

State Tax Reform—Tax Havens, Transfer Pricing, and More

TEI-SJSU High Tech Tax Institute

November 10, 2015

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Agenda

Tax Havens

Transfer pricing in the state arena

Other tax reform developments

Tax Havens

State Tax Havens (Combined Reporting Changes)

Expanding the unitary group

Reaching beyond Water's Edge

Broadening income tax base and
apportionment factor

Enacted in Alaska, Connecticut, Montana,
Oregon, Rhode Island, West Virginia and the
District of Columbia.

Proposed legislature in four states.

Additional State Tax Haven Legislation

States Where Enacted

- Alaska (Unique),
- Connecticut (MTC Approach),
- Montana (Blacklist),
- Oregon (Blacklist),
- Rhode Island (MTC Approach),
- West Virginia (MTC Approach), and
- District of Columbia. (MTC Approach)

Proposed Legislation

- Alabama House Bill 142 (MTC Approach),
- Kentucky's House Bill 374 (Blacklist),
- Massachusetts' Bill H.1524 (Blacklist), and
- New Hampshire's House Bill 551 (Blacklist)

“Tax Haven”

The new “Tax Haven” rules expand the combined filing group to include unitary entities incorporated in jurisdictions determined under two main approaches (Alaska has its own unique approach):

“Blacklist” Approach

- A list of “tax haven” jurisdictions are identified by state law

MTC Approach

- A list of qualifying activities is provided to determine whether a jurisdiction meets the definition of “tax haven”

Alaska Approach

- Jurisdiction does not impose an income tax or has a tax rate lower than 90% of the U.S. rate, and
- Has 50% or more of certain intercompany activity with members of the unitary return, or does not conduct any significant economic activity

“Blacklist” Approach Tax Havens

“Blacklist” Jurisdictions

- Oregon’s “Blacklist” includes the following 44 jurisdictions, including traditional tax planning jurisdictions such as the Cayman Islands, Luxembourg, and Malta.
- Andorra, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Barbados, Belize, Bermuda, Bonaire, the British Virgin Islands, the Cayman Islands, the Cook Islands, Curacao, Cyprus, Dominica, Gibraltar, Grenada, Guatemala, Guernsey-Sark-Alderney, the Isle of Man, Jersey, Liberia, Liechtenstein, Luxembourg, Malta, the Marshall Islands, Mauritius, Montserrat, Nauru, Niue, Saba, Samoa, San Marino, Seychelles, Sint Eustatius, Sint Maarten, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, the Turks and Caicos Islands, the U.S. Virgin Islands and Vanuatu.

MTC Approach Tax Havens

Based on “tax haven” definition provided in the Multistate Tax Compact

“Tax Haven” jurisdictions, have no or nominal effective tax and:

- has laws or practices that prevent effective exchange of information for tax purposes with other governments on taxpayers benefiting from the tax regime;
- has a tax regime which lacks transparency;
- facilitates the establishment of foreign-owned entities without the need for a local substantive presence or prohibits these entities from having any commercial impact on the local economy;
- explicitly or implicitly excludes the jurisdiction's resident taxpayers from taking advantage of the tax regime benefits or prohibits enterprises that benefit from the regime from operating in the jurisdiction's domestic market; or
- has created a tax regime which is favorable for tax avoidance, based upon an overall assessment of relevant factors, including whether the jurisdiction has a significant untaxed offshore financial or services sector relative to its overall economy.

Constitutionality

State taxation is permissible on foreign businesses/income

- *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983) and *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 304 (1994)
- Those cases did not involve states specifically targeting foreign jurisdictions.

Commerce Clause

- Congress has the ability to regulate interstate commerce. To the extent a state's tax structure discriminates against interstate commerce, it is impermissible.
- State tax laws cannot create the risk of international multiple taxation or prevent the federal government from "speak[ing] with one voice when regulating commercial relations with foreign governments." *Japan Line Ltd. v. County of Los Angeles*, 441 U.S. 434, 450 (1979).

