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by Howard Berger, Robert E. Culbertson,
Kandyce L. Korotky, and Barbara L. Rollinson

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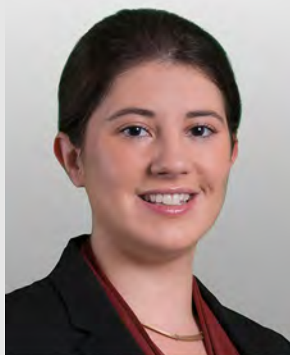
Howard Berger

Robert E. Culbertson


Kandyce L. Korotky

Barbara L. Rollinson

Howard Berger is special counsel, Robert E. Culbertson is a partner, and Kandyce L. Korotky is an associate with Covington & Burling LLP in Washington. Barbara L. Rollinson is a managing director with Horst Frisch Inc. in Washington.

In this article, the authors explore state transfer pricing adjustments and discuss how current state concerns, and the initial response to those concerns seen in some state audits, are leading to a replay of battles that were fought in the international transfer pricing world more than 25 years ago.

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Concerned about potential corporate tax avoidance through mispricing of transactions between related parties, state revenue authorities are pursuing transfer pricing audits vigorously.[1] Taxpayers, on the other hand, believe that many state transfer pricing adjustments depart from the economic value of the transactions at issue. Tensions in the state tax world have thus been rising and could boil over into substantial tax litigation involving millions — or even billions — of dollars in asserted corporate tax deficiencies. This article explores the sources of these rising tensions, in the hopes that a more constructive way forward can be found.

We begin by summarizing how transfer pricing in the state tax context differs from the traditional cross-border setting of federal transfer pricing analysis. Having outlined the differences, we then address the more important similarities between transfer pricing analysis at the state and federal levels. In particular, we discuss how current state concerns, and the initial response to those concerns seen in some state audits, are leading to a replay of battles that were fought in the international transfer pricing world over 25 years ago.[2]

The controversies of that era centered on the proper design and use of "profits-based" transfer pricing methods. Having lived through those battles as drafters of the federal

[1] *See, e.g.*, David Delahay and Karl Schmalz, "Abusive Transfer Pricing — By Governments!" *Tax Notes State*, June 15, 2020, p. 1315; and Eric Tresh, Maria Todorova, and Justin Brown, "The Growing Trend of State Transfer Pricing Scrutiny," *Law360*, Aug. 26, 2019.

[2] "Those who cannot remember the past are condemned to repeat it." George Santayana, *The Life of Reason: Reason in Common Sense* at 284 (1905). Although Santayana's aphorism has become overfamiliar, it seemed too apt to pass up.

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regulations, the authors believe that the lessons learned through that process can benefit the states today, and can be used to address the states' concerns without the need for wasteful litigation.[3] We thus detail how the federal approach to profits-based methods evolved in the 1980s and 1990s, and how some states today seem tempted to misuse those methods in precisely the ways that critics feared, and that the federal regulations were drafted to prevent.[4] We conclude by suggesting a few best practices for both taxpayers and departments of revenue engaged in transfer pricing analysis.

Federal and State Transfer Pricing Contexts

In a typical business transaction, one party (the seller) earns gross income, while the other party (the buyer) has a deduction for the amount it pays. If those parties are unrelated, market forces can be expected to determine the pricing of the transaction so that the respective income and deduction each party recognizes will accurately reflect the economics of the transaction and can reliably be taken into account for tax purposes.

However, if the buyer and seller are closely related, there is no economic compulsion to price their transactions under strict market terms. Further, if the buyer and seller are taxable in two different places and pay tax on their incomes at two different tax rates, there may be an incentive to shift income from one to the other. If the buyer pays more for purchased widgets than they are worth to a third party, then income will artificially shift from buyer to seller, while if the buyer pays less than they're worth, income will shift in the other direction. Given this potential to shift income by mispricing transactions between related parties, tax authorities have long wielded the power to adjust the pricing of related-party transactions to clearly reflect the parties' "true" income.[5]

At the federal level, the IRS has exercised its authority to adjust related-party transfer prices primarily in a cross-border context, when the mispricing of transactions between a U.S. taxpayer and its foreign affiliates could shift income out of the United States and into a different country (often a lower-tax jurisdiction). By contrast, transactions between the domestic members of a consolidated group have rarely attracted IRS transfer pricing scrutiny, since such transactions in most cases do not have the ability to affect the group's consolidated federal tax liability.

