2015 COST INCOME TAX CONFERENCE
Memphis, Tennessee

The MTC ALAS Project and the Growing Interest in Transfer Pricing at the State and Local Level

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Learning Objectives

What is the MTC ALAS Project?

Which States Are Involved?

Why Are States Interested in Transfer Pricing?

Why Is This Project Important?

What is the Latest On the DC Transfer Pricing Cases?

What is the Importance of Transfer Pricing?

What Impact Might the BEPS TP-Related Items Have on State Transfer Pricing?

MTC ARM'S LENGTH ADJUSTMENT SERVICE ("ALAS") PROJECT

- **May 2013—Genesis of Project**
  - MTC Executive Committee Meeting
  - Michael Bryan NJ Director of Taxation
- **June 2014—ALAS Advisory Group Initial Meeting**
  - Dan Bucks, Former MTC Executive Director and Director of Montana Department of Revenue is Project Facilitator

MTC ALAS PROJECT

- **Series of Meetings of Advisory Group and Various Iterations of Advisory Group's Recommend Approach**
- **October 2014—Meeting with Third Party Transfer Pricing Experts**
    - RFP Issued for Training Proposal
- **February 2015—Solicitation Letters Sent by Joe Huddleston to 45 States and DC**
    - 4 Year Commitment

MTC ALAS PROJECT

- **March 31-April 1, 2015—Training Conducted for 10 States by Third Party Contractor**
  - Ednaldo Silva, Former Senior Economic Advisor with Office of IRS Chief Counsel and Part of Team Which Drafted the IRC 482 Regulations
  - Attendees Included Alabama, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, New Jersey, North Carolina and Pennsylvania

MTC ALAS PROJECT

- **May 2015—MTC Will Seek Approval From Its Executive Committee to Move Forward**
  - 7 States Need To Commit
  - 4 Year Charter Period (July 2015-June 2019)

HIGHLIGHTS OF ALAS PROJECT

- **Provide Interrelated Service Elements**
  - Training
    - Analysis of Transfer Pricing Studies
  - State Capacity Building
    - Beyond Formal Training
    - Exchange of Information Among States
  - Individual Audits by MTC
  - Optional Joint Audits

HIGHLIGHTS OF ALAS PROJECT

- **Staffing of Project**
  - Over the Charter Period, it is Projected that ALAS Will Hire Three Economists, an Attorney, a Tax Manager and a Pricing Auditor
  - ALAS Will Also Use Third Party Consultants
- **Budget**
  - FY 2016--$1.25MM
  - FY 2017--$2.25MM
  - FY 2018--$2.213MM
  - FY 2019--$1.954MM

HIGHLIGHTS OF ALAS PROJECT

- **Costs to States to Participate**
  - 4 Year Commitment
    - Possible exceptions
  - Will Vary by State
    - How State Uses the Program
    - Number of Participant States
    - Size of State in Terms of Corporate Tax Revenue
  - Approximately $200,000 Per Year Per State
- **Estimated Revenues**
  - $110MM Over the 4 Year Charter Period

HIGHLIGHTS OF ALAS PROJECT

- **Timeline**
  - FY 2016 (July 2015-June 2016)
    - Launch
    - Developmental Stage
  - FY 2017 (July 2016-June 2017)
    - Developmental Stage
  - FY 2018 (July 2017-June 2018)
    - Fully Operational
  - FY 2019 (July 2018-June 2019)
    - Fully Operational

WHICH STATES ARE INVOLVED?

