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Strategic Transfer Pricing: A Potential Tool for Managing State Transaction Taxes

LEA GLOBAL 2024
NORTH AMERICA CONFERENCE

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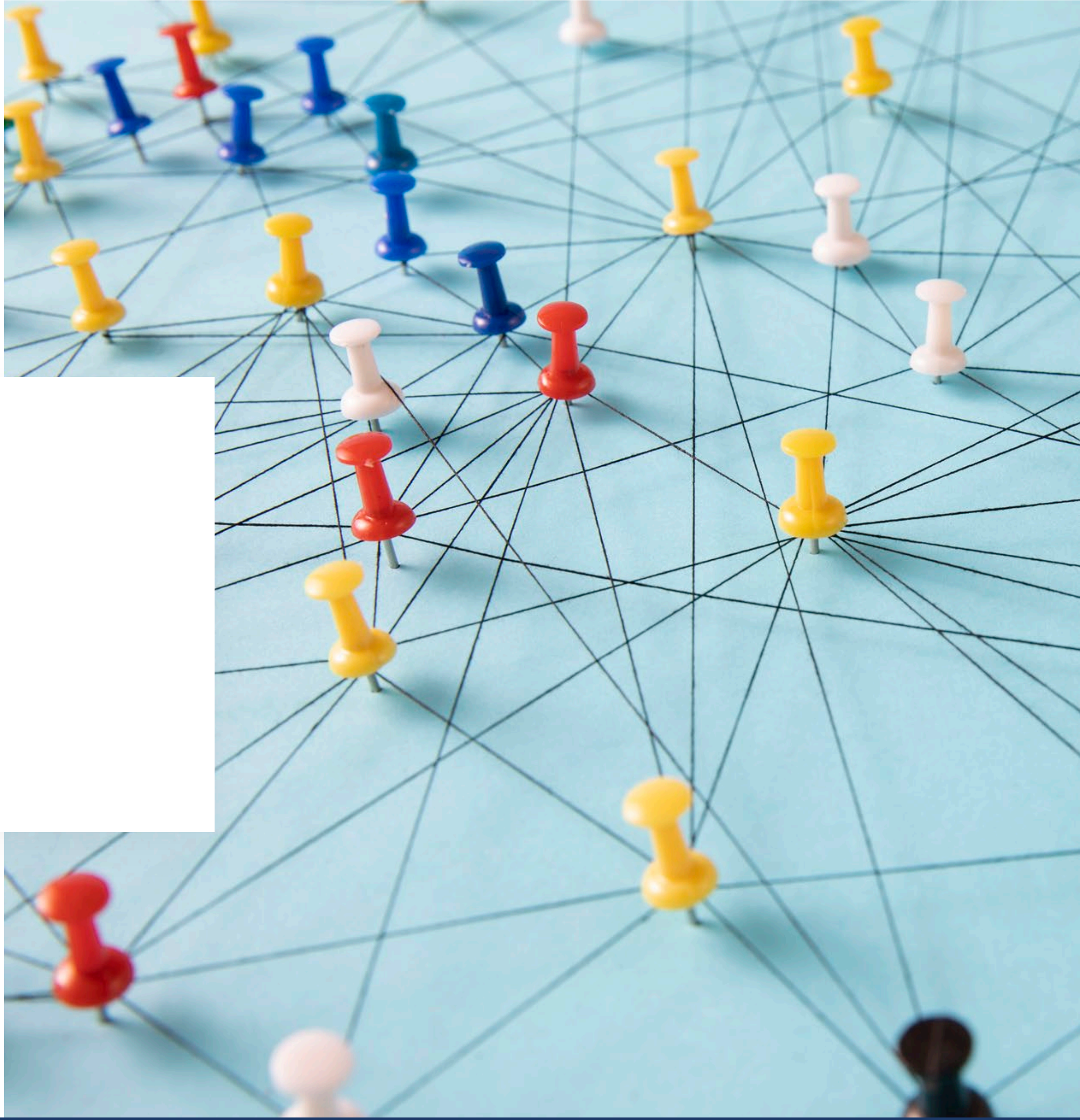
Introduction



Introduction

Purpose

- Understanding the role of transfer pricing in managing state transaction taxes for controlled transactions

Why?

- **Increasing Scrutiny**
- **Compliance Complexity**
- **Risk Mitigation**
- **Cost Savings**
- **Strategic Advantage**

Objective

- *Bring awareness of state enforcement trends and potential risks that may be incurred by clients.*
- *Provide insights into compliance strategies and potential tax planning opportunities for intercompany transactions among domestic affiliates.*

Regulatory Environment

Regulatory Environment

Why would States care?

