Beware States Offering Unilateral Advance Pricing Agreements for Transfer Pricing

A Practical Guidance® Article by Adam P. Beckerink, Thomas V. Linguanti, Matthew S. Mock, and C. Terrell Ussing, Morgan Lewis LLP

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As state revenue agencies train their auditors in traditional I.R.C. § 482 transfer-pricing methodologies or outsource transfer-pricing audits to third-party specialists, a recent initiative by the Indiana Department of Revenue follows another, alternative federal transfer-pricing compliance tool: advance pricing agreements (APAs).

There are numerous fact-and-circumstance-specific factors for taxpayers to consider when determining whether the benefits of applying for an APA outweigh the risks, but the primary benefit of an APA is "certainty" with respect to an intercompany transaction. That benefit appears illusory in the case of new state APA programs, however, unless or until other states agree to the results in a bilateral and multilateral manner.

State Investment in Transfer Pricing Compliance Expands Advance Pricing Agreements

As highlighted in our previous LawFlash, many states are focusing their tax enforcement efforts on transfer-pricing issues to increase their tax bases, and the growing state budget shortfalls resulting from the coronavirus (COVID-19) pandemic have only intensified states' focus on intercompany transactions. Also see "States Grappling With Hit to Tax Collections" (Aug. 12, 2020) (showing that most state budget shortfalls will reach 10% in FY 2020 (ending June 30, 2020) and over 20% in FY 2021 (ending June 30, 2021)). This material was created by the Center on Budget and Policy Priorities (www.cbpp.org).

The Indiana Department of Revenue (IDOR) has been a leader in this regard. In FY 2019, Indiana expanded its newly constituted transfer pricing team within its Audit Operations, continued working "with a collaborative

group of 13 states to share information regarding transfer pricing" and acquired the services of an expert economist. According to the IDOR, the "team's work is paying off," and it now is looking to expand its ability to collect additional transfer-pricing-related income through a new APA program. FY 2019 Indiana Annual Report at 46; Indiana Department of Revenue Tax Resource Advisory Council (TRAC) Committee Presentation, "Transfer Pricing" (Dec. 4, 2019), slide 14. Also, while not addressing future years like an APA but the past, the North Carolina Department of Revenue (NCDOR) appears to be following a similar, voluntary-disclosure path as the IDOR. On July 30, 2020, NCDOR announced a "Voluntary Corporate Transfer Pricing Resolution Initiative" that allows taxpayers to participate in an expedited review of their prior related-party transactions to "provide certainty and uniformity to taxpayers, reduce time in disputes, and form an efficient basis for resolution…for all open tax years." See North Carolina Department of Revenue, "Important Notice: North Carolina Announced Voluntary Corporate Transfer Pricing Resolution Initiative" (July 30, 2020).

Advance Pricing Agreements

APAs have been part of federal and international transfer-pricing regimes since the early-to-mid 1990s, but the IDOR's plan appears to be the first formal program offered at the state level. An "Advance Pricing Agreement" (APA) is defined in the IRS "APA Study Guide" as "an agreement between the Service and a taxpayer on transfer pricing methods to allocate income between related parties under Internal Revenue Code (IRC) section 482 and the associated regulations." Rev. Proc. 2015-41, 2015-2 C.B. 263 (2015 IRB LEXIS 440); New Jersey TAM 2012-1. The term is used for agreements with state and local governments, as well as non-U.S. governments, as well.

APAs can be unilateral (with one government) or, where tax treaties exist, bilateral or multilateral (between or among two or more governments and the relevant related parties within each country). Generally, taxpayers must apply with the relevant governments for an APA (which requires significant upfront fact and economic disclosures) in the hope that the governments accept the APA application. Even when the governments accept the application, there is no assurance that the governments and taxpayer will reach a final agreement.

From the taxpayer's perspective, the primary benefits of an APA are certainty of their future transfer-pricing results (which may also include a rollback to prior years), the avoidance of protracted audits and controversy, and the avoidance of double tax (in the bilateral/multilateral context). For its part, the IDOR states expressly that the removal of uncertainty is the benefit of its APA program. Indiana Department of Revenue TRAC Committee Presentation, "Transfer Pricing" (Dec. 4, 2019), slide 14. Taxpayers must carefully weigh this benefit (and others) against potential and perhaps significant risks, such as, for example, voluntarily disclosing facts and economic opinions to the IDOR that may be shared with other states besides Indiana. The facts-and-circumstances analysis of the numerous pros and cons of applying for an APA in any particular case is beyond the scope of this article.

