

ALAS – a taxpayer’s perspective on state transfer pricing

48th Annual MTC Conference

Spokane, WA

Steve Wlodychak

29 July 2015



Building a better
working world

Notice

These slides are for educational and discussion purposes only and are not intended, and should not be relied upon, as accounting advice.

Any US tax advice contained herein was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.

Today's presenters



Steve Wlodychak
Ernst & Young LLP
Center for State Tax Policy
Washington, DC



[Industry representative]

Disclaimer #2

- ▶ I am not a specialist in transfer pricing but I do have a point of view I want to share
- ▶ The views expressed are my own and in no way reflect those of Ernst & Young US LLP or the Ernst & Young global organization.
- ▶ SO ... let's get started with my assessment of a taxpayer's views on the MTC's Arm's Length Adjustment Service

Agenda



Agenda

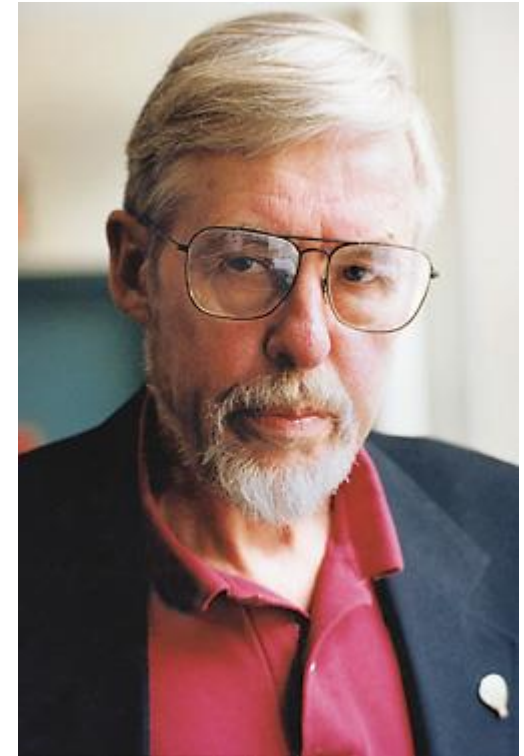
- ▶ Memorable transfer pricing stories from law school
- ▶ A short history of state transfer pricing
- ▶ Focus on transfer pricing across the globe...and the states – What do taxpayers think?
- ▶ Taxpayer suggestions on state approaches to transfer pricing

Memorable transfer pricing stories from law school



Professor James Eustice

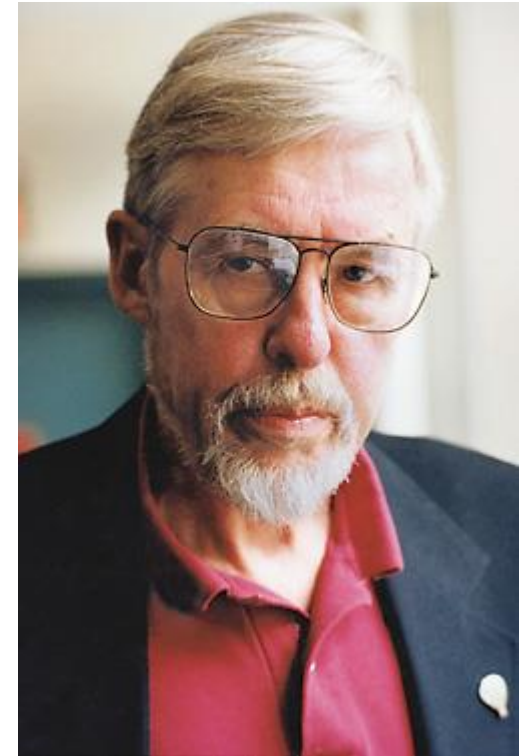
- ▶ NYU Law School Professor (Tax)
1960-2011
- ▶ Co-Author of *Federal Income Taxation of Corporations and Shareholders*
 - ▶ “The Bible” on federal corporate taxation
- ▶ I was a student of his twice
 - ▶ **Corporate Reorganizations**
(First semester, First year of LL.M. Tax)
 - ▶ My first LL.M. Class
 - ▶ Only time in my life I ever got a C+ final grade
 - ▶ **Taxation of Affiliated Corporations**
 - ▶ (Did better - B+)