But purely domestic transactions can readily affect state tax liabilities, particularly in separate-return states, where transfer pricing can affect state taxes in two ways.[6]

First, because separate-return states generally start with an entity's federal income calculated on a separate-company basis, the starting point for the state tax return will be affected by the pricing of transactions between the taxpayer and any affiliate, whether foreign or domestic, since all those transactions will affect the taxpayer's separate-company income and thus its taxable income base for state tax purposes.[7]

Second, the transfer pricing of related-party transactions can affect the sales factor in the apportionment formula. In-state sales are generally included in the numerator of the

[3] Rollinson was the senior economist in the Treasury Office of Tax Analysis with responsibility for the economic analysis reflected in transfer pricing regulations (and related OECD proceedings) from 1989 to 1996; Culbertson was the IRS associate chief counsel (international) from 1991 to 1995, with responsibility for the drafting of those regulations (and will if pressed admit to including a few subtle jokes in them (but only in the examples)); and Berger was a special counsel with the IRS Office of Associate Chief Counsel (International) from 1990 to 1994 and a drafter of the proposed, temporary, and final regulations discussed below (and deleted most of Culbertson's jokes but left in the "Fromage Frere" example). Others also participated in drafting and reviewing the regulations, but Korotky was in grade school at the time and paying little if any attention to transfer pricing developments, despite their importance.

[4] In addition to reflecting experience in the regulatory and OECD processes, the discussion in this article also reflects our more recent work representing clients in state and federal transfer pricing matters. While it may foreclose a strictly academic viewpoint, this real-world experience has shown us the extent of controversy currently percolating in the state transfer pricing world.

[5] The authority of the IRS to make transfer pricing adjustments arises under IRC section 482; its current language is based on predecessor statutes dating back to 1917. Many state laws allowing transfer pricing adjustments are modeled on section 482, and such rules should generally be interpreted to follow section 482. *See Utah State Tax Commission v. See's Candies*, 2018 UT 57 (2018).

[6] Income in unitary states may also be affected by transfer pricing, but our focus here is on the separate-company context where the effects are more pronounced.

[7] *See* Federation of Tax Administrators, State Corporate Income Taxes: Federal Starting Points (Feb. 2020).

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fraction that is used to apportion taxable income among the various states in which a company earns income.[8] Indeed, in-state sales are increasingly used as the single apportionment factor, or as a double- or triple-weighted factor in states that continue to use a multifactor formula. Thus, the pricing of sales between related entities in different jurisdictions will affect the computation of the sales factor, as well as the taxable income base.

Accordingly, state revenue departments may well have reason to consider the pricing of a company's related-party transactions, as both international and domestic related-party transactions can affect the company's state income tax liability. By the same token, however, any such audit focus should take full advantage of the lessons learned in the federal transfer pricing context; this follows because the technical aspects of a transfer pricing analysis will be the same, regardless of whether it is focused on domestic or cross-border transactions. Further, the potential for double taxation when transfer pricing adjustments are ill-founded is acute in both domestic and international contexts.[9]

Thus, the potential for controversy is substantial. There is also substantial potential for disruption of business and investment activity if states attempt to make transfer pricing adjustments that seek to tax an amount of income that is disconnected from the reality of a company's in-state economic activity.

Given the importance for both states and taxpayers of achieving proper outcomes in transfer pricing audits, one recent trend in such audits presents real concerns. In particular, some states have been moving toward using a version of the federal comparable profits method that fails to reflect the key lessons learned during the development of that method. We thus turn now to a summary of that development, and then contrast that history with recent state transfer pricing audit experience.

The Origin and Development of the Comparable Profits Method

Since 1935 federal transfer pricing regulations have used the arm's-length standard to determine whether a company's pricing of a transaction with an affiliate clearly reflects its income.[10] Pricing of such a transaction satisfies the arm's-length standard if its result is consistent with the result that unaffiliated companies would have realized if they engaged in the same transaction under the same circumstances. If the pricing does not satisfy the arm's-length standard, the IRS may adjust the company's income.

