MULTISTATE TAX COMMISSION

Working Together Since 1967 to Preserve Federalism and Tax Fairness

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Mr. Jeffrey Owens
Director, CTPA
Organisation for Economic Cooperation and Development
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Dear Mr. Owens:

On July 2, 2010, the Organisation for Economic Cooperation and Development announced that it was considering a new project on the Transfer Pricing Aspects of Intangibles and invited comments from interested parties on: (a) significant issues encountered in transfer pricing of intangibles; (b) the shortfalls, if any, in existing OECD guidance; (c) other areas of transfer pricing of intangibles in which the OECD could do "useful work"; and (d) the format of any work product produced by the OECD.

The Multistate Tax Commission ("Commission") applauds the on-going efforts of the OECD in addressing this important area of international tax policy and practice and wishes to express its appreciation for the opportunity to offer our comments on the scope and direction of the new project now under consideration by the OECD's Committee on Fiscal Affairs.

The Commission is the administrative agency for the Multistate Tax Compact, an interstate agreement among multiple sub-national jurisdictions in the United States allowing for implementation and administration of the Uniform Division of Income for Tax Purposes Act (UDITPA). The purposes of the Compact are to: (1) facilitate proper determination of state and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of tax systems, (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration, and (4) avoid duplicative taxation.[1]

Currently, 19 states and District of Columbia have adopted the Compact by statute; another 27 states are associate or sovereignty members of the Commission and participate in some or all of the Commission's activities, including the Commission's interstate auditing program.[2]

The Commission's interest in the OECD's project arises from the fact that virtually all states that impose income-based taxes on businesses use U.S. federal taxable income standards as the starting point for defining their tax bases. The states are thus directly affected by any understatement of the federal tax base through improper or inaccurate transfer pricing of transactions with related foreign entities. To fully appreciate the impact of international transfer-pricing deficiencies on states revenues, a brief explanation of state taxation concepts may be helpful.

The states use the formulary apportionment principles embodied in UDITPA in order to divide a business's net income among taxing jurisdictions, using easily-quantifiable measures of in-state property, payroll and sales as a proxy for gauging the amount of income generated in each state. This system obviates the need to engage in complex transfer pricing analysis to determine the amount of income generated by operations within each state. A majority of states have also adopted "combined reporting" regimes, which apply the principles of formulary apportionment to all related legal entities engaged in a single interrelated ("unitary") enterprise. In determining the scope of income subject to inclusion on the combined report, most combined reporting states require or permit taxpayers to exclude the income and apportionment factors of unitary foreign entities. Such reporting systems are referred to as "water's edge" filing, in contrast to world-wide unitary reporting, which applies formulary apportionment principles to all unitary entities, regardless of their place of incorporation. States using the water's edge methodology rely on the federal government to ensure that the amount of U.S.-sourced income earned by businesses operating within their borders is properly reported.

A. Recent Evidence Suggests that Existing Transfer Pricing Enforcement Has Not Prevented Multinational Enterprises (MNE's) With Significant Intangible Property Rights from Shifting Income to Low Tax Jurisdictions, Eroding the U.S. Federal Tax Base.

A recent report by the U.S. Congressional Research Service estimated the annual federal revenue losses from inappropriate income shifting to foreign low-tax jurisdictions as ranging between \$10 billion and \$60 billion.[3] The report cites several studies suggesting that transfer pricing abuses are the second largest source of corporate income tax revenue losses for the U.S. treasury arising from international transactions.[4] For instance, a 2003 study by Harry Grubert of the U.S. Treasury Department found that for U.S.-based manufacturing companies, approximately one-half of the income derived from research and development based intangibles is shifted from high-tax to low-tax countries.[5] The Congressional Research Service also cites the results of the United States' dividend "repatriation holiday" in the 2004 Jobs Creation Act as further evidence that intangible property transfers are not being properly accounted for under current tax laws, allowing income shifting and deferral to low tax jurisdictions. Congress authorized a temporary 85 percent deduction for dividends repatriated from foreign subsidiaries of U.S. businesses under the 2004 Act. The pharmaceutical, medical, electronic and computer industries repatriated \$157 billion dollars in dividends, almost half of the total amount repatriated through the program for all U.S.-based firms. These industries are uniquely dependent on intellectual property rights such as patents and copyrights for their profitability.

