



## **State Intercompany Transactions Advisory Service Committee 2022 Fall Report**

**Chair- Krystal Bolton**

The State Intercompany Transactions Advisory Service (SITAS) Committee met once in FY 2022 via teleconference on July 13, 2021. There were 63 attendees for this meeting including state participants, staff, and members of the public.

During the July meeting of the committee, state representatives reviewed and considered a proposed committee charter. Representatives also reviewed a revised Information Exchange Agreement. The agreement was revised to remove any obligation of the signatory state to participate in a SITAS program at the Commission should one ever be established. Participating state representatives suggested no changes to the agreement and it was finalized as written. MTC staff has received signed agreements from three states so far.

Eversheds Sutherland raised concerns and proposed edits to the Information Exchange Agreement to the Executive Committee on August 5th. MTC staff drafted a memo to address these concerns. Both documents are attached to this report.

The SITAS Committee provides support to states seeking to address tax base erosion of income based taxes due to inter-company transactions and provides a forum for members of the public to address state representatives on this topic. While public participation is important to the SITAS Committee, the suggested edits to the agreement limit the ability of member states to exchange information beyond existing information sharing standards and/or are outside the scope of this committee to address. Furthermore, this information sharing agreement has existed in a nearly identical form since 2016 and Eversheds Sutherland makes no claim that confidential information was exchanged improperly under the prior SITAS agreement.

The SITAS Committee will meet to discuss the concerns raised by Eversheds Sutherland and the response by MTC staff.



MULTISTATE TAX COMMISSION

## MEMORANDUM

<b>To:</b>	Krystal Bolton, Chair, MTC SITAS Committee
<b>From:</b>	Holly Coon, MTC Audit Director and Bruce Fort, MTC Senior Counsel
<b>Subject:</b>	Response to Letter from Eversheds Sutherland, LLC concerning Proposed Changes to the SITAS Committee's Participation Commitment and Exchange of Information Agreement
<b>Date:</b>	October 25, 2021

During the Executive Committee's meeting on August 5, 2021, representatives from Eversheds Sutherland (US), LLP submitted a letter (attached) objecting to certain aspects of the Committee's Participation Commitment and Exchange of Information Agreement (the Agreement). Those concerns were raised in the context of the Executive Committee's consideration of the SITAS Committee charter, which was approved by the Committee on the same day. The only difference between the current and former Agreement approved in 2016 was the elimination of references to fee payments by participating states.

The Executive Committee referred the letter to the SITAS Committee, and you asked us to provide a response. As explained below, we conclude that the letter should not cause any changes to the Agreement. The Committee can consider further action should taxpayers or their representatives provide additional facts and details in the future.

A. The Agreement Does Not Violate State Laws on the Exchange and Use of Confidential Taxpayer Data.

Eversheds Sutherland's letter begins by warning that exchanging confidential taxpayer information pursuant to the Agreement "could potentially subject revenue officials and their contractors to penalties under state law." (Letter, page 1.) Unfortunately, the letter provides no further details explaining how or why the Agreement may violate state laws, so we will have to respond generally.

The terms of the Agreement establish exchange procedures and protocols that are in accordance with the laws of every participating state; the Agreement specifies that it neither enlarges nor contracts the participating states' ability to exchange information under existing statutes and multistate agreements.<sup>1</sup> In addition, the Agreement explicitly prohibits the exchange of

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<sup>1</sup> Article V, Section 2 provides in part: "Nothing in this Agreement expands or diminishes the legal responsibilities, obligations, penalties, or liabilities of the signatory agencies, or their agents, contractors,



information that would violate any signatory state's laws, federal laws, or that otherwise would be "detrimental to the administration of the tax laws."<sup>2</sup> The Agreement is designed to fit within the criteria established in the Uniform Exchange of Information Agreement for this type of exchange program. The Agreement provides an appropriate framework for the proper and efficient exchange of confidential taxpayer information among the states participating in the program.