(1932-2011)

Professor James Eustice

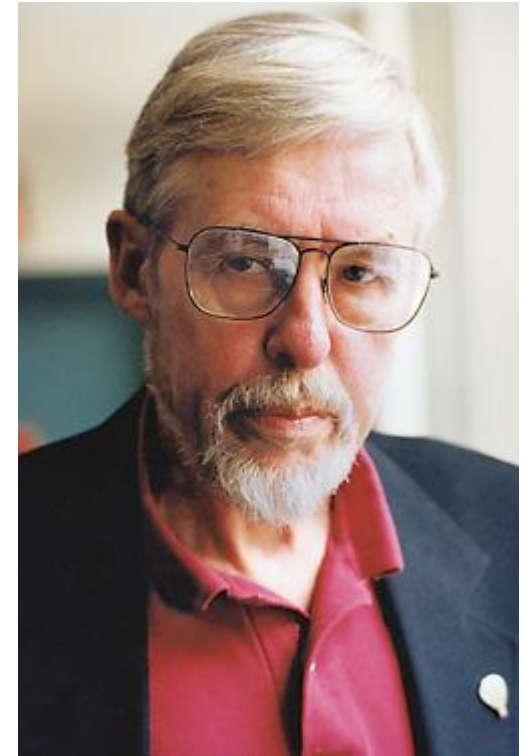
- ▶ Two stories from *Affiliated Corporations*:
 - ▶ *Helvering v. Elkhorn Coal Co.*, 92 F.2d 732 (4th Cir. 1938) *cert. denied*, 305 U.S. 605 (1938)
 - ▶ Transfer pricing and IRC §482
 - ▶ Three nights of classes
 - ▶ Read the handouts, the statute, the regs, the cases ... (no missing pages!!!)
 - ▶ Couldn't figure out what was going on!!!



(1932-2011)

Professor James Eustice

- ▶ Transfer pricing and IRC §482:
 - ▶ Fourth class
 - ▶ Prof. Eustice: “IRC Sec. 482 is not going to be on the exam” (?!?!)
 - ▶ Why?
 - ▶ No matter the question, if you answered with one sentence or twelve pages, your answer would be correct
 - ▶ Transfer pricing is dependent upon all the “facts and circumstances”
 - ▶ Completely subjective
 - ▶ Hire the **best and most experienced expert witnesses** in that industry



(1932-2011)

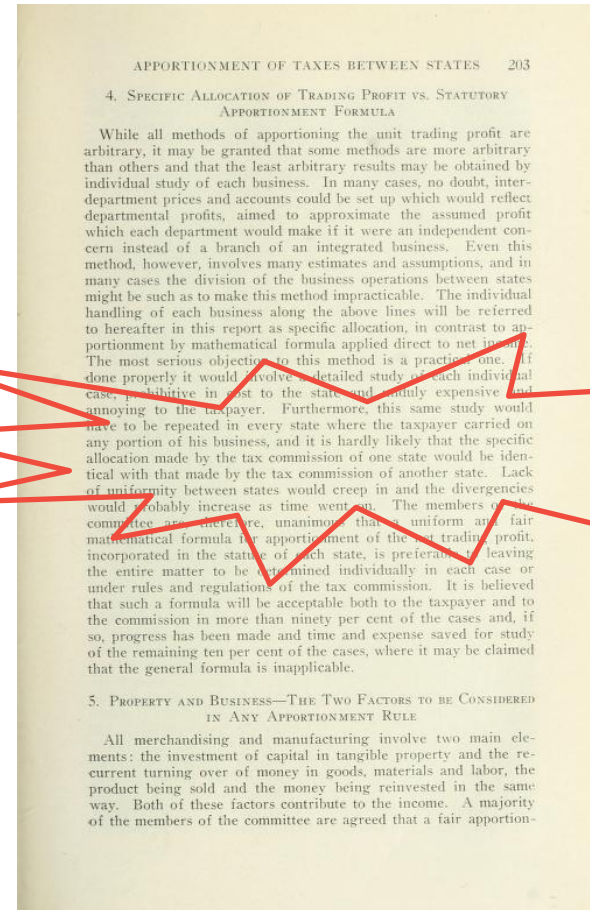
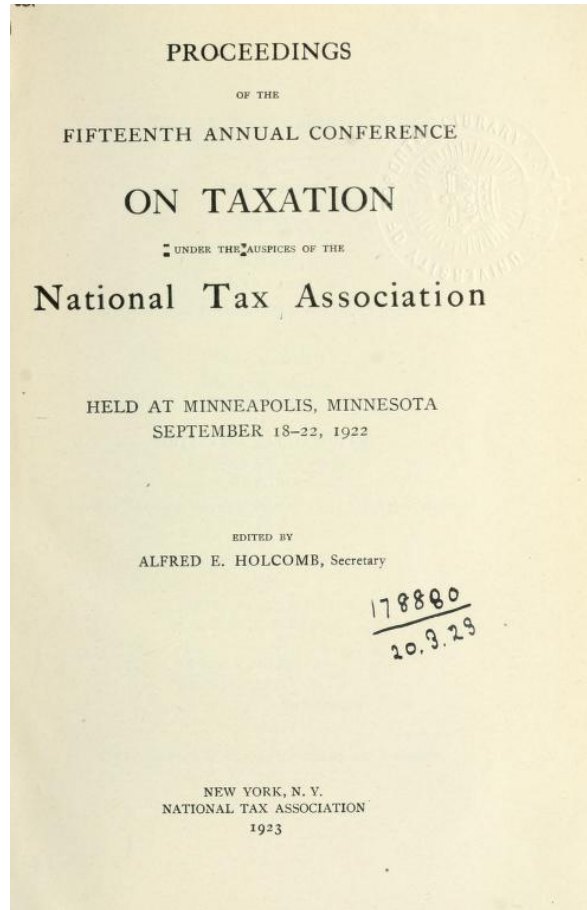
A short history of state transfer pricing



