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MICROSOFT CORPORATION, INC. Petitioner v. OFFICE OF TAX AND REVENUE Respondent	Case No.: 2010-OTR-00012

REDACTED FINAL ORDER GRANTING SUMMARY DECISION

I. Introduction

NOTE: Due to a Protective Order entered in this case, a full version of this Final Order was filed under seal but issued to the parties subject to the Protective Order. Since the parties have not filed timely objections to the proposed redactions, this redacted version of this Final Order will be made publicly available.

A hearing was held on April 11, 2012, on a Motion for Summary Judgment, filed by Petitioner Microsoft Corporation, Inc. ("Microsoft.") Microsoft is appealing a February 5, 2010, Notice of Proposed Assessment of Tax Deficiency for the 2005-06 tax year, in the amount of approximately $2.75 million. (the "Notice.") Respondent District of Columbia Office of Tax and Revenue ("OTR") issued the Notice, based upon a transfer pricing analysis conducted by Chainbridge Software, Inc. ("Chainbridge"). Chainbridge examined Microsoft's 2002 financial information, determined that Microsoft had underpaid its taxes for 2002 when it claimed a loss, and OTR applied the determination to 2005-06 when Microsoft carried the loss forward.

For the following reasons, I conclude that the transfer pricing analysis contained a fatal error. Chainbridge analyzed Microsoft's profit-to-cost ratio for the 2002 tax year and compared that ratio to the profit-to-cost ratios of [redacted]. However, Chainbridge included all of Microsoft's income, without seeking to narrow its analysis to controlled transactions between Microsoft and its affiliated businesses, in violation of federal standards for transfer pricing analysis.

While the regulations allow some flexibility to the taxing authority to select the appropriate method, the application of the method chosen here does not comport with the purpose of the regulations. Chainbridge selected the comparable profits method set forth in 26 C.F.R. § 1.482-5. However, this regulation requires the analyst using the profit-to-cost method, to the extent possible, to compare controlled transactions (between the tested party and its affiliated businesses) against uncontrolled transactions made at arm's length with third parties. Chainbridge included all of Microsoft's transactions, whether controlled or uncontrolled, in the analysis of its profit-to-cost ratio, and Microsoft engaged in many uncontrolled transactions with third parties. In addition, 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 to prevent an alleged or purported evasion of taxes.

On this basis, Microsoft has shown that the transfer pricing analysis is arbitrary, capricious, and unreasonable based on the undisputed facts in this case. D.C. Official Code §§ 47-4312 (review of tax deficiencies by OAH) and 47-1810.01 (the District's statute allowing transfer pricing analysis); 26 U.S.C. § 482 (the federal statute allowing transfer pricing analysis).

I conclude that there are no issues of material fact, and Microsoft is entitled to a decision in its favor as to its first ground for summary decision. OAH Rules 2819 and 2801.1; Superior Court of the District of Columbia Rules of Civil Procedure, Rules 12-I(k) and 56; *Kissi v. Hardesty,* 3 A.3d 1125, 1128 (D.C. 2010).

I must reverse the Notice issued on February 5, 2010. Nothing in this Order precludes OTR from issuing any additional notices of proposed tax assessments to Microsoft, consistent with all applicable laws.

I do not reach Microsoft's second ground for summary decision.

II. Background

This case arises under D.C. Official Code § 47-4312(a), and the Office of Administrative Hearings ("OAH") Establishment Act, D.C. Official Code § 2-1831.03(b)(4). On March 8, 2010, Petitioner Microsoft Corporation, Inc., through its attorneys, filed its Taxpayer's Protest of a proposed assessment with the Office of Administrative Hearings. By electing a hearing with OAH, the taxpayer has waived the right to have this matter adjudicated in the Superior Court of the District of Columbia. D.C. Official Code §§ 2-1831.03(j) and 47-4312(c).

Petitioner is appealing the Notice, issued by Respondent OTR on February 5, 2010. Respondent sought in the Notice to collect an alleged corporate franchise tax deficiency in the total amount of $2,746,344.00, plus interest and penalties, for the tax year ending June 30, 2006. For convenience, I have referred to this tax year as 2005.