Given the broad consensus among economists and tax experts that income is being improperly shifted into low tax jurisdictions through transfer pricing of intangible property, the Commission believes that reform of international tax standards in this area is important and that the OECD is uniquely positioned to provide leadership to the international community in addressing these imbalances.

B. Fine-Tuning Current OECD Transfer Pricing Guidelines for Intangibles May Be Inadequate to Address the Underlying Problem of Inappropriate Income Shifting.

The Commission believes the OECD's current *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* are thorough, thoughtful, and comprehensive in addressing the many factors which should be considered in attempting to value intangible property rights transferred among related components of multinational enterprises. The *Transfer Pricing Guidelines* are to be commended for their openness in conceding the difficulty and complexity of the task facing tax administrators in establishing a reasonable range of valuation for intangible property, especially since the value of such property may be inextricably interwoven with the value of tangible property incorporating patents, copyrights, and processes, or the value (goodwill) of the overall business concern.[6]

The Commission appreciates that the OECD remains committed to the use of arms-length accounting principles as the most appropriate means of determining the amount of income earned by a MNE within a particular jurisdiction. And the Commission has no reason to question the Transfer Pricing Guideline's conclusion that arms-length accounting principles

> "… provide the closest approximation of the workings of the open market in cases where property (such as goods, other types of tangible assets or intangible assets) is transferred or services rendered between associated enterprises. While it may not always be straightforward to apply in practice, it does generally produce appropriate levels of income between members of MNE groups, acceptable to tax administrations."[7]

The Commission suggests, however, that the long-standing academic dispute over whether formulary apportionment or arms-length accounting provides a better measure of income generation among related legal entities is misplaced. The Commission suggests that in many circumstances, reliance on arms-length accounting principles alone to address inappropriate income shifting underestimates the practical difficulties facing tax administrators. Tax authorities will often have inadequate knowledge of a taxpayer's business; will lack ready access to comparable uncontrolled pricing information; will have difficulty retaining the cadre of highly skilled auditors, accountants, economists and attorneys necessary to prosecute such cases; and will not have the necessary budget to effectively handle more than a few cases every year. A tax system that relies on limited enforcement efforts rewards taxpayers for questionable practices and ultimately undermines the integrity of the system as a whole. The Commission is concerned that there will always be a significant gap between the economic ideal of determining "appropriate levels of income" through arms-length accounting methods and the reality of under-funded, under-staffed tax agencies attempting to systematically police thousands of transfers between related parties. Those practicalities, rather than any theoretical problem with arms-length accounting methodology, may be at the root of the well-documented shift of income to low tax jurisdictions.

Taxpayers also experience difficulties in complying with the arms-length standard of income determination on a jurisdictional basis.[8] First, corporations do not generally engage in geographic separate accounting—accounting for income on a jurisdiction-by-jurisdiction basis; they account for income earned throughout the world, regardless of geographic source. Second, because of the economic interdependence among parts of an enterprise operating in different countries, it may be difficult to use geographic separate accounting to isolate the income attributable to each jurisdiction in which it operates.[9]

The Commission believes that the states' experience with arms-length accounting and formulary apportionment systems at the sub-national level suggests that the OECD should not foreclose the use of formulary apportionment methodologies (including combined reporting among related entities) where appropriate. Formulary apportionment has been widely employed in the United States for well over a century as a means of determining the in-state value of business property for integrated multistate businesses. *See, e.g., Adams Express Co. v. Ohio,* 165 U.S. 194 (1897) (apportioning goodwill of ongoing business concern). Formulary apportionment was later adopted as a means for establishing in-state earnings for purposes of state income tax impositions, especially after the Multistate Tax Compact became effective in 1967. Formulary apportionment is now the universally accepted method of determining the in-state earnings of multistate taxpayers. Given the rapid rise of interstate commerce in the latter half of the 20th century, it is doubtful that the states could effectively administer their corporate income tax systems without the use of formulary apportionment.