- **Principally Separate Filing States**
  - Alabama, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, New Jersey, North Carolina, Pennsylvania
- **Some Combined Reporting States**
  - District of Columbia, Hawaii
- **April 7, 2015—4 States Have Expressed an Interest in Committing**
  - Alabama, Iowa, New Jersey and North Carolina
  - 21 States Have Thus Far Responded to Huddleston's Letter

WHY STATES ARE INTERESTED IN TRANSFER PRICING

- **ALAS Advisory Group Preliminary Design**
  - “Why States Need to Act”
  - States Face Major Fiscal Problems Due to Businesses Shifting Income to More Favorable Jurisdictions
  - Significant Lost Revenues Per U.S. PIRG/Citizens For Tax Justice
    - Federal Estimate--$100B
    - State Estimate--$20B

MTC'S PERSPECTIVE ON WHY STATES NEED TO ACT

- **Uneven Playing Field for Industry**
- **Unfair Shifts of Public Service Costs to Other Taxpayers**
- **Loss of Societal Trust**

MTC'S PERSPECTIVE ON WHY STATES NEED TO ACT

- **States Are Ill-Equipped to Differentiate Between Proper and Improper Income Shifting**

- **Cost is Prohibitive for States to Deal With These Issues Individually**
  - Pool Their Resources

MTC'S PERSPECTIVE ON WHY STATES NEED TO ACT

- **Typical Transactions Identified**
  - Transfers/Licensing of IP
  - Purchase and Resale of Tangible Goods
  - Providing and Charging for Common Services
  - Stripping Earnings Out of States Through Financing Arrangements
  - Factoring Accounts Receivables
  - Utilizing "Embedded Royalties"—Including Charge for Use of Intangibles in Payment for Goods/Services

WHY COMPANIES ARE CLOSELY WATCHING THE ALAS PROJECT

- **Transfer Pricing Issues Arise With Respect to In-Bound and Out-Bound Transactions Between Related Parties**
- **Transfer Pricing Issues Arise With Respect to Interstate and Foreign Transactions Between Related Parties**
- **Transfer Pricing Issues Not Limited to Separate Filing States**
  - In Combined Reporting States, Related Party Transactions Between Entities in Combined Report and Those Outside the Combined Report Are Examined
    - E.g., Water's Edge Combined Reports
    - California Devotes Over 200 Pages of its Water's Edge Manual to Transfer Pricing Issues

LATEST ON DC TRANSFER PRICING LITIGATION

- **OTR Uses Chainbridge in its Transfer Pricing Audits**
  - Contingent Fee
  - Alabama, Louisiana and New Jersey
- ***Microsoft* (2012)**
  - OAH Held That Chainbridge’s Transfer Pricing Analysis was Arbitrary, Capricious and Unreasonable
  - Summary Judgment Granted for Taxpayer
  - Appeal by OTR Withdrawn
- ***BP* (2013)**
  - Superior Court Held That Validity of Chainbridge’s Method Involved Questions of Law and Fact
  - Denied Taxpayer’s SJ motion
  - Case Settled

LATEST ON DC TRANSFER PRICING LITIGATION

- ***Exxon, Shell and Hess* (2014)**
  - OAH Held That OTR Barred by Collateral Estoppel from Relitigating Chainbridge Method Issue Due to *Microsoft* Case
  - On Appeal
- ***Ahold, AT&T Services, Eli Lilly and ExxonMobil* (2015)**
  - Litigations Stayed Pending Collateral Estoppel Appeal

TRANSFER PRICING IN THE INTERNATIONAL CONTEXT

- "Transfer pricing" means the prices at which related parties within a multinational enterprise ("MNE") transfer goods, services and intangible property among one another
- Transfer pricing impacts the income tax liabilities of the affiliates within the MNE, and thus, the after-tax profitability of the entire enterprise

TRANSFER PRICING BASICS: CONCEPTS

- Control – Treas. Reg. § 1.482-1(i)(4) definition; presumption of control with arbitrary income shifting; *B. Forman*
- Arm's length standard – cornerstone concept
- Best method rule – no hierarchy of methods
- Comparability – functions, risks, assets, contractual terms, economic & financial conditions
- Arm's length range – from comparables; interquartile range for increased reliability of results

