

Preliminary Design for an MTC Arm's-Length Adjustment Service

**Design Based on the Recommended Approach
of the
Arm's-Length Adjustment Service Advisory Group**

**Dan Bucks
Project Facilitator
December 2, 2014**

Preface

This document presents a preliminary design for an MTC Arm's-Length Adjustment Service¹ to support states seeking to improve equitable business tax compliance in circumstances where taxpayers are found to use transactions among related parties to undermine equity in taxation.

This design reflects a decision made on November 3, 2014, by the Arm's-Length Adjustment Service Advisory Group to select from among three approaches a preferred path for developing and operating the service during its four-year charter period of operation.² The advisory group's recommended approach is intended to implement all the participating states' priorities in a high quality manner. It was chosen because it offers a pace of implementation the group considered best suited to the needs of both the states and the MTC for a feasible and realistic, yet sufficiently expeditious development of the service. The approach is estimated to have the lowest first-year cost among the approaches considered—a factor judged helpful to encouraging participation by the states in the service.

The advisory group's chosen approach is now labeled the “recommended” approach. It was previously referred to as the “deferred staff” approach.

The approach reflected in this preliminary design was chosen over two other approaches. One, now labeled the “accelerated” approach would have offered a faster pace of implementation and a slightly lower four-year cost, but the highest first year cost. That approach was detailed in earlier versions of this document, but the advisory group judged its pace of development too ambitious. It was previously labeled the “base” version.

The third approach, labeled the “contractor focus” approach was the most expensive by far and used only contract economists for economic expertise—as opposed to the combination of staff and contractors incorporated in the other two approaches. The exclusive use of contract economists not only raises costs, but also limits the extent, flexibility and effectiveness of certain elements of the service.

The details of this design and its earlier iterations are a product of listening to dozens of state tax agency staff, the members of the Arm's-Length Adjustment Service Advisory Group, MTC staff members and officials, more than a dozen private

¹ This document uses interchangeably the word “service” and the acronym “ALAS” to refer to the proposed MTC Arm's-Length Adjustment Service.

² For a detailed comparison of the three approaches, please see “Comparisons Among Three Design Scenarios: Recommended, Deferred Staff and Contractor Focus Versions,” Dan Bucks, December 2, 2014.

sector transfer pricing experts, and veterans of transfer pricing work by state agencies beyond those that are a part of the current design effort. Almost every key fact or idea or building block in this design has its origins in those conversations. More recently, several states on the advisory group contributed specific ideas for further improvements in the design. Footnotes recognize and provide details concerning these suggestions. I thank wholeheartedly everyone who has contributed to this design for their observations, their generosity with their time and their kind consideration. This listening and feedback process along with the formal guidance from the Advisory Group has shaped and improved this design for an Arm's-Length Adjustment Service.

This preliminary design attempts to offer a blueprint for a high quality MTC Arm's-Length Adjustment Service that will make a difference in improving the equity of income reporting for state corporate tax purposes. The advisory group now seeks the advice and guidance of the MTC Executive Committee on this design. Based on the comments it receives from the Executive Committee, the advisory group will finalize the design and transmit it to the Executive Director during the first quarter of 2015.

Dan Bucks
Project Facilitator

Table of Contents

Preface	ii
Table of Contents	iv
I. Executive Summary	1
II. The Problem: Why States Need to Act	2
II. Charter Period for the MTC Arm’s-Length Adjustment Service	5
III. Draft Mission Statement, Goals and Objectives	6
IV. Strategies Recommended to Improve Efficiency and Effectiveness	8
V. Elements of the Arm’s-Length Adjustment Service	10
A. Training	10
B. Transfer Pricing Analysis	13
C. Information Exchange, Process Improvement, & Case Assistance	18
D. Case Resolution and Litigation Support Services	20
E. Optional Joint Audits	22
VI. Developing, Operating and Funding the Service	23
A. Service Timeline	23
B. Staffing	28
C. Budget Considerations	30
D. Potential ALAS Fee Structure	33
VII. Measuring ALAS Performance	35
VIII. Alternative Approaches	35

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

Executive Summary

Multijurisdictional enterprises often use complex tax strategies to shift income among jurisdictions, via related party transactions, to reduce their tax liabilities. When wrongly done, these strategies can improperly reduce state revenues substantially, impair market competition, and unfairly shift the cost of public services to other taxpayers. States have found the challenges posed by improper income shifting to be too costly to address on their own. They are joining together to design an Arm's-Length Adjustment Service (ALAS) to pool their resources to more effectively, efficiently and equitably address this challenge.

