benchmark transfer of intangibles and mineral resources:

RoyaltyStat (proprietary database of royalty rates linked to unredacted license agreements, *i.e.*, agreements in which the royalty rate and other forms of license payments, such as upfront fees and sales milestones are disclosed).

Database Usage by the IRS

The source for comparables in the majority of the APAs executed in 2012 and 2013 was Standard & Poor's Compustat database. See U.S. APA Statutory Report on March, 2014 available at <http://www.irs.gov/pub/irs-drop/a-13-17.pdf>; and <http://www.irs.gov/pub/irs-drop/a-14-14.pdf>. Prior APA Statutory Reports provided the database usage per number of APAs completed per year:

| Year | Compustat Global (including North America and Global Vantage) | Compact Disclosure and Worldscope | Mergent (<i>ex</i> Moody's) | Amadeus | Orbis |
|------|--|--|---------------------------------|---------|-------|
| 2011 | 57 | 21 | 15 | 4 | ≤ 3 |
| 2010 | 79 | 28 | 15 | 5 | ≤ 3 |
| 2009 | 64 | 24 | 9 | ≤ 3 | ≤ 3 |
| 2008 | 101 | 40 | 14 | ≤ 3 | |
| 2007 | 101 | 40 | 14 | ≤ 3 | |

Source: <http://www.irs.gov/Businesses/Corporations/Annual-APA-Statutory-Reports>

Potential Comparables

Potential comparable companies in the United States with net sales > 0 and operating profit > 0 in FYE 2013:

| Industry | Count | Q1 | Median | Q3 |
|----------------------------------|-------|------|--------|-------|
| Manufacturer | 1,119 | 5.6% | 10.7% | 18.3% |
| Distributor of Durable Goods | 71 | 2.1% | 4.4% | 7.2% |
| Distributor on Non-Durable Goods | 50 | 1.6% | 3.4% | 5.7% |
| Business Services | 319 | 4.4% | 12.2% | 24% |
| Professional Services | 47 | 6.1% | 8.7% | 17.1% |

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OPM is used for durable and non-durable distributors. Markup is used for manufacturers, business and professional services. Business services include advertising, equipment rental, and computer programming (SIC Code 73). Professional services include engineering, accounting, research and management (SIC Code 87).

Tools to Support Transfer Pricing

RoyaltyStat includes useful tools for tax administrations to screen and audit transfer pricing cases:

- 1) **Audit screening:** RoyaltyStat provides industry statistics (including the IQR) for risk assessment by identifying the distribution of OPM, Markup and royalty rates of uncontrolled taxpayers.
- 2) **Review of taxpayer documentation:** RoyaltyStat provides information to benchmark transactions involving tangible goods (manufacturing and distribution) and business and professional services using financial information from companies worldwide. RoyaltyStat also provides license agreements with disclosed royalty rates to benchmark transactions involving intangible property.

Tools to Support Transfer Pricing

- 3) Determination of arm's length range: RoyaltyStat provides online statistical intervals in addition to the IQR, including Tukey's notches, and confidence intervals for the median and for the average, enabling the selection of the most reliable measure of the arm's length range.
- 4) Tax adjustments: RoyaltyStat/Compustat's company financials database allows the calculation of several adjustments, including for working capital, intangibles and operating assets. The analytical tools also allow online examination of the factors influencing the behavior of profits and royalty rates.
- 5) Preparation of transfer pricing documentation: RoyaltyStat's team of experts has over 20 years of experience and is qualified to perform on site training for tax authorities on matters related to transfer pricing and the valuation of intangibles.

Post-Audit: Expert Testimony

Leading expert, Ednaldo Silva has a Ph.D. in economics from the University of California at Berkeley. He was a drafting member of the U.S. transfer pricing regulations, and was the first economist (technical reviewer) in the APA Program, and the first Senior Economic Advisor at the IRS Office of Chief Counsel (CC: International).

- 1) Settlement negotiation: Experience in negotiating transfer pricing cases with taxpayers in audit defense and Appeals.
- 2) Litigation support: Engaged in several controversy representations, including *WorldCom Inc. et. al.*, regarding a dispute of \$22 billion in intercompany royalty payments and \$6 billion in service fees.
- 3) Expert testimony: Extensive transfer pricing expert testimony experience, including four cases on behalf of the state of New York, one case of behalf of the state of North Carolina, and several cases on behalf of the IRS. This includes expert for the IRS in *GlaxoSmithKline Holdings (Americas), Inc. v. Commissioner of Internal Revenue*.

Please send questions and comments to

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