Concerns and Considerations

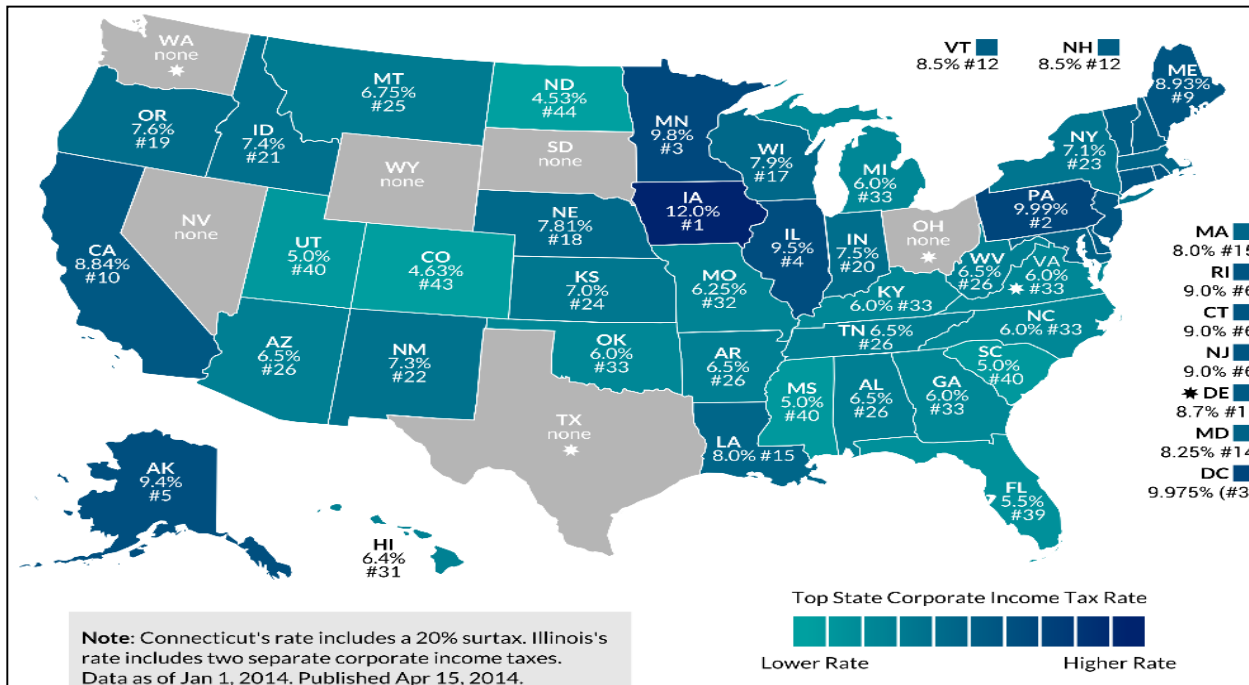
Increased or decreased tax liability

Tax residence v. incorporation in jurisdiction

Vagueness of MTC “tax haven” definition

*Transfer pricing
overview and current
transfer pricing
environment*

Why is transfer pricing a growing area of state scrutiny?



- Different tax regimes (e.g. combined reporting, sourcing)
- Legislatures reluctant to raise taxes

Current State Transfer Pricing (“TP”) Environment

Federal Level: I.R.C. § 482

States and § 482:

- Many states have § 482 like powers
- Authority does not always track 482 exactly
- Related powers (add-back, sham, etc.).

Current state transfer pricing environment

Increasing scrutiny in separate company states

- Increased number of audits (e.g., Massachusetts over 20 pending or recently resolved appeals at ATB)
- Expanded categories of transactions subject to scrutiny

Typical state challenges

- Is pricing arm's length, reasonable, other standard?
- Allocation method between states
- Additional “embedded royalty”?
- Basis for combination

Current state transfer pricing environment

- **Connecticut** – Products, Services, Management Fees
- **DC** – Products, Services, Management Fees, Loans, Royalties, Foreign
- **Florida** – Services, Management Fees, Loans, Royalties
- **Georgia** – Products, Services, Management Fees, Loans, Royalties, Foreign
- **Massachusetts** - Products, Services, Management Fees, Loans, Royalties, Foreign
- **New Jersey** - Products, Services, Management Fees, Loans, Royalties, Foreign
- **New York** - Products, Services, Management Fees, Loans, Foreign
- **Pennsylvania** – Royalties
- **Wisconsin** - Products, Services, Management Fees, Loans, Royalties

*State revenue
departments
approaches to
transfer pricing*

Department of Revenue transfer pricing strategies

Increasing scrutiny through standard audit

Outsourcing to 3rd party auditor

Both can be difficult to implement

Issues with transfer pricing audit conducted by state auditors

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Issues with third-party auditors

Often contingent-fee based

- Most arrangements with contract auditors are contingent fee based (14-16% of collection), which is controversial within the tax community as many believe this arrangement encourages abuse.
- Contract auditors historically used in a multitude of states (CT, AL, DC, LA, KY, and NJ).