The proposed design for the Arm's-Length Adjustment Service entails two broad components for correcting improper income shifting. The first and largest cost involves using advanced economic and technical expertise to produce analyses of taxpayer-provided transfer pricing studies and, where appropriate, recommend alternates to taxpayer positions taken based on those studies. The second component envisions enhancing the ability of states to use this expertise and the resulting analyses effectively in addressing cases of income shifting through related party transactions. This component involves training state staff, establishing information exchanges, helping states improve their tax administrative and compliance processes, expanding audit coverage for related party transactions in the MTC Audit Program, providing assistance to states in developing and resolving cases, and supporting states in defending their work in litigation.

An Arm's-Length Adjustment Service Committee appointed by the top tax administrator of each participating state will provide advice and guidance for the operation of the service.

The development and initial operation of the service will span four years, beginning ideally on July 1, 2015. States participating in the service will be asked to commit to supporting it for this "charter period," subject to the availability of appropriations. The critical step in developing this service is the first one—recruiting state participants. An early authorization to MTC staff to recruit states would be a substantial aid to launching the service on the schedule outlined in the design.

The budget for the project is about \$2 million annually over the charter period—or an average of \$200,000 each if ten states participate. (Actual state costs are proposed to vary partially on state size and usage of services.) While the cost is substantial, it is not overwhelming. Those costs are small compared to the benefits of cooperative action, conservatively estimated at \$25 million annually in revenues that can be properly and effectively collected by those states.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

**I. The Problem:
Why States Need to Act³**

States face a major fiscal problem arising from businesses using sophisticated and complex methods to shift income to more favorable tax jurisdictions.⁴ When improperly used, these practices result in significant lost revenues to the states, an uneven playing field for industry, and unfair shifts of public service costs to other taxpayers. The states are currently ill equipped to identify and analyze instances where these methods may exist both to differentiate proper and improper income shifting and to address instances of improper income shifting. Because doing this individually may be cost prohibitive to the states, the states hope to pool their resources in order to leverage their resources and to maximize the return on their efforts.

Businesses shift income to related companies—companies that are part of the same business group—through a variety of methods. These methods include, but are not limited to:

- The transfer and licensing of intangible assets (such as patents, trademarks, and copyrights),
- The purchase and resale of tangible goods (such as inventory and business supplies),
- Providing and charging for common services (such as legal, accounting, and payroll),
- Stripping earnings out of a state through financing arrangements,
- Factoring accounts receivables, and
- Utilizing “embedded royalties” (including in the payment of goods and services a charge for the use of intangibles).

Prices on these transactions between related companies are often set at artificially high or low amounts. In this way, the related companies can shift income to those tax jurisdictions that provide the most favorable tax benefits. Businesses seek to justify these arrangements by using one of several methods and documenting their positions through complex, involved and expensive studies prepared by consultants and advisors.

Improper income shifting affects society in several ways. First, when a business improperly avoids taxes, it gains an unfair economic advantage over competitors and unjustified access to capital—conditions which distort economic outcomes and

³ Florida substantially revised an earlier version of this section and greatly improved the explanation of the improper income shifting problem faced by states. Alabama, the District of Columbia, Iowa, Georgia and Kentucky each made major contributions to the content of this section.

⁴ Businesses also engage in methods that similarly shift expenses and losses to more favorable jurisdictions. For purposes of this discussion, the concept of shifting of income should be considered to include the shifting of expenses and losses.

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

reduce market efficiency. Second, other taxpayers—other businesses, wage earners and retirees—will unfairly pay higher taxes to make up for the taxes avoided by the income-shifting corporations. Third, public knowledge that some businesses improperly avoid taxes undermines societal trust and cohesion, spreads cynicism and may encourage tax non-compliance by other taxpayers.

This problem has a major fiscal impact on states, but is difficult to quantify precisely. Estimates of the federal revenue loss from international income shifting suggest that those losses approach \$100 billion annually. Assuming that is the case, state revenue losses would be nearly \$20 billion a year. Information from “separate entity states” further suggests a large fiscal effect. For example, one state reports that a business paid \$70 million in a single case where it corrected underreporting arising from related party transactions. Another state reports collecting \$10 million in otherwise unpaid taxes from their transfer pricing enforcement efforts. A third state notes that it has pending three cases involving \$6.3 million in revenue, and another is working with five cases with nearly \$54 million in revenue at issue. Other states anticipate they would receive amounts ranging from \$5 to \$10 million annually from improved compliance activities designed to reduce improper income shifting. Even cutting the low end of this latter range in half to generate a quite conservative estimate of potential results, ten states could anticipate achieving together \$25 million annually in added revenue from effectively addressing this problem.

