

Discussion of Questions Posed by MTC ALAS Group to Economic Consulting Firms

DRAFT

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Challenges (1/2)

Question: What are the greatest challenges that states might face in improving tax compliance related to intercompany transactions that distort the reporting of income to their states?

Answer:

- Challenges inherent in the states' corporate income taxation system
 - Principles of income sourcing and economic nexus
 - Addback rules
 - Scope of combined reporting
 - Jurisdiction over controlled transactions that involve foreign countries
 - Aligning state income tax systems with the federal one
- Balancing corporate taxation against maintaining business-friendly climate
- Legislative and budgetary considerations

Challenges (2/2)

Question: What are the greatest challenges that states might face in improving tax compliance related to intercompany transactions that distort the reporting of income to their states?

Answer:

- Challenges of applying arm's length standard
 - Tax planning by corporations
 - Challenging-to-analyze intercompany transactions
 - IP royalties
 - Fees for centralized services
 - Payments for financial services
 - interest on intercompany loans
 - guarantee fees
 - insurance fees

Ways to Address Challenges (1/2)

Question: What are some of the best ways for states to meet those challenges?

Answer:

- Develop multistate agreements on the common set of principles for corporate income taxation
 - Conformity to the Federal tax base
 - Jurisdiction over transactions that involve foreign countries
- Develop best practices for auditing transfer pricing cases
 - Common approaches to audit (build on the current MTC Audit Program)
 - Selection of cases based on the assessment of the tax avoidance risk
 - Adopt principles of the IRS Transfer Pricing Audit Roadmap
 - Common approaches to transfer pricing documentation

Ways to Address Challenges (2/2)

Question: What are some of the best ways for states to meet those challenges?

Answer:

- Explore a concept of safe harbors
- Explore a possibility of drafting a multi-state agreement that provides uniform relief from double taxation
- Monitor transfer pricing developments at the Federal and international arenas
- Use the expertise of consulting firms
- Develop in-house transfer pricing expertise at MTC

NERA Services

Question: What type of services is your firm prepared to provide states to assist with transfer pricing tax compliance and in what manner might those services be provided?

Answer:

- NERA is prepared to provide the following services
 - Participation in state transfer pricing audits as outside economics experts
 - Expert witness support in arbitration or litigation proceedings
 - Assisting MTC in refining the ALAS project
 - Training of MTC employees in transfer pricing matters
- These services may be provided under an engagement agreement with MTC or separate states
- NERA engagements typically carry fixed fee or fee computed on hourly basis
- NERA does not practice contingent fee arrangements

Integration of Economic Services with State Tax Audits (1/2)

Question: Given the fact-intensive nature of transfer pricing work, how might states best integrate expertise in economics and statistical analysis with their audit and legal staffs in the tax administrative process?

Answer:

- States could involve economists early on to determine whether the particular transaction rises to the level of abusive
- States could adopt common procedures for audit process that involve transfer pricing matters, e.g.:
 - Development of a common set of audit steps and timelines among states
 - Request for TP documentation and supporting documents early in the audit
 - Application of safe harbors to certain transactions
- States may need to develop procedures to accommodate situations when certain states may wish to join or exit the joint transfer pricing audit process
 - Define the phases of the audit and set up decision points at the end of each phase
 - Terms of payment
 - Sharing of information

Integration of Economic Services with State Tax Audits (2/2)

Question: Given the fact-intensive nature of transfer pricing work, how might states best integrate expertise in economics and statistical analysis with their audit and legal staffs in the tax administrative process?

Answer:

Possible structure of the multi-state transfer pricing audit:

1. Planning

- Pre-examination analysis
- Opening conference and orientation
- Initial risk analysis, exam plan
- Decision to continue by states

2. Execution

- Fact finding (IDRs)
- Functional and economic analysis
- Issue development and preliminary report
- Decision to issue assessments by states

3. Resolution

- Pre-NOPA issue presentation
- Resolution discussions
- Final NOPAs
- Next steps?

Taxpayers' Objections

Question: What objections will states face from taxpayers as they increase their compliance work? Which of those objections is a legitimate concern? How can states best respond to those criticisms?

Answer:

- Possible taxpayer objections:
 - Additional compliance burden due to
 - Additional disclosures and analyses that may be required
 - Possible nonconformity between federal and state tax rules
 - Adverse impact on the business climate in the state
- Possible solutions:
 - Competent execution of audits
 - Careful selection of audit issues
 - Application of sound economic expertise
 - Conformity of state income base with the federal rules (including application of Sec. 482 Regulations)
 - Application of safe harbors
 - Consideration of the multistate program similar to the federal APA program

Lessons for States

Question: What lessons can the project states learn from other taxing authorities with regard to transfer pricing enforcement?

Answer:

- Early involvement of experienced TP economists creates the audit process that focuses on correct issues and facilitates timely conclusion
- Focusing the audit process on high-risk and/or abusive transactions typically yields positive results
- MTC's Alternative Dispute Resolution Process could be the basis for developing a program that is more cooperative in nature (i.e., along the lines of the IRS APA program)
- Centralization of TP expertise at MTC similar to APMA TPO may be a best practice

Remedies

Question: What remedies are most effective in correcting income manipulation associated with intercompany transactions?

Answer:

- The facts of “income manipulation” have to be proven first
- The process of proving “income manipulation” will require economic expertise from the audit team
- The audit team has to be prepared for the possible legal challenges mounted by taxpayers
- Provided that income manipulation is proven, the most straightforward approach appears to be taxable income adjustment under the arm’s length standard or addbacks