



Transfer Pricing: A Multi-State Problem with a Multistate Solution

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The Problem

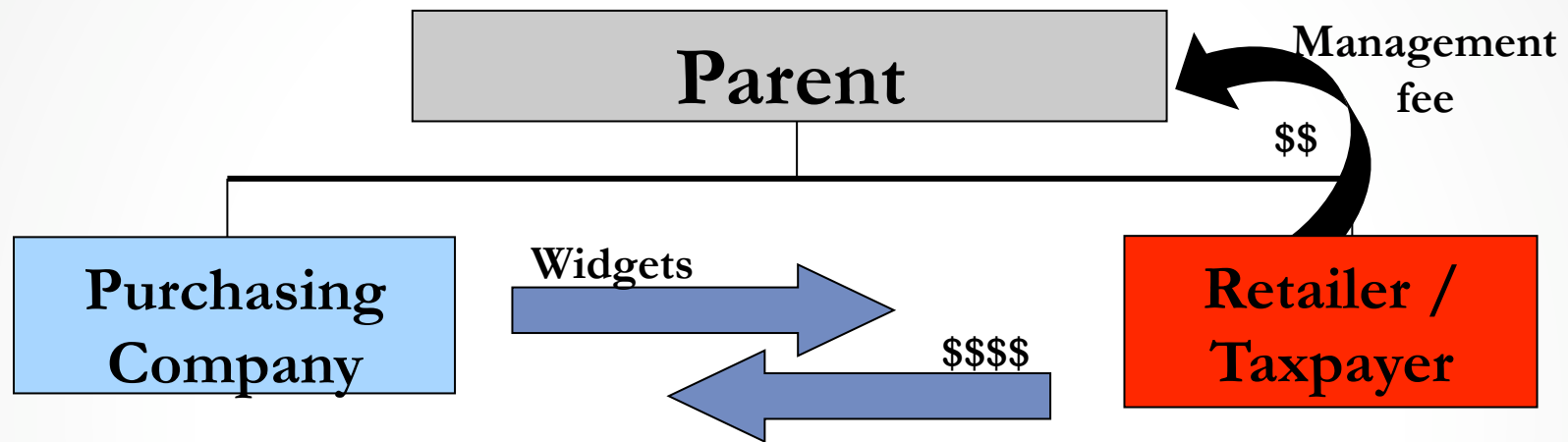
Multijurisdictional enterprises often use complex tax strategies to improperly shift income, expenses, and losses among jurisdictions via related-party transactions to reduce their tax liabilities

Shifting Income

Businesses shift income to related companies through a variety of methods, such as —

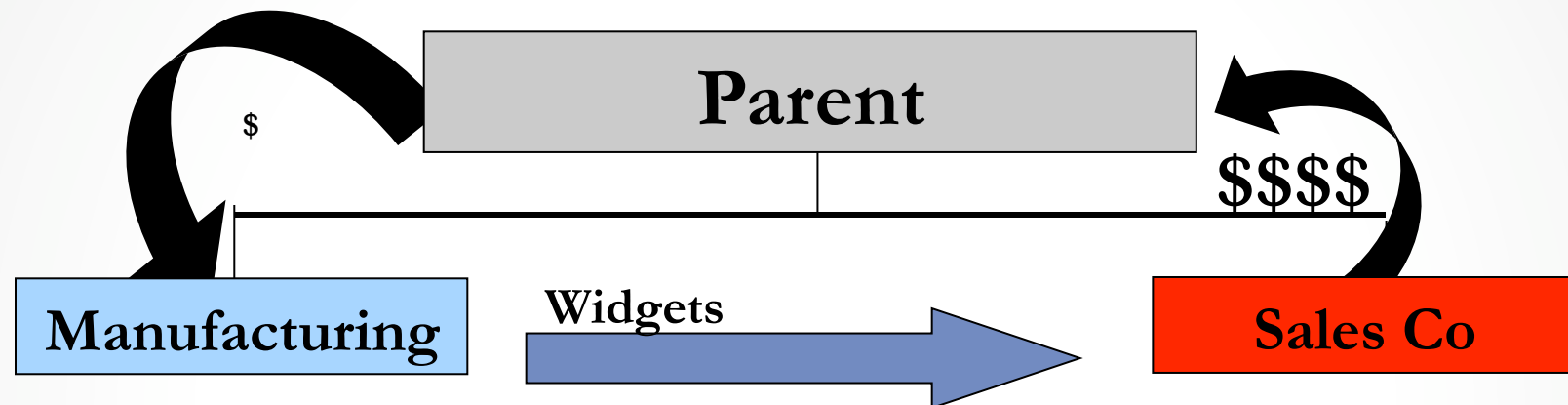
- The transfer and licensing of intangible assets
- The purchase and resale of tangible goods
- Providing and charging for common services
- Stripping earnings out of a state through financing arrangements
- Factoring accounts receivables
- Utilizing “embedded royalties”