States face key gaps in information and expertise for this issue. Businesses engage well-paid consultants and advisors typically utilizing Ph.D. economists. State personnel need training in a number of areas, including but not limited to:

- Understanding complex federal and state laws and practices concerning transactions among related business entities,
- Selecting appropriate cases for audit,
- Identifying related party issues within audits,
- Securing documents and information from taxpayers for adequate audits,
- Determining the proper and sound basis for reasonable and defensible audit assessments, and
- Conducting non-economic reviews of taxpayer transfer pricing studies.

At a minimum, expert assistance is needed to:

- Help identify the critical data needed from taxpayers,
- Conduct economic analyses of transfer pricing studies,
- Complete less formal evaluations of issues arising in audits,
- Support voluntary case resolution, and
- Serve as witnesses for cases that proceed to formal appeals and litigation.

The cost of economic and other expertise in this area is expensive, so states seek to reduce those costs by working together to secure these services.

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

States frequently find responses by businesses to their compliance efforts insufficient. These challenges suggest a need for states to improve their compliance processes and practices. Areas needing attention extend across the board, including tax return design, taxpayer communications, information document requests, audit and analysis practices, enforcement and penalties, voluntary disclosure settlements, and case resolution procedures.

It is entirely possible for states working together to meet these needs and reduce the harm imposed on society by improper income shifting. This document describes in more detail how states could make major progress on this issue. The costs are significant at about \$2 million a year for ten states, or \$200,000 per state. Those costs are small, though, compared to the benefits of cooperative action, conservatively estimated at \$25 million annually in revenues that can be properly and effectively collected by those states.

II. Charter Period for the MTC Arm's-Length Adjustment Service

The draft design proposes a charter period for the service of four years starting with initial implementation steps in mid-year 2015. The purpose for the length of this charter period is to allow adequate time for the MTC and the states to develop, operate and evaluate the service before determining its future course.

During this charter period, all components of the services called for in the design will be implemented in phases and operated for a sufficient length of time to allow for an evaluation of the usefulness of each component. Near the close of the charter period, states will determine how the service might continue into the future.

The objective of having all components of the project operating for sufficient time to facilitate their evaluation has an important effect on the project design. It results in implementing the service in an expeditious manner and addressing all activity areas in some manner in the first fifteen months—with full operations attained during the third year.

A sufficiently strong commitment by states to the project is also necessary to be able to effectively recruit talented employees and consulting economists to operate an effective service. Veteran professional staff persons are unlikely to commit to working on a project if it has a projected period of operation of only a year or two. Thus, participating states would be asked to commit to funding the service throughout the charter period contingent only on the lack of availability of state appropriations for this purpose.

The states will also be asked to designate a representative and, if desired, an alternate representative to an Arm's-Length Adjustment Service Committee that will advise the MTC on the operation of the service, establish operating objectives and evaluate its performance.

III. Draft Mission Statement, Goals and Objectives

A. Mission Statement

The MTC Arm's-Length Adjustment Service provides states with timely, cost-effective services and opportunities for interstate cooperation to help attain equitable compliance by corporate taxpayers with state business taxes in circumstances where improper related party transactions undermine equity in taxation.

B. Goals and Objectives

1. Enhance the ability of participating states to correct cases of taxpayer underreporting associated with related party transactions.
 - a. Assist states in achieving equitable, cost-effective results that compare positively with other state tax compliance activities.
 - b. Provide high-quality and strategically-focused training to state staff on (i) related party transaction and transfer pricing law, practices and issues, (ii) identifying, developing and documenting related party issues and cases, (iii) resolving those issues effectively, and (iv) other relevant topics, procedures and practices.
 - c. Create a community of state staff working on related party issues and a forum for continuing consultation to address those issues effectively.
 - d. Establish an information exchange process to support joint work by states on related party transaction issues.
 - e. Provide affordable, economic analysis and technical expertise to evaluate taxpayer related party positions and transfer pricing studies and, upon request, to recommend alternative state positions on related party issues.
 - f. Assist states, jointly and individually, with improving their compliance and administrative processes to enhance the effectiveness, convenience, equity and efficiency of related party compliance activities.
 - g. Provide timely and flexible audit, legal and economic expertise to assist states in successfully addressing and resolving specific compliance cases.
 - h. Provide such other services as states judge important to improving their ability to correct underreporting associated with related party transactions.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