Although some states continue to rely on arms-length accounting standards for policing transfer prices between separately-incorporated but related entities, the volume of litigation resulting from valuation disputes has been enormous. The landscape of the state income tax world is littered with tax disputes over income-shifting practices, burdening tax administrators and taxpayers with protracted and expensive litigation yielding highly uncertain results. *See, e.g., Sherwin-Williams Co. v. Commissioner*, 778 N.E. 2d. 504 *(*Mass 2002) (allowing deduction for royalty payments to Delaware intangible holding company; *Syms Corp. v. Commissioner,* 765 N.E. 2d 758 (Mass. 2002) (disallowing deduction for royalties paid to Delaware intangible holding company); In re *Tropicana, New York Tax Appeals Tribunal Nos. 815253 and 815564 (6/1/2000), http://www.nysdta.org/Decisions/815253.dec.htm.* (upholding state transfer pricing adjustment); In re *Kellwood Co., New York Tax Appeals Tribunal No. 820915 (5/18/2010), http://www.nysdta.org/Determinations/820915.rem.htm* (rejecting state challenges to transfer pricing and economic substance). The landscape is similar at the federal level; scores of prolonged tax disputes and reams of regulatory guidance under Internal Revenue Code Section 482 have not prevented widespread income shifting. *See, e.g., Intel Corp. v. Commissioner,* 100 T.C. 616 (1993);

Today, in the United States, a majority of states have concluded that the task of policing thousands of transactions between thousands of related parties to prevent income shifting is beyond their capabilities. Those states have now adopted combined reporting systems, eliminating the need to undertake any transfer pricing analysis on a domestic basis.

The *Transfer Pricing Guidelines* recognize that there are instances in which the arms-length standard may be extremely difficult to apply—specifically when the property transferred is so unique that the search for comparables is unavailing or when the projections of benefits is too uncertain or speculative.[10] In addition, there are some instances where the integration of operations, tangible and intangible property, and industrial processes is so complete that it is unrealistic to suggest that the source of income generation can be meaningfully isolated in related entities operating in multiple countries. In such situations, formulary apportionment may be the most accurate as well as the most practical means of achieving a fair allocation of income among competing taxing jurisdictions. The Commission accordingly hopes the OECD will study the question of whether formulary apportionment should also be applied to some highly integrated industries operating across national borders.

C. Adoption of a Deemed-Earnings International Tax Standard for Certain Transactions with Subsidiaries Operating in Low Tax Jurisdictions May Reduce Income Shifting.

As another alternative to adjusting arms-length pricing guidelines to prevent income shifting, the OECD should study the possibility of adopting a set of recommended rules similar to the Subpart F provisions of the U.S. Internal Revenue Code. Under Subpart F,[11] income earned by controlled foreign corporations (CFC's) operating in low-tax jurisdictions is included in the U.S, parent's tax base as deemed dividend income, before repatriation, and subject to a deduction if the income is subsequently repatriated in the form of an ordinary foreign dividend. The federal government allows a tax credit for any taxes paid to the foreign jurisdiction, preventing double taxation. These rules are an important backstop to the use of "arms-length" accounting standards and transfer pricing determinations. Unfortunately, the Subpart F rules currently in place in the U.S. have proven to be susceptible to elaborate and complex tax planning strategies involving multiple international transactions and inconsistent international tax regimes. The Commission believes that international adoption of a comprehensive Subpart F system for avoiding deferred recognition of profits would greatly reduce the ability of MNEs to engage in this type of inappropriate tax planning and would eliminate the need to engage in transfer pricing analysis and litigation in many circumstances.