TRANSFER PRICING BASICS: METHODS

<table>
<tr><th colspan="2">Tangible property</th><th colspan="2">Intangible property</th><th colspan="2">Services</th></tr>
<tr><td colspan="2">CUP
(Comparable Uncontrolled Price Method)</td><td colspan="2">CUT
(Comparable Uncontrolled Transaction Method)</td><td colspan="2">CUSP
(Comparable Uncontrolled Services Price Method)</td></tr>
<tr><td colspan="2">RPM
(Resale Price Method)</td><td colspan="2">–</td><td colspan="2">GSM
(Gross Services Margin Method)</td></tr>
<tr><td colspan="2">Cost Plus
(Cost Plus Method)</td><td colspan="2">–</td><td colspan="2">CSPM
(Cost of Services Plus Method)</td></tr>
<tr><td colspan="2">CPM
(Comparable Profits Method)
(cf. to TNMM in OECD Guidelines)
(Transactional Net Margin Method)</td><td colspan="2">CPM / TNMM
(Commensurate with income rules)</td><td colspan="2">CPM</td></tr>
<tr><td colspan="2">PSM
(Profit Split Method)</td><td colspan="2">PSM</td><td colspan="2">PSM</td></tr>
<tr><td>CPS
(Comparable Profit Split Method)</td><td>RPS
(Residual Profit Split Method)</td><td>CPS</td><td>RPS</td><td>CPS</td><td>RPS</td></tr>
<tr><td colspan="2">Unspecified Methods</td><td colspan="2">Unspecified Methods</td><td colspan="2">-</td></tr>
<tr><td colspan="2"></td><td colspan="2">Income method –(coordination with 482-7T)</td><td colspan="2">SCM
(Services Cost Method)
–</td></tr>
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WHY IS TRANSFER PRICING IMPORTANT?

Transfer pricing planning opportunity			
	Parent (Country A)	**Sub (Country B)**	**Consolidated**
Total profit reported on tax return	700	300	1,000
Tax rate	40%	10%	
Tax liability before change to transfer price	280	30	310
Global Effective Tax Rate (“ETR”)			31%
Effect of Transfer pricing change on ETR			
Total profit after using transfer pricing to shift 400 of income	300	700	1,000
Tax rate	40%	10%	
Tax liability after change to transfer price	120	70	190
Global ETR			19%

WHY IS TRANSFER PRICING IMPORTANT?

Exposure to double taxation			
	Parent (Country A)	Sub (Country B)	Consolidated
Total profit reported on tax return	300	700	1,000
Tax rate	40%	10%	
Tax liability before Country B transfer pricing adjustment	120	70	190
Global Effective Tax Rate ("ETR")			19%
Double taxation effect on ETR			
Total profit after adjustment (increase in profits) by Country A of 400 (assumes no correlative relief in B)	700	700	1,400
Tax rate	40%	10%	
Tax liability after Country A transfer pricing adjustment (penalties and interest not included)	280	70	350
Global ETR			35%

WHY IS TRANSFER PRICING IMPORTANT?

- **Governmental interest**
  - The related party aspect of the transactions suspends the normal laws of supply and demand
  - Without IRC § 482 and similar statues in other countries, related parties could artificially shift income to achieve tax benefits
  - Tax rate differential – IRS perspective
  - Intense focus on transfer pricing enforcement

WHY IS TRANSFER PRICING IMPORTANT?

- **Three core strategies:**
  - Better case selection, development and presentation
    - o "Take back the audit process"
    - o Focus more on issues, less on taxpayers - IPNs
    - o TPP audit road map
    - o Information Document Request (IDR) directives
  - Revise technical rules to support rational economic outcomes
    - o Section 367(d) regulatory project
    - o OECD projects (e.g., Chapter 6 revisions, Base Erosion and Profit Shifting (BEPS) project)
    - o US international tax reform
  - Win in litigation to rebalance perceived hazards

OECD BEPS ACTION PLAN – TP-RELATED TOPICS

Action Item 8: Transfer pricing for intangibles – *September 2014/September 2015*

