

## State Advance Pricing Agreement and Transfer Pricing Audit Initiatives in Indiana and North Carolina

### Overview

With states ramping up transfer pricing enforcement, as evidenced by recent litigated cases, efforts are underway by certain states to offer alternatives to resolve transfer pricing disputes more efficiently and, in some cases, on a prospective basis. Such alternatives could provide welcome certainty to companies dealing with complex transfer pricing issues.

The Indiana Department of Revenue (IN DOR) is in the process of establishing an Advanced Pricing Agreement Program (APA Program) that should give companies the opportunity to gain prospective certainty regarding their Indiana transfer pricing issues.<sup>1</sup> The IN DOR has yet to issue administrative guidance on its APA Program. While federal and state transfer pricing principles differ in certain respects, in the absence of issued procedural guidance from IN DOR, it may be helpful for a company considering the Indiana APA Program to refer to the general parameters of the federal APA process offered by the Internal Revenue Service (IRS), discussed below.

The North Carolina Department of Revenue (NC DOR) also recently launched its Voluntary Corporate Transfer Pricing Resolution Initiative (Initiative) to address North Carolina transfer pricing issues for tax years open under the statute of limitations for which a tax return has been filed.<sup>2</sup> Taxpayers seeking to participate in the Initiative must submit an application by September 15, 2020. For taxpayers resolving transfer pricing issues under the Initiative, NC DOR will waive penalties that would have otherwise applied; conversely, other taxpayers face a heightened risk of future penalties in the event of a North Carolina transfer pricing audit adjustment.

### IRS Advance Pricing and Mutual Agreement Program

In 1991, the IRS established the federal APA Program to help taxpayers resolve intercompany pricing issues. After a 2012 reorganization, the federal program is now referred to as the Advance Pricing and Mutual Agreement Program ("APMA").<sup>3</sup> APMA's goal is to "resolve actual or potential transfer pricing disputes in a timely, principled,

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<sup>1</sup> Amy Hamilton, *Indiana to Scrutinize Transfer Pricing Studies, Offer APAs*, St. Tax Notes (July 14, 2020).

<sup>2</sup> *Important Notice: North Carolina Announces Voluntary Corporate Transfer Pricing Resolution Initiative*, N.C. Dep't of Revenue (July 30, 2020), <https://www.ncdor.gov/news/press-releases/2020/07/30/north-carolina-announces-voluntary-corporate-transfer-pricing-resolution-initiative#:~:text=On%20August%201%2C%20the%20North%20Carolina%20Department,Transfer%20Pricing%20Resolution%20Initiative%20Skip%20to%20main%20content>.

<sup>3</sup> *Advanced Pricing and Mutual Agreement Program*, IRS, <https://www.irs.gov/businesses/corporations/apma>.

and cooperative manner.”<sup>4</sup> The federal APA process is considered an alternative dispute resolution process.

The APMA Program is designed to prevent double taxation by allowing taxpayers to enter into unilateral, bilateral, or multilateral agreements with the United States government and foreign countries with APA programs. While a unilateral APA only involves a taxpayer and the IRS, a bilateral APA also involves a foreign tax authority (and in the case of a multilateral APA, two or more foreign tax authorities).

Over nearly 30 years of issuing APAs, the IRS has issued several versions of formal procedures for the APA process.<sup>5</sup> As part of initiating the APA process, taxpayers submit an APA request. The APA request requires the submission of information specified in the current APA procedures and must be accompanied by required exhibits, including but not limited to: (1) intercompany agreements; (2) federal income tax filings; (3) proposed draft APA; (4) covered issue diagrams; and (5) documents submitted to foreign competent authorities. It is encouraged, and in some cases mandatory, for taxpayers to also submit a pre-filing memorandum. Taxpayers may also request a pre-filing conference. The purpose of the pre-filing activity is to obtain feedback from the IRS, and in bilateral or multilateral APAs, the foreign tax authority(ies), prior to filing the formal APA request so that the feedback is considered in making the formal APA request.

After the payment of a user fee and submission of the APA request, the assigned APMA team leader will schedule an opening conference with the taxpayer to discuss the underlying facts, proposed covered transactions, proposed covered method(s), and critical assumptions. The IRS and any relevant foreign tax authority(ies) will usually issue one or more information requests during the APA process. In a small percentage of cases, the tax authorities will conduct interviews of taxpayer’s personnel.

Throughout the APA process, the taxpayer and the IRS team have the opportunity to participate in teleconferences or in-person meetings to negotiate and discuss questions or concerns. The IRS will then issue a paper or memorandum providing its conclusions, and taxpayers are welcomed to provide comments. In a bilateral or multilateral case, the IRS will negotiate the substantive terms of the APA with the foreign tax authority(ies). Following this discussion and negotiation period, the taxpayer and the IRS will reach a formal, binding agreement in the form of the APA. In most instances, the APA is prospective for at least five years and in some cases the APA will have retrospective effect, including “rollback” years. Generally, unilateral APAs take about 30 months on average to resolve and other APAs longer. Renewals of an APA generally take a shorter period of time to resolve.

