



Intercompany Transfer Pricing and Advanced Pricing Agreements

TAM 2012-1 – Issued February 16, 2012
Tax: Corporation Business Tax

This technical advisory memorandum (TAM) concerns the use of intercompany transfer pricing and advanced pricing agreements in the context of intercompany and related party transactions.

INTERCOMPANY AND RELATED PARTY TRANSACTIONS IN CONTEXT

New Jersey is a separate-entity reporting state for Corporation Business Tax (CBT) purposes. Consequently, corporations or business entities, even those that are related or affiliated, report income and deductions on a separate-entity basis and not in a group or combined report. Pursuant to N.J.A.C. 18:7-11.15(a), corporations are not permitted to file consolidated returns except for those companies that hold a license pursuant to the Casino Control Act; operate as air carriers; or are compelled to report income in a consolidated filing to reflect the "true earnings of the taxpayer on its business carried on in this state" as provided in N.J.S.A. 54:10A-10(c). At times, separate-entity reporting may not accurately reflect income earned within the state's borders in the context of intercompany and related party transactions when arm's length terms and rates are not utilized by the parties.

DIRECTOR'S AUTHORITY TO ENFORCE ARM'S LENGTH STANDARDS

To help ensure that CBT taxpayers accurately report income and deductions arising from intercompany and related party transactions, N.J.S.A. 54:10A-10 grants the Director a number of discretionary tools to examine and potentially adjust the entire net income of taxpayers. These tools are available to the Director even when there is no tax evasion or avoidance at issue; but rather, when the "true earnings of the taxpayer on its business carried on in this state" are not accurately reported to the Division. The statute provides in pertinent part that the Director may make "adjustments in any tax report or tax returns as may be necessary to make a fair and reasonable determination of the amount of tax payable under this act." N.J.S.A. 54:10A-10(a).

Based on this section, the Division adopted regulations in 1992 defining the term "fair and reasonable tax" as "the tax that would have been payable by a taxpayer reporting the same transaction(s) on a separate entity basis where the parties to the transaction(s) had independent economic interests." N.J.A.C. 18:7-5.10(a) 3. This analysis of determining a "fair and reasonable tax" is similar to that with respect to arm's length pricing requirements of the Internal Revenue Code (IRC) section 482. The arm's length analysis provided in N.J.A.C. 18:7-5.10 does indeed incorporate certain standards of IRC 482, such as the "Comparable uncontrolled price method," the "Resale Price method," and the "Cost plus method." N.J.A.C. 18:7-5.10(a) 8. In addition, the Division has outlined methods for calculating interest charges between related entities. N.J.A.C. 18:7-5.10(a) 5. Several examples are provided in the regulation.

ADVANCE PRICING AGREEMENTS

Under IRC section 482, the Internal Revenue Service (IRS) has the authority to “distribute, apportion, or allocate gross income, deductions, credits, or allowances” between businesses and organizations that are “owned or controlled directly or indirectly by the same interests.” In order to reduce administrative burdens and help provide some level of certainty to taxpayers, the IRS has an advance pricing agreement program. This is a voluntary process whereby the IRS and taxpayers may resolve transfer pricing issues under section 482 of the IRC in a cooperative manner on a prospective basis. An “Advance Pricing Agreement” (APA) is defined in the IRS “APA Study Guide” as “an agreement between the Service and a taxpayer on transfer pricing methods to allocate income between related parties under Internal Revenue Code (IRC) section 482 and the associated regulations.” Revenue Procedure 2006-9 as modified by Revenue Procedure 2008-31 sets forth the current procedures for negotiating and administering APAs.

ADVANCE PRICING AGREEMENTS ACCEPTED AS PROPER DOCUMENTATION

As part of an arm’s length analysis in determining a “fair and reasonable tax,” the Division has the authority to request information and documentation supporting the reported transactions at issue. As provided in the pertinent regulation:

The Director may require any person or corporation to submit whatever information under oath or affirmation, or to permit whatever examination of its books, papers and documents, as may be necessary to enable him or her to determine the existence, nature or extent of an agreement, understanding or arrangement to which this section relates, whether or not the person or corporation is subject to the tax imposed by the Act.

The information required by the Director may include an APA with the IRS or other competent authority, and any transfer pricing studies performed by independent parties and used as a basis for the APA. Since many IRC section 482 standards are incorporated into the Division’s arm’s length analysis as provided in N.J.A.C. 18:7-5.10, the Division will accept an APA or third-party pricing study between a taxpayer and the Internal Revenue Service as proper documentation and evidence in the evaluation of intercompany transfer pricing and the determination of a “fair and reasonable tax.”

APPLICATION OF ADVANCE PRICING AGREEMENTS IN AN ARM’S-LENGTH ANALYSIS

In most cases, when arriving at a “fair and reasonable tax,” the Division will use IRC 482 standards in auditing and adjusting items above line 28 of Schedule A of the CBT return. If a taxpayer can demonstrate that it has met the standards of IRC 482, no adjustments are likely to be made above Line 28 of Schedule A. Consequently, in most circumstances, APAs and their content, including pricing methodologies, economic assumptions and analysis and market valuations, will be respected by the Division. However, pursuant to N.J.S.A. 54:10A-10 and N.J.A.C. 18:7-5.10, the Director has the authority to examine these agreements and challenge their underlying assumptions and interpretations in determining a taxpayer’s entire net income if the “true earnings of the taxpayer on its business carried on in this state” are not reflected by the terms of the APA or advance pricing study at issue.

The Division intends to codify the contents of this TAM in a regulation, pursuant to the Administrative Procedure Act, N.J.S.A.52:14B-1 et seq.

Note: A Technical Advisory Memorandum (“TAM”) is an informational statement of the law, regulations, or Division policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions or changes in Division policies could affect the validity of the information presented in a TAM.