According to Petitioner's taxpayer protest, Respondent disallowed the use of Petitioner's 2002 net operating loss ("NOL") carryforward for the tax year ending June 30, 2006. Petitioner

contends that Respondent has erroneously concluded that Petitioner's book income and tax income are materially different. Petitioner argues that Respondent's analysis of D.C. Official Code § 47-1810.03 is in error. Finally, Petitioner maintains that Respondent has failed to comply with applicable limitations periods in making an untimely adjustment to the 2006 tax return.[1]

The basis for the Notice was a transfer pricing analysis conducted as to Petitioner's 2002 tax year, when it reported losses that were carried forward to future years, including 2005. Respondent contracted with ACS State and Local Solutions, Inc., ("ACS") to provide the transfer pricing analysis, and ACS sub-contracted with Chainbridge. The central issue in this case is whether Chainbridge's transfer pricing analysis, which formed the basis for Respondent's Notice, (and Respondent's proposed assessment generally) was arbitrary, capricious, and/or unreasonable.

While the Internal Revenue Service ("IRS") has relied upon transfer pricing analyses to reallocate taxable income for many years, and federal statutes and regulations have been promulgated to govern the use of such analyses, *see* 26 U.S.C. § 482; 26 C.F.R. §§ 1.482-0 *et seq.*, it appears that this is a relatively new practice and procedure for OTR. The District's comparable statute, D.C. Official Code § 47-1810.03, contains nearly identical language to that of the federal statute.

Because of the unusual basis for Respondent's action, and the fact that Respondent and its agents maintain most of the information necessary to understand their transfer pricing

[1] Microsoft later conceded that OTR was not barred by limitations from seeking the proposed tax deficiency, because the 2005-06 tax year was within the limitations period, even though OTR relied upon information from 2002.

analysis, I have allowed extensive discovery not normally permitted in cases before OAH, including interrogatories and depositions.

The procedural schedule in this case, which has been amended from time to time, provided for a discovery phase, followed by a motions phase, and finally followed by a scheduled hearing.

Various rulings have been issued regarding discovery disputes that have arisen. I will not detail these disputes here, except to note that, on May 25, 2011, I issued a Protective Order prohibiting the public disclosure of certain information pertaining to Chainbridge's work product and processes. As a result, the parties have filed certain documents and portions of pleadings under seal, and have also provided redacted copies of the documents and pleadings for public viewing.

Pursuant to the procedural schedule, on December 23, 2011, Microsoft filed its Motion for Summary Judgment.

OTR requested that the discovery phase be reopened so that it could depose Microsoft's designated expert witness, David Guenther. That request was granted, and the deadlines for OTR's response and Microsoft's rebuttal were extended.

On March 29, 2012, OTR filed its Response. On April 5, 2012, Microsoft filed its Rebuttal.

A hearing was held on the Motion for Summary Judgment on April 11, 2012. Stephen Kranz, Esq., Diann Smith, Esq., and Wilson Barmeier, Esq., appeared on behalf of Microsoft. Edward Blick, Esq., Alan Levine, Esq., and Aisha Hashmi, Esq., appeared on behalf of OTR.

Nancy Cook and Eric Cook, of Chainbridge, and their attorney, Helen Guyton, Esq., attended the hearing.

In the next section, Section III, I will summarize the parties' arguments. In Section IV, I will discuss the standard for motions for summary decision. In Section V, I will set forth the undisputed material facts. In Section VI, I will analyze the arguments of the parties. In Section VII, I will issue the order reversing the Notice.

III. The Parties' Arguments

Background: Chainbridge analyzed Microsoft by determining its profit-to-cost ratio in 2002, and comparing that profit-to-cost ratio to the profit-to-cost ratios of [redacted] that were deemed to be similar to Microsoft (the "comparables").

The objective is to place Microsoft in the same category as the corporations that are being compared to Microsoft, the comparables, so that the analysis compares apples to apples. This can be problematic because the financial information reported to various agencies can rely on different factual and accounting assumptions. [redacted]

[redacted] Based on this analysis, Chainbridge concluded that Microsoft was shifting income to avoid paying taxes in the District.

A. Microsoft's Motion

Microsoft moves for summary decision for two reasons.

First Ground – Improper Aggregation of All Transactions, Controlled and Otherwise.

Microsoft contends that, when Chainbridge determined the profit-to-cost ratio for Microsoft's 2002 transactions, Chainbridge improperly included all of Microsoft's transactions without first separating out the "controlled transactions" between Microsoft and its affiliated businesses. Microsoft contends that the federal regulations, and in particular several provisions of 26 C.F.R. § 1.482-5, require the analysis to be tailored to controlled transactions. Because Chainbridge calculated the profit-to-cost ratio for all transactions, the result is unreliable in determining whether Microsoft has improperly shifted income to avoid paying taxes.