Retailer with Purchasing Company



- Retailer sells goods with small mark up and breaks even on its tax return after paying substantial management fee to Parent
- Purchasing sells goods to Retailer at a substantial mark up and reports a majority of the Group's taxable income
- Parent reports substantial taxable income despite having little in the way of property or employees
- Taxpayer's transfer pricing study reflects the fact that Purchasing and Parent own the Group's intangibles

Manufacturer with Sales Company



- Sales Co sells goods with small mark up and breaks even on its tax return
- Parent, located in a combined return state, sells goods to Sales at a substantial mark up and reports a majority of the Group's taxable income
- Manufacturer sells goods to Parent with small mark up and breaks even on its tax return
- Taxpayer's transfer pricing study reflects the fact that Parent owns the Group's intangibles

Why States Need to Act

Improper Income Shifting Causes—

- Significant, unjustified state revenues losses
- Uneven playing field among businesses
- Unfair shifts of public service costs to other taxpayers
- Loss of societal trust

However ...

- Many states are currently ill equipped—
 - To identify and analyze instances where these methods may exist
 - To distinguish between proper and improper income shifting
 - To remedy instances of improper shifting
- States have found the challenges posed by improper income shifting to be costly to address

Major Fiscal Impact

- This problem has a major fiscal impact on states, but is difficult to quantify precisely
- Estimates of the federal revenue loss from international income shifting suggest that those losses approach \$100 billion annually
- Assuming that is the case, state revenue losses would be nearly \$20 billion a year

What do the States Say?

- One state reported that a business paid \$70 million in a single case where it corrected underreporting arising from related party transactions
- Another state reported collecting \$10 million in otherwise unpaid taxes from their transfer pricing enforcement efforts
- A third state noted that it had three cases pending that involved more than \$6 million in revenue, and another state was working five cases with nearly \$54 million in revenue at issue
- Other states anticipated they would receive amounts ranging from \$5 to \$10 million annually from improved compliance activities designed to reduce improper income shifting

State Adjustments

- In one manner or another, all states have the ability to adjust transactions or income among related corporations
- States have some traditional remedies available to them other than arm's-length adjustments—
 - Assert nexus or jurisdiction to tax with regard to the related party that appears to have received a disproportionate amount of income from the corporation filing in their state
 - Disallow a deduction by a corporate taxpayer if the deduction was created through transactions with a related party
 - Reverse the transaction for lacking economic substance

Alabama's Transfer Pricing History

- Alabama enacted transfer pricing legislation in 2001
 - Ala. Code Section 40-2A-17 —
“In any case of two or more organizations, ... owned ... by the same interests, the Commissioner ... may ... [reallocate] if the commissioner determines ... [reallocation] is necessary in order to ... to clearly reflect the income of any such organization ...”
- Closely tracks IRC 482
 - Statute instructs Commissioner to apply Alabama's law *“consistent with ... to the extent applicable, 26 U.S.C. § 482 and the rulings and regulations issued thereunder”*
- Enacted with Alabama's add-back statute — same legislative session
- To date Alabama has published no rules to go along with the statutory transfer pricing authority

Alabama's Transfer Pricing History, cont.

