

AN ALERT FROM THE BDO TRANSFER PRICING PRACTICE

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SUBJECT

THE MULTISTATE TAX COMMISSION APPROVES DRAFT DESIGN FOR STATE TRANSFER PRICING AUDIT PROGRAM

SUMMARY

On May 7, 2015, the Multistate Tax Commission's (the "MTC") Executive Committee approved a draft design for the Arm's Length Adjustment Service ("ALAS"), which will help states audit transfer pricing arrangements used by multi-jurisdictional enterprises - a capability states have typically lacked the monetary resources and expertise to provide. Under the approved draft design, which the MTC anticipates implementing over a four-year "charter period," the ALAS will provide states with training and support pertaining to audits of transfer pricing arrangements. Through this initiative, the MTC intends to help states recover a portion of an estimated \$20 billion they lose annually due to improper income shifting.

DETAILS

The MTC, which was created in 1967, is an organization of state governments. The MTC works on behalf of states to assist with administration and uniformity of tax laws, which it has historically done through such initiatives as its multistate Nexus and Audit Programs. The ALAS, which is the MTC's most recent initiative, was developed with the help of representatives from Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey and North Carolina.

Goals, Objectives, and Strategies of the ALAS

The ALAS has four main goals and objectives: (i) improve the ability of states to identify and "correct" cases of taxpayer "underreporting" associated with related party transactions; (ii) increase audit coverage of related party transactions; (iii) foster dispute resolution by offering an initial voluntary disclosure opportunity, encouraging use of the MTC Dispute Resolution process, and providing litigation support to states; and (iv) inform and advise states on emerging developments regarding related party transactions.

Integral to achieving these goals and objectives are the ALAS's overall



CONTACT

TRANSFER PRICING

ROBERT PEDERSEN, International Tax Practice Leader
212-885-8398 / rpedersen@bdo.com

VEENA PARIKAR, Principal
408-352-3534 / vparrikar@bdo.com

MICHIKO HAMADA HANEY, Senior Director
212-885-8577 / mhamada@bdo.com

KIRK HESSER, Senior Director
312-233-1802 / khesser@bdo.com

JON JENNI, Senior Director
714-913-2574 / jjenni@bdo.com

SEAN KIM, Senior Manager
212-885-7237 / skim@bdo.com

SALT

WEST:

ROCKY CUMMINGS, Tax Partner
415-490-3130 / rcummings@bdo.com

PAUL MCGOVERN, Tax Senior Director
714-913-2592 / pmcgovern@bdo.com

NORTHEAST:

JANET BERNIER, Tax Partner
212-515-5405 / jbernier@bdo.com

MATTHEW DYMENT, Tax Principal
617-239-4130 / mdyment@bdo.com

SOUTHEAST:

ASHLEY MORRIS, Tax Senior Director
919-278-1963 / amorris@bdo.com

SCOTT SMITH, Tax Senior Director
615-493-5629 / ssmith@bdo.com

ATLANTIC:

JONATHAN LISS, Tax Senior Director
215-636-5502 / jliss@bdo.com

JEREMY MIGLIARA, Tax Senior Director
703-770-0596 / jmigliara@bdo.com

CENTRAL:

ANGELA ACOSTA, Tax Senior Director
248-688-3313 / aacosta@bdo.com

NICK BOEGEL, Tax Senior Director
414-615-6773 / nboegel@bdo.com

JOE CARR, Tax Principal
312-616-3946 / jcarr@bdo.com

MARIANO SORI, Tax Partner
312-616-4654 / msori@bdo.com

RICHARD SPENGLER, Tax Senior Director
616-776-3687 / rspengler@bdo.com

SOUTHWEST:

GENE HEATLY, Tax Senior Director
214-665-0716 / gheatly@bdo.com

TOM SMITH, Tax Partner
918-281-4080 / tasmith@bdo.com

strategies, which include: (i) building transfer pricing audit capacity through knowledge/experience sharing and training of MTC and state staff; (ii) collaboration among state staff, MTC staff and expert consultants across compliance, auditing, economics and law disciplines (i.e., the disciplines usually associated with a transfer pricing audit); (iii) hiring and developing core staff at the MTC, as well as contracting with outside consultants; and (iv) developing procedures and steps to improve tax compliance as it pertains to related party transactions.

Elements of the ALAS

The ALAS is comprised of five main elements, (i) training; (ii) transfer pricing analysis; (iii) information exchange, process improvement, and case assistance; (iv) case resolution and litigation support services; and (v) optional joint audits, which are aligned with its goals, objectives, and strategies.

(i) Training. Initial ALAS training courses will be provided for state staff on identifying audit issues, securing documents, and conducting non-economic technical reviews of taxpayer transfer pricing analyses (e.g., calculation errors, inappropriate selection of comparables, absence of business purpose, etc.). Thereafter, general training courses that cover federal and state related party tax laws and related party compliance methods (e.g., information gathering methods, audit selection procedures, identifying related party/transfer pricing issues, developing defensible transfer pricing adjustments, etc.) will be offered. Beyond formal training, periodic conference-style training sessions will be organized to discuss emerging related party/transfer pricing issues.