### **Indiana Advanced Pricing Agreement Program**

The IN DOR is in the process of starting its own APA Program to address Indiana transfer pricing issues for open tax years and up to six subsequent years.<sup>6</sup> Unlike the federal program, IN DOR does not expect to charge a user fee for access to its APA Program.<sup>7</sup>

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<sup>4</sup> *Id.*

<sup>5</sup> The current APA procedures are set forth in Rev. Proc. 2015-41, 2015-35 I.R.B. 263.

<sup>6</sup> Amy Hamilton, *Indiana to Scrutinize Transfer Pricing Studies, Offer APAs*, St. Tax Notes (July 14, 2020).

<sup>7</sup> *Id.*

As administrative guidance on the Indiana APA Program has yet to be issued, it is unclear whether the process will be comparable to the federal APA Program process described above or a more streamlined version. When evaluating whether to undertake the process, one factor to be considered is that the IN DOR collaborates with other states to share information regarding intercompany pricing issues.<sup>8</sup> While an Indiana APA would not be a bilateral or multilateral agreement that includes other states, it could be influential or persuasive in other states that take a transfer pricing approach similar to Indiana.

### **North Carolina Voluntary Corporate Transfer Pricing Resolution Initiative**

On July 30, 2020, the NC DOR announced its Initiative.<sup>9</sup> The Initiative is aimed at expediting the resolution of taxpayers' North Carolina intercompany pricing issues in all open tax years within the statute of limitations for which the corporate taxpayer has filed a return. Registration for the Initiative began August 1, 2020 and companies have until September 15, 2020, to submit a written, nonbinding election to participate in the Initiative. For cases resolved under the Initiative, the NC DOR will waive penalties that would have otherwise applied.<sup>10</sup> Importantly, for eligible taxpayers not electing to participate in the Initiative or unable to reach agreement with the NC DOR under the Initiative, the NC DOR states that it will impose and not waive penalties. The NC DOR also states that it will not agree to a methodology or settlement with nonparticipating taxpayers for any unaudited open tax years. Taken literally, this would mean that nonparticipating taxpayers audited after the Initiative would have to either accept the NC DOR's proposed transfer pricing adjustment with penalties or appeal the assessment.

Taxpayers that timely elect to participate in the Initiative have until October 16, 2020, to submit the required documentation, which includes, but is not be limited to, the following: (1) all state and federal returns; (2) all transfer pricing studies; (3) descriptions of all companies with intercompany transaction(s) including descriptions of the transaction(s); (4) related party agreements; and (5) consolidated financial information. Then, within 31 days of receiving all of the taxpayer's documentation, the NC DOR would issue a summary report with any proposed adjustments including its methodology and conclusions. The NC DOR and the taxpayer then have 15 days to reach an agreement on the proposal. Upon reaching an agreement in that timeframe, the NC DOR would waive penalties for all agreed upon issues.

### **Considerations**

The Indiana APA Program signals a willingness among states to resolve state transfer pricing issues on a prospective basis, and other states could potentially follow suit. Taxpayers wishing to participate in a state APA program should be mindful of potential issues with timelines to complete the program, negotiation opportunities, and the potential for double taxation in the event states on the other side of these transactions do not provide correlative relief for any agreed-upon adjustments.

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<sup>8</sup> *IN Review: FY19 Annual Report*, Ind. Dep't of Revenue, at 46, <https://www.in.gov/dor/files/2019-annual-report.pdf>.

<sup>9</sup> *Important Notice: North Carolina Announces Voluntary Corporate Transfer Pricing Resolution Initiative*, N.C. Dep't of Revenue (July 30, 2020), <https://www.ncdor.gov/news/press-releases/2020/07/30/north-carolina-announces-voluntary-corporate-transfer-pricing-resolution-initiative#:~:text=On%20August%201%2C%202020%2C%20the%20North%20Carolina%20Department,Transfer%20Pricing%20Resolution%20Initiative%20Skip%20to%20main%20content>.

<sup>10</sup> *Election to Participate in Transfer Pricing Resolution Initiative*, N.C. Dep't of Revenue (2020), <https://www.ncdor.gov/documents/nc-tpri-participation-election>.

In contrast, North Carolina's Initiative appears to be more like an amnesty program focused on resolving historical transfer pricing issues and penalizing companies that do not comply with its terms. Companies seeking to participate in either state program should consider the relevant federal transfer pricing rules as well as the nuances applied to those rules by Indiana and North Carolina. In addition, the effect of those adjustments on other state-specific tax concepts, such as state nexus and sourcing methodologies, should also be evaluated and considered.

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