Memorandum

To: MTC Arm's-Length Project Advisory Group

From: Dan Bucks, Project Facilitator

Date: May 27, 2104

Re: Preliminary Discussion of Issues for Arm's-length Project

I. Introductory Information

The purpose of this memorandum is to identify potential topics to assist the advisory group in developing an agenda of issues for consideration in developing the design for an MTC Arm's-Length Adjustment Project. It is not an exhaustive review of the subject of income shifting and transfer pricing problems and arm's-length methods or other remedies. It is intended only as a simple springboard for productive discussion.

Any views expressed in this memorandum are solely those of the author and do not represent the views of the Multistate Tax Commission, any state, the advisory group or any of its members.

This memorandum is informed, in part, by interviews conducted in April 2014 with the states participating in the project.[1] I appreciate greatly the time devoted to the interviews by the state tax agency staff members.

Background

States have a legitimate interest in ensuring that corporate income reasonably attributable to a state is actually reported for tax purposes. States have a general duty to ensure the fair and equitable distribution of taxes among taxpayers. Corporations earn income within states by engaging in business activities that require and benefit from state and local government services. If any corporation fails to report income properly to a state, that corporation is shifting the cost of these services unfairly to other taxpayers. Further, a corporation that underreports income gains an unfair competitive advantage in the marketplace.

Most importantly, ensuring the proper reporting of corporate income is the law. Each state in this project has enacted laws requiring the reporting of income to a state in an accurate, true, proper or fairly representative manner. Such laws authorize each tax agency to take corrective action whenever they find that a corporation has fallen short of the state's income reporting standard.

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[1] As is general practice, the District of Columbia is included in references to "states."

The need for state tax agencies to take corrective action has risen in the last several decades as corporations have become increasingly aggressive in shifting income to avoid equitable taxation. Individual and cooperative state efforts to improve fair and equitable corporate income reporting are quite justified and serve the public interest.

One example of methods for taking corrective action is provided by the federal government through its regulations implementing Section 482 of the Internal Revenue. However, states with their own income adjustment laws are generally not bound by all the details of federal practices. Such would even appear to be the case in North Carolina where its recently enacted law on the topic requires adherence to the "standards contained in the regulations adopted under Section 482 of the code" as opposed to either the full text of the regulations or the IRS's application of those regulations in specific taxpayer cases.[2] States that have little or no mention of federal practices in their statutes would seem to have substantial, independent authority in making arm's-length adjustments and flexibility in designing solutions they find effective and equitable. This independence is important if a state has any major reservations about federal procedures and methods.

State Statutes

The degree of commonality among state legal structures—while not determinative—will be a factor in influencing cooperative efforts among the states. All of the states have laws that grant authority to tax agencies to adjust reported corporate income to achieve a reasonable result. Two of the jurisdictions, Hawaii and D.C., have combined reporting statutes. However, in both cases circumstances may arise where adjustments are judged as necessary between the income of a combined group and jointly owned entities outside the combined group. Some states have, in addition to their income adjustment statute, a UDITPA Section 18 type of provision allowing for accounting adjustments if the reported income does not "fairly represent the extent of the taxpayer's business activities in the state."

The general adjustment statutes use terms that authorize tax agency assessments if a corporation's reported income does not meet certain standards or benchmarks as indicated by these short excerpts from various laws:

- The *true earnings* of the taxpayer on its business activities carried on in this state (New Jersey),

[2] The author would defer, however, to the interpretation of this language by North Carolina authorities.

- (Director authorized to adjust income) to the extent necessary *clearly to reflect the net income* of such taxpayer (Florida),
- To prevent *evasion* of Alabama income taxes or to *clearly reflect* the income of any such organization, trade or business (Alabama),
- The department may determine the amount of taxable income . . . having due regard to the *reasonable profits* . . . which might or could have been obtained . . . . the director may require such facts as are necessary for the *proper computation of the entire net income* and *the net income properly attributable to the state.* (Iowa), or
- The Secretary may redetermine the State net income of the corporation *properly attributable* to its business carried on in the State (North Carolina).

These statutes and others like them generally aim at restoring income reporting that is "true," "accurate," "reasonable," "proper," or that "clearly reflects the net income of the taxpayer."

Kentucky and North Carolina have the most specific statutes. Kentucky's law is a well-defined "add-back" statute that disallows deductions for intercompany transactions under certain specified conditions. In general terms, the failure of an intercompany transaction to be conducted at arm's length is sufficient to require adding back to income the deduction for that transaction. Other factors may require adding back the deductions, but the arm's-length condition is most relevant to this project.

North Carolina's law requires the tax agency to find that transactions either lack economic substance or are not at fair market value before proceeding to make income adjustments. If the agency proceeds, the law specifies requirements for taxpayer notice, a procedure for voluntary redetermination and conditions for requiring a combined report. The North Carolina income adjustment law contains numerous definitions that appear to set further standards for the exercise of income adjustment authority in that state.

