



# Insights: Transfer Pricing

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## Transfer pricing is not just an international issue

In light of the severe economic impact of the COVID-19 pandemic, tax authorities, including those at the state level, are seeking ways to continue to collect revenue. One avenue for states is transfer pricing audits, particularly for states that do not require that a taxpayer calculate state tax liability on a combined or consolidated basis. US federal transfer pricing principles are generally used to allocate income between affiliated companies in different states in the same manner as US federal regulations set forth the profit allocation between legal entities across international borders. Even prior to the COVID-19 pandemic, state tax authorities had begun focusing on transfer pricing issues. In the last few years, CRA has assisted clients in state transfer pricing audits and planning with greater frequency. State audit issues range in magnitude from simple transactions such as management fees being charged across states to complex recharacterizations such as imputed royalties for IP profit apportionment.

### Increasing state scrutiny

States have bolstered their transfer pricing expertise. States, including Alabama, North Carolina, and Louisiana have hired an external transfer pricing advisor for assistance with audits.<sup>1</sup> In addition, states have coordinated their auditing efforts through the Multistate Tax Commission (MTC), in which participating states share information and train audit teams. The MTC created the State Intercompany Transactions Advisory Service (SITAS) to address transfer pricing matters. In a sign of transfer pricing's prominence, the SITAS held a meeting on March 23, 2021, its first since 2016. The group planned to examine ways to help states audit large multistate companies and perform the economic analysis necessary for the reviews. The meeting agenda also included options for information sharing and training across states.<sup>2</sup>

While state transfer pricing audits have been around for decades, the number of states actively pursuing tax adjustments has also increased.<sup>3</sup> Further, some states have adopted their own transfer pricing regulations,

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<sup>1</sup> Morgan Lewis, "State Transfer Pricing Enforcement – State Efforts and Taxpayer Best Practices," May 28, 2020, <https://www.morganlewis.com/events/2020/05/state-transfer-pricing-enforcement-state-efforts-and-taxpayer-best-practices>.

<sup>2</sup> Michael J. Bologna, "States Reboot Effort Against Tax Loss from Intercompany Pricing," *Bloomberg Tax*, August 18, 2021, <https://news.bloombergtax.com/transfer-pricing/states-reboot-effort-against-tax-loss-from-intercompany-pricing?context=article-related>.

<sup>3</sup> See Rebel Curd et al., "The Implications of Recent New York Transfer Pricing Decisions for IP Lawyers," *Bright Ideas*, The New York State Bar Association, July 11, 2007, <https://www.crai.com/insights-events/publications/implications-recent-new-york-transfer-pricing-decisions-ip-lawyers/>.

while both Utah and Indiana have formally included US federal transfer pricing regulations into their tax codes. Meanwhile, Virginia is requiring corporate taxpayers to refile tax filings for the tax year 2019 as they transition from separate to combined tax reporting in an effort to combat tax avoidance from transfer pricing.<sup>4</sup> Some states are now offering new ways forward to help taxpayers reduce state transfer pricing risks. For example, Indiana started an advance pricing agreement program in April 2020, while North Carolina started a short-term transfer pricing amnesty program in August 2020.<sup>5</sup> Several states have also implemented related party expense add-back exceptions which rely on arm's length pricing. For example, in Pennsylvania, the add-back of intercompany intangible and interest expenses does not apply if a taxpayer establishes that the transaction was conducted at arm's length rates and terms.

## Focus on state planning and defense

Transfer pricing matters can be as simple as determining the arm's-length price of a management fee charge out or financing arrangements such as intercompany loans. In other cases, the state tax authority has attempted to recharacterize a simple routine distribution arrangement into a profit split or use an apportionment method. This is not surprising, as courts agreed that state tax authorities misused their discretionary authorities to reallocate the taxpayer's income in three high profile state transfer pricing cases we summarize below.<sup>6</sup>

- In *Columbia Sportswear USA Corp. v. Indiana Department of State Revenue*, the Indiana Department of State Revenue claimed that the transfer price was distortive and instead used its discretionary authority to make an adjustment. The Indiana Tax Court ruled that the taxpayer had an arm's-length transaction supported by a transfer pricing study.
- In *Rent-A-Center East, Inc. v. Indiana Department of State Revenue* the Indiana Department of State Revenue claimed that the taxpayer's transfer pricing study was irrelevant. The Indiana Tax Court ruled that the taxpayer had arm's-length transactions supported by a transfer pricing study.
- In *Utah State Tax Commission v. See's Candies, Inc.* the Utah State Commission's adjustment ignored the arm's-length standard, and instead, would "clearly reflect" the taxpayer's income. This was rejected by the Utah Supreme Court.

With the increased scrutiny of state transfer pricing issues, taxpayers should (i) check materiality of their transactions with affiliates across state lines; (ii) prepare or review state transfer pricing documentation; and (iii) ensure that their transactions with affiliates across state lines are conducted at arm's-length.

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<sup>4</sup> Michael J. Bologna, "Virginia Set to Require Big Business to Refile 2019 Tax Returns." *Bloomberg Tax*, March 18, 2021, <https://news.bloombergtax.com/daily-tax-report-state/virginia-set-to-require-big-business-to-refile-2019-tax-returns>.

<sup>5</sup> Michael J. Bologna, "States Target Missed Tax Collections From Intercompany Transfers," *Bloomberg Tax*, August 13, 2020, <https://news.bloombergtax.com/daily-tax-report-state/states-target-missed-tax-collections-from-intercompany-transfers>.

<sup>6</sup> *Ibid.*

CRA assists clients in a wide range of state transfer pricing matters from planning and defensive documentation to audit support and court expert witnesses. For more information about the topics raised in this issue, please contact the authors.

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