Describing the arm's-length standard is easier than applying it, for both the IRS and taxpayers. When the IRS adopted the standard in 1935, its transfer pricing regulations provided no methods for determining whether a transaction produced arm's-length results. It wasn't until 1968 that federal transfer pricing regulations included methods to evaluate transactions. The 1968 regulations added the comparable uncontrolled price method, the resale price method, and the cost-plus method. All were "transactional methods" — they compared the pricing of a company's transaction with an affiliate to the pricing of actual transactions between unaffiliated companies.

Over time, the 1968 regulations proved to be inadequate. The accuracy of the three transactional methods depended largely on the similarity between the transaction whose price was being evaluated and the transactions whose prices were used as a benchmark. But identifying a truly comparable transaction frequently was difficult — and yet the

[8] Multistate Tax Commission, Model General Allocation & Apportionment Regulations (Feb. 24, 2017).

[9] In the international context, tax treaties reduce the possibility of double taxation through "mutual agreement" procedures. The authors are not aware of a similar administrative process to reduce the possibility of double taxation in the state tax context, potentially leaving double-taxed companies with no remedy short of federal court litigation over the constitutional limits of state taxing jurisdiction.

[10] Article 45-1(b), reg. 86 (1935).

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regulations appeared to disfavor other types of methods. Congress became concerned that the purportedly comparable transactions used to apply the arm's-length standard too often differed significantly from the transaction being evaluated and produced questionable results.[11]

As a result, in connection with a 1986 amendment to IRC section 482 that required income from transactions involving intangible property to be commensurate with the income from that property, Congress directed the IRS to consider whether the 1968 regulations should be modified.[12] Between 1986 and 1994, the IRS and Treasury considered alternatives to the transactional methods of the 1968 regulations, issuing a lengthy study in 1988,[13] proposed regulations in 1992,[14] temporary regulations in 1993,[15] and final regulations in 1994.[16] This process produced a profits-based approach for evaluating transfer pricing, primarily reflected in what is now the comparable profits method.[17] The CPM evaluates transfer pricing by comparing an indicator of profitability from transactions between a company and an affiliate to the profitability of a comparable company from transactions with third parties.

Taxpayers and tax treaty partners of the United States expressed significant concerns throughout the development of the CPM.[18] These concerns led to extensive multilateral discussions at the OECD, as well as bilateral discussions with many treaty partners, not to mention endless panel discussions at many (*many*) tax conferences in the United States and abroad. The concerns were in part theoretical — some comments argued that a profits-based approach is inherently inconsistent with the arm's-length standard. But they were also intensely practical — many comments expressed concern that the United States would use the CPM to overextend its tax net, for

[11] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1014-15.

[12] *Id.* at 1017.

[13] IRS Notice 88-123, 1988-2 C.B. 458.

[14] 57 F.R. 3571 (1992).

[15] T.D. 8470, 1993-1 C.B. 90.

[16] T.D. 8552, 1994-2 C.B. 93.

[17] Treas. reg. section 1.482-5.

