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D.C. transfer pricing analysis invalidated

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In Brief

A District of Columbia Administrative Law Judge ("ALJ") in *Microsoft Corp. v. Office of Tax and Revenue*[1] found a "fatal error" in a contract auditor's "comparable profits" transfer pricing audit methodology that included ***all of the taxpayer's income*** rather than narrowing its analysis to only ***controlled transactions*** among affiliated entities. By failing to separate Microsoft's controlled transactions (those between affiliates) from its uncontrolled transactions (those made at arm's length with third parties), the ALJ found the transfer pricing analysis "***arbitrary, capricious, and unreasonable.***" Additionally, the ALJ found fault in the analysis because it failed to separately measure similar types of transactions.

The ALJ recognized that transactions may be aggregated when they involve related products or services. Because there was no factual showing of such interrelationship, the ALJ found that aggregation was not permissible. While the decision is limited to the specific facts of this case, the ALJ's decision draws into question similar audit practices that do not comport with federal and state guidance.

Facts and procedural history

The District of Columbia Office of Tax and Revenue ("OTR") issued a Notice of Proposed Assessment to Microsoft Corporation, Inc. ("Microsoft") on February 5, 2010, alleging a corporate tax deficiency for the tax year ending June 30, 2006, in the amount of $2,746,344, plus interest and penalties. The OTR based the reallocation of

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[1] D.C. Office of Admin. Hearings, Case No. 2010-OTR-00012 (May 1, 2012).

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income and assessment on the results of a transfer pricing analysis conducted by a subcontractor, Chainbridge Software, LLC ("Chainbridge"), for Microsoft's 2002 tax year. In 2002, Microsoft reported losses that were carried forward to future years, including the tax year ended June 30, 2006.

D.C. and federal I.R.C. § 482 guidance

D.C. Code § 47-1810.03 provides the authority to reallocate income between two or more organizations owned or controlled directly or indirectly by the same interests in order to prevent the evasion of taxes or to clearly reflect the income of any such organizations. The ALJ found that this provision contains language "nearly identical" to Internal Revenue Code ("I.R.C.") § 482. While D.C. has not promulgated regulations to implement this statute, Microsoft and OTR agreed that it is appropriate to use the federal regulations as guidance in interpreting the OTR's authority to rely upon transfer pricing analyses under § 47-1810.03.

Under District law, the burden of proof in an I.R.C. § 482 analysis case is on the taxpayer to show that the analysis was "arbitrary, capricious, and unreasonable."

Federal regulations generally recommend a transfer pricing analysis to test controlled transactions. A taxing authority may select one of a number of methods to measure the taxpayer's controlled transactions against the arm's length standard. One such method is the "comparable profits" method, which is "based on the amount of operating profit that the tested party [Microsoft] would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable."

The "comparable profits" transfer pricing analysis did not separate controlled from uncontrolled transactions

Microsoft transacted with both related and unrelated parties during 2002. Chainbridge analyzed Microsoft's tax position using a comparable profits method by comparing Microsoft's total profit-to-cost ratio in 2002 with the profit-to-cost ratio of businesses that were deemed to be similar to Microsoft. In doing so, Chainbridge aggregated Microsoft's controlled transactions and uncontrolled transactions.

Chainbridge justified its methodology by asserting that Microsoft's business structure was too "complex and entangled" to separate out controlled transactions. Accordingly, Chainbridge claimed that the most ***narrowly identifiable business activity*** to determine controlled transactions was Microsoft's ***total gross receipts*** on its tax return, which inherently combine together controlled and uncontrolled income.

The OTR provided no factual support for aggregating transactions

Treas. Reg. § 1.482-1(f)(2)(i)(A) allows aggregation of controlled and uncontrolled transactions "if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transaction. Generally, transactions will be aggregated only when they involve related products or services . . . ."

While the ALJ recognized that aggregation is authorized, he found that the OTR provided "no analysis why there was a need to aggregate transactions." There was "no effort to isolate the controlled transactions," rather the OTR "simply decided to aggregate all of Microsoft's transactions, without inquiring as to whether the transactions were conducted with Microsoft's affiliates."

Analysis "useless" without considering whether profits and costs arose from controlled transactions

By aggregating controlled and uncontrolled transactions, the analysis failed to measure what is required under federal regulations: a comparison between: (1) Microsoft's controlled transaction profit-to-cost ratio; and (2) comparable companies' uncontrolled transaction profit-to-cost ratio.

The ALJ concluded that "Microsoft has proved that the transfer pricing analysis was arbitrary, capricious, and unreasonable, because the analysis does not measure what the regulations require it to measure."

Failure to separately measure types of transactions also contributed to deficiencies in the analysis

The ALJ also found fault with the transfer pricing analysis because it failed to comply with the federal regulatory requirement that comparable transactions must be of similar type. Microsoft argued that it engaged in seven different types of businesses, while the OTR argued that Microsoft engaged in only one line of business - software. While the transfer pricing report showed different types of business activities for Microsoft, Chainbridge made no effort to compare like kind transactions. The ALJ agreed with Microsoft that the transfer pricing analysis should separately compare similar types of Microsoft's transactions.

Additional arguments and appeal

Microsoft advanced an alternative ground for reversing the OTR's assessment regarding two major adjustment errors: (1) the OTR's failure to deduct the costs of employee stock options; and (2) the OTR's failure to include partnership income in its analysis. However, the ALJ did not reach Microsoft's alternative arguments.

The OTR has 30 calendar days from the mailing date of the order to file an appeal to the District Court of Appeals.

PwC Observes

Steve Snyder, Transfer Pricing Director with PwC in Atlanta, provides the following observation:

Transfer pricing is a complex topic, often involving multiple entities and categories of intercompany transactions. A proper transfer pricing report relies on a detailed analysis of the specific facts, circumstances, and financial data surrounding the intercompany transactions. This decision illustrates the importance of separating the independent transactions from the related party ones and considering each of the transfer pricing methods applicable to the particular intercompany transaction.

For more information, please do not hesitate to contact:

Steve Snyder	*(678) 419-1474*	*stephen.l.snyder@us.pwc.com*
Jack Kramer	*(646) 471-2640*	*jack.kramer@us.pwc.com*
Keith Robinson	*(678) 419-1188*	*keith.w.robinson@us.pwc.com*