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

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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