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In this article, Braddock examines the history of transfer pricing and the recent state transfer pricing enforcement trends.

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Transfer pricing maintains its global position as a significant tax issue facing national governments. The OECD[1] laid out the "arm's-length principle" in article 9 of its model tax convention[2] and regularly issues transfer pricing guidance for governments and taxpayers on how to apply the arm's-length principle to cross-border transactions to combat taxpayer shifting of taxable profits between jurisdictions.[3] At the 2023 G20 New Delhi Summit, G20 leaders issued a declaration of their continued commitment to swiftly implement pillar 1 of the OECD's two-pillar tax reform plan, which includes transfer pricing simplification rules.[4] And even closer to home, Jennifer Best, acting deputy commissioner of the IRS's Large Business and International Division, shared that with increased IRS funding from the passing of the Inflation Reduction Act of 2022, the IRS is looking to "do more audit work" on transfer pricing issues.[5] Transfer pricing continues to garner attention at the international and national levels, and states have been taking notice.

Historically, transfer pricing was primarily an international tax issue, and if transfer pricing ever did wander into the state tax world, it was in the context of separate return and combined reporting states. However, the number of state transfer pricing audits has quadrupled since 2015, and the financial pressures on state coffers from the COVID-19 pandemic have led to further state scrutiny of multinational enterprises' transfer pricing structures for additional state revenue.[6] Now, as previously predicted, tensions have boiled over.[7] State transfer pricing audits continue to rise, and litigation is ensuing from the wrap-up of pre- and post-pandemic state transfer pricing audits.

This article will look at the history of transfer pricing and state transfer pricing enforcement in this next frontier of state taxation.

[1]OECD, About. The OECD is an international organization, of which the United States is a part, that seeks to establish international standards to combat tax avoidance.

[2]OECD, Model Tax Convention on Income and on Capital (2017).

[3]OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

[4]G20 New Delhi Leaders' Declaration (Sept. 9-10, 2023); *see also* Stephanie Soong, "G-20 Leaders Call for Finalizing Pillar 1 Tax Treaty, Amount B," *Tax Notes Int'l*, Sept. 18, 2023, p. 1604.

[5]Tim Shaw, "Transfer Pricing Enforcement, Advance Agreement Changes Coming, IRS Official Says," Thomson Reuters, Mar. 14, 2023; *see also* Shaw, "Transfer Pricing Audits Likely to Rise, Tax Expert Says," Thomson Reuters, Oct. 18, 2022.

[6]*See generally* David Brunori, Mo Bell-Jacobs, and Brian Kirkell, "State Transfer Pricing Series: Be Prepared for Audits Ramping Up," RSM US LLP (Aug. 31, 2020).

[7]Howard Berger et al., "States Can Learn Much From Transfer Pricing History — Or Be Condemned to Repeat It," *Tax Notes State*, Feb. 22, 2021, p. 779.

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History of Transfer Pricing

Before discussing the history of transfer pricing, we must summarize what transfer pricing is. Transfer pricing is the method in which a division or subsidiary of an MNE prices intragroup cross-border transactions of goods, services, or intellectual property.[8] This can allow for tax savings because multinationals can move taxable income to low-tax jurisdictions. This shifting of taxable income to low-tax jurisdictions has led to the OECD, the U.N., and national and state governments to adopt transfer pricing rules, the most common being the arm's-length principle. Governments scrutinize MNEs' transfer pricing structures because in the marketplace, in which two independent parties negotiate over a transaction, the value of the transaction should reflect the current market —whereas when the parties are related, they may artificially undervalue the transaction to minimize tax liability.[9] Therefore, governments require the intragroup transaction to be at "arm's length" to reflect a transaction made in the marketplace between unrelated parties.

So where does the history of transfer pricing begin? It begins with the "company." The company is the most successful piece of legal fiction with its status as one of the pillars of the modern economy.[10] This has been possible only because of companies' attributes of limited liability and corporate separateness.

