Advanced Notice – COVID-Related Revenue Losses Further Incentivize States to Roll Out New Transfer Pricing Initiatives Through APAs, Amnesties and Audits

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Given the projected loss in tax revenue in 2020, and beyond, due to the COVID-19 pandemic, states are looking for ways to stop the bleeding, including through typical methods (e.g., raising tobacco, fuel and other excise taxes) and newer sources (e.g., marketplace facilitator laws, Wayfair-related nexus opportunities, increased taxation of digital goods and services, etc.). But it appears another source, something that was in the works well before the pandemic, has quickly risen to the top of the list – increased corporate income tax audits and enforcement through enhanced attacking of intercompany transactions and transfer pricing.

Certain states are starting to aggressively roll-out transfer pricing programs, with many states likely to follow suit after a recent report from the National Association of State Budget Officers ("NASBO") confirms that state revenues for fiscal year 2020 have declined for the first time since the Great Recession "with the worst still to come."[1] This article takes a look at states' past and present efforts to increase corporate tax revenue, an already declining number for years, through increased transfer pricing audits and enforcement, and a look at the new tactics states are using to carry this initiative out even sooner than expected due to the pandemic.

Fair Warning – States Have Looked to Transfer Pricing Before with Mixed Results

As a quick refresher for those unfamiliar with transfer pricing/intercompany transaction issues, "transfer pricing" refers to the pricing of transactions between controlled entities. Corporate taxpayers have long-engaged in transactions with related entities

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to provide various needed business services and functions (e.g., holding and protection of intellectual property, intercompany loans/financing, procurement services, and centralized management and administrative services) rather than through third-party entities as there are several corporate, financial and tax benefits to doing so. Over the past several years, however, states have examined corporate transfer pricing practices more frequently and with greater scrutiny than ever before, to determine if such transactions are being performed at below fair market rates/prices (i.e., not at "arm's length") and/or lack economic substance as a means to shift income away from a state.

Transfer pricing issues have been a major focus for the Internal Revenue Service for decades, but now states are taking front stage on the topic. And although many states, such as my home state of Kentucky, have recently moved to combined reporting/mandatory unitary structures thereby eliminating intercompany transactions between members of a combined reporting group, several past year liabilities are still open to attack under applicable statute of limitations in these states (where audits and administrative protests are ongoing), and approximately seventeen separate-entity reporting states still remain (primarily in the southeast) – likely to be ground zero for future transfer pricing disputes.

States have used a variety of approaches to challenge the validity and pricing of intercompany transactions, including relying on its interpretation of current laws which adopt or contain language similar to Section 482 of the Internal Revenue Code ("Section 482"), and related Treasury regulations, regarding the arm's length nature of such transactions, as well as using discretionary powers to adjust income, require combined reporting, statutory related-party expense disallowances and addbacks, application of alternative apportionment rules, enforcing affiliate nexus principles, and applying the economic substance/sham transaction doctrine.

These approaches have led to mixed results for states, and some major losses in court, including the most recent 2018 decision from the Utah Supreme Court in See's Candies in which the Court strongly rejected the Department's disregarding of the state's transfer pricing statute and its position that it has broad

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discretionary authority to adjust the taxpayer's income even if such transactions are arm's length in nature.[2] Prior to that case was a pair of decisions from the Indiana Tax Court in which the Court likewise rejected the state's attempt to unilaterally adjust the involved taxpayers' Indiana income bases and instead relied upon the taxpayers' transfer pricing studies to demonstrate the arm's length nature and economic substance of the transactions after Indiana did not provide any competing study or report.[3] While these are the most prominent taxpayer victories on transfer pricing over the past few years, other recent decisions, including a few in New Jersey, likewise show the importance of a taxpayer's transfer pricing study and/or the state's lack of a competing study in determining whether such transactions are "arm's length" and thus excepted from a state's addback or other adjustments statutes.[4]

State courts' deference to corporate taxpayer's transfer pricing studies has become a common problem for many states that do not have the experience, expertise or resources in transfer pricing through its traditional audit forces. So much so that states, with the help of the Multistate Tax Commission's plan in 2015 (the same year as the Indiana cases) and subsequent creation of a transfer pricing committee in 2016, began combining resources and intel to determine how best to challenge the rising transfer pricing issues nationwide.[5]