B. The Agreement Does Not Address the Use of Outside Contractors; Concerns About Such Contractors Should be Directed to the Relevant States.

Eversheds Sutherland's letter expresses numerous concerns over the employment of third-party auditors and other contractors by some states participating in the SITAS Committee. The letter proposes that the SITAS program add specific limitations on how confidential taxpayer information is shared with third parties and the use those parties can make of that information.

The use of third-party auditors or other outside contractors is not a subject matter covered in the Agreement because the states participating in the SITAS program are already subject to myriad laws and rules governing what kinds of information may be shared with outside contractors and under what conditions. Adding a second layer of restrictions on top of those already in place in each state for a particular subset of taxpayers and audit procedures would unnecessarily interfere with state decision-making in addition to being difficult to implement. Therefore, if anyone is concerned that outside parties employed by particular states are misusing confidential taxpayer information, the issue should be addressed with those states. If states object to how other states may permit information to be used, nothing in the Agreement precludes states from imposing restrictions on the use of shared information or declining requests for information entirely.<sup>3</sup>

The letter also advocates against sharing information regarding advance pricing agreements and settlement agreements, arguing that sharing such information among the states would discourage taxpayers from undertaking those efforts. We believe this is a matter properly governed by individual state policies and does not belong in the Agreement. The Agreement does not require a state to disclose an advance pricing agreement or a settlement agreement. Specifically, the Agreement does not apply to the disclosure of any information that may be "detrimental to the administration of the tax laws of any signatory state." Furthermore, "Each signatory state reserves the right to make the determination whether information is subject to exchange under the terms of this Agreement." Article IV, Sec. 2.

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employees, or representatives for the storage, handling, or destruction of confidential taxpayer information as established under the laws applicable to each signatory agency."

<sup>2</sup> Article IV, Section 2.

<sup>3</sup> Article IV, Section 2 provides: "Each signatory state reserves the right to make the determination whether information is subject to exchange under the terms of this Agreement." In addition, the Agreement provides that states are not required to share information if the state believes the exchange would be "detrimental to the tax laws of any signatory state."



C. The Agreement Should Not Impose Additional Criteria for the Exchange and Use of Information that May be in Conflict with the Existing Laws and Policies of the Participating States.

The letter concludes with five proposed changes to the Agreement that would provide taxpayers with greater assurances that their information will be used, protected, and safeguarded in an appropriate manner. (Letter, page 2.) We do not believe any of the proposed changes are appropriate. We briefly address suggestion each in turn:

1. “The SITAS Committee should consider adopting “written authorization” procedures as a matter of maintaining accountability and protecting taxpayers from fishing expeditions by third party auditors.”

States already have policies in place governing who may access taxpayer data and for what purposes. We see little reason to impose additional restrictions under the Agreement for a particular subset of taxpayers.

2. “Information sharing should be used solely for the requesting state’s transfer pricing audit.”

The SITAS program is not limited to assisting the states in transfer pricing audits.<sup>4</sup> We see no reason why information exchanged pursuant to the Agreement should be treated differently from any other information received by a taxing agency, including the use of such information in other tax administration contexts permitted under a state’s laws and policies.

3. “State administrators should discourage fishing expeditions by third party auditors. The Agreement should provide that requests must be relevant to a specific audit and set forth the audits in which the information will be used. The Agreement should expressly provide that the information exchanged will not be used for other commercial purposes, whether or not taxpayer-identifying information is redacted.”

State laws already provide that confidential taxpayer information may only be exchanged between state taxing agencies for purposes of state tax administration. The exact meaning of the phrase “fishing expeditions by third party auditors” is unclear to us, but to the extent it suggests the Agreement should preclude the use of outside contractors or databases for audit selection, we believe that is a matter of state policy preference. The letter does not explain why information exchanged through this particular program on this particular set of taxpayers should be treated any differently than any other information received by a taxing agency.