While limiting a shareholder's liability to the value of their investment dates back to the Middle Ages,[11] the concept of limited liability gained steam in the United States during the Industrial Revolution. One of the most famous cases of limited liability is the wrecked schooner of *The Rebecca*.[12] The concept of limited liability became a critical moment in economic history, as it allowed individuals to shield their personal assets and invest into a company with a predetermined amount of potential liability. This creation allowed the company to be separate from the individual shareholders behind it, and thus liability for wrongdoing would be limited to the legal person that is the company.[13]

The second pivotal moment in economic history came when limited liability expanded to corporate shareholders in a corporate group. The concept of limited liability initially covered only individual shareholders because companies could not be shareholders in other companies.[14] It was not until the late 1800s that a company could own shares in another company. In 1896 New Jersey adopted legislation that allowed corporations to form their own subsidiaries and to own shares.[15] Once companies could become shareholders of other companies, limited liability expanded to the parent company, thus shielding the parent company from the liabilities of its subsidiaries, therefore creating multilayer protection for the parent company and the individual shareholders behind the parent.

By the late 19th and early 20th centuries, the combination of expanded limited liability and the expansion of corporate groups operating in a single jurisdiction to multiple jurisdictions led to a flourishing of "big business" that dominated major sectors of the U.S. economy — meat packing, railroads, steel, oil refining, banking, and manufacturing.[16] The big business transformation of the U.S. economy following the Civil War also led to tax transformations that included early forms of transfer pricing regulations. Before 1917, possession corporations were ineligible to file

[8]U.N. Department of Economics and Social Affairs, Transfer Pricing.

[9]Thomson Reuters, "Transfer Pricing: What Is Transfer Pricing? Documentation Requirements by Country," Tax & Accounting blog, Nov. 11, 2021.

[10]Janet Dine and Marios Koutsias, "The Three Shades of Tax Avoidance of Corporate Groups: Company Law, Ethics and the Multiplicity of Jurisdictions Involved," 30 *Eur. Bus. L. Rev.* 1 (2019).

[11]In 11th century Italy, a *commenda* was an arrangement in which a "passive partner" would fund a merchant, the "managing partner," to embark on an ocean voyage, and if any incidents occurred, the passive partner's liability was limited to his funding of the voyage while the managing partner bore the remaining liability. *See* Robert W. Hillman, "Limited Liability in Historical Perspective," 54 *Wash. & Lee L. Rev.* 613, 617, 621-623 (1997).

[12]*The Rebecca Norwich Co. v. Wright Siobhan Faloughi*, 373 Case No. 11,619 (U.S. Dist. Ct. Me. 1831).

[13]Dine and Koutsias, *supra* note 10, at 6.

[14]*Id.* at 8 (citing Jose Maria Lezcano Navarro, *Piercing the Corporate Veil in Latin America Jurisprudence: A Comparison With the Anglo-American Method* 16 (2016)).

[15]*See* Harwell Wells, "The Modernization of Corporation Law, 1920-1940," 11 *U. Pa. J. Bus.* 573, 581 (2009); *see also* Henry Butler, "Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges," 14 *J. Legal Stud.* 129, 161 (1985).

[16]ehistory, "The Rise of Big Business," Ohio State University, Department of History; and Digital History, "The Rise of Big Business" (2021).

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consolidated returns with domestic affiliates, thus creating an opportunity for international tax avoidance. However, the U.S. Congress recognized this opportunity and passed the War Revenue Act of 1917, which authorized the revenue commissioner to "consolidate the accounts of affiliated corporations 'for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or business.'"[17]

In 1928 the consolidated return provision was expanded and broadened into a recognizable predecessor of the IRC section 482 provision:

> Section 45. Allocation of Income and Deductions. In any case of two or more trades or businesses . . . owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or business if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such trades or business.[18]

The early section 45 cases focused on the statutory language of "evasion of taxes" and "clearly to reflect the income"; thus, the courts applied several standards to transactions to clearly reflect taxpayer income. The arm's-length standard did not make an appearance until 1935, when section 45 regulations were promulgated; however, the U.S. Court of Appeals for the Ninth Circuit practically invalidated the regulations when it stated that it did not agree that "'arm's length bargaining' is the sole criterion for applying the statutory language of section 45."[19]

By 1968 section 45 was renumbered to section 482, and the IRS promulgated new section 482 regulations with a transfer pricing component. Because the Ninth Circuit stated that the arm's-length bargaining could not be the "sole criterion," the regulations provided types of transactions that the standard could be applied to and to varying degrees of specificity.[20] Since 1968, section 482's transfer pricing regulations have been with us with few changes and additions.