3rd party auditor controls methodology

Contract Auditors (cont'd)

- NJ Director of Taxation terminated multi-million dollar contract that involved performing transfer pricing analysis citing taxpayer resistance.
- Kentucky's Department of Revenue declined to renew its contract for transfer pricing audit assistance even though no assessments were issued and no taxes had been collected that would have resulted in contingency fees being paid.
- Will recent developments lead to reduced reliance on contract auditors or a fixed fee arrangement?
- Summary judgment for 3 additional taxpayers in DC.
- DC Office of Administrative Hearings ("OAH") recently appealed summary judgments.

Case studies in state transfer pricing—Massachusetts and Washington, D.C.

Massachusetts—State administered transfer pricing

- Industry-wide metrics
 - *TAP Pharmaceuticals, Inc. v. Commissioner*
 - *Andersen Windows, Inc. v. Commissioner*
- Berry ratio
 - *Sigma-Aldrich, Inc. v. Commissioner*
- Reliance on third-party studies
 - *Zimmer US, Inc. v. Commissioner*
- Transfer pricing plus embedded royalty adjustment
 - *PepsiCo, Inc. & Affiliates v. Commissioner*

Massachusetts—Other Issues at Audit

- Price set by federal regulation
- Adjustment to G/L accounts including purchases from third-parties
- Intercompany transactions with no-markup
- Selective or arbitrary pricing analysis
- Misapplication of sham transaction doctrine to transfer pricing adjustment
- Adjustments greater than effect under combined reporting.
- Adjustment where department lacks authority. *E.g., Tenneco Inc. v. Commissioner*

District of Columbia—Contingent Fee Transfer Pricing

- *Microsoft Corp. v. Office of Tax and Revenue*

- Transfer pricing audit conducted by Chainbridge Software
- Taxpayer files for summary judgment arguing Chainbridge method:
 - Violates IRC 482 regulations
 - Fails to properly reconcile tax accounting with financial statement accounting
- Taxpayer victory at Office of Administrative Hearings—no appeal

- *BP Products North America Inc. v. District of Columbia*

- Bench ruling denies taxpayer motion for summary judgment.
- Parties reach settlement.

- *Shell, Hess, and Exxon*: Court rules for taxpayer citing non-mutual offensive collateral estoppel.

- Appeal on issue of collateral estoppel.
- City argues that it is not bound by prior OAH decisions.

Several appeals in the pipeline as of August 2015

Multistate Tax Commission – ALAS Program

Multistate Tax Commission ("MTC")

- MTC's aim is to (i) develop recommended uniform state tax policies; and (ii) encourage compliance & consistency in enforcement through Joint Audit Program.
- February 2013: Income & Franchise Tax Uniformity Subcommittee drafts memo addressing states' authority to reallocate income & deductions, and suggests uniformity in applying Section 482 power.
- TEI responds to memo stating opposition to the proposed project.
- March 2013: MTC decides not to pursue uniformity project.
- May 2013: NJ challenges MTC to consider a proposal to create a dedicated multistate transfer pricing audit program.
- April 2014: MTC announces aim to create advisory board of state tax directors to draft model state TP audit program due December 2014 with final design for submission to Executive Committee / Commission by July 2015.

Multistate Tax Commission

- Multitude of states offered support to fund the development phase (separate entity & combined states).
 - States involved include: Alabama, D.C., Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, North Carolina.
 - One state (PA, RI, or IA) appears to have joined MTC audit program in anticipation of this program.
- MTC's Arm's Length Adjustment Services ("ALAS") program expected to comprise 3 types of services:
 - Pre-audit services: analysis and audit selection, training services, and transfer pricing development.
 - Audit services: including economic services.
 - Post-audit services: including legal assistance with litigation, and expert witness and economic services.
- Some practitioners believe that the MTC should allow taxpayers to address pricing issues on the "front end" akin to IRS Advance Pricing and Mutual Agreement Program.

