District of Columbia
Office of Administrative Hearings
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HESS CORPORATION, Petitioner, v. OFFICE OF TAX AND REVENUE, Respondent.	Presiding Administrative Judge The Honorable Bernard Weberman Case No. 2012-OTR-00027

AMICUS CURIAE BRIEF ON BEHALF OF PETITIONER, HESS CORPORATION

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INTRODUCTION

This case involves an assessment of Hess Corporation ("Hess") by the Office of Tax and Revenue ("OTR") for tax periods 2004, 2005, 2006, 2007, 2008, and 2009. For these periods, OTR relied on a third-party consultant, Chainbridge Software, Inc. ("Chainbridge"), which used a distorted and erroneous transfer-pricing scheme that failed to comply with the "comparable profits method" prescribed in Internal Revenue Service ("IRS") regulation 26 C.F.R. § 1.482-5. This Court has previously rejected this method. *See Microsoft Corp., Inc. v. Office of Taxation and Revenue*, Case No. 2010-OTR-00012 (D.C. O.A.H. May 1, 2012). Because OTR used this distorted and erroneous methodology and failed to properly conduct an audit on Hess's records, this Court should grant a motion for summary judgment in favor of Hess.

Amicus is deeply troubled that OTR is basing its assessment of Hess on the assertion that the taxpayer's overall profit is lower than the profits of its competitors. The District of Columbia's ("District") income tax law allows for deductions for capital investments, cost of goods sold, etc. The deductions taken by taxpayers in the same industry will vary, increasing or decreasing profitability, based on business decisions (*i.e.*, to expand, contract, develop, or otherwise change its current market segments). OTR's erroneous application of the comparable profits transfer pricing methodology, which is designed to adjust only related-party transactions to Hess's overall profitability fails to take these differences into account. The comparable profitability of its competitors, or lack thereof, for a given tax period is simply too extraneous to use as a valid transfer-pricing adjustment method in a case like this one.[1]

OTR's attempt to use Chainbridge's method of looking to competitor businesses' comparative profitability completely ignores the purpose of transfer-pricing adjustments—to

[1] The profit level indicators of a taxpayer's competitors may be relevant <u>after</u> OTR reviewed the taxpayer's books and records and determined the products, business lines, or discrete intercompany activities to be reviewed. Only after an in-depth audit is done can the appropriate comparable companies be determined.

ensure transactions between related entities are at arm's length. Instead, the Chainbridge method erroneously adjusts the profitability of one business to match the profitability of unrelated businesses. This method does not conform to D.C. Code § 47-1810.03 requirements, which are virtually identical to federal tax code provisions in 26 U.S.C. § 482 ("Section 482") and the regulations issued by the IRS to implement that section.

Further, as noted above, OTR is seeking to relitigate an issue that was previously decided by this Court. *Microsoft Corp., Inc. v. Office of Taxation and Revenue*, Case No. 2010-OTR-00012 (D.C. O.A.H. May 1, 2012). OTR could have appealed that decision, but decided not to do so. If OTR felt strongly that the methodology used by Chainbridge was acceptable, it should have continued litigating that case.[2] Litigation is expensive for both taxpayers and OTR; therefore, this Court should put this issue to rest and grant Hess's motion for summary judgment.

Finally, this type of assessment practice—increasing a taxpayer's taxable income without OTR conducting a full-fledged audit of the taxpayer's records—is a gross overreach of their authority to adjust a taxpayer's income. This Court should send a clear signal to OTR that its assessment practices are arbitrary, capricious, and unreasonable. OTR's assessment uses the same flawed Chainbridge method found to be arbitrary, capricious, and unreasonable by this Court in *Microsoft*. *Id*. at 27. Such actions also violate taxpayers' substantive due process rights. This Court should send a strong notice to OTR that these types of assessment practices are not permissible. Additionally, it would put other state and local tax agencies on notice that this type of erroneous transfer-pricing methodology used by Chainbridge is wholly unacceptable.

[2] A settlement would be different, but OTR did not enter into a settlement agreement to resolve Microsoft Corporation's tax assessments.

IDENTITY AND INTEREST OF *AMICUS*

The Council On State Taxation ("COST") is a nonprofit trade association based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce. Today COST has grown to an independent membership of approximately 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST members own an extensive amount of property in the District, conduct a substantial amount of business and employ a significant number of its' residents.

