Multistate Tax
EXTERNAL ALERT

MTC to Solicit State Commitments for Transfer Pricing Initiative

December 22, 2014

Overview

On December 12, the Executive Committee of the Multistate Tax Commission ("MTC"), after discussing project facilitator Dan Bucks'[1] latest preliminary design for a multistate transfer pricing initiative, passed a motion to formally solicit commitments from interested states for funding the initiative, termed the Arm's-length Adjustment Service ("ALAS"). In this Alert we outline the background and recent developments in the ALAS initiative, discuss the components of the preliminary design, outline the potential path forward for the initiative, and suggest taxpayer considerations.

Background

Under the auspices of the MTC, states participating in the ALAS initiative have been working to combine resources toward strengthening their abilities to reattribute income under their respective versions of IRC § 482 as well as other applicable statutory and administrative powers.[2] As noted in the preliminary design discussed at the December meeting, states "have found the challenges posed by improper income shifting to be too costly to address on their own."[3] The ALAS initiative is designed to "pool [state] resources to more effectively, efficiently and equitably address . . ." the challenges states face in addressing transfer pricing.[4]

Development and Preliminary Design

The ALAS Advisory Group was charged with developing the ALAS initiative and has held a number of in-person meetings and teleconferences with participating states,[5] including a conference to meet with third-party transfer pricing firms, one or more of which may be utilized as part of the service (see our **October 13 Alert** discussing that meeting). The ALAS Advisory Group's primary work product, the preliminary design, is now in its third iteration.[6] Through its various iterations, the core themes that ALAS would address have remained largely consistent. These include:

- **Transfer pricing analysis.** When there is a taxpayer-provided transfer pricing report, the MTC would hire or contract with economists for economic review of the report, and the MTC would utilize auditors to perform non-economic analysis of the report, such as checking for calculation errors and other non-economic technical issues.
- **Training.** The intent is to train auditors in a number of related areas, including how to identify issues, how and what information to obtain from taxpayers, and how to conduct the non-economic analysis noted above. Training efforts are already under way, with the MTC having sent a "call for training proposals" for outside assistance in developing a training program, which it suggests may take place in the first quarter of 2015.
- **Information Exchange.** The service would provide for tax authority exchange of taxpayer information related to transfer pricing issues and sharing of information for conducting joint audits.
- **Case Resolution and Litigation Support.** These activities include assisting states on strategies for appeals and litigation, providing expert witnesses in litigation, and other similar activities. The design also suggests a voluntary disclosure period to be implemented early in the program.

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[1] Dan Bucks was formerly the MTC Executive Director and Montana Director of Revenue.
[2] *See* our **June 10 Alert** for a detailed background on the origins of the project.
[3] *See* ***Preliminary Design for an MTC Arm's-Length Adjustment Service***, Dan Bucks, Project Facilitator (Dec. 2, 2014).
[4] *Id*.
[5] Participating jurisdictions include: Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey and North Carolina.
[6] The prior versions of the design are posted at **http://www.mtc.gov/The-Commission/Committees/ALAS**.

- **Optional joint audits.** This envisions ALAS as a component of the MTC's existing Joint Audit Program. Three states recently joined the audit program (Pennsylvania, Rhode Island, and Iowa), and Bucks commented that at least one did so in anticipation of a transfer pricing component.

Other parts of the design, such as the staffing model and problem statement, have evolved to take into account suggestions from the participants in the ALAS Advisory Group meetings, including choosing a model with a lower first-year cost and outlining the costs and benefits of the design.

Broad Intended Impact

Bucks highlighted in his presentation the relevance of the project to the varying tax regimes and provisions of all states. For example, he indicated that while the project would be important in analyzing transfer pricing studies in separate company reporting states, ***analyses would not be limited to the U.S. borders*** and while the states could be better positioned to analyze and adjust the pricing in cross-border transactions, ***ALAS resources could also be useful in conducting unitary relationship analyses*** to determine the members of a combined reporting group. Previous discussions have also highlighted the potential uses of transfer pricing as a component of state statutory intercompany add-back statutes, where ***transfer pricing could be used to identify indirect or embedded royalties***.

The Path Forward

It seems that the "elephant in the room" for this project from the state perspective has been the potential cost of the service, estimated at $2 million per year. MTC Executive Director Joe Huddleston noted at the December Executive Committee meeting that he would not recommend that the project go forward without commitments from the states for complete funding of the project. The preliminary design estimates a $25 million benefit per year return from the service, which Bucks asserted was very conservative.

The project calls for a final design to be submitted to the full MTC for ratification at its annual meeting in July 2015. The preliminary design would establish a four-year charter period, beginning in July 2015. The charter period would consist of a two-year "developmental stage" and a two-year "operational stage."[7]

Considerations

While the ALAS initiative is the first MTC initiative specifically developed to address transfer pricing, it is not by any means the states' first foray into this area. Adjustments to the tax base, whether through transfer pricing or other statutory or administrative authority, have long been a common state audit issue. Additionally, some companies have recently experienced heightened state audit scrutiny of the tax base, including bringing in foreign entities to the combined group or foreign income into the taxpayer's income. Transfer pricing issues have reportedly resulted in sizeable settlements and in some cases litigation. So while the ultimate fate of the ALAS initiative may not be known until the MTC's annual meeting in July 2015, it is evident from the ongoing discussion that states have an interest in banding together to more effectively audit and address interstate and international transfer pricing issues. Furthermore, some activities, such as the above-noted transfer pricing training programs, are already under way.

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 addbacks, in particular with respect to the pricing of goods that could be perceived as including an embedded royalty, as well as penalty provisions.

Taxpayers may also wish to consider whether this project, coupled with the potential for increased uniform compliance projects, signals a shift away from legislative and regulatory drafting toward more emphasis on enhanced enforcement through the leveraging of state discretionary administrative powers.

[7] *See* ***Preliminary Design for an MTC Arm's-Length Adjustment Service***, Dan Bucks, Project Facilitator (Dec. 2, 2014), for more detail on the charter period.

Contacts

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