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Transfer Pricing Agreements in State Tax Planning

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Multistate businesses routinely strive to make their corporate structures more efficient. This goal often entails forming corporate affiliates with a single functional purpose. For example, an entity could be formed to handle “back office” operations, to operate as the distributor of products sold by the business, to operate as the “bank” for the multistate operation, or to hold the intangible property used by the group. Although seeking such corporate efficiencies appears innocuous, their use in conjunction with state tax planning has raised the ire of many state taxing authorities.

Seeking state tax savings, multistate taxpayers benefit from state tax rate arbitrage to minimize their overall effective tax rate. The end result of such tax planning often involves shifting income from jurisdictions with a high tax rate state to those with a lower tax rate state. Taxing authorities, seeking to protect the public fisc, attack such restructuring by asserting that the taxpayer has “distorted” their reported income to the state.

In defense of their chosen corporate structure, the multistate taxpayer often commissions the completion of a transfer pricing study. The purpose of the transfer pricing study is to document the fairness of the intra-company pricing charged by the members of the affiliated group. The touchstone for fairness in these studies is found in federal law – IRC

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Section 482. This federal statute outlines the requirements for demonstrating that pricing is "arm's length" or fair.

As state tax planning has become more aggressive, state taxing authorities have often ignored transfer pricing studies. However, there have been several recent state court decisions affirming the importance of preparing a study and reminding state taxing authorities that such studies cannot be ignored.

The case of *See's Candies* is instructive. In the case, the taxpayer, doing business in Utah, sold its trademarks and other intellectual property (the "IP") for stock to a corporate affiliate located outside the state. In return for ongoing royalty payments, the affiliate granted the taxpayer a license to use the IP in its business. Prior to the sale, the taxpayer hired a team of economists to value the purchased IP and to prepare a transfer pricing study to make sure that the ongoing royalty payments met the arm's-length standard of IRC Section 482. The expense associated with the royalty payments made to the affiliate reduced the taxpayer's taxable income in Utah.

The Utah Tax Commission disallowed the full amount of the royalty expenses deducted by the taxpayer. Disregarding the taxpayer's transfer pricing study, the Commission argued that the royalty deductions resulted in an "improper shifting of income" between the taxpayer and its affiliate. The Utah Tax Court noted that state law mirrored the arm's-length standards of IRC Section 482. As a result, and because the taxpayer's transfer pricing study was not challenged, the Tax Court agreed with the taxpayer and upheld the deductions taken for the ongoing royalty payments. The holding of this case is not unique. In the last few years there have been several state court decisions reflecting the same approach, including the Indiana cases of *Rent-A-Center East, Inc.* and *Columbia Sportswear USA Corp.*