States have been made painfully aware of the perceived significant amount of revenue left on the table related to intercompany transactions by the MTC, as well as at government-focused conferences like the Southeastern Association of Tax Administrators ("SEATA"), which tout the need for external experts to help states and potentially double or triple corporate income tax collections.[6] Accordingly, states across the nation have dedicated significant resources to transfer pricing issues and hiring these outside consultants to aggressively go after this revenue, and/or train its audit teams to do so, with Indiana being among the leaders in this area.

Try, Try Again – States Team Up, Roll Out Plans for the Next Wave of Enforcement

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In response to the above-discussed losses in RAC East and Columbia Sportswear, the Indiana DOR has been increasing its experience and expertise in transfer pricing to better combat taxpayer's third-party transfer pricing studies over the past few years, and recently rolled-out a comprehensive transfer pricing initiative that includes not only contracting with an external economist and transfer pricing service (RoyaltyStat LLC), but also the use of advanced pricing agreements ("APAs") – a tactic long-used by the IRS and seldomly by states – to help resolve these disputes on a going-forward basis. This public announcement came via its recent annual report.[7] However, IDOR previously made the Indiana tax community aware of the initiative through informal presentations with local tax practitioners in late 2019.

While Indiana is far from the first state to contract with external resources to help on transfer pricing issues as several states have reportedly already done so with RoyaltyStat or another outside consultant/firm, including Alabama, Connecticut, Georgia, Louisiana, Massachusetts, Mississippi, North Carolina, and Rhode Island, its initiative appears to go much further as it includes: (i) increased training for its audit forces, (ii) developing subject matter experts (SMEs) on the topic assigned to each audit, (iii) working closely with a "collaborative group of 13 states to share information regarding transfer pricing" to ensure it uses most up-to-date techniques, processes and sharing of information about cases (discussed further, *infra*).; and (iv) the use of APAs.

IDOR acknowledged in its 2019 presentation that after its loss in RAC East, rather than using forced combination when it believed that intercompany transactions distorted Indiana source income, it now must analyze whether a taxpayer's transfer pricing study complies with Section 482 regulations, and challenge the study's methodology, comparables, and profit level indicators. Therefore, even if a taxpayer has been diligent in obtaining a transfer pricing study (or studies) to set its rates/pricings, it should expect a fight on its hands with IDOR and other state taxing agencies looking to do the same thing.

A major component of IDOR's transfer pricing initiative is the use of APAs to resolve transfer pricing disputes to cover two audit periods

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– or six years. Although IDOR has informally offered to use APAs to settle corporate income tax disputes in the past, Indiana appears to be the first state to publicly announce a formal APA program for transfer pricing disputes, which many other states will be watching closely. While IDOR's APA program is based off the IRS' APA program, it will be different in many aspects. And although an APA can provide certainty to a taxpayer for multiple years, there will also be several subtle, though important, differences between a formal APA and standard settlement agreement/resolution. Taxpayers should work closely with a local tax practitioner to evaluate the pros and cons of both options.

Another recent, and unique, approach to deal with transfer pricing can be found in North Carolina which just rolled-out an amnesty-style program for taxpayers to expedite resolution of potential intercompany transaction-related tax liabilities. In July, North Carolina announced the program that is available to any taxpayer currently under audit, notified of an upcoming audit, or that wants to voluntarily request such program (but *not* anonymously) if it has concerns of potential back liability for such issues.[8] The primary benefit of this program is to resolve same in an extremely expedited manner (by year-end 2020), and a waiver of penalties for any agreed-upon issues. North Carolina's program, however, is only for a limited time as it requires taxpayers to agree in writing to participate in the program by September 15, 2020 and provide all required transfer pricing, tax and financial information and documentation by October 16, 2020.[9] If a taxpayer timely met these deadlines, then NCDOR will review all information, quickly respond with a settlement offer that the taxpayer must accept (or quickly propose and agree to a counteroffer) within 15 days, with the goal of concluding the program by December 1, 2020.

