

Multistate Tax Commission's Arm's-Length Adjustment Service (Transfer Pricing) Advisory Group Holds Initial Meeting

June 10, 2014

Overview

On June 2, 2014, the Multistate Tax Commission's ("MTC") Arm's-Length Adjustment Service ("ALAS") Advisory Group convened for the first time at a live meeting in St. Louis, Missouri. The ALAS Advisory Group is designated to lead the MTC's project to develop a multistate transfer pricing audit service. As stated in the Report of the Executive Director of the MTC, the project "will evaluate a range of potential services that would support states in pre-audit, audit, and post-audit phases of addressing transfer pricing issues."¹ The initial timeline calls for a preliminary draft of the program to be completed by the end of 2014, with a final design to be submitted in time for approval at the annual meeting of the full MTC in July 2015.²

In this Tax Alert we provide a brief background regarding the ALAS initiative; summarize the June 2nd meeting, program design, and timeline; and suggest potential taxpayer considerations.

Background

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. Some states have engaged third-party contractors to provide transfer pricing analyses. The method employed by one of these third-party contractors was recently successfully challenged. In *Microsoft Corporation, Inc. v. Office of Tax and Revenue*, a District of Columbia administrative law judge held the method applied by one contractor to the taxpayer's facts "was useless in determining whether [taxpayer's] controlled transactions were conducted in accordance with the arm's-length standard."³ In addition to the District of Columbia, state tax authorities (including New Jersey) have in the past relied on the same contractor or similar methodologies in undertaking transfer pricing audits. As these methodologies are coming under greater scrutiny, state interest in forming a unified transfer pricing audit program has increased.

In a meeting of the MTC Executive Committee on May 9, 2013, Michael Bryan, Director of the New Jersey Division of Taxation, requested that the MTC evaluate the creation of a dedicated transfer pricing audit program. Director Bryan reasoned that such a program would allow a state to increase the effectiveness of transfer pricing audits by supplementing state audit staff with seasoned transfer pricing professionals. Director Bryan also cautioned that if a MTC transfer pricing audit program was not created, coalitions of states may form their own individual programs.

On March 13, 2014, the MTC announced its plan to develop a state transfer pricing audit program (the ALAS). In the announcement, the MTC stated that more than a dozen states (both separate entity and combined reporting states) had expressed an interest in an MTC transfer pricing audit program. The following nine jurisdictions are

¹ See "Report of the Executive Director," p. 9, dated May 6, 2014, available at: [http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/2013-05%20Report%20of%20Exec%20Director\(1\).pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/2013-14_Committee_Meetings/2013-05%20Report%20of%20Exec%20Director(1).pdf).

² See "Project Plan for Design of a Multistate Tax Commission Arm's-Length Adjustment Service," dated March 6, 2014, available at: http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Events/ALAS_Advisory_Group/MTC%20Arm's-Length%20Adjustment%20Service%20Project%20Plan.pdf.

³ *Microsoft Corporation, Inc. v. Office of Tax and Revenue*, Office of Administrative Hearings, Case No.: 2010-OTR-00012 (May 1, 2012).

officially participating in the ALAS project: Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey and North Carolina.

The June 2nd Meeting

Representatives from all of the participating jurisdictions (except Hawaii) took part in the June 2nd meeting. During the meeting, the Advisory Group discussed project timelines, each participating state's basis for attacking arm's-length issues, and arm's-length audit experiences/procedures. Also, the Advisory Group elected a Chairman.

Project Facilitator Dan Bucks⁴ introduced a list of suggested services that the Advisory Group should consider for implementation, such as: (1) legal assistance to states on arm's-length issues and litigation; (2) developing arm's-length policies, methodologies, and practices for state consideration; (3) providing economic analysis to assist state audits and litigation; (4) exchanging information to support arm's-length compliance; (5) conducting joint audits; and (6) supplying expert witnesses. The Advisory Group discussed but has not decided on whether to adopt or reject any of these suggested service offerings. However, representatives expressed a strong interest in a service model that includes the ability to secure economic experts to support arm's-length issues on audit and during litigation. All parties recognized the important role economic experts serve when addressing arm's-length issues, acknowledging that without such expertise, states are not able to effectively challenge a taxpayer's transfer pricing study. Historically, high costs have prevented states from investing in such expertise.

Project Facilitator Bucks also advised the Advisory Group that this is not solely a separate entity state issue and reminded the Advisory Group that arm's-length issues may arise in combined reporting jurisdictions in the context of 80/20 companies and waters-edge group considerations. He further emphasized that while only two combined reporting jurisdictions are currently participating, many others are closely following the ALAS project.

Timeline and Design Phases

The project plan proposes that the program will be designed in three phases, described as follows:

- A draft service design produced by mid-November 2014 for initial review by the MTC Executive Committee in December 2014.
- A revised service design completed by early April, 2015, to be approved by the MTC Executive Director and then submitted for review by the tax administrators of interested states.
- A final service design accompanied by signed commitments by interested states completed by June 20, 2015, to be considered by the MTC in July 2015. Participating states will be asked to commit to a six month start-up period and a three or three and a half year initial operating period.

If adopted in July 2015, the MTC anticipates implementation of the final service design (or a portion thereof) shortly thereafter. A second ALAS Advisory Group meeting is tentatively scheduled for June 25, 2014, and will be held via teleconference. A subsequent, in-person meeting is scheduled for July 28, 2014, to be held in conjunction with the MTC's annual meeting in Albuquerque, New Mexico.

Considerations

Although the full scope and potential implementation of the MTC transfer pricing program is unclear at this time, it is likely states will continue to conduct transfer pricing audits and may seek solutions to enhance their transfer pricing audit capabilities. While the development of the MTC's program is ongoing, taxpayers may wish to consider the following:

- The need for a transfer pricing study to the extent such a study has not been performed; and
- A review of current transfer pricing studies to explore whether the studies are timely and reflect the current nature of the taxpayer's business activities.

⁴ Dan Bucks was formerly the MTC Executive Director and Montana Director of Revenue.

Contacts

If you have questions regarding the ALAS project or other MTC matters, please contact any of the following Deloitte Tax LLP professionals.

Valerie Dickerson
Managing Partner, WNT Multistate
Deloitte Tax LLP, Washington, D.C.
vdickerson@deloitte.com
(202) 220-2693

Michael Paxton
Manager, WNT Multistate
Deloitte Tax LLP, Washington, D.C.
mpaxton@deloitte.com
(202) 220-2123

For questions regarding transfer pricing matters, please reach out to one of the following transfer pricing specialists.

Darcy Alamuddin
Principal
Deloitte Tax LLP, Chicago
dalamuddin@deloitte.com
(312) 486-2049

Kerwin Chung
Principal
Deloitte Tax LLP, Washington, D.C.
kechung@deloitte.com
(202) 879-3108

Robert Plunkett
Principal
Deloitte Tax LLP, Jericho
rplunkett@deloitte.com
(212) 436-5261

Ron Saake
Partner
Deloitte Tax LLP, San Francisco
rsaake@deloitte.com
(415) 783-6589

This alert contains general information only and Deloitte is not, by means of this alert, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This alert is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this alert.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2014 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited