

## Memorandum

To: MTC Arm's-Length Adjustment Service Advisory Group

From: Dan Bucks, Project Facilitator

Date: June 23, 2014

Re: Reports for June 25, 2014 Teleconference Meeting

This memorandum covers three agenda items scheduled for discussion at the June 25, 2014 teleconference meeting including:

- A progress report on joint economics expertise,
- A progress report on information exchange/management, and
- Preliminary options for joint auditing.

This is a "work in progress" type of memorandum intended as an aid to discussion. It will be supplemented by verbal reports at the meeting. This memorandum is not a thorough issue paper intended to support advisory group decision-making. It is intended to secure feedback from the advisory group on the direction of work leading up to the July 28 meeting in Albuquerque.

### A. Joint Economics Expertise

I have conducted individual phone discussions with seven vendors interested in providing various types of transfer pricing services to the states. Four of these vendors have either previously provided or currently provide transfer-pricing services to state governments. The remaining three anticipate offering their services as a result of the MTC undertaking an arm's-length project.

*Note: If additional vendors wish to be involved in these discussions, they should contact Greg Matson, MTC Deputy Executive Director, notifying him of their interest. I will then follow up to schedule phone discussions with those vendors.*

I anticipate further communication with these vendors, as additional information is needed to be able to estimate costs associated with projected services. The states should understand, however, that exact costs would not be known until an actual procurement process is undertaken in the early stages of implementing the arm's length service.

There are a series of topics that arise as result of the discussions thus far. They are discussed below.

### *Topic # 1: Scope of Transfer-Pricing Services*

The discussion of joint economics expertise has focused on (1) training, (2) assistance with identifying transfer pricing problems and cases, (3) responding to taxpayer transfer pricing studies, and (4) expert witness support.

Five of the seven vendors would provide services that cover these areas and go even further by offering structured audit selection services, support for auditors during the audit process (e.g. help with information document requests and/or issue analysis during audits), and analysis and advice to support case resolution. A sixth vendor would similarly be prepared to support the entire tax administrative process, but would reserve the right to not appear as expert witnesses if they had a conflict with their private sector work.

The remaining vendor primarily provides transfer price study and expert witness services, but might be prepared to assist on some other parts of the audit process. This firm does not appear to offer training services.

In short, six of the vendors would be prepared to offer economic and statistical services ranging fully or nearly fully across the entire tax administrative process—starting with training state staff and ending with litigation support. In fact, a majority of these “comprehensive service” vendors would prefer to operate in that manner as opposed to providing only some of the services or breaking them out into optional elements. However, at least one of the most experienced firms that offers comprehensive services actively supports breaking out and providing services as separate components.

In terms of other variations, one firm can provide extensive database services to states for analytical purposes along with the other services. A few other firms referred to databases, but have not fully clarified the nature, use or availability of that data to the states. Some firms specialize in domestic, intercompany transaction issues. A few cover both domestic and international issues. One firm specializes in international issues and urges states to place their focus there.

Two of the firms discussed working in ways that supported “capacity building” in the states and the MTC over time. As opposed to simply continuously providing services to the states, they recognized the need and desirability of developing the ability of states and the MTC to handle transfer pricing increasingly on their own over time. While some specialized services and outside advice might be needed over the long-term, these two firms both foresaw and were prepared to support states and the MTC in assuming responsibility for a larger share of the transfer pricing activities as they gain greater experience.

As noted, several of the firms prefer to provide their services as an integrated package instead of breaking them out into separate or optional components. Their perspective appears to be based on the following reasoning, which I provide in some detail because states may find some of these points of interest:

- Addressing transfer pricing issues at various stages in tax administration requires and benefits from a combination of economic, statistical, accounting, auditing and legal expertise.
- Economic and statistical expertise adds value at any point in the process and that value is further enhanced if applied in collaboration with the expertise of auditors and others. Example cited:
  - Audit selection is improved if both economic and financial analyses are applied together in winnowing down the potential pool of candidates.
- Time and money is wasted and opportunities for effective results are lost if economists are not working with auditors and lawyers during the audit process. Examples cited:
  - If auditors do not gather the most economically relevant information in the audit process, the data needed by economists to effectively evaluate a taxpayer's transfer pricing study may not be available. Hence, it is argued, economists need to assist with audit planning and information document requests.
  - Legal staff needs to be prepared to take action to require document production if data relevant to a taxpayer's transfer pricing study is not produced. (An actual case was cited of a taxpayer's refusal to produce source data referenced in a transfer pricing study.)
- Effective training in the transfer-pricing field arises not simply from structured courses, but from "learning by doing" where veteran experts work with state staff in the compliance process.
- Several vendors cite the failure of the IRS to integrate effective economic analysis into the transfer-pricing compliance process as a reason why the IRS selects some unproductive audits and produces disappointing audit results.
- These vendors note the success of the private sector in using an integrated, multidisciplinary approach as a key factor in producing spectacular results in shifting income to avoid taxes. They argue that a multidisciplinary approach is necessary to correct this income shifting.