As *amicus curiae*, COST has participated in numerous significant United States Supreme Court cases over the past 40 years, including most recently *Comptroller of the Treasury of Maryland v. Wynne*, 135 S. Ct. 1787 (2015); *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015); and *Alabama Dep't of Revenue v. CSX Transp.*, 135 S. Ct. 1136 (2015). COST has also filed an amicus brief before the District's Court of Appeals, *Sovran Bank/D.C. National v. District of Columbia*, 731 A.2d 387 (D.C. 1999).

COST has a strong interest in ensuring multijurisdictional taxpayers are treated equitably. Its membership is very concerned with OTR assessing multijurisdictional businesses using a fundamentally flawed transfer-pricing methodology that is not supported by D.C. Code § 47-1810.03 and that produces arbitrary and capricious results. COST's members are keenly interested in this issue, and *amicus* urges this Court to grant Hess's request for summary judgment and invalidate OTR's controversial and meritless assessments.

STATEMENT OF THE CASE

COST adopts the Statement of the Case set forth by Petitioner in its Memorandum in Support of Petitioner Hess Corporation's Motion for Summary Judgment (Aug. 30, 2013) ("Motion"). Motion at 4-14.

SUMMARY OF THE ARGUMENT

Fundamentally, the Chainbridge method at issue here is not a method used by, or countenanced by, the IRS to conduct audits to judge the validity of intercompany pricing between related members. Many of COST's members are international businesses that engage in numerous intercompany transactions subject to the Section 482 rules. These members routinely rely on the 482 regulations and IRS guidelines to appropriately price these transactions. Furthermore, many of these members have been audited by the IRS for compliance with the Section 482 arm's length standard. The analysis of proper arm's-length pricing is not done by looking at the top-line profits of an entity that has multiple products, transactions, business, segments, operational lines, etc. When a COST member determines the price of intercompany transactions, the member typically relies on a transfer pricing study that looks at specific transactions. This is especially so in the case of a commodity business, like Hess's, where the prices underlying transactions are widely reported by markets around the world and are thus patently transparent. For example, the analysis may look at transactions involving the licensing of a trademark from one affiliate to another or one affiliate buying a product manufactured by another. Similarly, when the IRS reviews a COST member's intercompany pricing, the IRS always reviews the transactions at a detailed level. Any suggestion that a taxpayer, like Hess, with multiple products, divisions, business segments, and operations can be analyzed under a single top-level profit analysis is contrary to the appropriate use of Section 482.

I. CHAINBRIDGE'S TRANSFER-PRICING METHODOLOGY IS CLEARLY ERRONEOUS

Neither Hess nor OTR dispute that the District's transfer pricing law, D.C. Code § 47-1810.03, is analogous to Section 482, which is used by the IRS to compute federal taxable income. Motion at 5-6 and Motion Exhibits 4 & 5. Rather, the parties disagree as to how an IRS regulation, 26 C.F.R. §§ 1.482-1 and 5, is applied to use the comparable profits method. Hess has correctly asserted that the comparable profits method does not authorize tax agencies (*e.g.,* the IRS or OTR) to make adjustments increasing the overall income of a taxpayer. Instead, it only permits a tax agency to make adjustments to income for specific transactions between related entities within the taxpayer's related group. *See* Motion at 10. With its use of a third-party consultant, Chainbridge, OTR clearly fails to appropriately use this approach. Instead, the Chainbridge method looks at the overall profitability of a taxpayer and compares that to the overall profitability of its competitors. *See* Motion Exhibit 5. OTR then used that discrepancy in overall profitability to inappropriately adjust Hess's income upwards.

Relying on Chainbridge's methodology, OTR asserts that any taxpayer with profit less the 25th percentile of its competition can be assessed by OTR to put its income at the median (50th percentile) of the range. Allowing OTR to rely on Chainbridge's flawed methodology produces absurd results. In essence, it would allow OTR to artificially increase a taxpayer's income for a given tax period if the taxpayer, when compared to its business competitors in the same industry segment, has a profit level that is not within the interquartile range (25th percentile to 75th percentile) of its competitors' profit level for the same period. *See* 26 C.F.R. § 1.482-1(e)(1). No attempt, however, has been made under this methodology to adjust income between related members of a group.

This further begs the question: what will OTR do with taxpayers that have a profit margin greater than the 75th percentile of its peers? Based on the logic of OTR and Chainbridge's transfer-pricing method, OTR should agree to grant refunds to those taxpayers to place them at the median (50th percentile) of the range. Is OTR really willing to commit to doing that? To date, *amicus* is not aware of any refunds approved by OTR based on this premise.