2. Increase audit coverage of related party transactions for states electing to participate in the MTC Joint Audit Program for corporate income taxes.
 - a. Provide the MTC Joint Audit Program with training and technical assistance to enhance the program's ability to address related party transaction and transfer pricing issues.
 - b. Provide states in the audit program access, on the same terms as those for individual states, to economic analysis and technical expertise to evaluate and recommend solutions to transfer pricing and related party issues.
 - c. Provide case assistance and other services necessary to improve the ability of the MTC Joint Audit Program to address related party and transfer pricing issues in audits.
3. Provide support for satisfactory resolution of disputes involving related party transactions and transfer pricing issues.
 - a. Offer an initial voluntary disclosure opportunity to taxpayers to resolve related party issues with participating states.
 - b. Encourage use of the MTC Alternative Dispute Resolution process to resolve related party and transfer pricing disputes consistently between individual taxpayers and multiple states.
 - c. Provide states with effective support in cases that proceed to litigation to encourage well-grounded and equitable decisions in such cases.
4. Inform and advise states of emerging developments concerning related party transactions and transfer pricing issues.
 - a. Monitor and conduct research on developments in the field.
 - b. Communicate developments and their implications to states in a clear, useful and timely manner.
 - c. Provide appropriate advice to states on such developments.

IV. Strategies Recommended to Improve Efficiency and Effectiveness

This service design incorporates certain strategies recommended to improve the efficiency and effectiveness of the proposed service.

Capacity Building

One central strategy involves maximizing opportunities to expand the capacity of the states and the MTC to address transfer pricing and related issues. The purpose is to reduce costs and maximize results over the long term. There are several parts to this strategy. One part involves having the service focus from the outset on training and assistance for the states. A second part involves providing continuing opportunities for state staff at different levels to share their knowledge and experience with each other. A key objective in this regard is to develop a growing community of state staff well versed in related party and transfer pricing compliance issues who work together across state boundaries to solve compliance problems. A third part of the strategy involves not simply “renting” economics expertise from outside firms, but asking those firms to develop that expertise within the MTC staff. Aiming to strengthen the capacity of the states may be the most important and enduring effort the service can pursue.

Interdisciplinary Collaboration: the Whole is Greater Than the Sum of the Parts

Success in dealing with related party and transfer pricing issues requires a collaborative approach among persons with different professional backgrounds: tax compliance/auditing, economics and the law. Transfer pricing and related party issues involve a large quantity of complicated details that require work and evaluation from different perspectives and professional expertise. Integrating the different types of expertise is one key to effectively identifying and resolving those issues. Failing to do so can waste time, money and energy and can diminish the results achieved. The projected MTC service staff and expert consultants would be expected to effectively combine that expertise in their own work and provide training and advice to states from that perspective. Thus, the service would support states in using interdisciplinary approaches in addressing transfer pricing issues.

Getting First Things First: Timing Is Everything

States are eager to gain access to joint economics expertise to deal with complex transfer pricing issues and to undertake activities with an early impact on resolving income shifting problems. Developing the core staff on a reasonable, but expeditious schedule is important to meeting these specific needs and providing a foundation for all of the elements of the service.

To secure contracted economic expertise early in the service, the MTC would hire a tax manager at the outset and provide assistance from its general legal staff to organize a request for proposal process. The goal would be to complete that process and enter a contract (or contracts) by the middle of the first year. At that point, a

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

senior economist would be hired to work in conjunction with the contract economists. This position is necessary to coordinate and manage the outside economics expertise. Beyond that staff, an attorney is needed on the ALAS staff to offer taxpayers the initial voluntary disclosure opportunity and to provide legal expertise for all elements of the service. Adding an attorney at about the eighth month of the project will complete the core staff team and should enable the service to launch the disclosure opportunity at the beginning of the second year of operation and to proceed effectively with developing the rest of the service on schedule. Finally, hiring the pricing auditor during the first year of operation is necessary to begin developing the process of non-economic reviews of taxpayer-provided transfer pricing studies. That process improves the quality, efficiency and effectiveness of the economic reviews of the same studies.

