Outsourcing the Revenue Department’s Discretionary Authority to Make Transfer Pricing Adjustments: Arbitrary and Capricious

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This article was first published in the August 2011 edition of the Institute for Professionals in Taxation’s (IPT’s) Tax Report.

Introduction

In 2005, a small firm filed a patent application with the United States Patent and Technology Office (USPTO) for a “system and method” to “analyze tax avoidance of a taxpaying entity.” Abstract, Patent 7,716,104 B2. Application of the “computer-implemented method” was represented to identify entities that have “avoided” a state corporate income tax, based on comparison of the entity’s return on assets, capital, sales and/or operating expenses, as compared with corresponding ratios for related firms operating in a predefined industry. In May of this year, the USPTO awarded patent number 7,716,104 B2 to Chainbridge Software, Inc. (“Chainbridge”), albeit the firm had already deployed its software pursuant to indirect/direct contract arrangements with several states in the interim, including Alabama, Louisiana, New Jersey, the District of Columbia and, more recently, Kentucky.

Section 482 of the Internal Revenue Code (IRC) (“Section 482”) authorizes the IRS Commissioner to allocate income and/or deductions between or among related entities in order to clearly reflect income; the Section 482 regulations place a controlled taxpayer on parity with an uncontrolled taxpayer by determining, according to the arm’s-length standard, the true taxable income of the uncontrolled taxpayer. Does application of patented software to a taxpayer’s financial information without discussion or input from the taxpayer sound like a garden-variety/standard Section 482 transfer pricing audit to you? Perhaps at first glance, but the many taxpayers that have been subjected to Chainbridge Software, Inc.’s special “black box” method of establishing an assessed liability for state corporate income tax purposes do not find anything about this type of “audit” to be standard—nor do they find them to be transparent, legal or fair.

Discretionary Authority: One Big Stick

States’ Discretionary Authority. State revenue commissioners wield broad powers to adjust the income, factors, deductions and expenses of taxpayers, in order to yield a “true” or “fair” tax liability. Of course, many states’ delegations of discretionary authority require that before a commissioner uses his/her discretionary

1 Chainbridge has been a subcontractor on contracts between ACS State and Local Solutions, Inc. and various states.

2 Note that other states are considering laws to permit outsourcing of tax audits, including Minnesota (see Minnesota HF0027, introduced July 19, 2011 and HF1219).
authority, the commissioner must prove a distortion or improper reflection of income to the state. However, once such discretionary authority is exercised, the courts’ deference to the resulting adjustments is difficult to overcome. The taxpayer that challenges such adjustments faces two specific hurdles: (1) an assessment is generally treated by state law as constituting prima facie evidence of a tax liability, hence the taxpayer bears the burden of proof regarding its invalidity; and (2) most state trial courts employ a standard of review that is very high—for example, reversal of a discretionary adjustment may occur only where the assessment was arbitrary and capricious, or constituted a manifest abuse of discretion.3

Traditional Controls over Abuses of Discretion. As a consequence, the department’s careful exercise of discretionary authority is the only way to ensure a perception of fairness and constitutionality in its treatment of taxpayers on audit. Still, there are certain strictures that govern the use of such discretion, particularly in the arena of transfer pricing. First, many states have a statutory taxpayer bill of rights that gives taxpayers the right to obtain information about the tax implications of any situation or transaction, as well as how the taxpayer’s liability was determined.4 Second, taxpayers are also entitled to explanation of any adjustment proposed on audit as a matter of substantive and procedural due process—without such notice of the basis for adjustments, a taxpayer is denied both meaningful notice and an effective opportunity to protest. Third, specifically in the transfer pricing arena, most states conform to Section 482 through rolling or static conformity to the Internal Revenue Code as a whole, and generally also through adoption of Line 285 of the federal corporate income tax return (Form 1120) as the starting point to determine state taxable income.

