October, 2015

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State Transfer Pricing Initiatives

Transfer pricing has become a major tax planning strategy employed by companies to shift profits to offshore subsidiaries. The Multistate Tax Commission (MTC) transfer pricing initiative is an attempt to address corporate tax avoidance by strengthening current regulations.

In June 2014, the MTC organized the Arm's-Length Adjustment Service (ALAS) to develop a program to assist states in addressing transfer pricing issues as they conduct corporate audits. At meetings held in October, the ALAS identified two major hurdles states must overcome in order to effectively evaluate transactions between related corporations: the lack of economic and technical expertise within state tax departments and states' concerns with the potential expense of the program.

A document prepared for the October meetings, which is titled "Draft Design for an MTC Arm's-Length Adjustment Service" served as the focus of discussion. The draft details both a proposed structure and implementation schedule of the ALAS program. The draft proposed an initial charter period of four years, with the first taxpayer audits commencing during 2015, and recommended that the MTC hire three new ALAS staff members to manage the program and coordinate with third party economic consulting firms. The draft calls for outside consultants to perform all substantive transfer pricing analysis at the outset, but would also have those consultants train MTC staff so that staff can become more involved in taxpayer audits over the course of the charter period.

As outlined in the draft design, the ALAS program will provide a variety of services to states, including:

- Audit selection procedures;
- Planning audits of related party transactions;
- Understanding how to integrate economic analysis into the audit process;
- Conducting technical audits prior to economic analyses; and

- Developing defensible transfer pricing adjustments.

A key strategy of the draft design is to expand the capacity of the states and the MTC to address related party transfer pricing issues in order to reduce costs. The goal would be to develop state staff well versed in transfer pricing compliance issues who could work across state lines and share knowledge and experience to solve compliance problems. By strengthening capacity, states would be able to rely less on economics expertise from outside firms.

To compensate for a lack of in-house resources and technical expertise, some states have hired outside contractors to assist with transfer pricing analysis and have had mixed results. In Microsoft Corp. Inc. v. D.C. Office of Tax and Revenue, No. 2010-OTR-0012 (D.C.O.A.H. May 1, 2012), a D.C. administrative law judge found the analysis prepared by the District's expert to be "useless in determining whether Microsoft's controlled transactions were conducted in accordance with the arm's length standard." In granting Microsoft's motion for summary judgment, the judge struck down a $2.75 million assessment against the taxpayer.

More recently, a different D.C. administrative law judge overturned franchise tax assessments against three major oil companies because they were based on the same transfer pricing analyses ruled invalid in the Microsoft case. Other states, including Massachusetts, Nebraska and New York, have included specific sourcing provisions within their market-based sourcing rules addressing specific digital-related goods or services.

The ALAS program will represent a significant commitment of states' resources with the hope of raising substantial revenue by developing state expertise in transfer pricing issues. It remains to be seen whether the program will obtain a critical mass of participating states to provide sufficient funding for the endeavour.

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