Microsoft also contends that it conducts seven types of businesses, and that most of its income is derived from transactions with third parties. It argues that Chainbridge has improperly aggregated all of these transactions into one total number, whereas Chainbridge was required under the federal regulations to separate transactions based on the type.

Second Ground – Failure to Adjust for Two Factors.

Within Chainbridge's model, Microsoft argues that Chainbridge made two major adjustment errors when it tried to compare Microsoft's profit-to-cost ratio to those of [redacted]

The first assigned error is that Chainbridge failed to deduct the costs of employee stock options that Microsoft offered its employees. The second assigned error is that Chainbridge failed to consider the unique problems created by the District's tax treatment of partnership income in a situation in which a related corporation and partnership both do business in the District. In 2002, Microsoft was affiliated with the partnership, MSLI, GP.

As to the second assigned error, the District taxes the partnership as an entity, instead of allowing the taxable income to pass through to the partners. Consequently, to avoid double taxation, the District allows the partners to deduct the partnership income that was subject to tax. Chainbridge had relied upon Microsoft's D20 tax form which included the deduction of the partnership income.

Microsoft contends that, in order to put Microsoft on the same footing as the comparables, Chainbridge was required to consider the profits and costs of the partnership as well.

Microsoft computes that, if the two assigned errors are corrected, Microsoft's profit-to-cost ratio jumps [redacted].

Microsoft states that it has many other objections to the analysis conducted by Chainbridge, but relies upon these two grounds for summary decision.

B. OTR's Argument

First Ground – The Narrowest Category is Microsoft's Gross Income

With regard to Microsoft's first argument, on improper aggregation of the income, OTR contends that Microsoft's business structure is so complex and entangled that the only proper way to analyze Microsoft's controlled transactions is to include all of the transactions. OTR notes that Microsoft has at least 100 affiliated businesses and that it has had thousands of intercompany transactions with those businesses. OTR relies on 26 C.F.R. § 1.482-1(f)(2)(i), which permits the aggregation of two or more transactions if the transactions are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions.

OTR claims that Chainbridge considered the arm's length transactions as well as the controlled transactions in analyzing Microsoft's income. OTR and Chainbridge concluded that the most narrowly identifiable business activity to determine the controlled transactions was the Gross Receipts line on Microsoft's D20 tax return.

Finally, OTR urges that Microsoft has an opportunity to misstate its income even as to uncontrolled transactions. On this basis, OTR urges that it is appropriate to look at the profit-to-cost ratio for the entire universe of transactions.

Second Ground – Concede Need for Adjustment in Part, but No Change in Result

As to the second argument, OTR has conceded that Chainbridge should have deducted the employee stock options costs. However, OTR contends that, if this adjustment is made, Microsoft's profit-to-cost ratio for 2002 only changes from [redacted] to [redacted], which

is still below the bottom of the interquartile range [redacted] compared to the comparables. This adjustment does not change the proposed tax assessment at all.

OTR disagrees with Microsoft, however, about the proper treatment of the partnership income. According to OTR, the proper adjustment for the partnership income is to exclude it completely from consideration. The bases for OTR's position are that: (1) the partnership has already been taxed on that income; and (2) D.C. law does not permit consideration of the related partnership's income.

IV. The Standard for Summary Decision

OAH Rule 2819.1 permits a party to file a motion for summary adjudication, requesting that the administrative law judge decide the case summarily, without a hearing. Such a motion must include sufficient evidence of undisputed facts and citation of controlling legal authority.

OAH Rule 2801.1 provides that where a procedural issue is not specifically addressed in the OAH Rules of Procedure, an administrative law judge may be guided by the Superior Court of the District of Columbia Rules of Civil Procedure.

Microsoft has moved for a decision in its favor, under OAH Rule 2819. It has labeled its motion, a "Motion for Summary Judgment." In support of the motion, it has also relied upon documents that are outside the scope of the pleadings. Therefore, it is more appropriate to consider the motion as akin to a motion for summary judgment or summary adjudication, than a motion for dismissal. *Compare* D.C. Superior Court Rules 12-I(k) and 56 [summary judgment] *with* D.C. Superior Court Rule 12(b)(6) [dismissal for failure to state a claim].