Enter Chainbridge/Exit Fairness. Rather than undertaking a careful exercise of their own discretionary authority, several states have turned to Chainbridge to prepare “economist’s reports” (using the “black box”) that serve as the basis for the state’s transfer pricing adjustments. States understandably might feel intimidated by a highly technical and evolved area of tax law such as transfer pricing. However, where the state’s own audit staff has not reviewed the taxpayer’s transfer pricing, they are not able to answer detailed questions relating to the proposed assessments. The states in turn look to Chainbridge for a response. It is striking that a state revenue department would be unable, in such circumstances, to articulate or “prove” the distortion/improper reflection of income upon which it has premised its exercise of discretionary authority to make transfer pricing adjustments, nor could it explain the nature of the adjustments that it proposes to correct the alleged distortion; in short, the prerequisite to exercise of discretionary authority is generally ignored, especially in situations where financial information is simply uploaded into a software program that spits out an assessment.

Chainbridge has jealously guarded its leverage by treating its software as “proprietary” and refusing to provide taxpayers with complete explanations of how its proposed adjustments have been generated and are justified. While purporting to apply Section 482 standards in its “audits” of taxpayers, the Chainbridge method appears

3 The North Carolina Superior Court went further in its recent decision in Delhaize America, Inc. v. Hinton, where it said that “[i]f the officer acted within the law and in good faith in the exercise of his best judgment, the court must decide to interfere even though it is convinced the official chose the wrong course of action.” Delhaize America, Inc. v. Hinton, Wake County Super. Ct. Docket No. 07-CVS-020801 (Jan. 12, 2011).

4 See, e.g., New Jersey Taxpayers Bill of Rights (P.L. 1992, c.175).

5 Line 28 of IRS Form 1120 sets forth federal taxable income before net operating loss and special deductions; this figure embodies the application of Section 482 principles.
to make a number of baseless assumptions, including that (i) the comparable profits method\(^6\) (CPM) is the best method to examine the degree of comparability between controlled and uncontrolled transactions, when in reality there are multiple methods that may be used; (ii) every dollar of income to a company results from transfer pricing; and (iii) all transactions engaged in by a participant in related-party transactions are controlled. Such assumptions are often inconsistent with or fail to satisfy the requirements of Section 482.

**Defending Against a Chainbridge-Proposed Adjustment.** Departments of Revenue (DOR) have generally been highly deferential to Chainbridge in audits. As a result, taxpayers have been forced to try to educate state DOR staff on the principles of a Section 482 transfer pricing audit, while simultaneously pointing out the flaws in Chainbridge’s proposed adjustments. These flaws, which must be demonstrated by reference to each taxpayer’s specific facts, have ranged from the failure to select true comparables, which is the cornerstone of a valid 482 transfer pricing exam, to the failure to apply audited financial income and balance sheet statements and effectuate adjustments for comparability (especially when using the CPM), which are not only best practices but also required by the Section 482 regulations. Additional flaws that have been identified in select Chainbridge-issued reports include the failure to identify the related-party transactions that are being reviewed, and the failure to apply standard adjustments to improve comparability (e.g., accounting, asset intensity, level of the market and foreign exchange adjustments).

**Bridging the Gap in Perceptions.** New Jersey taxpayers have by and large been able to reach mutually acceptable resolutions of audits by the New Jersey Division of Taxation (the “Division”), due to the Division representatives’ interest in settling such disputes, and New Jersey has not renewed its outsourcing contract with Chainbridge. However, the District of Columbia is aggressively pursuing audits through its arrangement with Chainbridge/ACS.

“**APAs, and Beyond!”** Chainbridge had at first hesitated to cross swords with taxpayers whose transfer pricing was “blessed” by virtue of an Advance Pricing Agreement\(^7\) (APA), presumably in recognition that an APA is reviewed and approved by the IRS.\(^8\) Therefore, if the IRS and taxpayer enter into an APA, and the taxpayer relies on the APA when completing its state return (i.e., a return that starts the calculation of tax with federal taxable income), can a state that conforms to the IRC, and more specifically Section 482, make an adjustment that violates the APA? It seems at the very least that states that have adopted Section 482 and its regulations should presume that the APA, which was implemented in compliance with such laws and regulations, produces an arm’s-length result. Therefore, we believe the state should be bound by an APA if

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\(^6\) The Section 482 regulations specify several different methods to determine the arm’s-length nature of intercompany transactions, of which the comparable profits method is but one.