National Tax Association (NTA)

- ▶ Founded 1907
 - ▶ Includes representatives of state tax officials, academics, tax directors of industrial concerns, tax professionals
- ▶ Nine years after first state income tax (Wisconsin – 1911), NTA met in Salt Lake City and appointed the “*Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business*”
 - ▶ “... [Study] the question of apportionment between states of income derived by mercantile and manufacturing business conducted in more than one state”

National Tax Association – 1922 – formulary apportionment v. transfer pricing



Proceedings of the 15th Annual Conference on Taxation of the NTA (available on the Internet at: <https://archive.org/details/proceedingsofann1922natiuoft>)

National Tax Association – 1922 – formulary apportionment v. transfer pricing

- ▶ “While all methods of apportioning the unit trading profit are arbitrary, it may be granted that some methods are more arbitrary than others and that the least arbitrary results may be obtained by individual study of each business.”
- ▶ “In many cases, no doubt, interdepartment prices and accounts could be set up which would reflect departmental profits, aimed to approximate the assumed profit which each department would make if it were an independent concern instead of a branch of an existing business....”

National Tax Association – 1922 – formulary apportionment v. transfer pricing

- ▶ “If done properly it [i.e., specific allocation with transfer pricing] would involve a detailed study of each individual case, ***prohibitive in cost to the state and unduly expensive and annoying to the taxpayer...***”
- ▶ “Furthermore, this same study would have to be repeated in every state where the taxpayer carried on any portion of his business, and it is hardly likely that the specific allocation made by the tax commission of one state would be identical with that made by the tax commission of another state.”