Nonetheless, most of these vendors are willing to break out their services separately, but prefer not to. A few, however, would be reluctant to do so.

There is a dissenting perspective among the "comprehensive service vendors." One firm that provides perhaps the most complete set of services does not consider it necessary or even advisable for states to receive "end to end" integrated services. In part, this reflects this firm's commitment to "capacity building" within the states and the MTC and deference to the need for states to manage the tax administrative process. Although this firm can provide "end to end" services, they are not convinced that that is the best course of action.

So states, if they can finance the costs, have access to a broad range of transfer-pricing services from expert firms with considerable depth of knowledge and experience. There are variations in how states may use such services—and sorting through those variations is likely productive in terms helping clarify state needs and how they might best be served.

*Topic # 2: Developing a Joint Resource and Using the Resource Jointly or Separately to Varying Degrees.*

If the vendors differed on some issues related to the scope of services to be provided, they generally agreed that the greatest cost-effectiveness would be achieved by providing shared services to states using those services jointly as much as possible. Nonetheless, there was a practical recognition that the shared resource would inevitably also be used separately by states, but they encouraged joint work as much as possible. Interestingly, one firm whose expertise extends from domestic through international issues is also involved in discussing shared services with a group of nations.

Most frequently, the firms would note that if the states audited the same firm jointly, they could provide one transfer pricing study for use by several states instead of separate studies for the same group of states conducting separate audits. The cost per state of the studies would decrease substantially.

Some of these vendors state that the prospect of shared services through the MTC prompted their increased interest in providing transfer-pricing services to the states. That is a positive development because this response is coming from transfer-pricing professionals with impressively strong credentials in the field.

*Topic # 3: Domestic Only, Domestic and International or International Only*

Most of the vendors are comfortable with either a domestic only or a domestic and international focus by the states. One vendor suggests that focusing on international issues is much more cost effective for states than any efforts related to domestic intercompany transactions. This vendor views federal consolidated income as a residual left over after the bulk of corporate income has been shifted to overseas tax havens.

One long-term consideration is that vendors that are comfortable with both the domestic and international transfer pricing areas can offer services to a broad mix of states over time. Water's edge combined reporting states face the same related party transaction issues beyond the scope of the combined report as do separate entity states.

*Topic # 4: Cost*

Absent a more specific design for services, it is not possible to begin to develop budget estimates. Vendors mention varying methods of charging for the services: hourly, fixed amounts per product (such as \$xx,xxx per transfer pricing study) or performance or success based pay. While some fixed service costs were

suggested, vendors most frequently provided hourly rates. Rates for senior experts generally from \$500 to \$650 per hour, although one vendor mentioned even higher rates. Less senior experts are billed at \$300 to \$500 an hour. Staff doing routine work, such as data calculations, are billed in the \$150 to \$250 an hour ranges.

### *Resolving Service Issues*

I can continue to communicate with potential vendors and translate guidance from the Advisory Group to them to generate additional details concerning potential services and business models for providing those services. This approach could be supplemented approach by direct communication between the experts in these firms and the Advisory Group. One potential means for this communication could be a training conference for states—scheduled perhaps in August or September—for in-depth presentations to the Advisory Group, MTC staff and other interested state personnel. Depending on the number of firms invited, the presentations might extend over the better portion of two days. (Additional states not currently in the project, but potentially interested in joining could also be invited to this conference.)

This option is suggested because there is a wealth of expertise and a depth of knowledge available through discussions with these firms that is simply not accessible otherwise. It might be highly beneficial for states to hear and discuss issues and ideas directly with the expert professionals leading these firms.

## **B. Information Management and Exchange**

I have not begun addressing information exchange issues directly, but will begin doing so shortly. That work will include, among other tasks, contacting members of the Advisory Group for information or referrals to other staff members on aspects of information exchange in their states.

The interviews with vendors have prompted some initial issues and thoughts concerning information management. One economist with prior experience with federal issues was surprised that a taxpayer refused to provide the source information specifically footnoted in a transfer pricing study. The economist sought the information to review the calculations underlying the study. This proved to serve as a prelude to discussions with other vendors of the importance of auditors requesting relevant information helpful to economic and statistical analysis as early as possible in the audit process. It also prompted ideas related to information that might be required on tax returns.