\(^7\) The IRS’s APA program offers taxpayers the opportunity to reach agreement in advance of filing a tax return on the appropriate transfer pricing method to be applied to related-party transactions. Through the voluntary APA program, the IRS, the taxpayer and the foreign tax jurisdiction (where relevant) agree on the appropriate transfer pricing of certain identified transactions. If an APA is in place, the IRS will not seek a transfer pricing adjustment for a covered transaction so long as the tax return that the taxpayer files for a covered year reflects the agreed-on transfer pricing method.

\(^8\) In fact, Amendment #1 to the contract between the District of Columbia and ACS/Chainbridge (CFOPD-07-R-058, “Audit of Parent/ Subsidiary and Brother/Sister Corporations”), sets forth answers to questions raised by the District, including Question 17, which asks if ACS/Chainbridge will “defend its proposed adjustment amounts to the District if there is discrepancy between transfers pursuant to Advance Pricing Agreement under IRC Section 482.” In response to Question 17, ACS/Chainbridge states: “An IRS approved Advance Pricing Agreement (APA) will supersede adjustments proposed under IRC Section 482 to the extent that the taxpayer is following the agreement. Receipt of an APA will typically terminate any further CNIC analysis and should be provided as early in the process as possible.”
one is in place and the taxpayer complied with such APA in calculating its state taxable income. However, it has been our experience that Chainbridge now views taxpayers with APAs as being an appropriate subject of “black box” adjustments despite having an APA in place,\(^9\) apparently on the theory that its patented system and method is not focused on related-party transactions per se, but on establishing a “fair profit”—a concept that is presented as being broader in scope than “just” a transfer pricing examination.

**Published Guidance Clarifies Manner in Which NJ Transfer Pricing Discretion Can Be Exercised.** Coming off of its recent wave of transfer pricing audit settlements, New Jersey has now issued Technical Advisory Memorandum TAM-17 (June 6, 2011), entitled “Intercompany Transfer Pricing and Advanced Pricing Agreements.” The TAM states that “in most cases,” the Division of Taxation will use Section 482 standards in audit and when adjusting items above Line 28 in order to arrive at a “fair and reasonable” tax; and, where a taxpayer demonstrates that it has met these standards: “Since an advance pricing agreement between the taxpayer and the Internal Revenue Service would be accepted by the Service based on Section 482 standards, and Section 482 standards are incorporated into N.J.A.C. 18:7-5.10 [the regulation outlining the Director’s discretionary authority to make adjustments to correct distortions of entire net income], the Division will take into consideration an advance pricing agreement… in the evaluation of the appropriateness of intercompany pricing and determination of a ‘fair and reasonable tax.’” Still, the Division “reserves the right in particular instances to use other criteria besides an advance pricing agreement” because the statutory delegation of discretionary authority to make adjustments “goes beyond the scope of Section 482, Section 482 is not the only provision that relates to audits of related taxpayers, and other issues may arise in a particular audit such as ‘nexus’ rules for affiliates.” In an attempt to reassure taxpayers while putting this stake in the ground, the Division concludes with the statement that “[i]n general, [it] is pledged to ‘apply equitable principles to prevent unjust situations from occurring.’”

**Audit Arbitrage Runs the Risk of Yielding Arbitrary Results**

Where taxpayers can dialogue with state tax administrators concerning their specific facts and circumstances, and the administrators are open to reaching mutually acceptable resolutions of disputes such as transfer pricing, reassurances such as those of the New Jersey Division of Taxation will ring true. However, when state tax administrators both outsource their discretionary authority to make such adjustments, and fail to understand the nature of the proposed adjustments or the taxpayer’s objections thereto, this outsourcing exercise is much more likely to result in an arbitrary and capricious assessment—i.e., an abuse of discretion that courts of law will find offensive and subject to reversal. We continue to monitor the challenges to Chainbridge-generated transfer pricing adjustments in jurisdictions such as the District of Columbia, where it seems all but certain that the arbitrary nature of such adjustments will soon be under the judicial microscope.

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\(^9\) Interestingly, the audit reports issued by Chainbridge look remarkably similar whether the taxpayer under audit has an APA, a transfer pricing study or nothing in hand.

\(^{10}\) N.J.S.A. 54:10A-10.
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