We are not aware of any states permitting the use of confidential taxpayer information for commercial purposes, but to the extent such uses may be permitted, it is a state policy matter beyond the scope of the Agreement.

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<sup>4</sup> The program is intended to help states determine the tax consequences of intercompany transactions, not just the appropriate price. For instance, information received in the course of a transfer pricing dispute may indicate the taxpayer has nexus in a member’s state.



4. “Third party auditors should be required to sign an acknowledgment of the Agreement, in which they agree to abide by each state’s specific statutory provisions regarding the prohibition against the sharing of confidential taxpayer information. While we strongly oppose sharing of information with third party auditors, we recognize that as a practical matter many states already engage with such contractors. Accordingly, we would recommend that any such contractor sign an Agreement acknowledging the civil and criminal liability associated with information sharing and agree to abide by those specific state laws.”

Our understanding is that all states require outside contractors with access to confidential taxpayer information to sign agreements acknowledging that the contractors are bound by state confidentiality laws and penalties. States impose numerous other restrictions on the provision of confidential taxpayer information to outside contractors and their use of that information. We see no reason to require additional procedures in the Agreement for how states should govern their relations with contractors employed by states participating in the SITAS program.

5. “States should be required to notify a taxpayer whose information has been shared pursuant to the Agreement. We note that several states require practitioners to notify the agency when their taxpayer information has been breached, and we favor a similar disclosure requirement with respect to state agencies. Thus, it would seem fair to ask a state that discloses information being shared pursuant to the Agreement to do the same.”

We do not consider the exchange of information pursuant to the Agreement as being the equivalent to a breach of security of personal records held by a private party. States already have policies in place addressing disclosure of investigatory processes, including audit selection. We do not see a good reason—and the letter offers none—for why different or additional policies should obtain for exchanges of information made pursuant to this Agreement.

Attachment (8/6/21 letter from Eversheds Sutherland (US) LLP.)

Dear Chair Barnett and Esteemed Committee Members:

We appreciate the State Intercompany Transaction Service (SITAS) Committee's work on the revised information sharing agreement. As we have discussed with representatives from many of the Committee's member states, we believe that using federal transfer pricing principles is often the most appropriate method to allocate income among related entities. Initiatives that further certainty with respect to transfer pricing, like advance pricing agreements and settlement initiatives, are also most welcome. We write today, however, to express concern with the SITAS Committee's approach to information sharing among its member states and their third party contractors hired to assist with transfer pricing audits.

#### Proposed Information Sharing Agreement

During its July 13, 2021, meeting, the SITAS Committee discussed a "revised" State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement (Agreement).<sup>1</sup> The Agreement is expected to be executed by participating states to facilitate sharing taxpayer information. The SITAS Committee also approved a draft charter that *requires* participating states to sign the Agreement.

While we appreciate the SITAS Committee's efforts to memorialize limitations on information sharing, we are concerned that the Agreement does not sufficiently protect taxpayers' confidential information and could potentially subject revenue officials and their contractors to penalties under state law. Indeed, most states' laws prohibit and impose criminal and sometimes civil liability for disclosing taxpayer confidential information outside the formalities of state anti-disclosure statutes.<sup>2</sup>

Taxpayer specific information is generally afforded the highest degree of confidentiality under most states' laws. We have, however, recently become aware of instances where states have disclosed such information to other states or third parties outside of formal information sharing protocols.

Although the Agreement provides that it "is not intended to expand or contract any other state law or agreement pertaining to the exchange of confidential taxpayer information,"<sup>3</sup> it contains few substantive safeguards designed to secure taxpayer confidential information. Indeed, Article IV of the Agreement sets forth a laundry list of information that could be shared, placing the onus upon each individual signatory state to determine whether such disclosure runs afoul of state law.<sup>4</sup> The lack of clear guidance is not only concerning to taxpayers, but also it

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<sup>1</sup> See <https://www.mtc.gov/getattachment/The-Commission/Committees/SITAS/SITAS-Agenda-7-2021/SITAS-Agreement-2021-Proposed-Update-FINAL.pdf.aspx>.