So, although North Carolina's program is no longer available to taxpayers that haven't already opted in, other states may soon offer similar programs depending upon its success in North Carolina. Also note that NCDOR hired RoyaltyStat as an outside consultant, so if a taxpayer opted into the program but ultimately does not resolve it and gets kicked back to the normal audit process, or a taxpayer is audited in normal course, the state now has more resources to scrutinize a taxpayer's transfer pricing/intercompany

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transactions.

Rather than using these full-scale, or limited time, initiatives like Indiana and North Carolina, some states have decided to just move forward with litigation by challenging the taxpayer's transfer pricing studies and methodologies under Section 482 through its own experts. The question then becomes, if both sides have a reputable expert touting their respective party's positions and view of what rates, fees and activities are arm's length and fairly reflect the taxpayer's income base, which party gets the benefit of the doubt – the taxpayer (under the general rule that tax imposition statutes are strictly construed against the government, or because taxing agencies often have the burden for adjustments made using alternative apportionment[10]), or the state (under general administrative agency deference principles)?

The jury is still out on this question as taxpayers, and states, patiently wait to see which way the scales move, including in states with active litigation still at the administrative (non-public) levels[11], but some states may not have the ability to wait as their fiscal forecasts are expected to only get worse. There is also concern that some states may view the recent federal court decision in Altera Corp. v. Comm'r[12] as another reason to become more aggressive in scrutinizing intercompany transactions. Because of all of these factors, things are likely to move very fast on these fronts.

Ready or Not – COVID-19 Revenue Losses Will Force States to Move Forward

It has been approximately two years since the last major case (and loss for states) in the ongoing fight over intercompany transactions in See's Candies, with many states waiting to see how successful states like Indiana and North Carolina are with their aggressive initiatives, before they decide to either quickly resolve their transfer pricing disputes to get a little revenue and move on, or move forward with litigation again, this time with more firepower through third-party consultants. Nevertheless, because multiple states continue to meet monthly to share information and discuss audit strategies related to transfer pricing, these issues will be ramping up in the near future – especially as states try to mitigate loss of

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revenue from COVID in 2020, and future years.

For example, NASBO's recent report not only shows that despite strong revenue growth through March 2020, states reported a 6-percent (6%) revenue shortfall for fiscal year 2020 due to the pandemic, but also that "this initial decline is only the beginning of what is projected to be a multi-year revenue challenge."[13] In support of the latter point, NASBO's report looked to the 2008 Great Recession for comparison as it took a decade for state general fund revenues to recover and return to fiscal 2008 numbers in that scenario.

The NASBO report paints a very grim picture as, based on surveys of states, these revenue shortfalls include: (i) a 9.5% decline in corporate income tax revenue (was projected to be a 1% increase), (ii) a 3.7% decline in personal income tax revenue (was projected to be a 2.7% increase), (iii) a 17.5% decline in gaming-related/excise tax revenue, and (iv) a 0.5% decline in sales tax collections (a smaller decrease due to increased online transactions during the pandemic and most states having economic nexus and/or marketplace facilitator laws in place, but it is still a large overall decline as states estimated a 5% increase in fiscal year 2020 and reported a 10% drop for the fourth quarter of fiscal year 2020 alone).[14]

Now, it is possible that given the unprecedented nature of the pandemic-caused economic downturn, and the increase in online/global sales compared to the economy back in 2008, it may not take states quite as long to recover this time around. The NASBO's report, however, notes that 2021 and future years could be worse for state revenues as the reported fiscal year 2020 numbers only account for essentially one quarter of COVID-19, federal stimulus measures likely artificially propped the economic up (and softening the blow for state revenues), and that state tax collections traditionally lagging behind an economic downturn.

Regardless of whether its two years or ten years, states will have to find ways to mitigate these shortfalls – and all indications are that transfer pricing is a primary candidate to do so. And with most state (and local) governments hurting from this economic hit, their respective taxing agencies will have no choice but to fight to secure the needed revenue through litigation. They have no other choice.

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So, while the nation hopes for light at the end of the tunnel with the pandemic, the desperate fight over precious corporate income taxes by focusing on transfer pricing is only just beginning.