Meanwhile, at the international level, countries recognized the transfer pricing issue, and by the late 1950s the Organization for European Economic Cooperation,[21] the predecessor to the OECD, drew up what would become article 9 to the OECD's 1963 draft convention.[22] In 1979 the OECD began issuing its transfer pricing guidelines with periodic updates, the latest in January 2022.

State Transfer Pricing Enforcement

So what about the states? State transfer pricing enforcement has evolved extensively over the years. While many states have incorporated section 482 into their state income tax structures or have given their revenue departments section 482-type discretion,[23] states have historically ignored the arm's-length standard. In the past, states have challenged intercompany transactions on the basis that the transactions lacked economic substance or were tax motivated.[24] However, states are shifting their approach. Today, states are tackling transfer pricing enforcement in one of three ways:

[17] Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" 3 (U. Mich. L. & Econ., Olin Working Paper No. 07-017, U. Mich. Pub. L., Working Paper No. 92, 2007) (citing Regulation 41, articles 77 and 78 of the War Revenue Act of 1917).

[18] *Id.* (citing Revenue Act of 1928, ch. 852, section 45 (1928)).

[19] *Id.* at 6 (quoting *Frank v. International Canadian Corp.*, 308 F.2d 520, 528 (9th Cir. 1962)).

[20] *Id.* at 8.

[21] OECD, About the OEEC. The OECD's predecessor, the Organization for European Economic Cooperation, was established in 1948 under the Marshall Plan to distribute aid to the countries of Western Europe.

[22] Jeffrey Owens, Opening Speech at OECD Conference: Transfer Pricing and Treaties in a Changing World (Sept. 21-22, 2009).

[23] *See, e.g.*, Ala. Code section 40-2A-17(a); Ark. Code Ann. section 26-51-805(e); Cal. Rev. & Tax. Code section 24725; Conn. Gen. Stat. sections 12-213(a), 12-226(a), and 12-225(a), (b); Ind. Code section 6-3-2-2(m); Md. Code Ann., Tax-Gen. section 10-109; Mass. Gen. Laws ch. 63, sections 30.4, 33; N.J. Rev. Stat. sections and 54:10A-4(k), 54:10A-10; N.Y. Tax Law section 208.9(i); Ohio Rev. Code Ann. sections 5733.04(I) and5733.031(C); 72 Pa. Stat. and Cons. Stat. Ann.section 7401(3)1(a); and Utah Code Ann. section 59-7-113.

[24] *See, e.g.*, *Branch Bank & Trust Co. v. D.C. Office of Tax and Revenue*, No. 2015-OTR-00015 (D.C. O.A.H. 2016); *Gore Enterprise Holdings Inc. v. Comptroller of Treasury*, 87 A.3d 1263 (Md. 2014); *Sherwin-Williams Co. v. Tax Appeals Tribunal*, 12 A.D.3d 112 (N.Y. App. Div. 2004); *Syms Corp. v. Commissioner*, 765 N.E.2d 758 (Mass. 2002).

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1. adjusting the tax base (for example, addback of intercompany expenses, disregarding affiliated entities or certain transactions);
2. adjusting or changing the arm's-length standard; or
3. forced combination.

Let's examine adjusting the tax base. The 2018 Utah Supreme Court case *See's Candies* remains the preeminent case in which a state taxing authority has argued it has complete discretion to adjust the intercompany transactions that go into the tax base.[25] In *See's Candies*, the taxpayer paid a royalty to an affiliate for the use of that affiliate's intellectual property in Utah. The taxpayer took a corresponding deduction on its Utah corporate tax return. On audit, the Utah State Tax Commission (USTC) viewed the intercompany transactions, despite supporting third-party transfer pricing reports, as a mechanism for removing income from the Utah tax base. The USTC then disallowed the royalty deduction. The USTC dismissed the transfer pricing studies that supported the arm's-length nature of the royalty transactions and argued that Utah's codification of a section 482-like statute — Utah Code Ann. section 59-7-113 — gave the USTC broad authority to allocate income whenever it deems necessary.[26]

The Utah Supreme Court relied in part on IRC section 482's legislative history to determine that the phrase "necessary in order to prevent the evasion of taxes or clearly to reflect . . . income" meant that "parties dealing at arm's length would not enter," and the arm's-length standard was incorporated into Utah Code Ann. section 59-7-113.[27] The Utah Supreme Court also found that because IRC section 482 and Utah Code Ann. section 59-7-113 were "strikingly similar," the allocation of income is only necessary when "related companies enter into transactions that do not resemble what unrelated companies dealing at arm's length would agree to do."[28] The Utah Supreme Court rejected the USTC's position and upheld the lower court's ruling to allow the taxpayer's deductions.