National Tax Association – 1922 – formulary apportionment v. transfer pricing

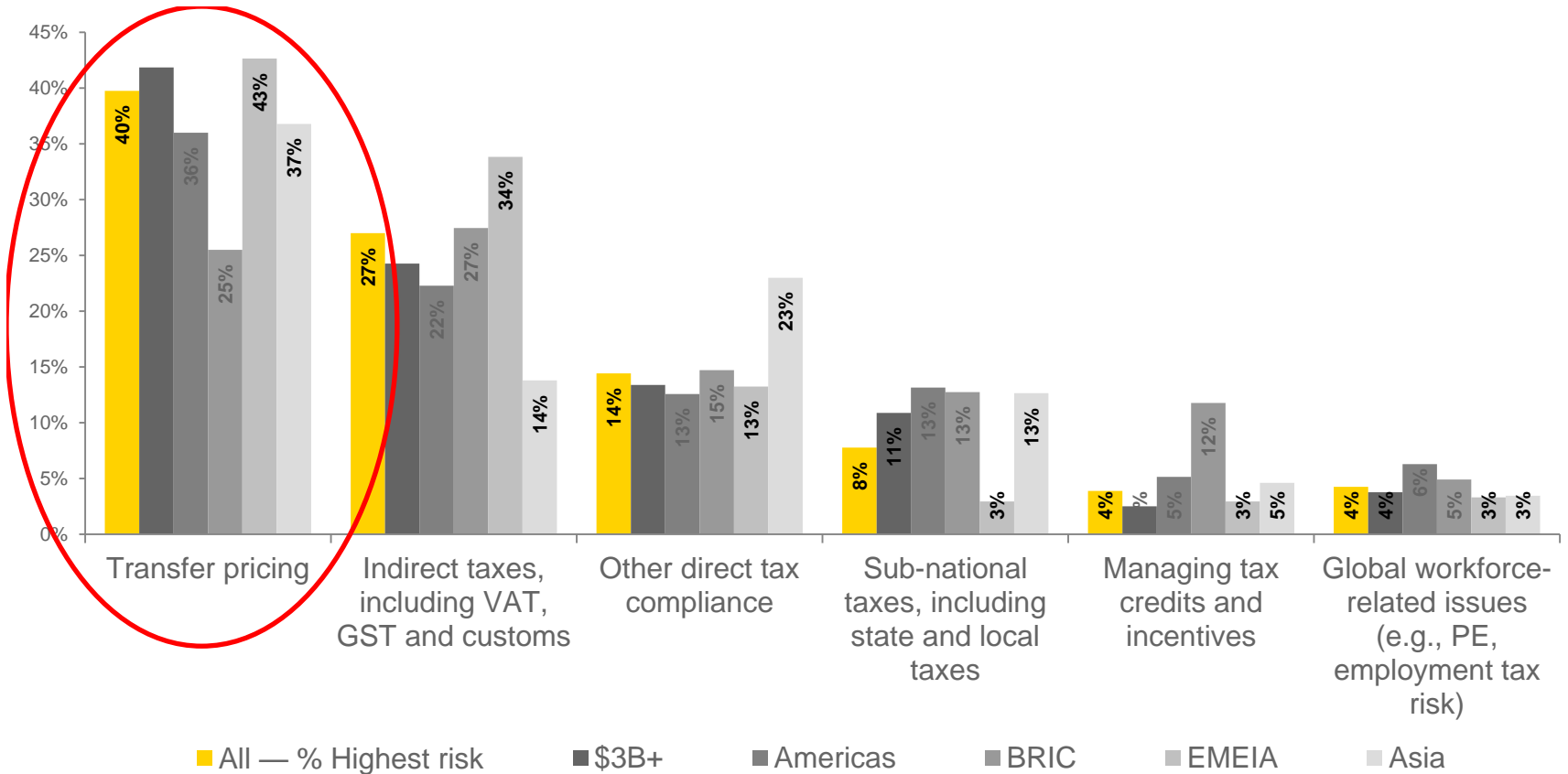
- ▶ “Lack of uniformity between states would creep in and the divergences would probably increase as time went on.”
- ▶ “The members of the committee are therefore, **unanimous** that a uniform and fair mathematical formula of apportionment for net trading profit [i.e., apportionable income], incorporated in the statute of each state, is preferable to leaving the entire matter to be determined individually in each case under rules and regulations of the tax commission.”
- ▶ “It is believed that such a formula will be acceptable both to the taxpayer and to the commission in more than ninety percent of the cases...”

Focus on transfer pricing across the globe...and the states – What do taxpayers think?



Transfer pricing is leading tax risk issue worldwide

Which of the following tax types or issues represents the highest tax risk for you?



Source: EY 2011- 12 Tax Risk and Controversy Survey

Key findings

- ▶ Taxpayers' highest priorities in transfer pricing strategy:

	2012	2010	2007
Tax risk management	66%	50%	50%
Effective tax rate (ETR) optimization	11%	18%	22%
Cash tax optimization	6%	7%	
Alignment with management/operational objectives	14%	20%	18%
Performance measurement	1%	5%	7%
None of these	1%	0%	3%

- ▶ Conclusion:

- ▶ Most taxpayers aren't trying to game the system—they're just trying to get the transfer pricing right for compliance and financial statement reporting purposes (and not get fired!)

