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Multistate Tax Commission Hears From Firms on Transfer Pricing Project



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The Multistate Tax Commission's (MTC's) Arm's-length Adjustment Service Advisory Group held a two-day conference in Atlanta, Georgia on October 6 and 7 to meet with transfer pricing firms and discuss the MTC's project to develop a multistate transfer pricing service.

On the first day of the conference, seven economic firms specializing in transfer pricing presented to and fielded questions from the Advisory Group. While project facilitator and former MTC Executive Director Dan Bucks made clear that these presentations were not part of a procurement process, the state participants' discussions and the preliminary draft design show that some combination of contracted assistance from transfer pricing firms and/or direct employment of economists on the MTC staff is currently being considered.

On the second day of the conference, the Advisory Group discussed their observations based on the presentations and a preliminary draft design for an arm's length adjustment service, which Bucks had prepared in advance of the conference.

The Advisory Group is currently working toward a goal of approving a draft service design by mid-November 2014 for initial review by the MTC Executive Committee in December 2014. The Advisory Group's next scheduled meeting is a teleconference on November 3. This alert provides background on the MTC transfer pricing project, summarizes issues and ideas discussed during the conference, and suggests additional considerations.

Background on MTC Transfer Pricing Project

Many states have the ability to evaluate and potentially challenge intercompany transfer pricing arrangements through arm's length statutes and regulations similar to IRC §482, including the Treasury regulations thereunder. In addition, states may have statutes providing discretionary authority to adjust income, statutes requiring the add-back of certain intercompany payments, and statutory or judicial economic nexus principles. However, state taxing authorities have had varying levels of success challenging and litigating transfer pricing arrangements. The MTC transfer pricing project came about in an effort to enable states to pool resources to support arm's length issues on audit and during litigation. States are considering transfer pricing not only in the context of interstate transactions, but also within international transactions that may already be subject to Internal Revenue Service scrutiny. States have not typically challenged international related-party transactions on transfer pricing grounds. However, as international tax structures come under increasing scrutiny from various authorities at the international level (e.g., the Organization for Economic Cooperation and

Development's Base Erosion and Profit Shifting project), some states have started to consider taking their own action. For instance, several states have in recent years begun enacting "tax haven" provisions that bring the tax base of a foreign entity doing business in some overseas jurisdictions into a combined report.¹ Some states have also increased challenges to U.S.-foreign intercompany debt structures that otherwise passed IRS muster. Discussions at previous Advisory Group meetings indicate that states are now considering using transfer pricing principles to audit international structures.

The Advisory Group held its first in-person meeting on June 2, and a second in-person meeting on July 28. One area of interest at these meetings and other teleconferences was how the states may obtain cost-effective joint economic expertise. The October conference was set up, in part, to hear from firms that could provide outside economic expertise.

Nine jurisdictions have officially committed seed money to the project: Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina. However, attendance at project meetings has not been limited to these states. For example, representatives from other state taxing authorities that have not officially committed, including Connecticut and Pennsylvania, attended the conference.

Economics Firm Presentations²

On the first day of the conference, the Advisory Group heard presentations from seven economic firms specializing in transfer pricing: Chainbridge Software, LLC; Economic Analysis Group; Peters Advisors; NERA Economic Consulting; Economists Incorporated; RoyaltyStat; and WTP Advisors. The firms encompassed a broad spectrum in terms of size, background, and level of experience with state-specific transfer pricing and related issues, and typical client base (taxpayer or taxing authority). Several firms had generally focused on federal transfer pricing issues but indicated that they would be available to support the MTC on state transfer pricing issues.

The firms were asked to frame their discussion around several previously circulated questions that focused on ways to improve taxpayer compliance, the types of services the firms could provide to the MTC, how the MTC might best integrate economic expertise, and what lessons the states might learn from other taxing authorities.³

The firms discussed transfer pricing broadly, as well as recommendations as to how the MTC might proceed. All the firms indicated they could support the MTC or individual states in some way. Rather than summarize each firm's presentation, in this alert we highlight a few themes and ideas that spurred discussion among the participating states.

The general theme among presenters was that getting the right information at the right time would be of critical importance for the success of a transfer pricing audit. Several firms suggested requiring detailed disclosure and reporting of intercompany transactions on taxpayers' state tax returns. One suggested imposing penalties for failure to meet those disclosure requirements. Several firms also suggested the possibility of a state-by-state version of the country-by-country reporting the OECD has included in a revised version of its transfer pricing guidelines. This would include reporting elements such as the allocation of profits, taxes paid, and indicators of economic activity on a state-by-state basis,

¹ See, e.g., Alaska Stat. § 43.20.145(a)(5); D.C. Code Ann. § 47-1810.07(a)(2)(F)(i); Mont. Code Ann § 15-31-322(f); Or. Rev. Stat. § 317.715(2); R.I. Stat. 44-11-4.1(d); W. Va. Code § 11-24-13f(a)(7).