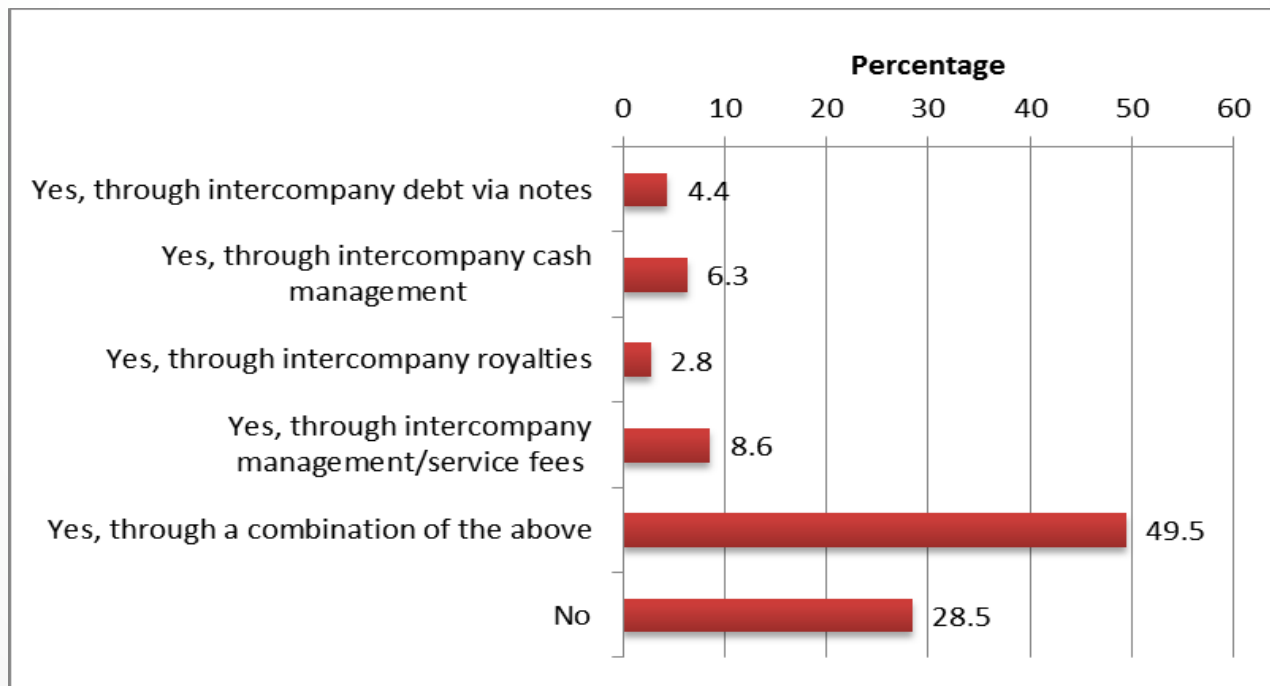
- First transfer pricing audits conducted 2003 - 2004
- Chainbridge LLC provided the economic analysis for our early audits
 - Flat fee per report — no contingency
- Audits selected by ADOR based on in house return review
- Success combining add-back and transfer pricing audits
- Alabama chose not to implement large scale transfer pricing audit program and not “automate” transfer pricing audits
- Pace of audits too slow, number of audits too low
- New vendor, Economist Inc., and also looking to MTC's ALAS program

Is it a Problem for Combined Reporting States?

- Transfer pricing study analysis can substantiate unitary relationships
- Beyond the water's edge, all states are separate entity states and need arm's-length analysis

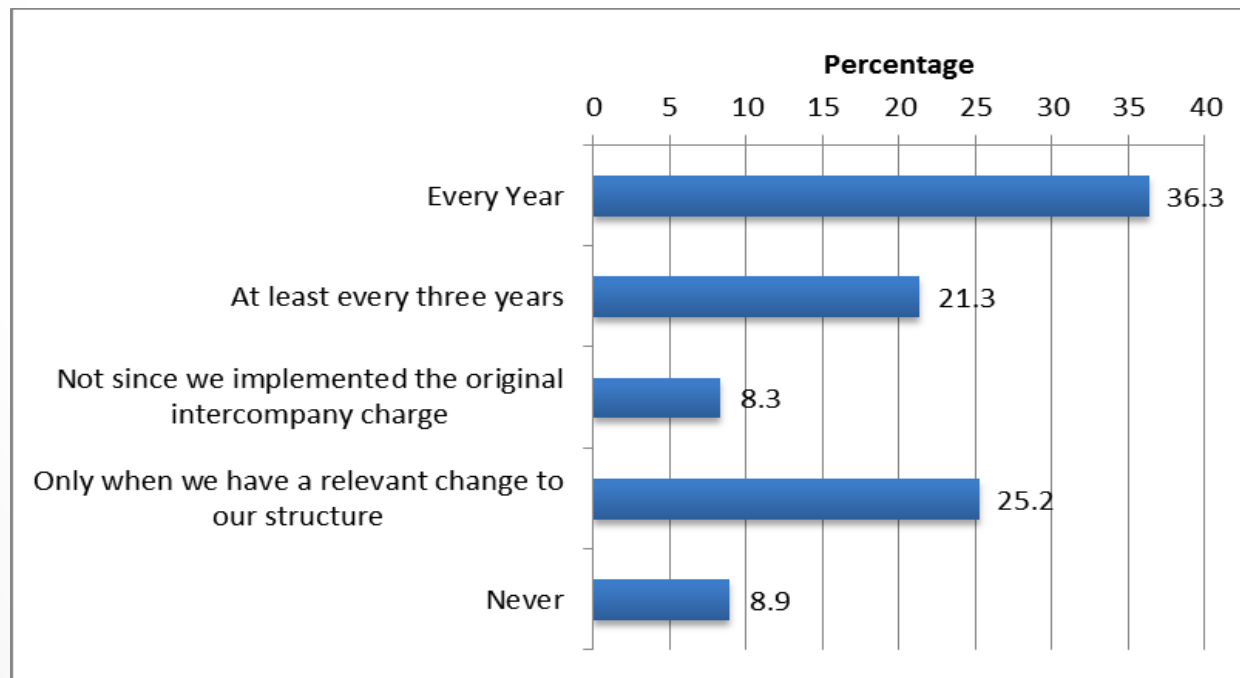
Are Intercompany Transactions an Issue for Business?