D. Conclusion.

Once again, the Commission wishes to express its gratitude to the OECD for recognizing the problems facing tax jurisdictions and taxpayers in valuing intangible property transfers in highly complex economic systems. As noted scholar Joann Martens-Weiner writes:

> "The nature of cross-border intercompany transfers has also changed. Multinational enterprises no longer primarily transfer basic goods for which arm's length prices are readily available. Their internal transfers increasingly involve transfers of difficult-to-s value intangible property (patents, copyrights, trademarks, etc.)."[12]

While there are undoubtedly some improvements which can be made to the current *Transfer Pricing Guidelines* to address particular problems, the Commission believes that the benefits of formulary apportionment systems for equitably sourcing income from intangible property rights should not be understated. As the U.S. Supreme Court wrote many years ago, determining where and how income arose "bears some resemblance to … slicing a shadow." *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 193 (1983). The current *Transfer Pricing*

Guidelines certainly apply well-reasoned economic and accounting principles to the task, but from a practical standpoint, other approaches may prove more efficicacious in preventing inappropriate income shifting.

Again, thank you for the opportunity to submit comments on this important topic on behalf of the Multistate Tax Commission.

Sincerely,

Joe Huddleston LL.D
Executive Director
Multistate Tax Commission

ENDNOTES

[1] Multistate Tax Compact, Art. I.

[2] *Compact Members*: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. *Sovereignty Members*: Georgia, Kentucky, Louisiana, Maryland, New Jersey, and West Virginia. *Associate Members*: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Wisconsin, and Wyoming.

[3] Jane G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service, June 4, 2010, available at www.crs.gov.

[4] See, for example, Melissa Redmiles, "The One-Time Dividends-Received Deduction," Internal Revenue Service, Statistics of Income Bulletin, Spring 2008, http://www.irsustreas.gov/pub/irs-soi/08codivdeductbul.pdf.

[5] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, Volume 56, No.1, Part 2, March 2003, p.221.

[6] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, July 2010, pp. 197-203.

[7] Id. at 38.

[8] Id. At 203.

[9] Although McLure's outlines the difficulty that multistate corporate income taxpayers find in complying with arm's length accounting among U.S. states, his analysis has relevance in the international context as well. Charles McLure, "Implementing the State Corporate Income tax in the Digital Age*," National Tax Journal*, Volume 53, No. 4, Part 3, December 2000, p. 1291.*See also*, Charles E. McLure and Joann Martens-Weiner, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income," in *Taxing Capital Income in the European Union: Issues and Options for Reform*, pp. 243-92. Oxford University Press, 2000. McLure and Weiner discuss the suitability of formulary apportionment for use in the international context within the EU.

[10] *OECD Transfer Pricing Guidelines, op. cit.;* pp. 197, 203

[11] Subpart F was designed to prevent U.S. citizens and resident individuals and corporations from artificially deferring otherwise taxable income through use of foreign entities. Enacted in 1962, these rules incorporate most of the features of Controlled Foreign Corporations (CFC) rules used in other countries. The rules require a U.S. Shareholder of a CFC to include in its income currently its share of Subpart F income of the CFC and its share of earnings and profits (E&P) of the CFC that are invested in United States property, and further exclude from its income any dividends distributed from such previously taxed income. Subpart F income includes the following types of income (IRC sections 953 and 954):

- Foreign Personal Holding Company Income (FPHCI), including dividends, interest, rents, royalties, and gains from alienation of property that produces or could produce such income.
- Foreign Base Company Sales Income from buying goods from a related party and selling them to anyone or buying goods from anyone and selling them to a related party, where such goods are both made and for use outside the CFC's country of incorporation.
- Foreign Base Company Services Income from performing services for or on behalf of a related person
- Foreign Base Company Oil Related Income from oil activities outside the CFC's country of incorporation.
- Insurance Income from insurance or annuity contracts related to risks outside the CFC's. In addition, a U.S. shareholder must include in its income its share of earnings and profits (E&P) invested in U.S. property. U.S. rules provide that a U.S. shareholder excludes from its income any dividend received which is considered paid from amounts previously taxed under Subpart F.

Corporate U.S. shareholders are entitled to a foreign tax credit for their share of the foreign income taxes paid by a CFC with respect to E&P underlying a Subpart F inclusion. To prevent avoidance of Subpart F, U.S. shareholders of a CFC must recharacterize gain on disposition of the CFC shares as a dividend. In addition, various special rules apply.

[12] Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU*, Springer 2006, p. 106