



MULTISTATE TAX COMMISSION

# State Use of IRC Section 482

## Authority: Alternative Approaches to Transfer Pricing Analysis?

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# Section 482 of the IRC:

- 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. In the case of any transfer
- (or license) of intangible property (within the meaning of section
- 936(h)(3)(B)), the income with respect to such transfer or license
- shall be commensurate with the income attributable to the
- intangible.

# State Authority: Separate Statute or Inherent in Reference to IRC?

- **14 states have separate 482-like authority;**
- *See* Ala. Code § 40-2A-17; Ark. Code Ann. § 26-51-805; Conn. Gen. Stat. § 12-226a; Del. Code Ann. tit. 30, § 6403; Fla. Stat. § 220.44; Ga. Code Ann. § 48-7-58; Ind. Code § 6-3-2-2(m); Iowa Code § 422.33; La. Rev. Stat. Ann. § 47:95; Md. Code Ann., Tax-Gen. § 10-109; Montana Stat. Ann. § 15-31-505; N.J. Stat. Ann. § 54:1A-10; N.C. Gen. Stat. Ann. § 105-130.6; Tenn. Code Ann. § 67-4-2014; and Va. Code Ann. § 58.1-421.
- Some states incorporate 482 as the standard for Mandatory Combined filing: *See, e.g.,* Arizona: A.R.S. §43-942
- or “Forced” Combined Filing: *See* N.C. Sec. GSNC 105-130.6;

# Is 482 Authority Inherent?

- States Have Authority to Separately Compute Federal Taxable Income. *See, e.g., Holt v. New Mexico T.R.D.*, 59 P.3d 491 (N.M. 2002). Use of 482 authority should be similar...But see:
- *Comptroller of the Treasury v. Gannett Co, Inc.*, 741 A.2d 1130 (Md. 1999): State did not have separate 482 authority since state adjustments were “discretionary” in nature.

# *Gannett v. Comptroller, cont.*

- Distinction between “discretionary” and “mandatory” adjustments: not supported by precedent... .
- Use of “presumption against tax imposition” should not be a rule of reason, not decision.
- Adjustment wasn’t “discretionary” and shouldn’t have needed IRC 482: conversion of federal consolidated income to separate-entity income is a state tax issue, not a federal one. Nothing “discretionary” about reversing inter-company eliminations for separate-reporting purposes.

*Microsoft Corp. v. Office of Tax and Revenue for  
the District of Columbia,*

No. 2010-OTR-00012 (5/1/12)

- Used “comparable profits” methodology applied to entire Microsoft industry even though not all components did business in the district.
- State attempted to argue that “transactions” subject to comparison were all transactions reflected on Line 28 of the federal 1120 return;
- Hearing Officer ruled that failure to separate controlled from uncontrolled transactions rendered analysis “arbitrary, capricious and unreasonable.”

# Microsoft, Cont.

- District authorities felt constrained to use federal treasury regulations incorporating arms-length pricing and procedures.
- Hearing Officer could have allowed District to short-circuit other methodologies in favor of comparable profits approach;
- Had case been argued on traditional 482 grounds, D.C. might have lost battle of transfer pricing reports.
- *Was There a Better Way to Use District's Authority to Adjust Income and Expenses to Clearly Reflect Income?*

## *Lost in Translation:*

# Section 351 Transfers and Their Effect on Separate-Entity Profits

- Section 351 allows for non-recognition transfers of property between domestic entities in exchange for controlling stock of recipient—
- furthers federal tax policy of more efficient use of capital.
- Both donor and recipient subject to federal tax, and will likely be filing federal consolidated return;
- By contrast, transfers of intangible assets to foreign subsidiaries triggers gain recognition under IRC 367: deemed fixed periodic income.
  - Also, IRC 482 was amended in 1986 to clarify that 482 adjustments for intangible transfers are appropriate.



# Lost in Translation: IRC 351 and State Tax Jurisdiction

- Section 351 allows a taxpayer to transfer property (minus current and historic expenses) outside the state's jurisdiction; income is returned as non-taxed domestic dividends under IRC 243, loaned back or simply held in parent/holding company indefinitely.
- Unintended consequence of reliance on federal tax system intended for nationwide jurisdiction, by states with limited jurisdiction;
- Effects on Profitability are Dramatic: Income to Expense Ratios of 500% or more: Geoffrey; VFJ Ventures; K-mart Properties...
- Distortion potential especially acute in financial services industry.

# State Responses to Section 351 Transfers (whether they knew it or not)

- *Add-Back Statutes* need safe harbors and often miss the point: establishing “fair market value” for lease-back of previously-donated property is irrelevant.
- *Nexus assertions* over recipient is hit-or-miss. See *Scioto Insurance Co. v. Oklahoma Tax Commission*, 279 P.3d 782 (Ok. 2012);
- *Sham Transaction* theory is also hit or miss: *Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E.2d 504 (Mass. 2002).

# *In re Inter-Audi Bank F/K/A Bank Audi (USA)*

State of New York Tax Appeals Tribunal Decision

DTA No. 821659 (4/14/11).

- Applied New York's forced combination statute to require combination of bank and Delaware holding company-
- Recognized the effects of IRC 351 transfer of investment assets without associated borrowing expenses; held arm's-length nature of transaction (assets for stock) irrelevant to distortion question;
- Holding co. expenses: 1% of profits;
- Bank's expenses: 96% of profits after transfer.

# IRC 482 is An Accepted Response to Distortion Created by Sec. 351 Transfers

- **IRC Regulations Allow Use of Sec. 482 to reverse effects of 351 transfers: CFR 1-482-1(f):**
- “(iii) Non-recognition provisions may not bar allocation--(A) In general. If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for non-recognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).”
- IRS FSA 200125007, 2001 WL 702228 (IRS FSA) (Jasper Cummings, IRS Counsel)
- Federal court consideration of IRC 482 to correct distortion caused by IRC 351 transfers has been mixed: most courts have upheld use of IRC 482, but some courts suggest that Congress intended distortion, e.g., transfers of intangibles to IRC 936 corporations. *See, e.g., Foster v. Commissioner*, 80 T.C. 34 (1983), aff'd in pertinent part, 756 F.2d 1430 (9th Cir. 1985), cert. denied, 474 U.S. 1053 (1986);
- Helping the Delaware economy is likely not an intended legislative purpose (outside of Delaware).

# Are the States Bound by IRC 482 Transfer Pricing Regulations, And if Not, What Guidelines Should the States Use?

- States relying on incorporation of IRC Sec. 482 as part of state tax base determination are more likely to be held bound to use IRS arms-length accounting regulations—*in the absence of a state regulation*;
- States with separate 482 statutes should have a strong argument that they can use state tax principles and ignore transfer pricing procedures and standards—*but having a state regulation might be better tax policy*;
- Should states rely on federal transfer pricing enforcement in international arena?
- What if the state does not include Subpart f income in the tax base or water's edge return? Can the state apply Sec. 482 to reach shifted income?

# Potential Guidelines for State Use of IRC 482 Authority:

- Income and expenses (represented by apportionment factors) should be reflected on same return;
- Gross imbalance of profits and expenses?
- Rebuttable presumption, switching burden to taxpayer?
- Direct resort to comparable profits or split profit methodology?
- Prior use of IRC 351 to transfer real estate (captive REITs) or intangibles to low-tax jurisdiction?
- Is combined reporting an allowable means of implementing implicit or explicit 482 authority?