See's Candies is important for two reasons. First, the case supports the proposition that when a state has adopted a section 482-like statute, federal authorities can be examined for interpretive guidance of the state statute. Second, the case acts as a check on state revenue departments that seek to use their discretionary authority to include or exclude intercompany transactions from the tax base despite those transactions being supported by transfer pricing studies.

States have also begun to obtain technical knowledge, via in-house development or third-party consultants, to challenge a taxpayer's selected transfer pricing method. This approach is significant because states are taking a fact-intensive approach to scrutinize taxpayers' selected transfer pricing methods and are purportedly applying a more accurate arm's-length standard that generally results in more state tax liability.

This trend can be seen with the Multistate Tax Commission's creation of the State Intercompany Transactions Advisory Service (SITAS).[29] While SITAS was recently disbanded,[30] the MTC acted as a forum for states to collaborate on transfer pricing issues, including through information sharing, consultant recommendations, and strategy.

SITAS also led states to develop their own voluntary transfer pricing disclosure and managed audit programs, demonstrating this state pursuit of increased section 482 expertise. Indiana,[31] Louisiana,[32] New Jersey,[33] and North Carolina[34] developed transfer pricing programs amid the COVID-19 pandemic. Moreover, Alabama, Connecticut, Georgia, Indiana,

[25] *Utah State Tax Commission v. See's Candies Inc.*, 435 P.3d 147 (Utah 2018).

[26] *Id.* at 151.

[27] *Id.* at 156.

[28] *Id.* at 157.

[29] Multistate Tax Commission, Background & Reference Information on the State Intercompany Transactions Advisory Service (SITAS) (last accessed Oct. 30, 2023).

[30] Amy Hamilton, "MTC Dissolves Transfer Pricing Committee," *Tax Notes State*, Nov. 21, 2022, p. 681.

[31] Indiana DOR, Advanced Pricing Agreement Program (Sept. 2020).

[32] Louisiana DOR, Rev. Info. Bull. No. 21-029 (Oct. 26, 2021).

[33] New Jersey Division of Taxation, Transfer Pricing Initiative.

[34] North Carolina DOR, "Press Release: North Carolina Announces Voluntary Corporate Transfer Pricing Resolution Initiative" (July 30, 2020).

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Louisiana, Mississippi, North Carolina, Rhode Island, and Washington, D.C., have all been noted as engaging third-party transfer pricing consultants to assist in scrutinizing taxpayers' selected methods of transfer pricing.[35]

In short, states are developing transfer pricing expertise through third-party consultants, voluntary transfer pricing programs, and collaboration with other states. Georgia recently went about challenging Trader Joe's transfer pricing method in *Trader Joe's East*.[36] In the case, the Georgia DOR challenged Trader Joe's transfer pricing study that blessed fees paid by a subsidiary to the parent company for services and IP licensing. Georgia's transfer pricing statute, Ga. Code Ann. section 48-7-58(a), allows the commissioner to consider "the fair profit that would normally arise from the conduct of the trade or business" when making a transfer pricing adjustment. The case was settled while on appeal at the Georgia Tax Tribunal; however, the court decision would have likely focused on what constitutes a "fair profit" while hopefully providing insight into how much deference is granted to the Georgia DOR's challenge to a third-party transfer pricing study.