Improving Compliance Processes to Achieve Results

A fourth strategy involves evaluating the compliance process from beginning to end to develop procedures and steps likely to achieve the most productive compliance results. The design seeks to identify key points where the proposed services can make the most effective contributions to the state efforts aimed at improving compliance. Often those points are earlier rather than later in the compliance process because it is more costly and difficult to make up for lost opportunities in the later stages of a case.

Efficient Use of Resources

A fourth strategy involves a determined focus on using scarce and expensive resources wisely and efficiently. Often that means ensuring that expensive economics expertise is not used on technical tasks that can be performed using other resources. It also means that information needed for economic analysis should be sufficiently acquired at an early stage so that the economists can work with the most relevant information in arriving at their conclusions. Applying expensive analysis to inadequate information typically does not yield the most effective results.

V. Elements of the Arm's-Length Adjustment Service

A. Training

Training of state staff is a critical component of the service and would be provided through formal courses, conference-style training sessions of state staff and individual mentoring or coaching. Much of the mentoring will occur through the “case assistance” component of the service, which is described later in this design.

The Arm's-Length Adjustment Service Committee should set standards for the types and levels of knowledge to be attained through ALAS training. The audience for the training will be state and MTC staff involved in related party and transfer pricing issues including managers, auditors, attorneys, economists, policy analysts, and protest resolution staff.⁵ The faculty for the courses will include outside experts, state staff, and ALAS staff with expertise in law, economics, tax auditing and administration.

The service will also explore opportunities to work with the IRS on training. Those possibilities are not known at this point.

Formal Courses

The service will offer strategically focused training courses that address both specific needs for skills by state staff and general topics in related party tax law and compliance administration.

Initial training to meet specific needs include courses on (1) identifying audit issues and securing documents⁶ and (2) conducting non-economic, technical reviews of taxpayer transfer pricing studies. Advisory Group members specifically requested the first course aimed at training auditors on how to identify key related party/transfer pricing issues and to secure from taxpayers relevant information to evaluate those issues. Once trained with these skills, auditors can then confer with supervisors and call upon additional expertise necessary for the state to develop related party findings in the case. The service would offer the course on “Identifying Audit Issues and Securing Documents” for auditors in the fourth quarter of the first year and in subsequent years.

The second course aimed at specific needs will train state staff persons—auditors or other technical staff—in the skills needed to conduct non-

⁵ Kentucky noted that this training was relevant to a larger audience and suggested adding protest resolution staff to those served by it.

⁶ New Jersey suggested this early training for auditors, and the District of Columbia contributed ideas for the content of that training.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

economic reviews of taxpayer transfer pricing studies. An MTC pricing study auditor—working with a network of state staff members assigned to this effort—will coordinate such reviews. The purpose of those reviews is to identify technical problems in taxpayer studies—calculation errors, inappropriate selection of comparables, the absence of business purpose for transactions, and similar issues—that are significant in developing a case, but do not require more expensive, economics expertise to address. Indeed, without technical reviews, flaws in a transfer pricing study may complicate or hinder a proper economic analysis. Supplementing economic analyses with technical reviews enhances the cost-effectiveness of the overall transfer pricing review process.

The training for technical, non-economic reviews of pricing studies will occur in two-parts: (1) an initial session teaching the basic review skills and (2) a few months later a review and feedback session where participants bring examples of their work and review it in a seminar style setting. The first round of the two-part training would begin in the first quarter of FY 2017, after the hiring of the pricing study auditor in the last quarter of FY 2016.

General training courses will begin in FY 2017 and will include (1) features of federal and state related party tax law and (2) related party compliance methods. Both courses will be offered in “fundamental” versions in the early years of the service and may expand to also include “advanced topics” in the law and compliance methods.

The training in the substance of state and federal laws and regulations is self-explanatory. Training in compliance methods deserves some additional discussion. A wide range of topics may fall within the compliance methods category and will likely include:

- Information gathering methods, including tax return design, taxpayer documentation standards, information request development, and similar processes,
- Audit selection procedures,
- Planning audits of related party transactions and developing audit procedures,
- Identifying related party and transfer pricing problems,
- Understanding how to integrate economic analysis into the audit process,
- Using and enforcing effective information document requests,
- Developing defensible transfer pricing adjustments,
- Evaluating audit results and establishing priorities for case resolution, and
- Other compliance techniques and approaches.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

Periodic Conference-Style Training Sessions

Beyond formal courses, the service will also provide training through regular interstate staff conferences. Some case discussions during confidential sessions will be inherent in the ALAS Committee meetings that typically involve management level personnel. Even more significant for training purposes may well be the semi-annual sessions of front line state staff—lead auditors, audit supervisors, and attorneys—held to review case histories and compliance procedures.⁷ These conferences will be useful for sharing knowledge among states about emerging issues and successful methods for resolving them. The conferences might include special presentations on a rotating basis by individual states and also by outside experts. Breakout sessions for attorneys on litigation in process could also occur at these conferences.

