

May 2, 2012

Transfer Pricing Assessment Invalidated by DC ALJ

The controversial methodology relied upon by several states to assess corporate taxpayers for transfer pricing violations has been ruled invalid by a D.C. Administrative Law Judge (ALJ). *Microsoft Corporation, Inc. v. Office of Tax and Revenue*, D.C. Office of Administrative Hearings, Case No.: 2010-OTR-00012 (May 1, 2012). Specifically, the Judge found the methodology “useless” for purposes of determining whether the Taxpayer complied with the arm’s-length standard for the pricing of intercompany transactions embodied in IRC § 482. Several revenue authorities, including New Jersey, Alabama, Louisiana, Kentucky and the District of Columbia, have relied on this now invalidated transfer pricing audit methodology to assess corporate franchise and income tax. The favorable decision was reached on a motion for summary judgment argued by Sutherland SALT attorneys Stephen Kranz and Diann Smith.

Background

Chainbridge Software, LLC (Chainbridge), a subcontractor to contingent fee auditor ACS State and Local Solutions, Inc., performed what it claimed were transfer pricing analyses of District of Columbia taxpayers. In one such analysis, Chainbridge determined that Microsoft engaged in improper pricing of its domestic and international intercompany transactions. The District of Columbia, like many other states, has a statute modeled after Internal Revenue Code § 482. Under the federal code and regulations, taxpayers that engage in transactions with affiliates must price those transactions at arm’s length—meaning the result of the transaction must be “consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances.” Treas. Reg. § 1.482-1(b)(1).

In asserting that Microsoft violated transfer pricing rules, Chainbridge purported to rely on the comparable profits method permitted under the federal regulations to perform the analysis, and chose the net-profit-to-sales ratio as the profit level indicator by which to benchmark Microsoft against a list of “comparable” businesses. Importantly, Chainbridge did not perform a traditional audit of Microsoft’s books and records, but instead relied solely on Microsoft’s D.C. tax returns and publicly available information such as the consolidated financial statements of the “comparable” businesses. Chainbridge did not identify or examine any particular intercompany transactions of Microsoft in its analysis. Instead, it reviewed Microsoft’s total sales and other income, cost of goods sold, and total deductions as reported on Microsoft’s D.C. tax return to arrive at a Microsoft’s net-profit-to-sales ratio. The problems with this methodology are numerous and, had the case proceeded to an evidentiary hearing, would have been the subject of the litigation.

Before proceeding to an evidentiary hearing, however, Microsoft filed a motion for summary judgment raising two discrete problems with the Chainbridge methodology that did not involve any potentially disputed facts.

First, Microsoft argued that Chainbridge’s analysis violated the § 482 regulations because: (1) only controlled transactions can be used in applying the comparable profits method, not transactions with third parties; and (2) aggregation of even just controlled transactions is allowed only if the transactions are interrelated.

Second, Microsoft argued that Chainbridge failed to reconcile the tax accounting used to determine Microsoft’s net-profit-to-sales ratio with the financial statement accounting used to calculate the “comparable” businesses’ net-profit-to-sales ratios for purposes of ranking Microsoft under the

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comparable profits method. Specifically, Microsoft argued that Chainbridge and the District of Columbia failed to add-back two deductions permitted for tax purposes (and taken by Microsoft on its D.C. returns) but not required or allowed for financial statement purposes. According to Microsoft, these two deductions resulted in an \$8 billion difference to the analysis, and if Chainbridge had properly accounted for the financial statement/tax accounting differences as required under the § 482 regulations, Microsoft would have been securely within the range required by the comparable profits method to demonstrate no improper intercompany pricing had occurred.

In response, Chainbridge and the District of Columbia Office of Tax and Revenue (OTR) argued that the analysis fully complied with the § 482 regulations. They argued that the regulations permitted aggregation of all of Microsoft's transactions because of the complexity of Microsoft's business structure and the volume of intercompany transactions. And, although they acknowledged that it was necessary to equalize the treatment of tax accounting and financial statement accounting in performing its analysis, they contended that accounting for such differences in Microsoft's case would not change the final results.

Decision

The decision on the motion for summary judgment, issued publicly on May 1, 2012, by Administrative Law Judge Paul Handy, is comprehensive (30 pages) and rules squarely in Microsoft's favor, finding that Chainbridge and OTR

failed to conduct a comparable profits analysis of Microsoft's 2002 income based on applicable law because they [Chainbridge and OTR] improperly aggregated all of Microsoft's income, regardless of whether the income was derived from controlled or uncontrolled transactions.

The Judge further found that the methodology was invalid because the § 482 regulations:

Require[] the analyst . . . to the extent possible, to compare controlled transactions (between the tested party and its affiliated business) against uncontrolled transactions made at arm's length with third parties. . . . [and that] Chainbridge failed to compare specific types of transactions conducted by Microsoft against comparable uncontrolled transactions. Therefore, Chainbridge's analysis cannot form the basis for a determination that OTR may reallocate income between Microsoft and its affiliated businesses. . . . On this basis, Microsoft has shown that the transfer pricing analysis is arbitrary, capricious, and unreasonable based on the undisputed facts in this case. (emphasis added).

OTR and Chainbridge had argued that they could aggregate all of Microsoft's transactions because "Microsoft has engaged in thousands of controlled transactions with over 100 affiliated business"—basically arguing that it was too difficult to follow the regulations. The Judge saw through this argument, however, and noted that "the fact that Microsoft has 100 or even 2,000 affiliates does not address the question of why there was no effort to isolate the controlled transactions." The Judge noted that this aggregation of all intercompany transactions is a "significant error" because the relevant profit level ratio may be quite different for different types of transactions.

The decision raises serious questions about the continued viability of the Chainbridge methodology and the use of third-party auditors who use questionable transfer pricing practices. One quote stands out from the Judge's ruling as emblematic of the decision and of the fundamental problem with Chainbridge's methodology: "Chainbridge's framing of the data renders the analysis useless in determining whether

Microsoft's controlled transactions were conducted in accordance with the arm's length standard." (emphasis added).

Sutherland Observation: Next Steps: Should it choose to do so, OTR must appeal Judge Handy's decision to the D.C. Court of Appeals by May 31, 2012. For an appeal to be successful the Court of Appeals would need to reverse Judge Handy on both of the two independent grounds for his decision. First, Judge Handy found that OTR and Chainbridge violated the § 482 regulations by including both controlled and uncontrolled transactions in their analysis. Secondly, the Judge found that OTR and Chainbridge also violated the § 482 regulations by aggregating all of Microsoft's intercompany transactions without proving that all of the transactions were functionally comparable. Even if OTR were to obtain a reversal of the summary judgment determination, OTR would still have to contend with (1) the second issue raised by Microsoft in its summary judgment motion (regarding the financial statement/tax equalization requirement) but not addressed by the ALJ; and (2) the numerous other problems with the methodology that Microsoft would raise should an evidentiary hearing be required.

The broader impact of Judge Handy's decision in the *Microsoft* case remains to be seen, including whether OTR and other states will continue to pursue assessments based on Chainbridge's transfer pricing methods. The decision should caution other states against assuming assessments relying on this methodology will raise additional funds.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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