



# TAX EXECUTIVES INSTITUTE, INC.

## MEMORANDUM

To: Ms. Robynn Wilson  
Chair, Multistate Tax Commission Income and Franchise Tax Uniformity Subcommittee

From: Daniel B. De Jong, Tax Counsel, Tax Executives Institute, Inc.

Cc: Shirley Sicilian, General Counsel, Multistate Tax Commission  
Bruce Fort, Counsel, Multistate Tax Commission

Re: Possible Uniformity Project: Regulation Regarding Use of Formulary Apportionment Principles in Applying State “IRC Section 482” Authority to Adjust Income and Expenses of Related Parties to Clearly Reflect Income

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Tax Executives Institute (TEI) would like to express its opposition to the Income Tax Uniformity Subcommittee’s proposed project to draft a model regulation regarding state application of IRC Section 482. We will provide a more formal letter explaining our reasons for opposing the project after the Subcommittee’s meeting on March 5 (if necessary), but summarize our concerns here to ensure they are received in time for that meeting. Those concerns are:

- **The project would result in less uniformity.** Reliance on the arm’s length principle follows the approach used by the Internal Revenue Service (and tax administrations of other nations). This approach provides uniformity, as nearly all states begin their calculation of state taxable income with federal taxable income. The proposed project would replace this uniform standard with an undefined menu of options that would not be universally adopted or implemented.
- **The proposed project would result in a less efficient tax system.** For transactions between domestic corporations and their foreign affiliates, states can leverage the expertise of the transfer pricing experts at the IRS, creating efficiencies for both state departments of revenue and taxpayers. Those transactions are already subject to audit by the IRS, and taxpayers must report IRS audit adjustments to the states where they file corporate income tax returns. Thus, states do not need to devote already scarce resources to auditing these transactions, since well-trained IRS professionals review them under the current system. Recently, the IRS reorganized and added significant resources to its transfer pricing operations to become more effective and efficient in auditing Section 482 (for details from the IRS website, see <http://www.irs.gov/Businesses/APA-and-Mutual-Agreement-Program-Realignment>).
- **Established rules already address transactions between related parties.** Approximately half the states have adopted combined reporting, and intercompany transactions between corporations included in those combined reports are

eliminated in the computation of state taxable income. Thus, a model regulation addressing intercompany transactions would be of no use in those states (other than with respect to transactions with foreign affiliates, which are addressed above). The other states that require separate company reporting have almost uniformly adopted statutes designed to combat intercompany transactions perceived to be abusive, denying deductions for royalties and interest paid to related parties unless certain conditions are met (commonly referred to as “add-back statutes”). TEI questions the dedication of scarce MTC resources to a project that is applicable to a limited number of states and targets related party transactions which are addressed through statutory add-back statutes.

- **The project would derogate policy decisions made by state legislatures.** State legislatures in approximately half the states have made a policy decision to require separate company reporting. That approach respects the separate legal existence of related corporations. The options suggested in MTC staff memoranda as alternatives to the arm’s length standard would selectively combine certain related corporations into a single return or disregard transactions between related corporations. Where states have employed the latter approach (*e.g.*, through add-back statutes discussed above), they have done so legislatively. The type of major policy shift contemplated by the proposed project should not be made by an administrative change such as a regulation, but, instead, should be made through the legislative process.

Please let me know if you have any questions regarding the points made in this memorandum. My contact information is provided below.

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