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Yours, mine, and ours

Intercompany transactions and transfer pricing

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Agenda

1. Authority to adjust income
2. Common remedies to adjust income
3. Intercompany transactions and unitary apportionment
4. Documenting intercompany relationships

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Authority to adjust income

IRC Section 482



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. [Emphasis added.]

State-level authority to adjust income

- State tax laws may grant similar discretionary authority to state tax administrators via:
 - State laws/rules adopting IRC Section 482
 - State laws/rules adopting the “arm’s-length” principle
 - State-specific anti-abuse provisions

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Common remedies to adjust income

Common remedies to adjust income

- State-level remedies available via state discretionary authority include:
 - Challenges to business purpose or economic substance
 - Transfer pricing adjustments
 - “Forced” combination of legal entities
 - Alternative apportionment
 - Addback of deductions for related-party expenses
 - Disallowance of credits and net operating loss (NOL) deductions

Related-party expense addback rules

Commonly apply to:

- Interest
- Royalties
- Other intangibles
- Management fees

Exceptions often include:

- Principle purpose is *not* tax avoidance
- “Conduit” rule – corresponding income is paid to third party
- Unreasonable result
- Corresponding income is subject to tax
 - What does it mean to be “subject to tax”? Consider:
 - Deductions, exclusions and exemptions
 - US-international tax treaties
 - 0% tax rate

Transfer pricing controversies

State taxing authority requests for contemporaneous documentation:

- IRC Section 482 compliance
- Documentation of business purpose
- Timeliness, especially updated profit-level indicators
- Geographically-relevant comparables (CPM)

Examples of proposed adjustments:

- Adjustment to selection or application of relevant method
- Exclusion of loss companies from comparables (CPM)
- Reference to consolidated financial statement profit

Settlement positions:

- Interquartile range

Transfer pricing agreements

Recent formal programs

- (2022) New Jersey
- (2021) Louisiana
- (2020) North Carolina
- (2019) Indiana

Notable features

- State advance pricing agreement (APA) and similar administrative programs are unilateral
- Resolution of future periods under an APA is contingent on the taxpayer's facts, as well as changes to those facts
- State tax administrators may choose to negotiate an APA, even where there is no formal (public) program

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Intercompany transactions and
unitary apportionment

Transfer pricing v. unitary apportionment

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Taxation by apportionment and taxation by allocation to a single situs are theoretically incommensurate.

Mobil Oil Corp. v. Commissioner of Taxes,
445 U.S. 425, 444 (1980)

Addressing intercompany transactions through apportionment

- Use of alternative apportionment to effect a transfer pricing adjustment:
 - May be limited by statute
 - E.g., Indiana: State taxing authority is permitted under alternative apportionment statute “to use only methods that divide the tax base, not methods that recalculate the tax base.” (*Columbia Sportswear USA Corporation v. Indiana Dept. of State Revenue*, 2015 WL 9263882 (Ind. Tax Ct. 2015))
- Use of apportionment to tax related-party income earned and/or sourced out of state:
 - Approach generally respects deduction for in-state entity and amount of income for out-of-state entity, but seeks to apportion out-of-state entity’s income to the state
 - E.g., Florida: Taxpayer properly used statutory sourcing method for related-party services revenue; Department of Revenue could not require alternative apportionment methodology, which sourced taxpayer’s income on the basis of its affiliate’s in-state use of the services (*Target Enterprise, Inc. v. Dept. of Revenue*, No. 2021-CA-002158 (Fla. 2d Cir. Ct. 2022))

Addressing intercompany transactions through apportionment

- Recharacterization of related-party income otherwise sourced outside the state, resulting in apportionment to apportion to the state:
 - E.g., North Carolina: Private letter ruling advises taxpayer performing contract manufacturing services for parent company that service fee income from parent must be sourced “in the same manner as its related customer – as the sale of tangible personal property.” (North Carolina Dept. of Revenue, PLR 2023-02 (June 20, 2023))

Forced combination

- Many states have required a group of affiliated taxpayers to file as a combined group, rather than on a separate entity basis.
 - The taxing authority generally has burden of proving that a separate entity return does not clearly reflect income in the state.
 - Often is defined as the water's-edge unitary affiliated group. Variations can include:
 - Nexus-only entities
 - Worldwide unitary affiliates
 - Discretionary combination may not be subject to statutes or regulations defining the tax base and apportionment, e.g.:
 - Treatment of intercompany transactions (including federal consolidated return rule conformity)
 - *Joyce versus Finnigan* method

Forced combination

- Interaction of forced combination with other remedies:
 - Indiana:
 - State taxing authority may require combined reporting only after first determining that other alternative apportionment methodologies would result in an equitable apportionment of the taxpayer's income. Ind. Code § 6-3-2-2(p); *AE Outfitters Retail Co. v. Indiana Dept. of State Revenue*, 2011 WL 5059896 (Ind. Tax Ct. 2011).
 - South Carolina:
 - “And, if there was a way to fix the significant artificial dilution of ... business activity in South Carolina through fixing the transfer price and utilizing separate reporting, then I would rule in that direction.” *Tractor Supply Company v. South Carolina Dept. of Revenue*, Docket No. 19-ALJ-17-0416-CC (Aug. 8, 2023).
 - Virginia:
 - Legislative study (pursuant to 2021 HJR 563) on mandatory combined reporting concluded that “Virginia's existing add-back statute was sufficient and that no further action should be taken at this time.”

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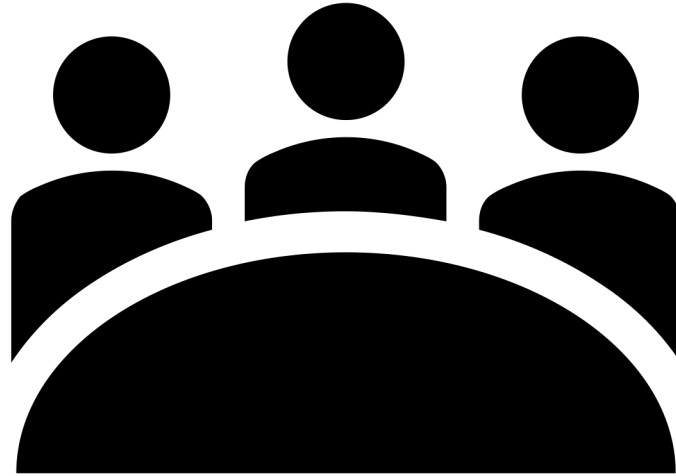
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Documenting intercompany
relationships

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Transfer pricing documentation



Panel discussion

Intercompany account characterization

- The tax characterization of intercompany accounts (whether interest-bearing or not) can be ambiguous, and purported debt may be respected as debt for tax purposes or may be recharacterized as equity under IRC Section 385 and related Treasury regulations.
- Debt versus equity characterization may create significant tax uncertainties and costs – each resulting in its own tax issues, including:
 - Uncertainty with respect to state separate return interest deductions
 - Imputed interest on non-interest-bearing accounts
 - Creation of other potential federal and state income tax issues
 - Violation of debt covenants
 - “Springing” partnerships
 - Insolvent entities
 - Deemed distributions

Intercompany account settlement

- Important considerations for intercompany account settlement:
 - Establishment of accounting policies regarding settlement
 - Procedures
 - Timing and frequency
 - Technology and automation
 - Understanding tax impact of settlement
 - Consolidation and elimination, where applicable
 - Treatment of any distributions (incl. dividend income)
 - Changes to balance sheet and franchise tax base
 - Reflection in transfer pricing documentation

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Thank you for participating.