State & Local Tax Advisory ▪

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The MTC's Transfer Pricing Audit Program Comes into Focus

Overview of the Program and Recent Advisory Group Meeting

On October 6 and 7, the Arm's-Length Adjustment Service (ALAS) Advisory Group of the Multistate Tax Commission (MTC) held a meeting to further refine the MTC's proposed multistate transfer pricing audit program ("ALAS Program" or "program"). Throughout the meetings, the ALAS Advisory Group participants echoed two themes: (1) the ALAS Program's goal of remediating the inadequate technical and financial resources that exist at the state level to effectively evaluate multistate transfer pricing issues; and (2) the states' persistent concerns with the potential expense of the program.

On the first day of the meeting, the ALAS Advisory Group hosted a series of presentations from representatives of economic consulting firms specializing in both domestic and international related-party transactions, including Chainbridge Software, Economics Analysis Group, Economists Incorporated, NERA, Peters Advisors, RoyaltyStat and WTP Advisors. While the Advisory Group described the presentations as informational in nature, the group's discussions essentially acknowledged that at least one of the presenting firms is likely to be hired in connection with the program.

The meeting's second-day agenda and discussions were focused on a memorandum titled "Draft Design for an MTC Arm's-Length Adjustment Service," authored by project facilitator (and former commissioner of the Montana Department of Revenue) Dan Bucks, which sets forth detailed proposals for both the structure and implementation schedule of the ALAS Program.[1] Bucks's memorandum proposes an initial charter period of four years for the program, with the first taxpayer audit projected to commence during 2015. Furthermore, Bucks recommends that the MTC hire three new ALAS staff members—a tax manager, a senior economist and an attorney—to both manage the program and to coordinate with third-party economic consulting firms. According to the memo, the outside consultants will perform all of the substantive transfer-pricing analysis at the outset of the program; however, the memo calls for those outside economic consultants to

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[1] Dan Bucks, Draft Design for an MTC Arm's-Length Adjustment Service (2014), *available at* http://www.mtc.gov/getattachment/The-Commission/Committees/ALAS/2014-10-03-DRAFT-Design-for-MTC-ALAS.PDF.aspx.

educate and train the MTC staff so that the staff can gradually increase their own share of taxpayer audits over the initial four-year charter period.

The MTC's Stated Need for the ALAS Program

According to representatives from the participating states, states using separate entity reporting, and to a lesser extent states that have adopted mandatory combined reporting, have been unable to adequately address income shifting arising from the perceived aggressive use of transfer pricing on corporate tax returns. The participants stated that current transfer-pricing cases are substantially more complicated than the income-shifting cases of the 1980s and 1990s, which primarily involved economic nexus challenges to special purpose entities (including intangible holding companies) and related-party add-backs.

To address their lack of resources and technical expertise, certain states have independently hired outside contractors to assist with transfer-pricing analyses, albeit with mixed results. For instance, in *Microsoft Corp., Inc. v. Office of Tax & Revenue*, a District of Columbia administrative law judge declared that the analysis produced by the government's third-party contractor was "useless in determining whether Microsoft's controlled transactions were conducted in accordance with the arm's length standard."[2] With these methodologies coming under increased scrutiny, states have become more interested in implementing a coordinated, multistate transfer-pricing service.

Details of Proposed Program and Timeline for Implementation

As outlined in Dan Bucks's draft design memo and as discussed in the Advisory Group's meeting, the MTC—through the ALAS Program—will provide a wide range of services, including, among other things:

- up-front audit selection assistance, driven by expertise;
- a cost-effective means for obtaining assistance from economic experts;
- training for the states in identifying audit targets, auditing taxpayers' returns and documentation to verify factual and technical details, and performing economic analyses of intercompany transactions;
- services to improve states' audit processes;
- a confidential taxpayer information exchange process; and
- assistance with particular taxpayer cases, including a resolution process.

One prominent role of the ALAS Program will likely be to draft economic transfer-pricing studies to generate alternative pricing positions during an audit. In this regard, it is anticipated that the program's capacity for participating in audits will increase throughout the four-year charter period. This increase in capacity is largely attributed to the expansion of in-house staff during years two and three of the ALAS Program's charter period.

Training of state staff was also identified as a critical component of the program. Specifically, Bucks has proposed that through the program, the MTC should provide formal courses to the states regarding the

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2 *Microsoft Corp., Inc. v. Office of Tax & Revenue*, No. 2010-OTR-00012, 2012 WL 7149181 (D.C.O.A.H. May 1, 2012) (commenting on adjustments proposed by the Chainbridge Software firm and adopted by DC's Office of Tax and Revenue).

substance of federal and state transfer-pricing law. Additionally, Bucks has proposed that the ALAS staff host regular interstate conferences to encourage information sharing and collaboration among the states.

Analysis and Concerns

If implemented as proposed, it is clear that the ALAS Program would be a robust program with the potential to impose substantial compliance obligations on multistate taxpayers—and it might do so as soon as 2015. One major hurdle to the implementation of the program, however, is the participating states' concern regarding its potential costs. For example, Marshall Stranburg, executive director of the Florida Department of Revenue, suggested that the Advisory Group needs to build a business case, including an estimate of how much revenue will be recovered by the program—to convince state decision makers to fully commit to the program.

The states' concern over the ALAS Program's costs points to one of the program's chief flaws and one of the many reasons Alston & Bird is concerned that taxpayers audited under the program will struggle to receive fair treatment. The states that contribute funds to the program will be closely watching the results of the program audits, especially the early audits, to see what kind of returns (i.e., assessments and additional tax revenues) the audits are generating. Similarly, the outside economic consulting firm (or firms) hired by the MTC will be incentivized to generate such returns from the ALAS audits to demonstrate their own value and, in turn, to extend the length and/or scope of their engagement.

Presently, eight states and the District of Columbia have committed seed money to the development of the ALAS Program, which still has substantial questions regarding a number of issues, including how costs would be charged and allocated among the participating states, how much technical analysis would be performed prior to the outside firms' economic analysis and how the states would coordinate among themselves and with the MTC.[3] A follow-up meeting is tentatively scheduled for November 3, 2014. The Advisory Group anticipates forwarding a draft program design to the MTC Executive Committee for approval on December 10, 2014, which means that a great deal of work will need to be undertaken in the next two months in order to meet the targeted deadline.

Conclusion

Although the scope and timeline for the ALAS Program are still evolving, states will continue to conduct their own transfer-pricing audits (both before the program gets underway and afterwards). Thus, the MTC's proposed ALAS Program only increases the need for taxpayers to make sure that their intercompany transactions have been reviewed by a transfer-pricing expert and that they are carrying out their businesses in accordance with the structure and substance on which the taxpayer's transfer-pricing study was based.

Alston & Bird has extensive experience assisting clients with reviewing and defending transfer-pricing issues at the federal and state levels and would be happy to answer any questions our readers may have. We will continue to monitor developments related to the ALAS Program and will provide updates as we learn more.

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[3] The nine charter members are Alabama, the District of Columbia, Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey and North Carolina.

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