[18] *See, e.g.*, T.D. 8552, preamble to final section 482 regulations (July 8, 1994) (generally describing comments received with respect to the CPM); International Electronics Manufacturers and Consumers of America, "Comments on Temporary and Proposed Regulations Under Section 482 of the Internal Revenue Code" (Oct. 12, 1993) ("Even shorn of its 'trumping' role, the comparable profits method ('CPM') may still be challenged as inconsistent with the arm's length standard. . . . [W]e ask that invocation of the method by the IRS be restrained until the United States convinces its major trading partners of the method's value and/or proposes modifications that are sufficient to garner international support."); Ministry of Finance of the Republic of Korea, comment on temporary and proposed regulations under section 482 (Aug. 9, 1993) ("The CPM is an unprecedented method which needs some testing before it can be proven as a legitimate measure. . . . I recommend to limit the application of the CPM only as a last resort where no other method is more appropriate than the CPM. . . . The comparability standard under the CPM seems quite vague and leaves room to misdirect the establishment of the arm's length range."); Tax Executives Institute, "Temporary and Proposed Regulations Under Section 482 of the Code Relating to Transfer Pricing" (Aug. 6, 1993) (The "CPM creates a great deal of uncertainty and controversy. There is a serious lack of reliable data on the profitability of transactions between unrelated parties. Such information is almost never available from public sources. Consequently, CPM should not be given priority — either explicitly or implicitly — over the resale-price and cost-plus methods."); The Federation of Korean Industries, comments on the temporary and proposed section 482 regulations (July 19, 1993) ("[W]e believe that the Regulation's language coupled with a lower standard of comparability would lead the IRS to favor the CPM method at the expense of other methods that may provide more accurate measure."); Keidanren, the Japan Federation of Economic Organizations, "Comments on the Temporary Income Tax Regulations Relating to Intercompany Transfer Pricing Under Section 482 and the Proposed Profit Split Method Regulations" (July 13, 1993) ("We believe that giving the CPM an emphasis equal to the CUP, RP and CP methods, is not in accordance with the international rule of transfer pricing taxation."); U.S. Council for International Business, "Comments on the Temporary Regulations Under Section 482" (Apr. 22, 1993) ("The U.S. Council strongly recommends that CPM be removed form [sic] the list of prescribed methods in both the tangibles and intangibles areas, and relegated to the status of an 'other' method, much the same as the profit split methodology. CPM is fundamentally incompatible with the arm's length standard and, therefore, its role should be deemphasized."); OECD Committee on Fiscal Affairs, Intercompany Transfer Pricing Regulations Under Section 482 Temporary and Proposed Regulations (1993); National Foreign Trade Council, "Comments on Intercompany Transfer Pricing and Cost-Sharing Regulations Under Section 482, Proposed January 24, 1992" (Aug. 13, 1992) ("By departing from an arms-length standard that emphasizes operating income or return on asset investment instead of transactional comparables, [an early version of the CPM] could lead to disputes among our trading partners and to double taxation of income."); and Organization for International Investment, "Comments on Proposed Transfer Pricing Regulations section 1.482-1 & 2" (July 27, 1992) (The CPM "inappropriately supersede[s] virtually all internationally accepted methods for transfer price determination.").

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example by using the CPM without considering other methods and by using industry averages instead of data from truly comparable corporations, or otherwise cutting corners. The IRS responded to these criticisms throughout the development of the CPM, clarifying its relationship to other methods and modifying its technical requirements to increase its reliability.

First, the IRS added the "best method" rule to the regulations. That rule did away with the priority of methods under the 1968 regulations (in which the CUP method trumped the resale price method, which in turn trumped the cost-plus method) and replaced it with a more flexible approach. Under the best method rule, all methods are potentially applicable. The best method rule evaluates pricing using the method that produces the most "reliable" results under the particular facts and circumstances, where "reliability" focuses on the degree of comparability, and the availability and quality of data, for the transaction under review.

For example, under the best method rule, the CUP method likely would be the best method for the sale of a commodity if quotation media provided reliable data about prices of sales of the same product. In that case, the product, a commodity, is by definition comparable, and the media quotation, properly applied, provides reliable data. In contrast, the CPM likely would be the best method for pricing routine services used to manufacture a unique product if there were reliable profitability data about companies performing similar services.

Second, the IRS beefed up the requirements of the CPM to clarify that it would be the best method only when it was applied rigorously. The regulations now make clear that the CPM requires taking into account the same comparability factors that other methods consider, including functions performed, contractual terms, risks, economic conditions, and property employed. And the IRS added comparability considerations specific to the CPM, including the size and scope of operations, the level of the market at which a corporation operates, and the stage in a business or product cycle. Bolstering the regulations in this way addressed concerns about the use of broad average measures of profitability that ignored relevant comparability factors.

A very recent case, *Coca-Cola Co. v. Commissioner*, illustrates an application of the CPM as articulated in the final regulations.[19] The Tax Court applied the best method rule and considered whether the CPM was the best method for the transactions at issue. After stating that "like other transfer pricing methods, the CPM requires consideration of the general comparability factors," the opinion concluded that the CPM appeared applicable because "the tested parties . . . and uncontrolled comparables . . . engaged in similar business activities under similar circumstances." The scope of the Tax Court's analysis illustrates the extensive and demanding technical requirements that the regulations impose on an application of the CPM.

In its analysis, the court reviewed the selection and quality of data and the assumptions the IRS had employed to bridge any gaps in the data. The court also analyzed the way the IRS had selected comparable companies and the quality of adjustments to the data. The court found that the IRS had met the regulation's requirements in identifying comparable companies and in making adjustments to account for differences between the comparable companies and the corporation being evaluated, and in doing so considered extensive economic analysis and testimony.

At 244 pages, the court's analysis illustrates the level of detail needed to apply the CPM properly. The opinion shows that a CPM may be accepted as the best method, but only if it addresses all aspects of the analysis required under the regulations.