<sup>2</sup> *E.g.*, Ala. Code § 40-2A-10(a) (classifying each act of unlawful disclosure as a Class A misdemeanor); Miss. Code Ann. § 27-7-87(3) (imposing criminal liability, punishing same by minimum fine of no more than \$1,000, imprisonment of no more than one year, or both; dismissing officers and employees of the state from office and prohibiting same from holding any public office in the state for a period of five years); N.C. Gen. Stat. § 105-259(c) (imposing criminal liability as a Class 1 misdemeanor for violations of anti-disclosure law; dismissing officers or employees from public office or employment and prohibiting same from holding the public office or employment for a period of five years after the violation); S.C. Code Ann. § 12-54-240(A) (imposing civil and criminal penalties on violations of anti-disclosure law, classifying such violations as a misdemeanor subject to punishment by a fine of no more than \$1,000, imprisonment for no more than one year, or both; dismissing public officers and employees from office and disqualifying same from holding public office for a period of five years; and penalizing contractors who violate anti-disclosure laws by immediately terminating the contract and disqualifying such company from eligibility to contract with the state for a period of five years).

<sup>3</sup> State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement, Article III.

<sup>4</sup> See State Intercompany Transactions Advisory Service Committee Participation Commitment and Exchange of Information Agreement, Article IV.

should be concerning to participating states. For example, a participating member could unknowingly share information that would run afoul of another state's law—putting the group's work in murky legal territory.

We are also concerned with the provisions in the Agreement permitting information sharing with agents of signatory agencies (who are not a party to the Agreement). While some states' laws permit sharing information with third parties in limited circumstances, others do not. Moreover, to the extent information is shared with third parties, the Agreement does not adequately limit third parties' use of information to the particular audit for which the information is shared. Given their financial incentives, state contractors may attempt to use information obtained in one audit to further their ends in another state's unrelated audit. While we appreciate that contractors may wish to leverage their experience from one state to another, this type of "leverage" may run afoul of states confidentiality laws. Additionally, contractors should not be permitted to save or catalog taxpayer data for use on future audits.

We would also note that third party auditors' interests are not entirely aligned with state tax enforcement agencies, and therefore, sharing information with these contractors raises additional concerns. As the Council on State Taxation (COST) has observed, contingent fee contracts, while perhaps authorized by state law, still undermine equitable, effective, and efficient tax administration.<sup>5</sup> In the context of information sharing under the Agreement, our concerns regarding third party contractors paid on a contingent fee basis are heightened. The prospect that a third party fee-contingent contractor will misuse confidential information is elevated because the contractor is incentivized to do so. These are not just abstract concerns – there is evidence that third party auditors are not bound by the same ethics as state tax enforcement agencies. For example, in a recent Delaware Supreme Court case, the court upheld the denial of an administrative subpoena where the lower court suspected the third party auditor would misuse the subpoenaed information (i.e., for a another state audit).<sup>6</sup> And just a month ago, a large third party auditor, with whom many would-be signatory states have contracted, may have exposed taxpayer confidential information in the popular tax press to advertise its services for conducting transfer pricing audits.<sup>7</sup> If not a direct violation of state anti-disclosure laws, this certainly seems a violation of their spirit.

Furthermore, not all state anti-disclosure laws are written the same. Alabama's state anti-disclosure law and administrative code, for example, disfavors sharing information with another tax agency's third party auditors.<sup>8</sup> Indeed, because taxpayer information is highly sensitive, most states' laws prescribe a strict processes that must be followed prior to authorizing release of confidential taxpayer information. When information is shared between tax agencies, the process generally requires a written request from the party seeking taxpayer information and a written authorization from an official having custody over such information.<sup>9</sup> The proposed draft Agreement fails to expressly take these procedures into account, although it may be within the parties' intentions to do so.

