PKF O'CONNOR DAVIES ACCOUNTANTS AND ADVISORS

Tax Notes Newsletter

Transfer Pricing Considerations in the U.S. on a Federal and State Level

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Multinational enterprises (MNE) with operations in the U.S. typically engage in cross-border transactions between related parties and consider transfer pricing rules and regulations on a federal level in the U.S. and the country where the related party is located. MNEs must make sure that related-party transactions are in accordance with the arm's length standard. According to the IRS, the arm's length standard for a transaction between controlled taxpayers is met "if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances."

The Organization for Economic Cooperation and Development (OECD) and countries that follow the OECD guidelines are also using the arm's length standard with a slightly different definition. The pricing of goods, intangibles and services between related parties can be subject to an examination by tax authorities to determine whether the transaction was used to shift income and led to tax base erosion.

A transfer pricing initiative in New Jersey highlights the fact that taxpayers should not only think of transfer pricing on a federal/international level but also should consider transfer pricing related issues on a state level.

New Jersey Implementing Transfer Pricing Initiative

On June 15, 2022, the State of New Jersey opened a voluntary initiative to work with corporate taxpayers to expedite the resolution of corporate intercompany pricing issues. The program will continue through March 2, 2023 and has the following purposes:

- Fairly and consistently expedite the resolution of intercompany pricing issues subject to adjustment;
- Provide certainty and uniformity to taxpayers;
- Reduce time in disputes; and
- Form an efficient basis for resolution of this corporate tax issue for all open tax years.

The reason for intercompany pricing issues is that New Jersey corporate taxpayers may engage in transactions with members of an affiliated group (intercompany transactions) that have a negative impact on the net income allocated to the State of New Jersey. Intercompany transactions that lack economic substance or are not at fair market value can cause a taxpayer to inaccurately report net income attributable to New Jersey.

One of the main benefits for taxpayers to participate in the initiative is that New Jersey will potentially waive a portion or all penalties that are assessed. By participating in the initiative, New Jersey would also be willing to agree to a transfer pricing methodology or settlement for any unaudited open tax years.

The following taxpayers are eligible to participate in the initiative and must agree in writing by September 15, 2022 to participate:

- Taxpayers currently under audit;
- Taxpayers notified of an upcoming audit;
- Taxpayers with a case pending before the Conference and Appeals Branch; and
- Unidentified taxpayers with related-party intercompany pricing.

The initiative does not apply to matters in any stage of litigation.

Transfer Pricing Issues Overlooked on a State Level

The transfer pricing initiative in New Jersey sheds some light on a topic that is often overlooked by entities under common control engaging in related-party transactions within the U.S. that cross state borders. Although not a frequent topic of discussion, there can be significant incentive to manipulate transfer pricing on a state level. States have different corporate income tax rates, ranging from 2.5 per cent in North Carolina to 11.5 per cent in New Jersey and taxpayers might be looking for ways to shift income to lower-tax jurisdictions. Another reason for shifting income can be to utilize net operating losses that have been generated in a state.

The means by which income can be shifted between states are as follows:

- Pricing of goods, intangibles and services exchanged between two entities under common control and
- Allocation of income and expenses between commonly controlled entities.

The Multistate Tax Commission has implemented a State Intercompany Transactions Advisory Service Committee that supports states seeking to address tax base erosion of income-based taxes due to inter-company transactions. The Committee has issued an Information Sharing Agreement and, as of February 2, 2022, five states have signed on to the agreement (Alabama, Louisiana, Mississippi, New Jersey and Washington). Taxpayers should expect that more states will sign the agreement and will start sharing information.

Adjustments on the state level might lead to double taxation as there is currently no competent authority mechanism between states. In general, U.S. tax treaties include provisions related to competent authority procedures to avoid double taxation for taxpayers, but U.S. tax treaties are only applicable on a federal level.

It has to be noted that the inter-state transfer pricing issue does not exist if the entities are members of a controlled group that has to submit a combined or consolidated state tax return in both states as intercompany transactions would have to be eliminated when preparing the group financial statements.

Conclusion

Taxpayers should review inter-state related party transactions and whether the transactions comply with the arm's length standard. The review should start with analyzing transactions and whether agreements between related parties are in place. Many states have adopted federal rules and regulations determining a proper transfer pricing methodology or have implemented similar provisions. Taxpayers should check whether they comply with these rules. Taxpayers should expect that more states will sign on to the MTC Information Sharing Agreement and will increase efforts to identify and analyze related party transactions on an inter-state level.

Contact Us

PKF O'Connor Davies can help taxpayers to identify transfer pricing issues on a federal and state level and provide transfer pricing and other international tax-related services. If you would like to know more about this topic or have questions, please contact your PKF O'Connor Davies client engagement partner or:

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