(ii) Transfer Pricing Analysis. The ALAS is focused on minimizing the cost of evaluating taxpayer transfer pricing studies by securing information from taxpayers to assist with preparation of economic analyses, conducting initial technical audits of transfer pricing studies, and performing economic analyses in transfer pricing studies. The ALAS will help states through training initiatives, process improvement and case assistance, developing and working with state staff devoted to technical audits, and providing economic expertise for transfer pricing studies and alternative pricing solutions, if needed. During the early stages, the MTC will rely upon contractors to conduct economic analyses and provide alternative pricing recommendations, but it intends to hire three MTC economists to perform approximately 70 percent of the economic analyses in subsequent years. The MTC also anticipates hiring an auditor to work with designated state staff for document gathering and technical reviews.

(iii) Information Exchange, Process Improvement, and Case Assistance. The ALAS will develop a taxpayer information exchange process to help states notify each other when they encounter cases wherein a joint economic analysis of a taxpayer's transfer pricing study is warranted. An information exchange process will also serve as a vehicle for sharing information, documentation, and results of any joint analysis. The ALAS will also improve processes and procedures to secure taxpayer information through questions concerning related party transactions on returns and other forms, and by developing audit protocols and standard information requests. Lastly, ALAS staff will provide information and advice to individual states concerning procedures and issues in particular taxpayer cases.

(iv) Case Resolution and Litigation Support Services. The MTC will offer its Alternative Dispute Resolution program to help taxpayers and states resolve disputes over related party arrangements. To help facilitate this program, ALAS staff will provide legal advice and support to participating states. MTC staff may explore the feasibility and desirability of developing and using an advance pricing agreement process with taxpayers. The ALAS may also support a six-month voluntary disclosure program early in its operation (e.g., July 1, 2016 through December 31, 2016).

(v) Optional Joint Audits. States seeking to expand audit coverage of related party transactions and transfer pricing arrangements will be invited to join the corporate income tax portion of the MTC Joint Audit Program.

Development, Operation, and Funding of the ALAS

The estimated annual budget for the ALAS is approximately \$2.0 million. The MTC must receive an annual financial commitment of at least \$200,000 from at least nine states to participate in the program. Full development and implementation of the ALAS will span the charter period and will be completed in three stages, which include: (i) pre-launch stage; (ii) developmental stage; and (iii) operational stage.

(i) Pre-Launch Stage. The pre-launch stage, which began in January 2015, will likely conclude by July 2015, with the goal of launching the ALAS shortly thereafter. During the pre-launch stage, the MTC has been tasked with recruiting participating states, recruiting staff positions, and finalizing formal program designs and implementation plans. Recruiting states to participate in the program is arguably the most critical activity during the pre-launch stage since the ALAS will not launch until the necessary nine or ten states have committed funding. To date, only six states (Alabama, Iowa, Kentucky, New Jersey, North Carolina and Pennsylvania) have agreed to fund the program. If a sufficient number of states do not commit funding by July 2015, the timeline may be adjusted.

(ii) Developmental Stage. The developmental stage is expected to begin in July 2015 and conclude by June 2017. During the developmental stage, the MTC will sequentially implement, refine, and expand elements of the service (e.g., training, a voluntary disclosure opportunity, technical reviews, economic analyses, process improvement, and audits) to lay the foundation for the operational stage. During this stage, the MTC will contract with consulting economists, develop in-house staff, and hire multiple personnel to facilitate day-to-day activities. Anticipated hires include a tax manager to coordinate communication among state staff and the ALAS, two economists to conduct economic analysis, a staff attorney to provide legal support for the administration of the ALAS, and a transfer pricing auditor to assist with technical reviews.

(iii) Operational Stage. The ALAS will be fully operational by June 2017. Audits, which address the full range of related party and transfer pricing issues, will be regularly conducted and trainings will be held on a regular schedule. During the operational stage, which is expected to run through June 2018, additional staff economists will be hired to bolster in-house capacity for economic analyses and compliance efforts. Process improvement, case assistance, case resolution and litigation support activities will be monitored and reviewed during this stage as well.

BDO INSIGHTS

- ▶ By designing a draft version of the ALAS, states are moving from reliance on existing laws that address related party transaction issues (e.g., related party add-backs and factor presence nexus) to enforcement of underreported related party transactions. In light of this initiative, taxpayers should review their existing transfer pricing arrangements to determine whether updates are warranted.
- ▶ The MTC is discussing several mechanisms that could minimize administrative tasks associated with compliance efforts (e.g., state-level advance pricing agreements, safe harbor rules, and a state-level competent authority). If implemented, taxpayers could formalize positions with several states at once.

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