Several vendors are interested in training and working with auditors on information document requests related to transfer pricing issues. I would suggest that states might consider working together on common elements of a document request template that would serve as starting point for requests to taxpayers. Further, states may also want to consider adding some brief items to their tax returns concerning related party transactions. Questions related to whether or not a corporation engages in related party transactions and whether it has secured or

prepared a transfer pricing study to support those transactions are examples of simple questions that could be added to returns. Such information could be useful in the audit planning stage.

Working together on organized and consistent processes for gathering information can also be beneficial to corporate tax departments. Making requests early is generally more convenient for taxpayers than several separate requests over time. Follow-up requests cannot be avoided, but they would ideally not be mixed with requests that could have been anticipated and made earlier.

In many ways tax administration is, at its core, information management and analysis. This project provides states with the opportunity to look at transfer pricing compliance from the perspective of the flow of information needed to ensure proper results. The question is whether states wish to work together on consistent information gathering procedures that apply relevant expertise in an efficient manner and that may also offer time and convenience benefits to taxpayers.

### **C. Preliminary Options for Joint Audits**

As noted in the “Priorities for Issues and Work” document of June 9, 2014, I intend to prepare an issue paper on joint audit options for the July 28 Advisory Group Meeting. A short, preliminary discussion of options will occur at the June 25 teleconference to provide input into the drafting of that paper.

Joint auditing has developed to typically serve certain tax administrative goals with regard to multijurisdictional taxpayers. Some of those goals might be expressed as follows:

1. More effective and efficient tax compliance for a larger group of taxpayers than can be achieved through separate state audits.
2. Consistent treatment of taxpayers to the extent that state laws and regulations allow such consistency.
3. Acceleration and extension of the learning process for states of issues emerging from changes in taxpayer operations, accounting and tax reporting.

A few comments on how joint auditing works are in order. Joint auditing can be effective and efficient by (a) reducing total time spent on repetitive audit tasks, (b) discovering inconsistent filing positions by taxpayers, (c) concentrating specialized expertise to resolve complex audit issues, and (d) extending audit coverage for states with limited audit resources. Joint auditing comes with a need for states (a) to spend time and effort on coordinating audits with their laws, procedures and audit programs and (b) to finance a trained and well-managed joint audit staff.

There is no presumption in the project discussions thus far that joint auditing would involve all the states in the project. Indeed, the opposite is the case. The

presumption has been that joint auditing might be chosen as an option by some states, but not by others.

The discussion of joint auditing at the June 2 meeting was instructive. It started with a threshold question as to whether or not such audits would be "standalone" audits. The response was, "yes." The response did not clarify precisely whether "standalone" meant either, "full joint audits separate from other joint MTC corporate income tax audits," or "joint audits limited to arm's length issues only." The response led to some important and helpful comments on the challenge of states coordinating (1) their audits limited to arm's length issues only with (2) their audits that cover other issues for the same corporate taxpayers. In that regard, the discussion noted taxpayer convenience issues arising from separate audits for different purposes.

The June 2 discussion prompted thinking about additional options. One possibility is to incorporate arm's length issues and the use of the project's economics expertise into the existing MTC corporate income tax audit program—an approach that addresses the coordination and convenience issues raised on June 2. The project's economics expertise would, of course, also be used by states in separate, individual state audits. States interested in joint audits that address both arm's length issues and other relevant income tax issues could use the existing MTC joint audit service in addition to conducting their own audits. Those states interested in conducting only their own audits and not participating in joint audits could also do so with the benefit of the project's economic expertise. Importantly, all project states would have access to arm's length economics expertise for use in (1) their own separate corporate tax audits, (2) joint corporate audits or (3) more limited purpose compliance activities such as audit selection. There may be other options as well.

If the project considers incorporating arm's-length economics expertise into the existing MTC corporate income tax audit program, it will be important to engage the MTC Audit Committee in the discussion.

At this stage—and without regard to their merits or any prior discussions—there are three options identified thus far for joint auditing by interested states:

1. Joint audits to address arm's length issues only.
2. Joint audits separate from the current MTC corporate tax audit program that would address the full range of tax issues—both arm's length and all other relevant issues.
3. Joint audits through the current MTC corporate tax audit program that address arm's length issues along with all other relevant issues. The Arm's-Length Adjustment Service economics expertise would be used by states in 1) these joint audits, 2) individual, separate state audits and 3) in other stages of the compliance process.

The request to the Advisory Group at the June 25 teleconference is simply to provide feedback as to whether, for purposes of the issue paper to be prepared for the July 28 meeting, any of these options should be dropped or others should be added. States may make suggestions for additional options, of course, at any time. It should also be understood that in the course of preparing the issue paper, I might identify and develop additional options for discussion.