Finally, Alabama has a law stating that the tax agency's income adjustment authority be exercised in a manner consistent with Alabama law and, "to the extent applicable," IRC Section 482 and accompanying rulings and regulations. The same statute also authorizes the agency to issue "additional regulations as are necessary" to enforce Alabama law.

While in general the state statutes do not require a close connection between state and federal practices (with North Carolina's being the most closely connected), in practice many states have by regulation chosen to tie themselves more closely to the Treasury's 482 regulations and procedures.

Levels and Types of State Compliance Activity

There is some variation among the participating states in the degree of income adjustment activity undertaken. Alabama, the District of Columbia, Florida and New Jersey appear to have, in this author's view, undertaken the most activity under their current statutes. North Carolina has also been active in seeking income tax compliance by corporations, but the bulk of that activity occurred under prior law. Insufficient time has elapsed since the enactment of a new income adjustment law for North Carolina to accumulate experience under this law.

The activities of the various states have not necessarily followed the same path. Some may have emphasized adjustments through comparable profits and others modifications in transfer prices. The variations in approaches and practices need to be understood along with their implications for an ongoing arm's-length service.

Kentucky has developed a specific add-back process under its law, with the administration of its law assisted by structured reporting required of taxpayers. Because there are several separate conditions that can lead to the adding back of a deduction, parts of the Kentucky experience appear to have accumulated around issues other than a transaction failing to be conducted at arm's length.

II. Potential Project Issues

This section explores some potential issues the project may wish to consider. This discussion may not be exhaustive—states or members of the public may have additional ideas. This section reflects views expressed by states during recent interviews, the author's own knowledge and experience and information drawn from other sources.

There is no priority to the order in which these issues are presented here. The items are organized simply in a conceptual sequence of policy interpretation through compliance administration and case resolution. This sequence rarely occurs in actual practice in this linear order.

Policy Evaluation and Development of Best Practices

There are several reasons why the states may wish to include a policy evaluation and best practices component in the MTC arm's-length service:

- Interstate cooperation is enhanced by some level of consistency among states as to the details of their income adjustment practices.
- Some states are actively looking to the experiences of other states to improve their own practices.

- As states become more active in the income adjustment process, some taxpayers may be interested in common state approaches as a matter of administrative convenience and consistent resolution of audit adjustments.
- The rising consensus that the U.S. government has largely failed at the income adjustment process may lead states to evaluate using more effective and equitable approaches than those typically used by the federal government.
- There are some genuinely interesting and promising ideas in individual states that deserve attention from others.

At the very least states need to acquaint each other with their respective practices at an early stage in this project to develop a mutual understanding of both the common and varying elements of their current work. This could be accomplished by an exchange of materials, discussions at advisory group meetings, teleconference briefings, summary descriptions coordinated by the project facilitator, or some combination of all of these methods.

Consider a simple example of why some mutual education is advisable during the design phase of the project. The most interest expressed thus far by states in terms of possible project activities is in the joint development or purchase of economics expertise to support arm's-length audit practices. However, if some states primarily use the comparable profits method and others use comparable uncontrolled price adjustments, different sources of economic and statistical expertise may be required. In terms of the expertise to be developed, it is important to know the range of current practices being employed by states and to what degree.

There are also some state initiatives that appear promising in terms of improving arm's-length administration. In the context of its add-back statute, Kentucky has used structured self-reporting by companies as an essential component of administration. While the details would vary because other states do not have a comparable statute, the idea of requiring additional information with tax returns to aid the compliance administration process has potential.

Beyond mutual education, some level of evaluation of the equity and effectiveness of state and federal practices may be in order during the current design phase. The development of an operational MTC project creates an opportunity for states to reconsider what works well and what does not so that the project can build constructively on such lessons. Doing so prevents repeating efforts that have not yielded effective results in the past. Such evaluation at the design phase would be a prelude to what would occur on a continuing basis when the project is operational if states decide establish as a project component an ongoing policy evaluation and best practices development process.

Finally, there is an opportunity for states to consider again the meaning of what constitutes true, accurate, proper or clearly reflective reporting of income. Might states develop a common definition and standard of measuring income reporting results that conform to this statutory language? Could such objective standards serve as a guide for testing whether a not a taxpayer's income reporting practices are acceptable or not?

There is some initial interest among states in the development of policies and best practices. At least two participating states mentioned directly in interviews the need to develop additional arm's-length approaches and practices, and other states did so implicitly by stating a need to develop more tools to solve transfer pricing and income shifting problems.

At the current stage, it would be helpful if states would provide suggestions for a mutual education process and the degree to which they want information in the design phase on the relative merits of different arm's-length adjustment approaches, information reporting and other administrative practices.