[19]155 T.C. No. 10 (Nov. 18, 2020). Our comments focus on the Tax Court's application of the CPM.

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Recent Experience With State Use of Profits-Based Transfer Pricing Methods

Problems With Quasi-CPMs in State Transfer Pricing Audits

Problems arise when states conducting transfer pricing audits seek to apply a method that resembles the CPM but that ignores the technical requirements that make such an analysis reliable. Such attempts are not an entirely new phenomenon,[20] but they seem to be increasingly popular with revenue departments. These quasi-CPM approaches can perhaps seem attractive to state auditors as a way to reduce the time and money that would be required by a proper, comparables-based CPM audit. Further, many states have hired outside consultants for transfer pricing audits, and these consultants have not always followed the federal CPM standards.[21] Misapplying the CPM, by using incomparable comparables or without taking the time to consider other possible methods, may be a resource-saver on the front end, but this shortcut path to adjustments is precisely what the initial critics of the CPM feared, and for good reason.

In particular, applying a profits-based method while ignoring the safeguards the IRS included in its regulations can lead to results that are flatly inconsistent with the arm's-length standard that underlies all transfer pricing analysis. Once untethered from the arm's-length standard, adjustments are no longer grounded in fact or law. On top of that, the adjustments that result from a quick and dirty application of a quasi-CPM can contravene even basic common sense. For example, basing an adjustment on the profit levels of third parties without running the necessary traps can result in a transfer price many multiples higher (or lower, depending on whether the taxpayer is buying or selling) than the price unrelated parties would have agreed to.[22]

Applying a CPM-ish method in this manner is inconsistent with the principles of, and in some cases directly contradicts, the guidance developed in the federal regulations. One obvious example would be an attempt to apply the CPM to adjust the transfer price of a transaction with strong, well-accepted evidence of a comparable uncontrolled price, such as when a taxpayer is buying or selling indexed commodities.[23] Exacerbating the potential problems with states' attempts to use the CPM is the fact that state audits often focus on domestic entities that tend to be the larger, more complex entities within U.S.-based multinational groups; comparable profits analysis, however, is generally ill-suited for complex entities that have multiple functions or participate in more than one market level, and is instead more reliably applied to entities with more limited functions and markets.[24]

Some states have even considered an approach that effectively treats low profits as the controlling basis for an adjustment, rather than merely as a factor suggesting further analysis. This approach compares the profits of the taxpayer under audit to profits of third parties (which may or may not be actually comparable companies) and automatically imposes an adjustment, based on the assumption that the taxpayer should have been as profitable as the other companies, as if incorrect transfer prices could be the only possible reason for a profit disparity. The tool used to achieve this result is a profits-based method that superficially resembles a CPM, but that fails to follow the applicable guidance regarding the reliable application of the CPM.

Such quasi-CPM analyses have been problematic in several ways. For starters, the

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[20] For example, Microsoft prevailed in an administrative hearing against the District of Columbia's Office of Tax and Revenue because the office failed "to analyze the comparable profits of similar products or services." D.C. Office of Administrative Hearings, Case 2010-OTR-00012 (2012) at 26.

[21] *See* Amy Hamilton and Andrea Muse, "States Aggressively Contracting With Transfer Pricing Experts," *Tax Notes State*, Apr. 6, 2020, p. 95; and Delahay and Schmalz, *supra* note 1.

[22] See Example 1 below.

[23] *See* Treas. reg. section 1.482-1(c)(2) ("Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length."); and Delahay and Schmalz, "Why Upstream Oil and Gas Poses Lower Transfer Pricing Risks Than Other Industries," *Tax Notes Int'l*, Jan. 14, 2019, p. 175.

[24] *See, e.g.*, Treas. reg. section 1.482-1(c)(2)(i) (discussing differences in functions performed).

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practice of immediately resorting to this method, without evaluating whether it is the best method, is misguided. Quick resort to such a shortcut method could be appealing to a state, given the method's apparent simplicity and resulting cost savings — a few quick database searches, a simple spreadsheet, and presto, boxcar adjustments follow. However, as discussed, the best method rule is a core requirement of the federal transfer pricing regulations and is necessary to ensure an arm's-length result. Failing to analyze which method is best in a particular case — especially but not limited to cases in which there's clearly a better method — is not supportable.