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[1] *See* Shelby Kerns, "State Revenues Decline for First Time Since the Great Recession, With the Worst Still to Come," NASBO (Sept. 8, 2020), *available at* https://community.nasbo.org/budgetblogs/blogs/shelby-kerns1/2020/09/08/state-revenues-decline-for-first-time-since-the-gr#:~:text=0%20Recommend-,State%20Revenues%20Decline%20for%20First%20Time%20Since%20the%20G

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[2] Utah State Tax Comm'n v. See's Candies, Inc., 435 P.3d 147 (Utah 2018).

[3] *See* RAC East v. Ind. Dep't of State Revenue, 42 N.E.3d 1043 (Ind. T.C. 2015); Columbia Sportswear USA Corp. v. Ind. Dep't of State Revenue, 45 N.E.3d 888, 898 (Ind. Tax Ct. 2015) transfer denied, 50 N.E.3d 147 (Ind. 2016)

[4] *See e.g.*, BMC Software, Inc. v. Dir., Div. of Taxation, 30 N.J.Tax 92, 121 (N.J. Tax Ct. 2017); Lorillard Tobacco Co. v. Dir., Div. of Taxation, 31 N.J.Tax 153, 172 (N.J. Tax Ct. 2019).

[5] Originally known as the Arm's Length Adjustment Services (ALAS) Committee, and later renamed as the State Intercompany Transaction Advisory Services Committee (SITAS). More information can be found on the MTC's SITAS website, available at http://www.mtc.gov/The-Commission/Committees/SITAS.

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[6] For example, Ednaldo Slva of RoyaltyStat, Holly Coon, Director of the MTC's Joint Audit Program, and Richard Gilbert, Director of the North Carolina Department of Revenue Examination Division, gave a joint presentation on July 15, 2019 at the 2019 SEATA conference in Orlando, Florida, entitled "Transfer Pricing Impact on State Corporate Income Tax" which discussed, among other things, the benefits of states working together and sharing information, increased audits and training, increased corporate tax revenue as a result of these efforts, etc. (available at https://www.seatastates.org/uploads/1/1/8/5/118569104/transfer_pricing_-_coon_silva_and_gilbert.pdf).

[7] *See* FY 2019 Indiana Annual Report at 46, available at https://www.in.gov/dor/files/2019-annual-report.pdf.

[8] *See* North Carolina Department of Revenue, "Important Notice: North Carolina Announces Voluntary Corporate Transfer Pricing Resolution Initiative" (Jul 30, 2020), available at https://files.nc.gov/ncdor/documents/files/Important-Notice-Transfer-Pricing-Resolution-Initiative.pdf.

[9] North Carolina Department of Revenue, "Transfer Pricing Resolution Initiative Frequently Asked Questions" (Sept. 2020), available at https://files.nc.gov/ncdor/documents/files/TPRI-FAQs.pdf.

[10] *See e.g.*, Rent-A-Center West Inc. v. S.C. Dept. of Revenue, 792 S.E2d 260 (S.C. 2016); Equifax,. Inc. v. Miss. Dep't of Revenue, 125 So.3d 36 (Miss 2013); Microsoft v. Franchise Tax Bd., 139 P.3d 1169 (Cal. 2006).

[11] *See e.g.*, Trader Joe's East, Inc. v. Riley, Nos. IT-1735257 & IT-1735253 (Ga. Tax Trib.).

[12] 926 F.3d 1061 (9th Cir. Jun. 7, 2019), cert. denied No. 19-1009 (U.S. Jun. 22, 2020) (upholding the U.S. Department of Treasury's transfer pricing regulation requiring related participants in cost-sharing agreements to include stock-based compensation costs in order to meet Section 482's arm's length standard).

[13] *See supra,* n. 1. Note the NASBO report only included states operating on a July to June fiscal year, and thus would experience

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similar COVID-19 impacts on revenue, and therefore did not include states with different fiscal years, including New York (fiscal year starts April 1), Texas (starts September 1), Alabama and Michigan (starts October 1) and New Jersey (only for fiscal year 2021, starts October 1).

[14] Id.

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