Memorandum

To: Arm's-Length Adjustment Service Advisory Group

From: Dan Bucks, Project Facilitator

Date: July 21, 2014

Re: Summary of Issues for Joint Audit Models: Item III.D for July 28 Meeting

Disclaimer: Unless specifically noted, this document does not represent the views of the Multistate Tax Commission, the MTC Arm's Length Adjustment Service Advisory Group, or any state. The author prepared it to help facilitate discussions by the advisory group.

The purpose of this memorandum is to summarize issues and discussions related to three models for optional joint audits as a part of the projected MTC Arm's Length Adjustment Service. The three models include:

- Joint audits limited to transfer pricing issues only, separate from the regular MTC Audit Program.

- Joint audits that cover all corporate tax issues, including transfer pricing issues, separate from the regular MTC Audit Program.

- Joint audits that cover all corporate tax issues, including transfer pricing issues, integrated with and conducted through the regular MTC Audit Program.

Regardless of the model, the projected service would provide economics expertise necessary for these audits and, of course, the separate transfer pricing audits conducted by all individual states participating in the project. Also, in all of these models, participating in joint audits would be optional for project states.

<u>First Model</u>
With regard to the first model, the primary advantage of such audits would appear to be the focused attention it would provide to transfer pricing issues. On the other hand, the major disadvantages appear to be:

- A failure to address other tax compliance issues that may be important,
- Significant coordination and taxpayer convenience issues arising from a taxpayer being subject to separate audits for other corporate tax issues while being audited for transfer pricing issues only, and

- Substantive tax problems if transfer pricing issues are intertwined with other corporate tax issues.

Given the disadvantages identified for this model in advisory group discussions, it appears that there is little interest in pursuing this option further—although it has not been formally ruled out at this stage.

<u>Second Model</u>

The second model addresses the issue of a taxpayer being subject to one audit for transfer pricing issues only and a separate audit for all corporate tax issues, even potentially for the same state (provided that state law would allow that to occur). At least for the group of states choosing to conduct joint audits of all corporate tax issues, including transfer pricing issues, the audits of taxpayers would be of the same scope—and the potential for duplicate audits for the same states would be eliminated.

The second model would entail the MTC operating two separate joint audit programs presumably with separate staffs, supervisory structures and audit selection processes. One program would be for states that wanted to have transfer pricing issues covered in corporate income tax audits and the other for states that did not want to address such issues. The arm's-length project states interested in transfer pricing audits would presumably switch from the current MTC audit program to this new, separate audit program that covers transfer pricing issues.

The maintenance of two distinct MTC audit programs would create a mix of advantages and disadvantages. One possible advantage is that different audit selection criteria could be applied in each program, with different taxpayers being selected by the states in the separate programs to address their particular needs and issues.

One disadvantage is that maintaining two separate audit programs would entail higher costs for both, with the loss of economies of scale in supervision and training. A second disadvantage is that narrowing the number of states in the respective joint audit programs reduces the ability of states to identify compliance issues from a more comprehensive view of a taxpayer's operations and its filing positions in multiple states. A third disadvantage is that it may also reduce the ability of being able to offer taxpayers consistent resolution to common issues that cut across a larger number of states.

Taxpayer reaction to two separate MTC joint audit programs may vary. For taxpayers who might be subject to audits by both programs for distinct groups of states, some may prefer having to deal with fewer states at a time, and others might prefer having only one audit for all the states.

A final consideration is that the distinction between these two separate MTC audit programs might blur over time—and may even be somewhat blurred at present.

The current MTC audit program does, in fact, already address related party transaction issues for separate entity states. This program, like the states it serves, simply does not have the economics expertise available to it to fully address transfer pricing issues. If the expertise becomes available, the existing program would presumably find it possible to address these issues if that is the preference of its participating states. This consideration leads to the third model.

Third Model

In the third model, the current MTC audit program would use the economics expertise supplied by the projected arm's-length adjustment service and adapt the program to address transfer pricing issues to the degree requested by participating states. Arm's length adjustment project states wishing to avail themselves of joint audits that include, among other issues, transfer pricing issues could join the MTC audit program. States in the audit program that are not members of the arm's length adjustment service, but wishing to have the benefit of transfer pricing audits would pay a proportionate surcharge for the economics expertise engaged in those audits. The surcharge funds would go to support the arm's length adjustment service.

The advantage of this model is that it eliminates any extra net costs associated with operating two separate joint audit programs and enhances the overall capability of the MTC audit program to respond to the needs of the states. It would offer combined reporting states, for example, the potential ability to address transfer pricing issues with related parties outside of a combined group (e.g. foreign entities or 80/20 corporations).

The main disadvantage is that it adds complexities to audit selection, the training of staff and the management of individual audit cases. It may also raise concerns by states not interested in transfer pricing audit services as to whether their needs will be effectively addressed by the audit program. These disadvantages may be mitigated, however, by the reality that the expansion of the scope of audits to include transfer pricing considerations would be incremental and occur over a long enough period of time to manage adjustments to the program carefully.

The incorporation of transfer pricing issues into the MTC audit program is consistent with that program's objective of conducting audits for states applying their policies and practices. When states change their policies and practices, the program adjusts to fit those changes. As states move to develop transfer pricing analysis capabilities for their own audits, the program is, in this sense, obligated to move in the same direction. Given that the MTC audit program already encounters and addresses related party transactions, this change may be in inevitable in any event.

Any change of this scope, however, would need to be undertaken in close consultation with the MTC Audit Committee and staff leadership.

Background Information

It should be noted that five of the states in the arm's length project are already members of the MTC corporate income tax program: Alabama, District of Columbia, Hawaii, Kentucky and New Jersey. Georgia participates in the MTC sales and use tax audit program.