- Tax revenue from transaction taxes continue to be an increasingly important part of state budget goals.
- The U.S. census data indicates that these transaction taxes have increased by 3.1 percent from 2022 to 2023. In this same period, individual and corporate income tax collection has dropped 13.6 percent and 3.3 percent respectively.
- State transaction taxes make up 32 percent of state revenue compared to 9 percent for corporate income tax.

		Proportion of State Revenue (2023)	**Proportion of State Revenue (2022)**	**Percent Change**
Total taxes		100%	100%	-4.4%
Property		2%	2%	5.6%
Income	*Individual*	34%	38%	-13.6%
	Corporation (net)	9%	9%	-3.3%
Sales	***General and gross receipts***	**32%**	**30%**	**3.1%**
	Motor fuels	4%	4%	5.7%
	Tobacco products	1%	1%	-7.9%
	Alcoholic beverages	1%	1%	1.5%
Motor vehicles and operators license		2%	2%	3.1%
Other taxes, NEC		14%	14%	-1.0%

Regulatory Environment

State Enforcement Tools and Observations

- **Resolution Initiatives**
- **State Collaboration and Information Sharing**
- **Increased Resources Dedicated Transfer Pricing Expertise**
- **State Sec. 482–Type Adjustments**

Key Concepts

Key Concepts – State Transaction Taxes

What are State Transaction Taxes?

- State transaction taxes - sales taxes, use taxes, gross receipts taxes, and excise taxes for vehicles – are based on a transaction price and imposed on an entity basis.
- Sales tax is a tax on transactions involving sale, transfer, or exchange of taxable personal property and/or services. Use tax is imposed on the purchaser when a taxable item is purchased from a vendor that does not charge sales tax.
- Gross receipts taxes are imposed on the gross receipts of a seller. Gross receipts taxes are imposed in seven states: Delaware, Nevada, Ohio, Oregon, Tennessee, Texas, and Washington.

Key Concepts

- **Nexus**
- **Taxability of Product or Service**
- **State Specific Exemptions**:
    - Sales for resale (i.e., not the end user)
    - Occasional Sale
    - Manufacturers
    - Occasional/isolated sales by non-retailers
    - Mergers/acquisitions
    - Governmental entities
    - Not-for-profits
    - Controlled Transaction Exemptions

Key Concepts – Transfer Pricing

What is Transfer Pricing?

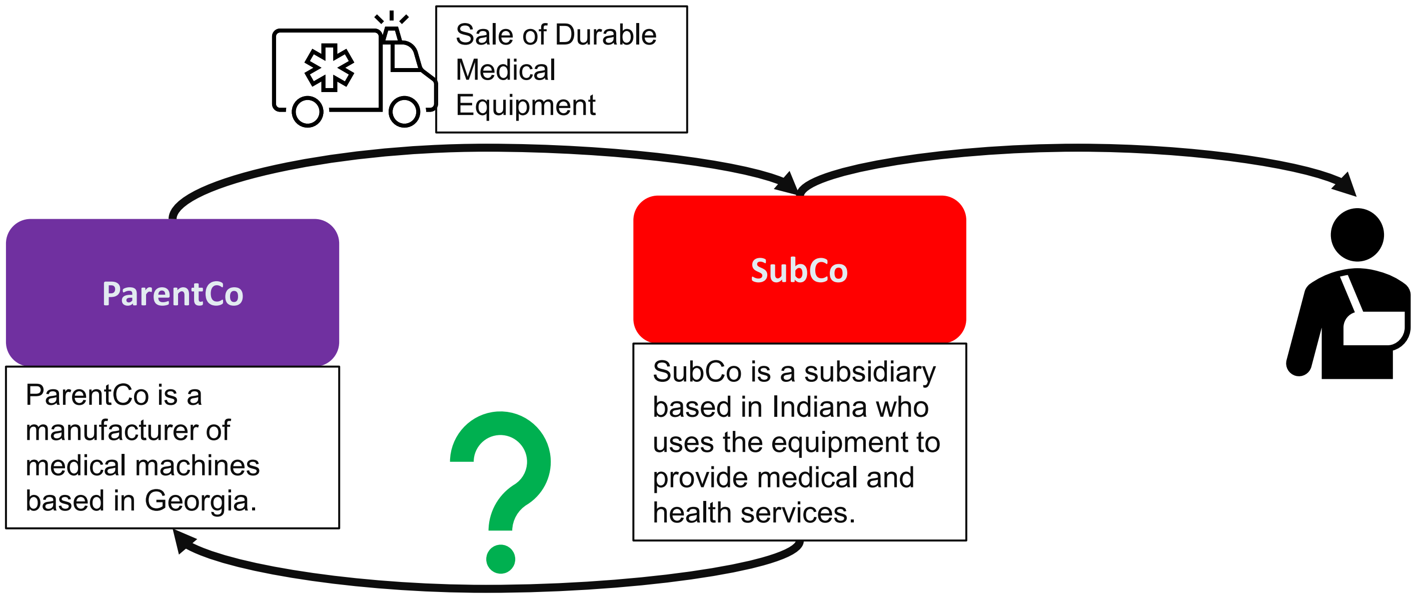
- Transfer pricing refers to the pricing used in intercompany transactions within a group of controlled taxpayers. Intercompany transactions can include sales of tangible property, intangible property, services, and financing.
- Rules and regulations are provided under Section 482 of the Internal Revenue Code.