Sharing the content of settlement agreements and advanced pricing agreements – a practice we have also observed in recent history – is also troublesome. Generally, the sharing of such information is likely to have the opposite effect of that which is intended. As recently expressed by a member state during the MTC's Annual Conference, sharing this information could start a race to the bottom. Moreover, the practice has a chilling effect on taxpayers' appetites to enter into such agreements.

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<sup>5</sup> Comment Letter, Council on State Taxation, Re: COST's Opposition to Georgia Senate Bill 480 (March 5, 2020) ("Contingent-fee arrangements jeopardize the neutral and objective weighing of the public's interest, and instead create a direct economic interest for the third party in the outcome of the services rendered.").

<sup>6</sup> *Dep't of Finance v. AT&T Inc.*, No. 303, 2020 (Del. June 1, 2021).

<sup>7</sup> See Tax Notes, Cook and Cook, "2.7 Billion 2018 Northeastern State Transfer Pricing Tax Gap".

<sup>8</sup> See Ala. Admin. Code r. 810-14-1-.29(2)(e) (excluding tax agency contractors from definition of authorized persons with whom information may be shared directly).

<sup>9</sup> See, e.g., Miss. Code Ann. § 27-7-83(2).

The recent success in Indiana bears this out. Indiana's advance pricing program, which serves the same policy objectives that the states hope to accomplish by entering into the Agreement, has seen success in large part because the program requires complete confidentiality. Information cannot be shared with any other states by the very terms of the program agreements.<sup>10</sup> The success of this program is an example of a policy that empowers a taxpayer and a state to engage in a productive conversation – made possible only because taxpayer information remains confidential.

#### Recommendations for Improving the Agreement

We hope that those considering entering into the Agreement bear in mind the foregoing concerns. Furthermore, considering these concerns, we offer the Executive and SITAS Committees five recommendations for strengthening taxpayer confidentiality while balancing the member states' ability to conduct fair and timely audits:

1. The SITAS Committee should consider adopting "written authorization" procedures as a matter of maintaining accountability and protecting taxpayers from fishing expeditions by third party auditors. Specifically, when information is requested pursuant to the Agreement, the request should be made in writing, should identify the person seeking the information and with whom the information could be shared. The request should also set forth the particular information requested, the dates for which such information is required, and the purpose for the request.
2. Information sharing should be used solely for the requesting state's transfer pricing audit.
3. State administrators should discourage fishing expeditions by third party auditors. The Agreement should provide that requests must be relevant to a specific audit and set forth the audits in which the information will be used. The Agreement should expressly provide that the information exchanged will not be used for other commercial purposes, whether or not taxpayer-identifying information is redacted.
4. Third party auditors should be required to sign an acknowledgment of the Agreement, in which they agree to abide by each state's specific statutory provisions regarding the prohibition against the sharing of confidential taxpayer information. While we strongly oppose sharing of information with third party auditors, we recognize that as a practical matter many states already engage with such contractors. Accordingly, we would recommend that any such contractor sign an Agreement acknowledging the civil and criminal liability associated with information sharing and agree to abide by those specific state laws.
5. States should be required to notify a taxpayer whose information has been shared pursuant to the Agreement. We note that several states require practitioners to notify the agency when their taxpayer information has been breached, and we favor a similar disclosure requirement with respect to state agencies. Thus, it would seem fair to ask a state that discloses information being shared pursuant to the Agreement to do the same.

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<sup>10</sup> See Bloomberg Tax, Bologna, "Indiana Commits to Confidentiality in Advance Pricing Agreements."



Again, we appreciate the Executive and SITAS Committees' attention to this matter and the opportunity to engage in open dialogue concerning such sensitive, yet important matters as sharing taxpayer confidential information. We look forward to continued conversations on these issues with the Committees.

Sincerely,

A handwritten signature in black ink, appearing to be 'E. T. S.', written in a cursive style.

Eversheds Sutherland (US) LLP