Under Rule 56, the burden is on the moving party to show: (1) that there are no issues of material fact; and (2) that the moving party is entitled to judgment as a matter of law. *See, e.g., Kissi,* 3 A.3d at 1128.

In ruling on a motion for summary judgment, the court must view the evidence in the light most favorable to the non-moving party, resolving any ambiguities against the moving party. *E.g., Young v. Delany,* 647 A.2d 784, 788 (D.C. 1994).

In this case, based on the uncontroverted facts, Microsoft's first ground for summary decision, that OTR and Chainbridge have improperly aggregated all of Microsoft's transactions, clearly has merit. Therefore, I will only discuss this ground for the remainder of this Order. It is not necessary to rule on the second ground.

Next, I will set forth the undisputed material facts. Then I will analyze the arguments.

V. Undisputed Material Facts

A. OTR's Selection of Chainbridge, and Chainbridge's Report

OTR is the taxing authority for the District of Columbia.

OTR has retained the services of ACS to conduct a transfer pricing analysis of Microsoft's 2002 income and expenses to determine whether Microsoft was underreporting its income to the District. ACS subcontracted this work to Chainbridge.

Chainbridge operates a business that, among other things, conducts transfer pricing analyses for various taxing authorities. Its principal owners/analysts are Nancy Cook and Eric Cook.

In July 2009, Chainbridge issued two documents based on its transfer pricing analysis, the "Economic Evaluation of the Arm's Length Nature of Intercompany Transactions between Microsoft Corporation and Related Parties for Tax Years 2005 through 2006," ("2005 Report.") and the "Economic Evaluation of the Arm's Length Nature of Intercompany Transactions between Microsoft Corporation and Related Parties for Tax Year 2002." (the "Report.")[2]

OTR contracted for the transfer pricing analysis in large part because:

In the 2005 Report, Chainbridge concluded that Microsoft did not underreport its income for tax year 2005 (again, the tax year ending June 30, 2006).

In the Report, Chainbridge concluded that Microsoft underreported its income for tax year 2002. The remainder of the findings concern the bases for the Report and its findings and conclusions.

[2] For purposes of this Motion, I am considering the contents of the Report, which was filed with OAH under seal in July 2011. Both parties have made references to the Report, although neither party attached a copy of the Report to their respective pleadings. I conclude that the parties assume that the Report, which is the subject of this case, is in evidence for purposes of the Motion.

B. Chainbridge's Methodology

Chainbridge elected to conduct a comparable profits analysis comparing Microsoft's profit-to-cost ratio to those of comparables, [redacted]

In determining Microsoft's income for 2002, Chainbridge chose to include all of Microsoft's income from any source. Chainbridge chose not to isolate controlled transactions between Microsoft and its affiliated businesses. The reasons for this decision were that Microsoft conducted thousands of transactions with its 100+ affiliated businesses, and that, based on this factor alone, Chainbridge concluded that the most narrowly identifiable business

activity for which data incorporating the controlled transaction is available (relevant business activity), was the gross income amount reported by Microsoft on its D20 return. Chainbridge concluded that the federal regulations permitted it to aggregate all of Microsoft's transactions for the period in question, regardless of whether the transactions were controlled or not.

Chainbridge conducted what they viewed as an arm's-length analysis of all Microsoft's transactions by comparing the overall profit-to-cost ratio for all transactions to the corresponding ratios for the comparables. Chainbridge's principals have conceded that they included transactions between Microsoft and unrelated third parties. Microsoft Exhibits C (Deposition of Nancy Cook) p. 172; and D (Deposition of Eric Cook) pp. 172-73.

Chainbridge also did not seek to compare similar goods and services, but aggregated all transactions into one analysis. Chainbridge in its report identified seven types of product segments for Microsoft's business: [redacted]

However, Chainbridge deemed that all product segments were interrelated because collectively they constituted the business of computer software. Chainbridge Report, pp. 1-6.

C. Chainbridge's Initial Findings

In its Report, Chainbridge issued its findings based on its selected analysis.

