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LEGAL ALERT

May 13, 2013

MTC Explores Transfer Pricing Audits, Shelves Pass-Through Entity Project

On Thursday, May 9, the Multistate Tax Commission (MTC) hosted an Executive Committee (Committee) meeting in Washington, D.C. The Committee discussed many items ranging from election of new officers to Committee updates to the status of federal legislation affecting state taxation. The two most important and interesting topics related to the consideration of transfer pricing audits and to the shelving of the MTC's "pass-through" project.

Transfer Pricing Audits

The most surprising issue debated by the Committee was the possibility of building an infrastructure to facilitate Internal Revenue Code § 482-style (transfer pricing) audits. A number of states have experimented with using third-party transfer pricing auditors in recent years, but no state has amassed internal staff with significant transfer pricing audit experience. A representative from the New Jersey Division of Taxation advocated for the use of transfer pricing techniques for use in the MTC's Audit Program. Some intercompany transactions are outside of the scope of New Jersey's addback statute, and New Jersey volunteered that it lacks the internal expertise needed to conduct extensive transfer pricing audits.

New Jersey asked the Committee to consider amassing specialized transfer pricing auditors that could be shared by participating MTC states. Utah, which is a combined reporting state that participates in MTC audits, questioned the value of a transfer pricing team in the audit in which they participate. The Committee ultimately voted to develop a proposal outlining the costs of creating a specialized transfer pricing team and to survey members of their Audit Program regarding their interest in this issue.

Pass-Through Project Shelved

The other significant development at the meeting was the effective termination of a long-running, and controversial, MTC project. The MTC's draft pass-through entity model statute, which began as a project in 2008, would impose income tax on pass-through entities (e.g., partnerships) that are owned by an entity that is not subject to corporate income tax. Practically speaking, the model targeted insurance companies (which are subject to premiums taxes rather than income taxes in many states), but could also affect other taxpayers that are subject to separate taxing regimes, such as financial institutions and telecommunications companies.

During the MTC's consideration of this project, the insurance industry and insurance regulators questioned the policy basis for the proposed model law. The insurance industry argued that insurance companies already pay higher effective tax rates in most states through premiums taxes and other special taxing regimes. Opponents argued that if states were legitimately concerned about some sort of abuse or inequity, states have a myriad of other regulatory powers to counteract such abuses. Others testifying focused on the MTC's entire uniformity process, suggesting that the MTC's goals could be better accomplished if the MTC did not allow itself to enter into large-scale, long-term legislative projects at the behest of a single state revenue department (i.e., Massachusetts). Ultimately, members of the Committee voted to write a whitepaper memorializing the work that has gone into the project. The whitepaper will not be adopted as an official policy of the MTC, which means that the project has essentially ended.

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Overall, the Executive Committee meeting was quite interesting. The shelving of the pass-through entity project through drafting a whitepaper showed that the Committee continues to listen both to its member states and to industry representatives when considering tax proposals. Further, the fact that the MTC may engage in transfer pricing audits could result in a significant increase in such audit activity by the states. Sutherland will continue to monitor these, and any other developments, from the MTC.

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