OTR is unlikely to grant such refunds because it understands a taxpayer's profit as compared to its competitors can vary for multiple reasons. Competitors can have significantly different capital expenditures from year to year, spend different amounts on research and development, sell to unrelated parties at prices that are more (or less) lucrative than their competitors, etc. Chainbridge's methodology, however, merely uses the Petitioner's profit in a given tax period and compares that to the profitability of its competitors, all the while completely ignoring the array of differences that can occur when the taxpayer's total profits, rather than discrete segment profits, are used as the baseline. These differences can be acute. For example, a business's profitability will be significantly different depending on whether a business is seeking to expand, is focused on immediately returning profits to its investors/shareholders, or its intangible value to others (*i.e.,* good will).

The following is an example to illustrate how Section 482 and its corresponding IRS regulations could be used properly in a transfer pricing audit using the comparable profits method. A related group includes an operating entity that paid $10 million in interest to a related financing entity. Upon audit of the operating entity's records, the tax agency seeks a transfer-pricing adjustment on the interest paid to its financing entity. The tax agency adjustment is based on it conducting a comparable profits analysis of the interest rate charged by the taxpayer's related financing entity and compared to the rate used by comparable businesses with

this type of financing structure. The tax agency determines that the 8 percent interest rate imposed by the related financing entity is too high (outside the interquartile range) and that the median interest rate (50th percentile) is 4 percent. Accordingly, the tax agency increases the operating entity's income by $5 million (50 percent reduction in the interest rate) and decreases the financing entity's income by $5 million. Thus, if the operating entity and financing entity were required to be combined before the tax is applied, the adjustment by the tax agency would be zero.

The Chainbridge method ignored this comparison and adjustment of transactions between related entities, thereby creating phantom profitability. That methodology simply increased Hess's income because its overall profitability from all operations was lower than (as compared to) that of its competitors. The table below shows the fallacy of the approach used by the Chainbridge method.

Business	Net Profit to Sales	Gross Sales from All Transactions	Adjustment	Interquartile Range
A	0.0%	$100,000,000	$3,000,000	Bottom
B	2.0%	$75,000,000	None	Within Range
C	3.0%	$125,000,000	None	Median
D	4.0%	$65,000,000	None	Within Range
E	6.0%	$150,000,000	-$4,500,000	Top

Under the table above, businesses B, C, and D are within the interquartile range and would not be subject to any adjustment using the Chainbridge methodology. However, just as Hess's income was adjusted, the Chainbridge method would require an increase to business A's income (resulting in a tax increase) since its profitability was below the interquartile range ($3,000,000 increase in income to reach the median 3 percent net profit to sales). Using the Chainbridge methodology, no attempt was made to determine whether the difference in profitability was related to a transfer-pricing issue between one or more of Hess related members

or to unrelated factors. Business A's income would simply be increased enough to achieve a profitability equal to the median profitability of its competitors.[3] Using the same Chainbridge method, business E should be able to seek a refund of tax since its profit was above the interquartile range, and decreasing its income by $4,500,000 to achieve profitability equal to the median. As the saying goes, "what's good for the goose is good for the gander." This court has even more reason to not affirm OTR's assessments using the Chainbridge method since it does not proactively notify taxpayers above the interquartile range that they can use this method to seek a refund from OTR.

The comparable-profits transfer pricing methodology is designed to adjust transactions between related parties. If the income of one party is increased, the income of the other party must be decreased. Importantly, the Chainbridge report provides absolutely no information reflecting which of Hess's related entities' income was decreased (*i.e.*, if those related entities have apportionable income in the District of Columbia they should be able to seek a refund) versus those related entities' income from doing business in the District of Columbia that had their income increased. *See* Motion Exhibit 5. This information is critical for understanding where the adjustments are being made to Hess's related entities and to comply with the District's transfer pricing law, D.C. Code § 47-1810.03 (analogous to Section 482), for the tax periods assessed and on a going forward basis.

II. CONTINUOUS AND PROTRACTED LITIGATION OVER OTR AND CHAINBRIDGE'S ERRONEOUS TRANSFER-PRICING METHOD IS UNNECESSARY

As indicated above, the assessment against Hess is based on the same flawed methodology as the assessment OTR made against Microsoft in *Microsoft Corp., Inc. v. Office of*

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[3] Note that this methodology might be compliant if it was applied to a single product's profitability, or a single transaction type. But it cannot be compliant when applied to a business.