[redacted]

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]	[redacted]
[redacted]	[redacted]
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[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]
[redacted]	[redacted]

3 [redacted]

[redacted]

Chainbridge chose to eliminate from consideration the outlier comparables, in the highest and lowest quartiles. Chainbridge considered the "interquartile range" to be the middle two quartiles. Since Microsoft's profit-to-cost ratio [redacted] was outside the interquartile range of [redacted] to [redacted], Chainbridge concluded that Microsoft was underreporting its income to the District in 2002, when it claimed an operating loss. [redacted]

D. OTR's Notice

OTR relied upon Chainbridge's Report in disallowing Microsoft's carryforward of the NOL for the 2005 tax year. On this basis, on February 5, 2010, OTR issued the Notice seeking payment of a corporate franchise tax deficiency of $2,746,344, the entire amount of the carryforward claimed.

E. Adjustment to Chainbridge's Findings

Both OTR and Chainbridge have conceded that they should have deducted amounts for employee stock options paid by Microsoft in 2002 in considering its income, [redacted] After accounting for this adjustment, Microsoft's profit-to-cost ratio changed to [redacted], which is still outside the interquartile range. OTR's Response, p. 11, Table 2.

This adjustment does not affect the overall conclusion of Chainbridge and OTR, that Microsoft underreported its income to the District in 2002. OTR Response, p. 12.

F. The Lack of Determination of Certain Facts

Because Chainbridge did not analyze such information, the record does not show: (1) what volume or dollar amount of controlled transactions Microsoft has conducted with its affiliated businesses; (2) what the profit-to-cost ratio Microsoft showed for controlled transactions; (3) what the profit-to-cost ratios the 21 comparables showed for arm's-length transactions; (4) what volume or dollar amount of transactions were conducted by Microsoft in its seven product segment categories; or (5) how the profit-to-cost ratios for Microsoft compared to those for the comparables in the specific product segments.[4]

In 2002, Microsoft conducted business in the District, along with its partnership, MSLI, GP. Because Chainbridge and OTR do not agree to include partnership information from Microsoft's partnership in calculating the profit-to-cost ratio, the record does not show the profit-to-cost ratio of Microsoft and MSLI, GP, combined, for 2002.[5]

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[4] Microsoft asserted in its Motion that 98% to 99% of its transactions were conducted with third parties. When I asked Microsoft at the hearing to clarify where this percentage came from and what it means, Microsoft withdrew the assertion, stating that this was a figure provided by its expert, David Guenther, based on the volume of transactions and not the dollar amount. If the case were to proceed to a hearing, Mr. Guenther would presumably testify to the basis for this assertion. For purposes of resolving the Motion, I make no finding as to this fact. The pertinent fact, which OTR has conceded, is that Chainbridge analyzed all of Microsoft's income together and that this income included many transactions between Microsoft and unaffiliated third parties. This fact is sufficient to establish that the analysis was arbitrary when focusing on the inquiry required by 26 C.F.R. §§ 1.482-1 and 1.482-5.

[5] Microsoft contends that this adjustment would raise its profit-to-cost ratio to [redacted] because the partnership reported information that would create a much higher profit-to-cost ratio, but I must deem this fact to be in controversy since OTR and Chainbridge have not computed the ratio based on this contingency.

VI. Analysis and Conclusions of Law

In this case, Microsoft carries the burdens of proof:

(1) To show that there are no disputes as to material fact, and that Microsoft is entitled to a decision in its favor as a matter of law; OAH Rules 2819.1 and 2801.1; Superior Court Rule 56; *Kissi,* 3 A.3d at 1128; and, ultimately,

(2) To show that OTR's Notice of a corporate franchise tax deficiency, based on a transfer pricing analysis conducted by Chainbridge, is arbitrary, capricious, and unreasonable. *Donahue v. District of Columbia*, 451 A.2d 85, 86 fn.1 (D.C. 1982) [the burden of proof as to a tax assessment is on the taxpayer]; *Altama Delta Corp. v. Commissioner,* 104 T.C. 424, 458; 1995 U.S. Tax Court LEXIS 22; 104 T.C. No. 22 (April 11, 1995) [the burden of proof in a § 482 analysis case is on the taxpayer to show that the analysis was arbitrary, capricious, and unreasonable].

For the following reasons, I conclude that Microsoft has met these burdens with regard to one of the grounds for its Motion, i.e., that OTR and Chainbridge failed to conduct a comparable profits analysis of Microsoft's 2002 income based on applicable law because they improperly aggregated all of Microsoft's income, regardless of whether the income was derived from controlled or uncontrolled transactions.

A. OTR's Authority to Reallocate Income

D.C. Official Code § 47-1810.03 provides in pertinent part that, "In any of 2 or more organizations … owned or controlled directly or indirectly by the same interests, the Mayor is authorized to distribute, apportion, or allocate gross income or deductions between or among

such organizations …, whenever in his opinion such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations[.]"