Action Item 9: Transfer pricing for risks and capital – *September 2015*

Action Item 10: Transfer pricing for other high-risk transactions – *September 2015*

Action Item 13: Transfer pricing documentation – *September 2014*

Action Item 14*:* Effectiveness of treaty dispute resolution mechanisms – *September 2015*

BEPS ACTION ITEM 8 – TRANSFER PRICING FOR INTANGIBLES

- The recommendations under Action 8 contain revised standards for transfer pricing of intangibles, including additional standards for comparability and transfer pricing methods
- The recommendations include amendments to Chapter 1 of the OECD Transfer Pricing Guidelines to address the treatment of location savings and other market features, assembled workforce, and MNC group synergies
- The main element of the recommendations is a revised Chapter VI on intangibles, which includes guidance on:
    - The definition of intangibles
    - Identifying and characterizing controlled transactions involving intangibles
    - Determining arm’s length conditions for transactions involving intangibles
- The recommendations also include guidance on determining ownership of intangibles and entitlement to an intangible related return, which is not yet agreed and which will be finalized in connection with the 2015 work on Action 9 on transfer pricing for risk (“special measures”)

BEPS ACTION ITEMS 9 and 10 – TRANSFER PRICING FOR RISKS AND CAPITAL AND OTHER HIGH-RISK TRANSACTIONS

- TP guidance for low value-adding services to provide protection against common types of base eroding payments (management fees and head office expenses)
- Carryover work from Action Item 8: adopting TP rules/special measures to clarify situations wherein transactions can be recharacterized (Draft issued 12/2014)
- Developing rules on use of profit splits in the context of global value chains
- Adopting TP rules with respect to cross-border commodity transactions
- The OECD has received extensive comments on these documents and a public consultation is scheduled for 19-20 March 2015

BEPS ACTION ITEM 13 – TP DOCUMENTATION AND COUNTRY BY COUNTRY REPORTING

- The recommendations under Action 13 contain revised standards for transfer pricing documentation and a template for country-by-country ("CbC") reporting to be included in the OECD Transfer Pricing Guidelines
- The CbC reporting template will require MNCs to report the following items annually for each country where they have an entity or permanent establishment:
  - Revenue, related and unrelated party
  - Profits
  - Income tax paid and taxes accrued
  - Stated capital and retained earnings
  - Employees
  - Tangible assets
  - Also identification of each entity in the country and the business activities of each entity
- The transfer pricing documentation framework is a master file/local file approach
- The OECD on 6 February 2015 announced agreement on some key implementation issues, including timing, delivery mechanisms, and conditions for use

BEPS ACTION ITEM 13 – TP DOCUMENTATION AND COUNTRY BY COUNTRY REPORTING

- **Under agreement on implementation of CbC reporting:**
  - First CbC reports are to cover 2016 fiscal years, with filing required within 12 months of year end
  - CbC report generally is to be delivered to the MNC parent entity's home country and shared with other relevant countries under government information exchange mechanisms
    - Secondary delivery mechanisms contemplated for situations where home country does not have CbC reporting mechanism
    - Exchange mechanism to include confidentiality protections
  - Exemption from CbC reporting for MNC groups with annual turnover of less than €750 million
- **Master file and local file to be delivered to local countries under local implementation guidance**
- **Model implementation language to be developed**

WHAT DOES THIS MEAN FOR STATES?

- *Are states going to follow through with developing resources dedicated to transfer pricing?*
- *To what extent will states' efforts be enhanced by information sharing from the IRS?*
  - Information sharing – electronic files from IRS from CbC reporting entities
- *Is attention being drawn by the OECD's BEPS project going to accelerate the states' activities?*
- *Separate return states vs. consolidated/combined return states – variances to the approach*
  - What is the impact for consolidated/combined return states?
  - Separate return states can mirror Treas. Reg. §1.482 approach

Questions?

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