Multistate Tax Commission

- On October 6-7, 2014, MTC interviewed 7 boutique transfer pricing firms.
- MTC issued “Updated Draft Design for an MTC Arm’s Length Adjustment Service” (“Updated MTC Draft Design”) on October 30, 2014.
- Updated MTC Draft Design estimates \$25 million annually in added revenue.
- Estimates costs of new MTC audit program of \$2 million annually.
- Actively recruiting states to commit to cover costs.
- Also, actively recruiting a few transfer pricing experienced professionals.
- Updated MTC Draft Design does not include framework. Will auditors follow Section 482 given lack of uniformity between the states?
- Targeting mid-2015 for start of ALAS program.
- Early October 2015, ALAS advisory group meets to discuss future plan and solicit state participation.
 - Still only six members.

*Pre-audit, audit,
and appeal
considerations*

Pre-audit: Documentation Requirements

Detailed company overview

- Functional Analysis

A comprehensive description of the global organizational and management structure

A description of the controlled transactions and related policies

Intercompany transactions supported by the documentation

- Tangible Property
- Intangible Property
- Services
- Financial Transactions (loans, guarantees)

Pre-audit: Documentation

Demonstration that transfer prices conform to arm's length principles

Supporting documents (invoices, intercompany agreements)

Financials (income statement, balance sheet)

- Legal entity, business unit, product line

Transaction Records (books and records, workpapers, product flows, invoicing and payment)

Common Pitfalls

Incorrect method of analysis given functions and risks

- Default to a CPM/TNMM analysis when internal comparables not examined
- Improper application of a method
- Documentation relies on data that can not be verified by tax authorities

Undocumented transactions

- Example: transfer of services or intangibles without compensation

Inconsistent use of method or policy among related parties

Not updating the transfer pricing methodology to reflect changes in operations, industry and general economic conditions

Inconsistencies in policy, documentation and intercompany agreements

Audit and Litigation Strategies

Arguments for Audit and Appeal

- Look to IRC § 482
- Can you argue for *increased* price? (e.g., no mark-up under IRC 482)
- Does Department have authority for adjustment for specific industry?
E.g., Tenneco Inc. v. Commissioner
- What is impact of Department method on later years (even outside audit period)?
- Apply Department positions in other appeals

Settlement Options?

- Mediation programs and expedited settlement

Other State Tax Reform Topics

Multistate Bills in Congress

H.R. 2315, Mobile Workforce State Income Tax Simplification Act of 2015

H.R. 2584, Business Activity Tax Simplification Act of 2015

H.R. 1643, Digital Goods and Services Tax Fairness Act of 2015

Marketplace Fairness bills – S. 698, H.R. 2775

ITFA expires (again) on 12/11/15

- P.L. 114-53 (9/30/15; H.R. 719), Continuing Appropriations Act, 2016
- Was set to expire 11/1/15.

Action

- On June 17, 2015, House Judiciary Committee passed H.R. 2315, H.R. 1643 and H.R. 2584.

State Tax Reform Themes (beyond transfer pricing)

Broadening sales tax base

Lowering income taxes and increasing sales tax

Accountability measures & evaluating incentives

Worker classification clarification or enforcement

Getting ready for possible enactment of Marketplace Fairness

Taxing marijuana

Supreme Court to Revisit *Quill*?

Concurring opinion in *Direct Marketing Association v Brohl, Exec Dir, Colorado Dept of Revenue*, No. 13-1032 (3/3/15), Justice Kennedy posited ...

- Perhaps given “changes in technology and consumer sophistication,” it is time to revisit Court’s 1992 decision in *Quill*, 504 U.S. 298.
- He also noted that *Quill* was a case “questionable even when decided, [that] now harms States to a degree far greater than could have been anticipated earlier.”