The language of this statute is virtually identical to that of its federal counterpart, 26 U.S.C. § 482.

The District has not promulgated regulations to implement this statute. The parties agree that it is appropriate to look to the federal regulations, codified at 26 C.F.R. §§ 1.482-0 *et seq.*, for guidance in interpreting the authority of OTR to rely upon "transfer pricing analyses" under D.C. Official Code § 47-1810.03. Indeed, Chainbridge, which has conducted many such analyses in the past ten years, specifically relied upon the federal regulations to support the methodology that it used.

B. General Requirements for Transfer Pricing Analysis – Measuring Controlled Transactions Against Arm's Length Standard

The general purpose for transfer pricing analysis, and for reallocation of income and deductions, is to "ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions." 26 C.F.R. § 1.482-1(a)(1).

Section 482 "places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer." *Id.*

In order to determine the true taxable income of a controlled taxpayer, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled

taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)." § 1.482-1(b)(1).[6]

The federal regulatory scheme provides a number of methods that the taxing authority may select to measure the taxpayer's controlled transactions against the arm's length standard. §§ 1.482-2 through 1.482-7, and 1.482-9. The taxing authority is required to choose the best method that, "under the facts and circumstances, provides the most reliable measure of an arm's length result." § 1.482-1(c)(1).

In order to determine whether a controlled transaction produces an arm's length result, the method used must measure against "results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances." § 1.482-1(d)(1). This requires an analysis of all factors that affect comparability, including functions, contractual terms, risks, economic conditions, and property or services. *Id.* The uncontrolled transaction and the controlled transaction should be functionally comparable. § 1.482-1(d)(3).

This does not mean that the uncontrolled transaction must be identical to the controlled transaction but they must be "sufficiently similar that it provides a reliable measure of an arm's length result." § 1.482-1(d)(2). The evaluator is required to adjust for material differences in the transactions. *Id.*

[6] Unless otherwise indicated, all references in this analysis will refer to the Code of Federal Regulations Title 26.

In analyzing the comparable transactions to be considered in the arm's length range, § 1.482-1(e)(2)(C) authorizes the evaluator to consider those results that are in the "interquartile range," defined as the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. This is the range that was employed by Chainbridge here.

The regulations allow aggregation of controlled transactions and uncontrolled transactions in limited circumstances:

> The combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions. Generally, transactions will be aggregated only when they involve related products or services[.]

§ 1.482-1(f)(2)(i)(A).

Based on the results of a transfer pricing analysis, the taxing authority may reallocate income when "either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer, in the conduct of its affairs, been dealing at arm's length with an uncontrolled taxpayer." § 1.482-1(f)(1).

In this case, Chainbridge and OTR selected the comparable profits method, under § 1.482-5, as the best method to measure Microsoft's controlled transactions against the arm's length standard.

C. Comparable Profits Method Still Must Measure Controlled Transactions Against Arm's Length Standard

The purpose for the comparable profits method is to evaluate "whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances." § 1.482-5(a). The standard is "based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit)." § 1.482-5(b)(1).

In applying this method, the evaluator must select the "tested party," which will usually be "the least complex of the controlled taxpayers," and which "will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables." *Id.*

As OTR notes, the arm's length range is "established using comparable operating profits derived from a single profit level indicator." § 1.482-5(b)(3). However, OTR omits that the profit level indicator still is required to measure controlled transactions against uncontrolled transactions of a similar kind. § 1.482-5(b)(2) ["To the extent possible, profit level indicators should be applied solely to the tested party's financial data that is related to controlled transactions."]

The same comparability factors listed generally in § 1.482-1, also apply to the comparable profits method. Section 1.482-5(c) contains many provisions that direct the evaluator to maximize the comparability of the controlled transactions and the uncontrolled transactions measured by the profit level indicator.