Key Concepts

- The key concept under Treas. Reg. Section 1.482 is the definition of the "Arm's Length Standard". The Arm's Length Standard (Treas. Reg. Section 1.482-1(b)) states that the price between related parties should be set as if the related parties were dealing with unrelated parties.
- Transfer pricing methods are specified for evaluating tangible goods transactions, intangible property transactions, services transactions and financing transactions.

Illustrative Case Studies

Case Study: Optimizing Sales Tax for ParentCo Equipment Sale



<u>Challenges</u>

1. Is the sale of durable medical equipment taxable? States have varying rules on taxability of durable medical equipment.
2. What price should ParentCo charge SubCo for the products?
3. If the product is taxable, is there a way to manage the tax implications within state regulations?

Case Study: Optimizing Sales Tax for ParentCo Equipment Sale

Background

- ParentCo is a manufacturer of medical machines based in Georgia. SubCo is a subsidiary based in Indiana who uses the equipment to provide medical services. ParentCo needs to sells used medical machines (“Product A”) to subsidiary which is considered a taxable transaction in Indiana.
- New medical equipment is sold for $200,000 to customers. The medical equipment sold under the transaction to SubCo has a book value of $80,000.

Challenges

- The CFO of Group reviews this transaction and notices this type of transaction to occur on a consistent basis. CFO also realizes that sales of other used equipment (“Product B” or “Product C”) to third parties has a lower sale price than book value given increased technology lowering resale value to third parties.
- CFO determines that book value may not be a reliable arm’s length price for Product A but does not know the price to use that would adhere to both state regulations and the arm’s-length standard under Sec. 482 of the IRC.
- Given the type of transaction occurs on a consistent basis, incorrect pricing could lead to increasing risk over time if deemed not to be supportable under audit.

Case Study: Optimizing Sales Tax for ParentCo Equipment Sale

Solution

- CFO engages BT to conduct a transfer pricing analysis to determine the arm's length price ParentCo should charge SubCo for Product A.
- BT conducts a thorough transfer pricing analysis exploring all applicable methods.
- BT determines an arm's length price for Product A using an unspecified method under Treas. Reg. Section 1.482-3 based on the Cost-Based Approach that results in a price for Product A where the original cost is adjusted for a variety of economic factors including: market use, age, condition, and remaining useful life. The analysis results in an arm's length price of $60,000.

Case Study: Optimizing Sales Tax for ParentCo Equipment Sale

Before BT:

- Original purchase price of equipment: $200,000
- Accumulated depreciation (over 3 years): $120,000
- Book value before transfer: $200,000 - $120,000 = $80,000
- Sales tax rate: 7%
- Sales tax liability without adjustment: $80,000 * 7% = $5,600

4,200

Conclusion

Conclusion – Potential Tax Planning Opportunities

- **Tax Obligation Identification**: Determining taxpayer obligations in state through a review of their nexus profile and transaction taxability in the state.
- **Proper/Accurate Reporting of Transactions**: Assisting with correct classification and reporting of controlled transactions, including the correct structuring of invoices and agreements.
- **State-Specific Exemption Application**: Determining if any exemptions are applicable to the controlled transaction to avoid unnecessary tax expenses.
- **Structuring Tax Efficient Intercompany Sales**: Aligning intercompany transaction prices with the arm's length standard not only ensures compliance under scrutiny but may also offer substantial benefits including:
  - Reduction in tax liabilities;
  - Enhanced compliance and audit defense; and
  - Optimization of cash flows.