Alabama Wants to Test *Quill*

Proposed regulation: <https://revenue.alabama.gov/rules/810-6-2-.90.03.pdf>

810-6-2-.90.03 Requirements for Certain Out-of-State Sellers Making Significant Sales into Alabama. **(NEW RULE)**

(1) Notwithstanding the provisions of Rule 810-6-2-.90.01, entitled Seller's Responsibility to Collect and Pay State Sales Tax and Seller's Use Tax, out-of-state sellers who lack an Alabama physical presence but who are making retail sales of tangible personal property into the state have a substantial economic presence in Alabama for sales and use tax purposes and are required to register for a license with the Department and to collect and remit tax pursuant to Section 40-23-67, Code of Alabama 1975, when,

(a) Seller's retail sales of tangible personal property sold into the state exceed \$250,000 per year based on the previous calendar year's sales; and

(b) Seller conducts one or more of the activities described in Section 40-23-68, Code of Alabama 1975;

(2) Sellers may satisfy the requirements described in (1) above by one of the following methods:

(a) Using the collecting, reporting and remitting provisions of Article 2, Chapter 23 of Title 40, Code of Alabama 1975, or

(b) Using the collecting, reporting and remitting provisions created by the Simplified Sellers Use Tax Remittance Act codified at §§ 40-23-191 through 40-23-199, Code of Alabama 1975.

(3) This rule shall apply to all transactions occurring on or after January 1, 2016.

Washington too (maybe) ... (HB 2224)

Proposed regulation: §902 at Chapter 82.08 RCW

(8) Therefore, the legislature intends by this act to address the significant harm and unfairness brought about by the physical presence nexus rule by testing the boundaries of the rule. This act also sets up a legal challenge to the physical presence nexus rule that could potentially lead to the United States supreme court reevaluating *Bellas Hess* and *Quill* or congress enacting legislation authorizing and establishing the requirements for states to impose a sales tax collection duty on remote sellers. To achieve these objectives, this act establishes clear statutory guidelines for determining when sellers are required to collect Washington's sales tax. These guidelines clarify the extent of the traditional physical presence standard and also incorporate an "economic nexus" standard under which a remote seller would establish a substantial nexus with this state solely by generating a meaningful amount of sales into this state. This act also amends the statutory guidelines for determining whether a taxpayer has sufficient nexus for purposes of the state's business and occupation tax.

What are other
states doing to grab
more sales tax
collectors?

USSC and *Wynne* case

Comptroller of the Treasury of Maryland v Wynne, No. 13-485 (USSC, 5/18/15)

- Md allows state credit for income tax paid to other states, but counties do not
- USSC
 - Violates dormant commerce clause as leads to double taxation of out-of-state income
 - Discriminates against interstate commerce as leads to such income being taxed more than intrastate commerce.

http://www.supremecourt.gov/opinions/14pdf/13-485_o7jp.pdf

*Are multistate
tax matters
moving
forward?*

50th Anniversary of Willis Comm'n Report

PL 86-272 (Sept 1959) called for report ...

- To fully address "all matters pertaining to the taxation by the States of income derived within the State from the conduct of business activities which are exclusively in furtherance of interstate commerce or which are part of interstate commerce."
- Purpose - allow for recommendations to provide uniform standards for imposition of income taxes by the states.
- Due by July 1, 1962.
- P.L. 87-17, 75 Stat. 41 (1961) – scope broadened to include sales tax
- Became a 3-year project.

A few tidbits from the Willis Comm'n report

G. Major Defects Pervading the System

It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States. It has also been found that the major problems encountered are not those of any one of the taxes studied but rather are common to all of them. This is not surprising in that all of these problems reflect the pervasive conflict between the approach to the taxation of interstate companies as it appears in State and local law, and the practical difficulties of realistic compliance expectations and effective enforcement. Increasingly the States, reinforced by judicial sanction, have broadened the spread of tax obligations of multistate sellers. As the principle of taxation by the State of the market has been accepted, the law has prescribed substantially nationwide responsibility for more and more companies. The expanding spread of tax obligations has not, however, been accompanied by the development of an approach by the States which would allow these companies to take a national view of their tax obligations. The result is a pattern of State and local taxation which cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States.

**Summary,
Vol 4, page
1127**

• Doesn't some of it sound like it was written today?

Next steps – multistate taxation

Issues are still on congressional agenda:

- Update PL 86-272
 - Example - Business Activity Tax Simplification (HR 2992, 113th Cong) + earlier Congresses
- Address sales tax nexus in response to 1992 *Quill* decision
 - Examples – variations of Marketplace Fairness
- Address mobile workforce income and withholding tax rules

Still on state agendas

- Should UDITPA be updated and address nexus?
- Streamlined Sales and Use Tax
- State challenge to possible today