In this case, Microsoft contends that Chainbridge's decision to include all of Microsoft's income as the tested party for purposes of assigning a single profit-to-cost ratio was overbroad for two reasons: first, because Chainbridge failed to narrow the focus of its analysis to compare controlled transactions between Microsoft and its affiliated businesses to uncontrolled transactions conducted at arm's length; and second, because Chainbridge failed to compare Microsoft's specific product segment transactions to similar uncontrolled transactions. Both arguments have merit, and the first argument is particularly persuasive. I will address each point separately.[7]

D. Chainbridge and OTR Failed to Measure Controlled Transactions Against Uncontrolled Transactions Conducted at Arm's Length

As the foregoing analysis shows, while the taxing authority has broad discretion to choose the appropriate method to determine whether the taxpayer's transactions meet the arm's length standard, the regulations clearly focus on an inquiry whether controlled transactions meet the arm's length standard. This focus permeates the regulations, including the regulation on comparable profits.

Microsoft made a *prima facie* showing in its Motion that the decision to include all of its income, controlled or not, on the tested party side of the analysis was overly broad and therefore inherently arbitrary. It was then incumbent on OTR to explain why it (or Chainbridge) decided to move from examining Microsoft's controlled transactions to examining all of its income.

[7] [redacted]

According to OTR, its tax experts decided that the "most narrowly identifiable business activity for which data incorporating the controlled transaction is available," under § 1.482-5(b), was the gross income entry by Microsoft on its 2002 D20 tax return. This conclusion was not supported by any factors.

OTR then stated that Microsoft has engaged in thousands of controlled transactions with over 100 affiliated businesses, many of which were listed in the Report and in OTR's Response. However, the fact that Microsoft has 100 or even 2,000 affiliates does not address the question why there was no effort to isolate the controlled transactions. In other words, the inquiry goes to the transactions, and not to the number of affiliates. Neither OTR in its Response nor Chainbridge in its Report provides any insight as to why the entire income of Microsoft was selected.

OTR then cited § 1.482-1(f)(2)(i)(A), which authorizes the aggregation of two or more transactions, "if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm's length consideration for the controlled transactions." But OTR provided no analysis why there was a need to aggregate transactions, and which transactions were aggregated.[8] Apparently, OTR simply decided to aggregate all of Microsoft's transactions, without inquiring as to whether the transactions were conducted with Microsoft's affiliates.

Although Microsoft did not specifically raise this issue, the record also shows that Chainbridge considered the entire income of the [redacted] comparables and their affiliates without

[8] OTR argued at the hearing that it was required to aggregate transactions to convert tax return data to financial data. This argument, however, does not address the larger problem that the aggregation of all transactions obscures the result, because the tested party's side of the equation was not limited in any way to controlled transactions.

considering whether the profits and costs arose from controlled transactions. Thus, 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. The analysis does not identify the tested party's controlled transaction profit-to-cost ratio, nor does it identify the comparables' uncontrolled transaction profit-to-cost ratio.

There is no need for a hearing on this issue because OTR and Chainbridge have conceded the facts that form the basis for Microsoft's Motion. Microsoft has proven that the transfer pricing analysis was arbitrary, capricious, and unreasonable, because the analysis does not measure what the regulations require it to measure.

E. Chainbridge and OTR Failed to Measure Comparable Transactions

In addition, Microsoft's Motion has merit for the second reason advanced in its first argument: that Chainbridge failed to measure the profit-to-cost ratios of similar types of transactions.

As noted above, the regulations require that the transactions being compared must be functionally comparable. §§ 1.482-1(d)(1), 1.482-1(d)(3), and 1.482-5(c)(3)(iii) [requiring allocations of the costs, income, and assets between the relevant business activities and other activities].

OTR contends that Microsoft engages in one business: software. However, Chainbridge's Report shows that [redacted] different types of business activities are identified for Microsoft, and yet Chainbridge made no effort to compare like kind transactions.

While § 1.482-5 generally allows some flexibility for the evaluator to address the facts and circumstances of a particular case, there was no effort here to address any of the different types of transactions at issue. This is a significant error because the profit-to-cost ratio of uncontrolled transactions in [redacted] may be quite different than, for example, [redacted].

Without any differentiation of the comparable profits for different product and server lines, an overall profit level indicator is meaningless to indicate that Microsoft's controlled transactions do not meet the arm's length standard. For example, if one company conducts mostly one type of transaction that is very profitable, then its overall profit-to-cost ratio will most likely be higher than one that does not.

Again, there is no need for a hearing because OTR and Chainbridge have conceded that they failed to analyze the comparable profits of similar products or services. There is some discretion allowed in this area, but the analysis must attempt to address the purpose of the regulations.

