LAW360 Tax Authority

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States' Transfer Pricing Push Raises Privacy Concerns

By **Maria Koklanaris**

Law360 (August 20, 2021, 2:52 PM EDT) -- States seeking to expand their efforts in transfer pricing are increasingly focused on methods that involve the exchange of taxpayer information between governments, raising concern among practitioners troubled by what they see as lax privacy controls.

The Multistate Tax Commission's headquarters in Washington, D.C. An MTC transfer pricing committee put forth an agreement last month that offers a structure for states to share taxpayer information.

Some of the move toward information sharing is taking place via the Multistate Tax Commission's recently revived committee to study transfer pricing methods. In July, the State Intercompany Transactions Advisory Service Committee, or SITAS Committee, put forth an information exchange agreement. The agreement offers a structure by which states that want to pursue transfer pricing can together use the same taxpayer information, which may be confidential. In addition to the information sharing agreement, the committee drafted a charter that requires participating states to sign the information agreement.

These proposed policies come from states' realization that finding the right price between related parties to avoid income shifting is a highly complex and labor-intensive process that individual states may struggle to undertake on their own. The SITAS Committee's charter said it will provide training and information sessions that "may involve confidential taxpayer information." It adds the committee will adhere to "an established exchange procedure," to verify that participants have the right to be present.

This raises some red flags, David Fruchtman, chair of the state and local tax practice at Steptoe & Johnson LLP, told Law360.

"I think the charter is very forgiving to themselves as far as any breach in taxpayer confidentiality," Fruchtman said. "I think they should be holding states to a much higher standard" to ensure privacy, he said.

The MTC document offers an array of specific information that would be shareable, with an emphasis on any material that could pertain to intercompany transactions. States could exchange information on proprietary taxpayer information, including information on intercompany pricing decisions, intellectual property values and profits, comparable industry profits and much more. Not shareable would be information coming directly from the Internal Revenue Service, unless the IRS authorizes it, or any disclosure that would violate federal or state law, the MTC said.

"I think taxpayer advocates of all types are going to be keeping a close eye on that," Fruchtman said. "They need to be sure they are not providing a forum for the improper sharing of taxpayer information."

Another concern is that some states, in addition to considering the exchange of information with each other, have contracted with third-party auditors to assist them in handling transfer pricing matters. That could potentially open up sensitive taxpayer information to people beyond state department of revenue employees, said Eric Tresh, state and local tax partner at Eversheds Sutherland.

In extensive comments to the MTC, Tresh said the agreement sets forth "a laundry list of information that could be shared," and third-party auditors, such as contractors with states rather than state employees, wouldn't be signatories.

By the law of individual states, "those third parties may not even be permitted to obtain information," Tresh told Law360. "A second concern is that they could warehouse information to use in subsequent audits of other taxpayers in other states."

Tresh said he is concerned about states exchanging information with each other unless it is specifically provided for in their individual laws.

Safeguards in the MTC agreement should be tightened to reflect those concerns, Tresh said in comments to Law360 and to the MTC.

The concern about information sharing comes as states **have heightened interest** in pursuing transfer pricing. Public litigation remains rare but behind the scenes, cases are becoming increasingly commonplace. One state where that is happening is South Carolina, which set the stage several years ago when it promulgated a policy document outlining its approach in using forced combination, or trying to require companies to file consolidated returns to achieve results in transfer pricing matters.

After publication of the document, South Carolina began audits asserting combination where it believed that was appropriate, Rick Reames, director of the state's department of revenue at the time, told Law360.

"Now we're seeing the results of that," said Reames, who is now a member at Nexsen Pruet LLC, a firm active in the transfer pricing space. "All these cases are now kind of bubbling up."

Meanwhile, at least two states have developed innovative programs that can be seen as another form of information sharing because they provide models for other states. Indiana has an advance transfer pricing agreement, whereby taxpayers **may voluntarily approach** the tax agency to negotiate an agreement to select the appropriate transfer pricing method. They may also negotiate to determine a comparable, or the price of a transaction between two unrelated companies, that will become a standard for determining the price of a transaction between related companies. Once Indiana reaches an agreement with a state, it can apply for six years or two audit cycles.

North Carolina drew attention this year when it announced the results of its first-in-the-nation voluntary disclosure agreement for transfer pricing disputes. Under the program, similar to a tax amnesty, taxpayers that entered into a voluntary disclosure agreement were rewarded with a penalty waiver. About 50 corporate taxpayers took advantage of the program, netting the state close to $100 million.

Despite that, the North Carolina Department of Revenue has no plans to repeat the performance. Former department spokesman Schorr Johnson told Law360 the state "engaged taxpayers for a specific period of time."

There is, however, a strong possibility that similar programs will appear elsewhere. Ednaldo Silva, a transfer pricing economist who helped draft the federal government's transfer pricing regulations and who is working with eight states to assist with transfer pricing, told Law360 he knows of at least three states discussing the implementation of a voluntary disclosure agreement similar to North Carolina's. He said all the states he is working with are paying attention to the programs in Indiana and North Carolina, noting that the voluntary disclosure agreement seems particularly attractive.

"First, it was administratively manageable; two, the state resolved several protracted audits. And three, the state was able to collect substantial tax revenue in a period of three months," Silva said. "So that initiative is very, very appealing."

States are discussing which documents to review, and the technical protocols for reviewing documents and coming to a settlement position, Silva said.

In another innovation that could be used by several states, two state transfer pricing experts, Bruce Fort, counsel for the MTC, and the late Andrew Eversole, who headed the transfer pricing program at the Indiana Department of Revenue, **suggested that** businesses and states could use transfer pricing studies for purposes beyond settling tax disputes over intercompany transactions. Those could include nexus determinations or justifying a lack of a unitary relationship between entities. The two spoke on a panel at the MTC's annual meeting in July.

In a follow-up conversation with Law360, Fort said this is a new approach states are beginning to take but noted he did not think it is yet prevalent.

"It's on the horizon, and I think it's starting to work its way into our audits," Fort said.

Practitioners realize states may try new approaches and will continue to seek to exchange information, Tresh told Law360, but the need for strict controls abides. He cautioned states against exchanging information in ways not provided for in statute.

"We appreciate that states can share information, but it has to be within the bounds of the law," Tresh said. "And not all state disclosure laws are the same."

--Additional reporting by Paul Williams. Editing by Tim Ruel and Roy LeBlanc.