² Copies of the presentations are available at the project website: <http://www.mtc.gov/The-Commission/Committees/ALAS>.

³ For a complete list of the questions, see *Draft Issues for October 6 Conference: Item III.B for July 28 Meeting*, Dan Bucks, Project Facilitator (July 25, 2014).

as opposed to a country-by-country basis.⁴ Several firms also discussed the importance of developing appropriate standard information document requests (IDRs), or in certain cases, tailoring IDRs once a transfer pricing audit candidate has been identified. Such requests would include obtaining a taxpayer's complete transfer pricing file, not just a transfer pricing report. Many state taxing authority participants agreed there is a need for both tax return disclosures and effective data requests, and that uniformity in those areas may yield the most effective results.

Several firms discussed how they could use training to equip auditors for gathering information, identifying transfer pricing audit candidates using risk indicators, and performing non-economic analysis (for example, making sure chosen comparables meet the identified criteria). With regard to identifying audit candidates, there was a general view among many of the state taxing authority participants that they may already know which businesses could be chosen for a transfer pricing audit, but they don't currently have the resources or expertise to conduct those transfer pricing audits. On that point, it was noted that North Carolina has as many as 150 transfer pricing audit candidates in the queue as of the date of the conference.

Several firms discussed the tools states have in addition to IRC §482-like powers, particularly statutory add-back provisions. One firm went as far as to say that transfer pricing expertise might be most effectively employed in determining the amount of intangible expense indirectly included in the cost of a tangible good (i.e., embedded royalties). The firm used an example of a good sold by a foreign related manufacturer to a U.S. distributor that cost \$7 with an embedded intangible cost of \$2. Auditing the overall price of the good, the firm argued, might yield some change at the margins, such as reducing the price from \$7 to \$6. However, the firm argued, if the state successfully asserted that the entire \$2 embedded royalty was subject to the add-back, this would achieve a more favorable result for the state. While many states may have statutory authority to add back embedded royalties, the firm indicated that those amounts may not necessarily be broken out in a transfer pricing study that does not take into account state tax laws.

Several firms suggested that the state taxing authorities should consider adopting regulations that express their legal authority to challenge intercompany transactions (if not explicit in the statute) and what standards the state taxing authorities would use to analyze intercompany transactions. Several state taxing authority participants agreed that this idea warranted further consideration as part of the project.

Draft Design for MTC Arm's Length Adjustment Service

On the second day of the conference, the Advisory Group discussed a preliminary draft design for an arm's length adjustment service, which Bucks had prepared in advance of the conference.⁵

The draft provides for a four-year charter period and commitment from the states. It would provide for a mix of hired staff, including hiring one senior economist and several junior economists on the MTC staff, as well as contracts with one or more third-party economic firms. The draft calls for these resources to be used to perform transfer pricing reviews -- either reviewing taxpayer-provided transfer pricing studies or conducting their own transfer pricing studies -- as well as training "front-line" auditors. This training would focus on the basics of transfer pricing, selecting taxpayers for transfer pricing audit, gathering appropriate information, and doing non-economic analysis that can be supplemented by economists. The draft also outlined procedures for information sharing and cooperation among the states, and estimates of the costs of the program.

The preliminary draft is a step toward the Advisory Group's goal of submitting a draft service design to the MTC's Executive Committee in mid-November for its

⁴ For background on country-by-country reporting see the OECD's *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (Sep. 16, 2014).

⁵ See *Draft Design for an MTC Arm's-Length Adjustment Service*, Dan Bucks, Project Facilitator (Oct. 3, 2014).

December meetings. The timeline calls for an ultimate goal of submitting a project design for full MTC approval in July 2015, with implementation shortly thereafter if approved.

In discussing the draft design, more than one state taxing authority participant expressed a desire to have flexibility in the operation and staffing of the project. Several also agreed on the need to articulate a business case for the project, including some “rough numbers” on the type of returns any audits might generate (whether through settlements or increased compliance).

Considerations

While the MTC’s joint effort on transfer pricing is still in the development process, the conference and earlier meetings have shown that many states have identified a desire to effectively audit and address interstate and international transfer pricing issues. With that in mind, taxpayers may wish to consider:

- Developing state-relevant, exam-ready transfer pricing documentation to the extent such a study has not been previously prepared; and
- Conducting a review of any existing transfer pricing studies to determine whether an update is advisable, given any changes to the taxpayer’s business activities, or whether such studies need to be adapted to take into account state laws, such as statutory add-backs, in particular with respect to the pricing of goods that could be perceived as including an embedded royalty, as well as penalty provisions.

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