On a major accounting firm's web seminar within the last year, the following polling question was asked of nearly 3,000 participants, "Is your enterprise involved in significant intercompany transactions?"



Are Intercompany Prices Up-to-Date?

On another major accounting firm's web seminar within the last year, the following polling question was asked of roughly 2,000 participants, "Where your company has domestic intercompany transactions, how often do you review and update the intercompany prices?"



A Multistate Solution

The Multistate Tax Commission's *Arm's-Length
Adjustment Service (ALAS)*

ALAS Project — Introduction

- Design Process
 - Open and transparent
 - State of the art knowledge from states and experts
 - Executive management perspective: fitting pieces together
- Service readily cost justified
- Long-term resource for several contexts & states
- Key step — response of states

ALAS Project — Background

- The director of the New Jersey Division of Taxation approached the MTC about setting up a program for a group of states to deal with transfer pricing issues; later invited to discuss the idea at the with the MTC Executive Committee in May 2013
- States recognized that there are significant issues related to transfer pricing at the state level
- Most states lack the expertise, resources, and flexibility to staff such a function themselves

ALAS Project — Design Phase

- In December 2013, the Executive Committee authorizes MTC executive director to explore interest among states, and if enough states interested, begin a design project
 - Project facilitator for a one-year design project hired in March 2014
 - Advisory Group of states supporting the design project formed by May 2014
 - Participating states were Alabama, D.C., Florida, Georgia, Hawaii, Iowa, Kentucky, New Jersey, and North Carolina

ALAS Project — Proposal

- Interrelated service elements, all mutually supportive —
 - Training
 - Analysis of Transfer Pricing Studies
 - State Capacity Building—Beyond Training
 - Optional Joint Audits (through Joint Audit Program)
- Additional service elements —
 - Early voluntary disclosure program
 - “Advanced Pricing Agreements” through existing ADR process

ALAS Project — Current Status

- MTC sent invitation letter to 47 states and D.C. to identify charter members of program
- Six states have indicated interest —

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| Alabama | New Jersey |
| Iowa | North Carolina |
| Kentucky | Pennsylvania |
- Program design approved by MTC Executive Committee on May 7, 2015
- Currently an insufficient number of states to launch program

ALAS Project — Next Steps

- MTC will continue recruiting states to the program
- Program agreements and contracts with participating states finalized
- Sufficient number of states triggers staff recruiting— a program manager initially, followed soon by an attorney and economist
- ALAS Committee formed by participating states
- Contracting process for outside economic services

ALAS — When Implemented

- Development and initial operation of the service will span four years, beginning upon implementation
- \$2 million annual budget
- Gradual roll out – audit adjustments are anticipated primarily in the third and fourth years

ALAS — Staffing

- The core staff will consist of a tax manager with expertise in audit processes, an attorney with related-party and transfer-pricing expertise, and a senior economist with transfer pricing experience
- Other staff will include an internal auditor to conduct non-economic audits of transfer pricing studies that do not require the skills of an economist, e.g., examine calculations, selection of comparable prices, and business purpose
- The design plan anticipates hiring additional in-house, transfer-pricing economists at the fifteenth and twenty-fourth months

ALAS — Voluntary Disclosure

- A one-time voluntary disclosure period is included in the program design in year two
- Taxpayers and states will be encouraged to use the Commission's existing alternative dispute resolution process to resolve issues consistently between a taxpayer and multiple states
- This ADR process also sufficient for working out advance agreements between a taxpayer and states when the program is mature enough to work through such issues

Questions

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