The key item to note is that states are shifting their approach on transfer pricing and are seeking to develop their own expertise on the matter. This approach could be a welcome shift from the states but only if their transfer pricing analyses are applied within the technical requirements of IRC section 482. Issues will arise if states apply a method that ressembles a transfer pricing method but ignores the technical requirements.[37] This could include:

> basing an adjustment on the profit levels of third parties without running the necessary traps [which] can result in a transfer price many multiples higher (or lower . . .) [or] attempt[ing] to apply the [comparable profits method] 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.[38]

The third and final approach to transfer pricing issues taken by states is forced combination of taxpayer affiliates. Intercompany transactions are eliminated in unitary combined filing states. Therefore, many separate return states will use forced combination as a means to eliminate transfer pricing issues, stating that the separate filings lack economic substance or do not fairly represent a taxpayer's activities in the state. The current leader of this approach is South Carolina, as seen in the recent *Tractor Supply* administrative law decision.[39]

In *Tractor Supply*, the taxpayer received 99 percent of its revenue from retail operations. The taxpayer created two subsidiaries relevant to the court's decision: (1) Tractor Supply of Michigan LLC (TS Michigan) and (2) Tractor Supply of Texas LP (TS Texas).[40] TS Texas operated retail stores, a distribution center, and a mixing center, but TS Texas also performed procurement services for the Tractor Supply group.[41] TS Michigan operated retail stores and leased all its employees from Tractor Supply Co. at cost plus a 10 percent markup per a master services agreement.[42] TS Texas also waived its right to compensation for licensing of trademarks but did charge a 9.7 percent markup on procurement services provided to Tractor Supply Co. and TS Michigan based on a third-party transfer pricing study.

South Carolina, a separate return state, audited the taxpayer and concluded that the taxpayer's South Carolina business activities were distorted for tax years 2014 through 2016. South Carolina argued that Tractor Supply Co. was shifting its income to TS Texas through the 9.7 percent markup on procurement services. South Carolina then relied on its discretionary authority to forcibly combine the taxpayer under South

[35] David Delahay and Karl Schmalz, "Abusive Transfer Pricing — By Governments!" *Tax Notes State*, June 15, 2020, p. 1315.

[36] *Trader Joe's East Inc. v. Commissioner*, *petition filed*, No. 1735253 (Ga. Tax. Trib. May 5, 2017).

[37] *See* Berger et al., *supra* note 7, at 784.

[38] *Id.*

[39] *Tractor Supply Co. v. South Carolina Department of Revenue*, No. 19-ALJ-17-0416-CC (S.C. Admin. Law Ct. Aug. 8, 2023).

[40] *Id.* at 2.

[41] *Id.* at 4.

[42] *Id.* at 6.

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Carolina's alternative apportionment statute[43] to assess more than $1.3 million in tax plus interest, which the company appealed to the administrative law court.

In what has been dubbed the "Battle of the Experts," both Tractor Supply Co. and South Carolina put up their transfer pricing experts. Both experts stated that the third-party transfer pricing study was flawed, although the taxpayer's expert noted that TS Texas's income was consistent with arm's-length standards. However, the administrative law court ruled for the state, finding that the state's transfer pricing expert demonstrated that the 9.7 percent procurement services markup did not reflect the arm's-length standard because, among other things, it was "illogical that [TS Texas] would have costs of around $13 million for its procurement function and reap almost $400 million per year."[44]

While the South Carolina Administrative Law Court withdrew and then reissued the *Tractor Supply* decision, the decision demonstrates that states are having some success in forcibly combining taxpayers rather than undergoing the difficult and fact-intensive approach of developing IRC section 482 expertise to challenge the nuances of a transfer pricing method.[45] When a state can win the so-called Battle of the Experts on the validity of a transfer pricing study, then forced combination can always remain an option for states in transfer pricing enforcement.

Conclusion

Historically, transfer pricing has been a tax issue of national governments. The OECD and U.N. model treaties, pillars 1 and 2, and G20 summits demonstrate that transfer pricing is an important international tax issue. However, state transfer pricing audits have skyrocketed, and the financial pressures from COVID-19 have led states to scrutinize multinationals' transfer pricing methods in search of additional revenue. The question today is what shape will that scrutiny take — tax base adjustments, section 482-like challenges, or forced combination. Each route is different, but all require a taxpayer to be prepared to defend its third-party transfer pricing studies. ■

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[43] S.C. Code Ann. section 12-6-2320(A)(4).

[44] *Tractor Supply Co.*, No. 19-ALJ-17-0416-CC at 22.

[45] *See also Delhaize America Inc. v. Lay*, 731 S.E.2d 486 (N.C. Ct. App. 2012) (note that the North Carolina statute at issue in *Delhaize America* was repealed in 2011, Session Law 2011-390, H.B. 619, section 1, Gen. Assemb. (N.C. 2011)).

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