Summary

For the reasons stated above, I conclude that there are no issues of material fact, and Microsoft is entitled to a decision in its favor as to its first ground for summary decision. OAH Rules 2819 and 2801.1; Superior Court of the District of Columbia Rules of Civil Procedure, Rules 12-I(k) and 56; *Kissi,* 3 A.3d at 1128.

While the regulations allow some flexibility to the taxing authority to select the appropriate method, the application of the method chosen here does not comport with the

purpose of the regulations. Chainbridge selected the comparable profits method set forth in 26 C.F.R. § 1.482-5. However, this regulation requires the analyst using the profit-to-cost method, to the extent possible, to compare controlled transactions (between the tested party and its affiliated businesses) against uncontrolled transactions made at arm's length with third parties. Chainbridge included all of Microsoft's transactions, whether controlled or uncontrolled, in the analysis of its profit-to-cost ratio, and Microsoft engaged in many uncontrolled transactions with third parties. In addition, Chainbridge failed to compare comparable 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 to prevent evasion of taxes.

On this basis, Microsoft has shown that the transfer pricing analysis is arbitrary, capricious, and unreasonable based on the undisputed facts in this case. D.C. Official Code §§ 47-4312 and 47-1810.01; 26 U.S.C. § 482.

This decision only rules on the Notice at issue in this case. This Order does not preclude OTR from issuing any other tax assessment notices, subject to the provisions of applicable laws.

VII. Order

Upon consideration of Petitioner's Motion for Summary Judgment, Respondent's Response, Petitioner's Reply, and the entire record in this case, it is this 1st day of May, 2012:

ORDERED, that Petitioner Microsoft Corporation, Inc.,'s Motion for Summary Judgment is **GRANTED**; and it is further

ORDERED, that the Notice of Proposed Tax Deficiency, issued by Respondent District of Columbia Office of Tax and Revenue on February 5, 2010, seeking to collect an alleged corporate franchise tax deficiency against Petitioner Microsoft Corporation, Inc., in the total amount of $2,746,344.00, plus interest and penalties, for the tax year ending June 30, 2006, is **REVERSED**; and it is further

ORDERED, that the appeal rights of any party aggrieved by this Order are stated below.

Paul B. Handy
Administrative Law Judge

After an administrative law judge has issued a Final Order, a party may ask the judge to change the Final Order and ask the District of Columbia Court of Appeals to change the Final Order. There are important time limitations described below for doing so.

HOW TO REQUEST THE ADMINISTRATIVE LAW JUDGE TO CHANGE THE FINAL ORDER

Under certain limited circumstances and within certain time limits, a party may file a written request asking the administrative law judge to change a final order. OAH Rule 2828 explains the circumstances under which such a request may be made. Rule 2828 and other OAH rules are available at www.oah.dc.gov and at OAH's office.

A request to change a final order does not affect the party's obligation to comply with the final order and to pay any fine or penalty. If a request to change a final order is received at OAH **within 10 calendar days** of the date the Final Order was filed (**15 calendar days** if OAH mailed the final order to you), the period for filing an appeal with the District of Columbia Court of Appeals does not begin to run until the Administrative Law Judge rules on the request. **A request for a change in a final order will not be considered if it is received at OAH more than 120 calendar days of the date the Final Order was filed (125 calendar days** if OAH mailed the Final Order to you).

HOW TO APPEAL THE FINAL ORDER TO THE DISTRICT OF COLUMBIA COURT OF APPEALS

Pursuant to D.C. Official Code § 2-1831.16(c)-(e), any party suffering a legal wrong or adversely affected or aggrieved by this Order may seek judicial review by filing a Petition for Review and six copies with the District of Columbia Court of Appeals at the following address:

Clerk
District of Columbia Court of Appeals
430 E Street, NW, Room 115
Washington, DC 20001

The Petition for Review (and required copies) may be mailed or delivered to the Court of Appeals, and must be received there within 30 calendar days of the mailing date of this Order, pursuant to D.C. App. R. 15(a)(2). There is a $100 fee for filing a Petition for Review. Persons who are unable to pay the filing fee may file a motion and affidavit to proceed without the payment of the fee when they file the Petition for Review. Information on petitions for review can be found in Title III of the Court of Appeals' Rules, which are available from the Clerk of the Court of Appeals, or at www.dcappeals.gov.

Certificate of Service:

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I hereby certify that on May 1, 2012, copies of this document were caused to be served upon the above-named parties at the addresses listed and by the means stated.

Clerk / Deputy Clerk