Taxpayers are ready

- ▶ Global taxpayers are already doing transfer pricing (and have been for years!)
- ▶ EY (one of Big Four) has 2,500 partners and staff globally working on transfer pricing – it's what we do.
 - ▶ Lawyers, Ph.D. economists, statisticians, market researchers, tax specialists from each country
 - ▶ Other Big Four, global accounting firms, law firms have same capabilities
 - ▶ The IRS has hundreds of individuals managing just transfer pricing matters
- ▶ Are the states really ready for this?

Taxpayers are ready

- ▶ Litigation?

- ▶ District of Columbia ALJ opinions in *Microsoft* and the oil company cases
 - ▶ Offensive non-mutual collateral estoppel
 - ▶ (**Hint:** Taxpayers are not going to go along willingly.)

- ▶ Are the rewards worth the risks?

- ▶ Transfer pricing is a “zero sum game”

- ▶ Winners and losers on every pricing adjustment

Taxpayer suggestions on state approaches to transfer pricing



Taxpayer suggestions on state approaches to transfer pricing

- ▶ First recommendation: Do the states really want to do this?
 - ▶ The states already have the power to challenge the most egregious transfer pricing problems
 - ▶ UDITPA Section 18 – Alternative apportionment
 - ▶ But the burden (appropriately) should be on the state to prove that the taxpayer's presentation of its taxes is incorrect.
 - ▶ Formulary apportionment served state taxation for over 100 years
 - ▶ Alternative to transfer pricing to divide the “tax pie” among the states
 - ▶ Not perfect (and never was) (nor is transfer pricing)

Taxpayer suggestions on state approaches to transfer pricing

- ▶ But ... If we are going to proceed, some suggestions (I hope!):
 - ▶ State and local tax is nothing but international tax, except it's all in English!
 - 1. Let's get rid of the already tired euphemisms!**
 - ▶ ALAS → State transfer pricing (nothing more, nothing less)

Taxpayer suggestions on state approaches to transfer pricing

- ▶ If we are going to do this, some suggestions

2. One global transfer pricing arrangement

- ▶ Let's not fall into the trap identified way back in 1922 by the NTA – 50 states, 50 transfer pricing arrangements
- ▶ Remember: NTA (1922) Costly for the state and “unduly expensive and annoying” to the taxpayer
- ▶ **Advanced pricing agreements (APAs)** – taxpayers (and the state) both require certainty ... APAs provide it
 - ▶ Subject to periodic adjustments by the taxing authority and the taxpayer
- ▶ Develop a “competent authority” concept
 - ▶ Some designated party at EACH state (or the MTC?) can agree to the APA
- ▶ Follow OECD BEPS program on international transfer pricing principles and modifications to IRC §482 (and on the states)
- ▶ **Bottom line:** If the taxpayer has a APA or other transfer pricing settlement with the IRS (or with the MTC), then the states should respect it

Taxpayer suggestions on state approaches to transfer pricing

▶ Suggestions

3. No “black boxes”

- ▶ Computer assisted transfer pricing software is very useful, indeed critical to transfer pricing analysis
- ▶ But, we can't let computer programs substitute for judgment
- ▶ As Professor Eustice made clear, transfer pricing is very subjective and dependent upon all the facts and circumstances

Taxpayer suggestions on state approaches to transfer pricing

▶ Suggestions

4. States must cede tax sovereignty on ALAS

- ▶ *Kimberly-Clark v. Comm.* (Minn. Tax Court June 19, 2015)
 - ▶ Can't have state claim that it did not have authority (either by statute or its constitution) to enter into a transfer pricing arrangement or be bound by the results of an MTC transfer pricing audit.
 - ▶ No "unmistakability doctrine" defense; no state "do overs"
 - ▶ If the transfer pricing goes against the state, it goes against the state – reminder: This is a "zero sum game" – there will be winners and losers
 - ▶ States really, **really, really** have to be bound by the results of a joint transfer pricing determination

Taxpayer suggestions on state approaches to transfer pricing

- ▶ Suggestions

- 5. No contingent fees**

- ▶ Transfer pricing is a normal tax compliance function,

Questions?



EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2015 Ernst & Young LLP.
All Rights Reserved.

1504-1436580
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com