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AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

THE MULTISTATE TAX COMMISSION TAKES STEPS TO DEVELOP A STATE TRANSFER PRICING AUDIT PROGRAM

SUMMARY

The Multistate Tax Commission ("MTC") is taking steps to develop a transfer pricing audit program. State tax officials recently met on June 2, 2014, in St. Louis to discuss the design of the MTC transfer pricing program. The initial draft of the program is expected to be presented at the MTC Executive Committee meeting in December 2014, with the finalized plan to be submitted for ratification during the MTC Executive Committee annual meeting in July 2015. If ratified, implementation should begin thereafter.

DETAILS

At its meeting in December 2013, the MTC Executive Committee announced its intention to create an advisory group of state tax directors with the purpose of designing and developing a multistate transfer pricing audit program similar to its present Joint Audit Program. The announcement came from a request made by Mike Bryan, Director – New Jersey Division of Taxation, during an MTC Executive Committee annual meeting in May 2013 to explore the possibility of developing such a program. Since that meeting, more than a dozen states, including Alabama, Florida, and, of course, New Jersey have declared their financial support to fund the development stage of the program.

The MTC selected Dan Bucks, former MTC Executive Director and Director of the Montana Department of Revenue, to head the project, which is being referred to as the "MTC's Arm's Length Adjustment Project." Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina are the states officially participating in the project.

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At the June 2, 2014, meeting, the state representatives discussed the potential service offerings under the proposed transfer pricing audit program, which include: (1) pre-audit services, such as analysis, audit selection, staff training services, and development of an arm's length policy and related practices; (2) audit services, such as a joint audit service program and econometric services in support of the transfer pricing audit; and (3) post-audit services, such as assistance with litigation and expert witnesses and further econometric analysis. While the actual services to be offered are yet to be determined, state representatives have 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.

The design of the program is expected to occur in three phases and according to the following timeline: (1) draft service design – to completed by mid-November for initial review by the MTC Executive Committee at its meeting in December 2014; (2) revised service design – to completed by March 31, 2015, for MTC Executive Director approval and then approval by the tax administrators of the interested states; and (3) final service design – to be completed by June 20, 2015, for consideration by the MTC Executive Committee at its annual meeting in July 2015. The draft service design stage is expected to be completed by a state advisory group, MTC staff, and possible outside experts and consists of determining the types of services to offer, whether some of the services could be optional, implementation of the program, and the legal standards and principles to apply. The next two phases will be comprised of refining and finalizing the draft service design.

BDO INSIGHTS

- The need for MTC's joint transfer pricing audit program likely arises from states' growing discontent with contract auditors. These contract auditors typically use software programs to determine underpaid tax, the use of which has resulted in a string of notable transfer pricing controversies.
- Also contributing to the states' need for a joint transfer pricing audit program are the challenges that many states face with respect to auditing complex intercompany transaction arrangements, including the associated costs. For example, many states do not have the resources to acquire and maintain the in-house expertise needed to perform transfer pricing audits. Under a joint audit type program, participating states would share the costs of a dedicated transfer pricing audit team.
- It is anticipated that the program will be more beneficial and appealing to separate-entity reporting states because the intercompany transaction arrangements that are typically the focus of a state transfer pricing audit are often eliminated in combination and consolidation. However, some support has come from combined reporting states, which are likely interested in capturing transactions between related parties outside the combined reporting group (*e.g.*, 80/20 companies and foreign corporations).
- Until the MTC releases a draft or revised service design for the joint transfer pricing audit program, there will be speculation as to how key transfer pricing issues will be addressed by the program. One question is whether or not the program will follow the arm's-length standard or opt for a non-traditional method such as required minimum profit percentages.
- If implemented, the program should greatly increase the ability of states to conduct transfer pricing audits. Thus, taxpayers should consider reviewing their current intercompany pricing arrangements and corporate structure to assess whether anything can be done currently--whether through an update to transfer pricing study and/or through an improved corporate structure--to better protect against state audit assessments and challenges to the transfer pricing.