Pre-Compliance Action Activities

There are several activities that precede states undertaking audits that could be a part of the ongoing arm's-length services. Some of these activities flow out of policy interpretation and the development of best practices. Among these are staff training and the development of manuals, written procedures and other ongoing materials for staff guidance. To the degree that states move toward common practices, joint training and development of written materials becomes a more likely candidate for project services.

Another set of activities involves information management. It includes the development and implementation of common forms for requiring additional filing information from taxpayers relevant to evaluating their intercompany transaction practices. Information management also includes potential exchange of information activities among participating states and the possible adaptation of technological systems to facilitate that exchange of information. Increasingly, integrated systems include features to enable such exchanges, and adapting those systems to use within the framework of the arm's-length service may be feasible. Finally, it could also include joint evaluation of information (1) to identify compliance problems that might otherwise be missed by individual states and (2) to assist with audit selection.

Again, there is some initial interest among states in joint training for staff. Exchange of information was also mentioned by at least one state. Another state made a specific request for developing through the arm's-length service the ability to identify compliance problems that would be otherwise missed. However, the concept of a systematic approach to securing and managing information about intercompany transactions is a new one and deserves some explicit discussion.

Audit Related Activities

There are two audit related activities that are a topic of active discussion by states: (1) the development of a central source of economic and statistical expertise to support audit work, especially in evaluating taxpayer transfer pricing studies, and (2) joint audits.

States most frequently mention a joint economic/statistical service as an essential component of an arm's-length service. States find it challenging to finance independent analyses of the transfer pricing studies presented by taxpayers during audits. Thus, they see joint funding as the solution for this problem. Less clear is the degree to which states understand that variations in their arm's-length practices add to the cost of such services. Hence, the development of shared practices among the states could enhance the affordability and feasibility of such a joint service.

The idea of joint audits receives a more varied response. Some states strongly support developing a joint audit function within the arm's-length service. Other states express little initial interest in joint auditing. Still others are open to the idea, but need more information and discussion of how such audits would work. Thus, with the range of response from strong support to little interest, joint audits may need to be considered an optional component of the arm's-length service.

This author also recommends that there is value to considering the role of joint auditing in the overall cooperative effort envisioned for this service. Joint audits are not simply a freestanding compliance activity. They are probably the fastest means of developing lessons and ideas for participating states about what is actually effective or not effective in practice. Joint audits accelerate the training and acquisition of expertise by the staff of individual agencies. Further, they encourage the joint resolution of cases on a consistent basis—a subject discussed further below. In this regard, joint audits complement and support both the individual operations of states and the cooperative effort of states to become more effective in coping with intercompany transactions.

Case Resolution Activities

There are four types of case resolution activities that are of some interest to states. They include: (1) ongoing consultation among states of cases with taxpayers, (2) joint resolution of audit cases, (3) advanced pricing agreement assistance, and (4) the provision of expert witnesses to support assessments in litigation.

States generally assume that the arm's-length service will facilitate ongoing consultation among states on major cases involving intercompany transactions.

This is assumed to be an effort that requires few resources and would be a logical adjunct to other project activities.

A few states also express interest in the joint resolution of audit cases, noting that some taxpayers might also welcome consistency in the outcomes from state compliance efforts. How audit cases might be jointly resolved outside the context of joint audits is not clear, however. It would be a matter of happenstance if states individually conducted audits of the same taxpayer for the same time periods, thus creating the practical conditions for a potential joint settlement of such audits. Thus, joint resolution of cases may be a companion to joint auditing.

At least one state indicated potential interest in the arm's-length service providing support for advanced pricing agreements. It was unclear if the state envisioned joint agreements among a taxpayer and several states or simply expertise provided to individual states in entering such agreements separately with taxpayers. If such advanced pricing agreement support is of interest, states may wish to evaluate first the federal experience with such agreements. Press coverage of international income shifting to tax havens indicates that such agreements have frequently facilitated some of the worst income shifting abuses. APAs that underprice the initial transfer of intangible assets to overseas subsidiaries have served as the first step in setting up enormous income shifting through the notorious "Double Irish/Dutch Sandwich" tax shelter. It is, of course, possible that states may be able to implement APAs effectively if they develop practices that avoid serious federal valuation mistakes.

Finally, a number of states assume that if the arm's-length service facilitates the joint provision of economic and statistical expertise in audits, the same expertise would be available to serve as expert witnesses in cases under litigation. That would appear to be a reasonable assumption. The only question may be how such expert witness costs would be financed.

III. Conclusion

This memorandum presents for consideration a range of issues, ideas and potential activities for an MTC arm's-length service. States can evaluate these ideas separately or as interacting elements of a larger cooperative effort. The interactions among the various potential activities should not be overlooked. Again, all viewpoints and opinions in this memorandum are entirely those of the author and should not be attributed to the Multistate Tax Commission, any state or the advisory group.