Questions?

Additional Illustrative Case Studies

Case Study: Licensing of SaaS between Related Parties

Background

- ParentCo is a developer of software as a service ("SaaS") products based in Georgia. SubCo is a subsidiary based in Pennsylvania who uses the SaaS as a tool to provide professional services to clients. ParentCo licenses the SaaS product to SubCo which is considered a taxable transaction in Pennsylvania. ParentCo acts as a software development and commercialization company. SubCo operates as a services company with no ownership of IP.
- ParentCo licenses the fee for the SaaS product to enterprise customers (>100 clients) as a subscription of $120,000 per year. No third-party customer of ParentCo has less than 100 clients. SubCo is licensed the same product but only has 10 clients.

Challenges

- The CFO of Group realizes that the license from ParentCo to SubCo results in $7,200 of PA sales tax ($120,000*6%) on an annual basis.
- ParentCo will release other SaaS products that will be licensed to enterprise customers and SubCos in the future that may also incur a sales tax payable by SubCos.
- Given the type of transaction occurs on a consistent basis and ParentCo will release future products that will be licensed, it is imperative to have support for the intercompany pricing to draft the respective intercompany licensing agreements and manage the sales tax consequences of the transaction on an ongoing basis.

Solution

- CFO engages BT to conduct a transfer pricing analysis to determine the arm's length price ParentCo should charge SubCo for the license of the SaaS product.
- BT conducts a thorough transfer pricing analysis that explores all applicable methods and detailed functional analysis.
- BT determines that the economic relationship for the licenses between ParentCo and third parties are not comparable to the economic relationship between ParentCo and SubCo. In particular, ParentCo engages in sales and marketing functions and increased product support services for licensing engagements with third parties that it does not perform for SubCo.
- BT determines that using an internal price under the CUT method would not result in an arm's length price for the SaaS product. BT conducts an external benchmarking analysis using the External CUT method to determine an arm's length license fee between $50,000 and $80,000, with a median of $60,000. BT assists counsel with drafting the intercompany license agreement between ParentCo and SubCo.

Results

Before BT:

- Standard licensing fee for software: $120,000
- Sales tax rate in Pennsylvania: 6%
- Sales tax liability without adjustment: $120,000 * 6% = $7,200

After BT:

- Arm's Length License Fee: $60,000
- Sales tax rate: 6%
- Sales tax liability with adjustment: $60,000 * 6% = $3,600
- **Benefit: Savings: $7,200 - $3,600 = $3,600**

Case Study: Managing Bundled Transactions between Related Parties

Background

- ParentCo, based in Georgia, provides services to SubCo that is located in Indiana.
- ParentCo will also sell hardware and equipment when delivering the services. The services and hardware are currently bundled together and given a single standard price of $10,000 a month for the service.

Challenges

- Given the transaction is bundled together with no itemization, the entire transaction becomes taxable due to the taxability of the tangible goods sold with the nontaxable services. The bundling of these items saves the Group administrative time but causes the whole transaction to become taxable and results in $700 ($10,000*7%) payable.
- The service fee for the services is not based on an established transfer pricing method under 1.482-9.

Solution

- CFO engages BT to conduct a transfer pricing analysis to determine the arm's length price ParentCo should charge SubCo for the services and products.
- BT conducts a thorough transfer pricing analysis that explores all applicable methods and detailed functional analysis.
- BT determines through the application of the external CUSP method that the service fee should be based on an hourly rate of $100. This method determines a service fee of $8,000 a month on average. BT determines that it is appropriate to price any hardware and equipment at cost. This results in $500 a month on average.
- BT advises that the transaction should be itemized going forward and sales tax should only be applied to the taxable portion related to hardware and equipment ($500). This results in a total sales tax of $35 ($500*.07) which is a

Results

Before BT:

- Total Non-Itemized Invoice: $10,000
- Sales tax rate in Indiana: 7%
- Sales tax liability without adjustment: $10,000 * 7% = $700

After BT:

- (Nontaxable) Arm's Length Service Fee: $8,000
- (Taxable) Hardware Price: $500
- Sales tax liability with adjustment: $500* 7% = $35
- **Benefit: Savings: $700 - $35= $665 a month or $7,980 a year!**