In addition to treating the CPM as a default method, states have ignored another cardinal rule of transfer pricing — the absolute necessity of finding and using reliable comparables. Comparability is the touchstone of the federal transfer pricing regulations, and material differences between the taxpayer and the comparables, at a minimum, warrant adjustments to the data.[25] At some point the differences become stark enough that adjustments are not a sufficient tool and the conclusion that the chosen method is the best method must be revisited. Rather than carefully choosing and adjusting comparables, state auditors (or their consultants) have applied the CPM using inappropriate comparables, such as companies that are more or less complicated or at a different market level than the taxpayer. An even more troublesome technique when searching for comparable companies has been to automatically exclude all unprofitable companies from the search results. This in effect treats the CPM as a way to guarantee taxable profits, even for a company that is bearing economic losses, and even when some potentially comparable companies operating at arm's length are themselves bearing losses.

Some states have also considered applying transfer pricing adjustments to the taxpayer in a wholesale manner that would exceed the scope of their authority. For example, regardless of the transfer pricing method used, revenue departments have the legal authority to adjust the prices of only *related-party transactions*; transactions with unrelated parties are clearly beyond any revenue department's transfer pricing authority. Yet some authorities have proposed to make an across-the-board upward adjustment to the income of an entire company, without identifying the related-party transactions that are subject to the adjustment, or the related parties whose income should be correspondingly decreased. Such a course amounts to a fundamental distortion of transfer pricing principles. Further, and especially with more complex companies, using one set of comparables for all the taxpayer's activities, rather than segmenting and separately analyzing its component lines of business, is a surefire way to miss critical factors of a principled transfer pricing analysis. As a consequence of these shortcuts, the other side of a transaction is never examined as a "sanity check" and the counterparty's income receives no downward adjustment that corresponds to the upward adjustment, potentially resulting in double taxation.[26]

Examples of Misapplication of the CPM

The following examples highlight the ways in which misuse of the CPM can lead to inappropriate results.

> **Example 1:** Company A and Company B are related. Company A buys products from Company B for 300x. Company A sells the products to third parties for 400x, incurring 92x of costs in doing so. Company A's operating income is 8x and its operating margin is 2 percent (8x/400x). The state tax authority identifies a group of companies that provide marketing and selling services to third parties. Those comparables have 8 percent operating margins. Finding that

[25] *See* Treas. reg. section 1.482-1(d)(2) ("If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results.").

[26] Increasing the income of one taxpayer without a corresponding decrease in the income of another taxpayer is a sure path to double taxation and may raise constitutional concerns. *See, e.g.*, *Comptroller of Maryland v. Wynne*, 575 U.S. 542 (2015) (striking down a state taxation scheme that resulted in double taxation).

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Company A's operating margin is too low, the state tax authority applies a purported CPM analysis to increase Company A's income by 24x to 32x so that the company's operating margin is 8 percent, matching that of the comparables.

The state tax authority's application of a purported CPM was deficient in several ways. Among other things, the state tax authority did not consider all facts and circumstances, used unadjusted financial data, and considered only operating margin as profit-level indicator. A more detailed review of the facts would have shown that Company A took only flash title to the products and did not have to pay Company B for the products until Company A was paid by its customers. Company A therefore incurred no additional costs or risks in formally buying and selling the property.

To use operating margins from the comparables properly to test the profitability of Company A, the state tax authority should have adjusted Company's A financial data to remove inventory costs and corresponding revenues. Removing the inventory costs and revenues from the data would have shown that Company A's functions, property, and risks corresponded to those of the comparables. Accordingly, in comparing Company A's operating margin to the comparables, the tax authority should have adjusted Company A's financial data to ignore 300x of revenue and 300x cost of goods sold. Doing so would result in recognizing that Company A in fact has the same 8 percent operating margin as the comparables (8x/100x).

Considering another indicator of profitability, markup on operating costs, also would have shown the tax authority that no adjustment was warranted. Company A's 8x markup on its 92x of operating expenses constituted an 8.7 percent markup on operating costs (8x/92x), precisely matching the comparables' 8.7 percent markup on their operating expenses.[27] The state tax authority's proposed increase to Company A's income would give it a 34.9 percent markup on costs, four times that of the comparables — an improbable result on these facts.