Little is known about how the IDOR plans to implement its APA program, but one significant issue is obvious: Indiana's program will provide for *unilateral* APAs only. See Indiana Department of Revenue TRAC Committee Presentation, "Transfer Pricing" (Dec. 4, 2019), slide 14 (stating that "DOR and the Taxpayer will agree to the pricing methods and comparables used on a 'going forward' basis," which will typically be good for two audit cycles (six years)). Due to the robust international tax treaty network, taxpayers often have the option of applying for bilateral or multilateral APAs for their international transactions, which is necessary to lock in real "certainty" with respect to the intercompany transactions in each relevant geography (both sides of the transaction) and avoid double tax. At the federal level, bilateral or multilateral APA applications compose the vast majority of all APA applications. See IRS, Announcement and Report Concerning Advance Pricing Agreements 2019-03 (showing that over 80% of all US APA applications filed in 2018 were bilateral or multilateral).

In contrast, no such bilateral or multilateral option exists at the state level. Without assurances that other states (which are also looking to expand their own tax bases through transfer-pricing adjustments) will respect the transfer-pricing results agreed to between a taxpayer and Indiana, taxpayers will not have certainty that the results of their intercompany transactions will not be subject to audit, adjustment, and double tax by other states. NCDOR's "Voluntary Corporate Transfer Pricing Resolution Initiative" is subject to many of the same concerns.

The expansive information sharing between Indiana and other states exacerbates this problem, because the other states can now take advantage of the information provided by taxpayers to the IDOR in seeking an APA. No part of Indiana's APA program forecloses the state from sharing taxpayer provided information with other states. In short, by seeking an APA with Indiana, taxpayers may be compromising their positions with other states where they may or may not be under any sort of transfer-pricing audit. Unless states agree to respect the results of APAs entered into between taxpayers and other states, it appears that

few taxpayers will be interested in applying for APAs under Indiana's APA program. Indeed, doing so could cause more state transfer-pricing controversy and uncertainty, not less.

Takeaways

As expected, state revenue agencies are looking to transfer pricing as a means to generate more revenue to make up deficits, whether by looking to the past like North Carolina or to the future like Indiana. To its credit, Indiana has proposed an APA program that taxpayers often find to be a particularly effective way to obtain certainty with respect to their future transfer pricing. Until the results from a state APA or other voluntary disclosure lead to certainty in the other states for which the cross-border transactions relate, however, taxpayers should approach the opportunity with some trepidation and recognize that these programs could create more controversy and not less.

Related Content

Lexis Tax

- Practical Guide: U.S. Transfer Pricing § 21.01, "APA Basics"
- Practical Guide: U.S. Transfer Pricing § 28.01, "Introduction" (State Tax Transfer Pricing Issues)
- Bender's State Taxation: Principles and Practice § 7.01et seq.
- Federal Income, Gift and Estate Taxation § 11.03, "Intercompany Pricing"
- 44 USC Law School Institutes On Major Tax Planning P 502, "Transfer Pricing"
- 2016 NYU Institute On State & Local Taxation § 7.02, "Federal Transfer Pricing Concepts"
- Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 18.09
- Eaton Corp. & Subsidiaries v. Comm'r, T.C. Memo 2017-147 (2017)

Practical Guidance

- Transfer Pricing Tax Fundamentals
- Consolidated Return Fundamentals in C Corporations
- Combined Reporting State Law Survey
- The Growing Trend Of State Transfer Pricing Scrutiny
- Pros And Cons Of State Transfer Pricing Program Participation

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Matt provides guidance on the application of numerous state and local transfer taxes, in addition to issues created by the significant differences between state taxes and jurisdictional standards, as well as those presented by the United States and international tax regimes.

Outside of his practice, Matt regularly lectures on tax issues for various organizations, including the Tax Executives Institute and The Council on State Taxation.

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