Taxation and Revenue, Case No. 2010-OTR-00012 (D.C. O.A.H. May 1, 2012). With this case OTR is relitigating an audit approach that was struck down by this Court in the *Microsoft* case. Because OTR in this case made no changes to the audit methodology as applied to Hess's tax returns, and used the same faulty comparable sales method struck down in *Microsoft*, this Court should expeditiously grant Hess's motion for summary judgment and avoid protracted litigation that is expensive and fruitless for both taxpayers and the District. This case squarely fits into the standard of review for summary judgment to determine "whether any relevant factual issues exist by examining and taking into account the pleadings, depositions, and admissions along with any affidavits on file, construing such material in the light most favorable to the party opposing the motion." *Graff v. Malawer*, 592 A.2d 1038 (D.C. 1991), cited by *Kissi v. Hadesty*, 3 A.3d 1125 (D.C. 2010). "[I]f there are no genuine issues of material fact in dispute …," then it is appropriate to grant summary judgment. *See Jack Baker, Inc. v. Office Space Dev. Corp.*, 664 A.2d 1236, 1240 (D.C. 2013) applying OAH Rule 2819.1.

There is nothing gained by requiring a long-drawn-out trial on this matter when this Court has already held the method used by Chainbridge was arbitrary, capricious, and unreasonable. *See Microsoft*. On its face, the Chainbridge method of simply increasing a related taxpayer's income if its overall profit is not within the interquartile range (25th percentile to 75th percentile) of competitors is grossly inconsistent with how transfer pricing studies should be conducted. Chainbridge made no attempt to examine Hess's transactions with its related members compared to what those similar transactions would have been using an arm's-length transaction analysis with similarly situated competitors either when it conducted its study or when it provided its report to OTR. OTR should not be allowed to skirt a true Section 482 transfer pricing methodology by instead using a profitability analysis of an overall business

compared to the overall profitability of its competitors. This Court should enter an order on summary judgment cancelling the assessments against Hess to: 1) promote fairness by treating similarly situated taxpayers the same and not varying how they are treated based on which administrative judge reviews a case and 2) protect against protracted litigation over the same issues.

III. OTR'S ASSESSMENT VIOLATES SUBSTANTIVE DUE PROCESS

Substantive Due Process protects against arbitrary government actions. *See Sacramento v. Lewis*, 523 U.S. 833 (1998). In support of Hess's motion for summary judgment, this Court should also consider whether OTR's assessment is beyond all reason. *See Scott v. Crestar Fin. Corp.*, 928 A.2d 680, 688 (D.C. 2007). Recently, a U.S. District Court in Delaware, reviewing the State of Delaware's escheatment practices for unclaimed property, which has audit issues similar to those occurring during tax audits, held a "due process [violation arises] where the estimation methodology creates misleading results." *Temple-Inland, Inc. v. Cook*, 192 F. Supp. 3d 527, 549 (2016). In that case, an estimation process used by a private contract auditor hired by Delaware's escheator to audit Temple-Inland was found to use an estimation process that produced "significantly misleading results." *Id*. Similarly, OTR's use of the Chainbridge method, also a private contractor situation, produces significantly misleading results by not properly using the comparable profits method prescribed by an IRS regulation, 26 C.F.R. § 1.482-5. To properly make a transfer-pricing adjustment, the adjustment must be a zero-sum equation between members of a related group (some members have an increase in income while others have a corresponding decrease in income).

This Court has already held in *Microsoft* that OTR's use of Chainbridge's report to assess additional tax against Microsoft warranted summary judgment action against OTR because it was arbitrary, capricious, and unreasonable. This Court should reach the same conclusion in this

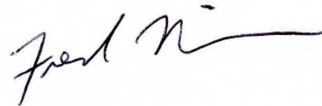
case by rejecting an assessment against Hess based on the flawed Chainbridge transfer-pricing method as a violation of substantive due process.

CONCLUSION

The transfer pricing regulations are not a one-way street for OTR and Chainbridge to adjust profitability up but not down when the situation warrants. OTR's assessment against Hess is clearly based on a report supplied to OTR by Chainbridge that misapplied the transfer pricing statute and regulations and is clearly erroneous. *Amicus* respectfully requests this Court enter an order on summary judgment that assessments against Hess for the 2004, 2005, 2006, 2007, 2008, and 2009 tax periods are not supported by any valid transfer-pricing study. Thus, the assessment for these tax periods are arbitrary, capricious, and unreasonable, and are therefore unlawful.

Dated: August 30, 2017

Respectfully submitted,



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CERTIFICATE OF COMPLIANCE

I hereby certify that on this 30th day of August, 2017, a true and correct copy of the foregoing *Amicus Curiae* Brief on Behalf of Petitioner, Hess Corporation, was submitted via email and U.S. mail, first-class postage prepaid, upon the following:

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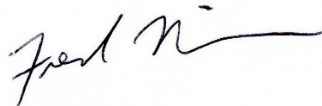

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