Example 2: Expanding on Example 1, Company B manufactures the products it sells to Company A. Its manufacturing costs are 285x. Company B's operating profit therefore is 15x (300x minus 285x), and its markup on its manufacturing costs is 5.3 percent (15x/285x). Comparable manufacturing companies have a markup on manufacturing costs of 5.3 percent.

The state tax authority's increase to Company A's income in Example 1 implies that Company A overpaid Company B by 24x; a corresponding adjustment should thus reduce B's revenue from 300x to 276x, leaving Company B with an operating loss of 9x (276x revenue minus 285x COGS). However, the tax authority of the state in which Company B operates does not reduce Company B's income, almost certainly resulting in some level of double taxation.[28]

In short, the CPM is not the easy fix that some states have been led to think it is. Faulty applications of the method by state revenue departments and their consultants are resurrecting the concerns about the CPM that taxpayers and treaty partners raised years ago, and that we thought were resolved during the drafting of the section 482 regulations.

[27] Service companies like the comparables, with no COGS and operating margins of 8 percent, would have a markup on costs of 8.7 percent. For example, a company with revenue of 200x, no COGS, and an operating margin of 8 percent, would have operating profit of 16x, meaning it would have operating expenses of 184x. Its markup on operating expenses would be 8.7 percent (16x/184x).

[28] The precise level of double taxation will depend on considerations such as the apportionment formulas used by the two states, but the fundamental point remains that one state will treat 24x of revenue as being earned by Company A, while the other state will treat the same 24x of revenue as being earned by Company B, with a resulting near certainty of double taxation.

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Recommendations

Some state tax authorities have proposed untenable transfer pricing adjustments based on quasi-CPM analyses that could lead to resource-squandering litigation. Accordingly, we suggest that state tax authorities and taxpayers step back from the brink and consider how best to use the actual CPM (not a CPM-ish analysis) as a useful transfer pricing compliance tool.

We suggest first that state tax authorities develop the in-house expertise needed to evaluate transfer pricing compliance by taxpayers, as well as to supervise and evaluate the work of any outside transfer pricing consultants. This should not require extensive (or expensive) new hiring but can instead be achieved by dedicating current audit personnel to the development of such expertise; because at some level transfer pricing analysis amounts to common sense, a reasonable level of practical expertise does not require years of study to achieve. Certainly, the expertise provided by a PhD economist may be helpful with particularly difficult cases, but such expertise is neither necessary nor sufficient to run a transfer pricing audit program, beginning with the sound selection of cases deserving further analysis. Thus, experienced state revenue officials can readily develop the practical transfer pricing knowledge needed to administer such a program. Such practical knowledge should enable the officials responsible for managing state transfer pricing audits to supervise the work of any outside experts who may be hired, and to ensure that any proposed adjustments are based on a fully supported application of the best available method, whether a CPM or otherwise, rather than a shortcut method that will collapse under scrutiny.[29]

On the taxpayer side, we suggest that companies be prepared to explain their transfer pricing compliance programs. This preparation often includes an audit-ready transfer pricing file, prepared at the time that a return is filed. Such a file may be valuable in enabling the taxpayer to provide state tax auditors with an initial understanding of the company's transfer pricing compliance approach, including the taxpayer's analyses under the best method rule. That understanding may help the two sides agree on any areas of concern that justify closer evaluation. In those instances when the taxpayer itself selected the CPM as the best method, the audit-ready file may be valuable in demonstrating a proper application of the method. Although some taxpayers understandably may be reluctant to devote their own resources to doing work that makes a tax authority's job easier, the alternative — which could include battling over a tax authority's attempt to apply a quasi-CPM — is even more undesirable.[30]

We will end where we began, by encouraging both tax authorities and taxpayers to consider the history of the CPM, including the technical requirements that were developed to address concerns about the potential weaknesses of the method, and to facilitate its evaluation under the best method rule. Used properly, the CPM can be a useful tool to help determine arm's-length prices. But used improperly, a purported CPM will yield unsustainable results, waste time and resources, deepen disputes, and produce more litigation. ■

[29] The MTC has very recently announced that it will be restarting its transfer pricing committee. *See* Hamilton, "MTC to Restart Transfer Pricing Committee in 2021," *Tax Notes State*, Dec. 14, 2020, p. 1206. While this is a step in the right direction, it is not a substitute for states' establishing their own expertise and conducting their own audits.

[30] In Example 1, if the taxpayer's file had shown why financial data should be adjusted, an improper application of the CPM might have been prevented.

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