The first interstate consultation session for frontline staff will occur in the latter half of FY 2016 and twice a year thereafter.

Overall, the training component of the service will contribute to the development of a community of MTC and state experts who will be able to work together to address related party transaction issues on a continuing basis.

Financing Training Courses

Training course costs would be financed through a combination of variable course fees for ALAS member and non-member states and the ALAS fee paid by member states. States that are members of ALAS would pay per student course fees that cover outside faculty (faculty who are not ALAS staff members), site costs, materials, faculty travel, and other incidental costs. States not participating in ALAS would be welcome to participate on a space available basis. The course fees for non-members would include the costs paid by ALAS members plus the preparation and instructional time of ALAS staff serving as faculty. The ALAS states would not be paying a course fee that includes the cost of ALAS staff serving as faculty because training is a core mission of the service and their fee already covers that cost.

In the early stages of the service, courses will rely somewhat more on outside expertise than in later periods when staff would more likely serve as faculty. If that trend occurs as expected, training course fees will moderate over time.

⁷ The District of Columbia highlighted the need for the service to engage front-line compliance staff, to provide training tailored to the needs of that staff and to create an interstate community of transfer pricing compliance experts.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

The cost of interstate front-line staff conferences and the ALAS Committee meeting where informal training occurs would be funded by the ALAS fee. Further, training state staff for technical reviews of transfer pricing studies develops the operating team for this part of the service. For that reason and to encourage states to assign staff to this activity, no fees would be charged to ALAS states for that course.

B. Transfer Pricing Analysis

The primary impetus for the Arm's-Length Adjustment Service has been the identified need of states to find a cost-effective means of evaluating taxpayer transfer pricing studies. Through the service, states will be able to secure analyses of taxpayer transfer pricing studies and independent recommendations for alternative transfer pricing remedies.

Economics expertise for transfer pricing purposes is expensive. Thus, this service design incorporates three strategies to minimize those costs or maximize the quality of the work performed. One strategy involves ensuring that the taxpayer information, secured during an audit of the taxpayer, is sufficiently complete to support a quality analysis. The second strategy involves conducting technical, non-economic audits of pricing studies prior to economics analysis. That prevents the time of economists from being spent on non-economic analysis and enables economists to account for technical flaws in transfer pricing studies in doing their statistical work. The third strategy consists of developing MTC staff to conduct economic analysis at costs lower than those incurred through contracted services.

The first strategy to maximize the value of expensive consulting services is to assist states in securing information from taxpayers that helps ensure that the economists can conduct the best possible analyses of the transfer pricing studies. Economists need access to adequate background materials used to produce the taxpayer's transfer pricing studies if they are to produce an effective evaluation of those studies. Accordingly, this design proposes that the service help states in securing the necessary information for analysis through training, process improvement, and case assistance. Details of this strategy are discussed in those portions of this design.

The purpose of the second strategy—conducting initial technical audits—would be to identify calculation errors, inconsistencies and flaws in the selection of comparable prices or profits, the absence of a business purpose for transactions, and other technical problems of a non-economic nature. The design recommends that the technical audits be performed by a transfer pricing study auditor who would develop and work with, as explained in the

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

training section, a network of state staff devoted to the same purpose.⁸ The objective would be to develop a sufficient network so that by FY 2018 all of the taxpayer pricing studies will undergo a technical audit prior to being submitted for an economic analysis. The technical audits would be divided between the MTC study auditor and designated state staff, with state staff working on a portion of the transfer pricing studies in which their state is a participant. By conducting technical audits up front, the states should receive higher quality and more cost-effective evaluations of taxpayer transfer pricing studies.

While the primary purpose of technical reviews is to improve the overall analysis of transfer pricing studies, individual states may also rely on those reviews as a separate basis for audit adjustments in cases where an economics analysis is not performed.

Turning to the third strategy, at the outset of the service, contractors would provide nearly all of the economics expertise for transfer pricing studies and alternative pricing positions. However, over the first four years of the service, this design proposes that MTC economists would provide a progressively larger portion of those analyses. Shifting transfer pricing analysis substantially, but not entirely, from contractors to MTC staff will reduce the costs of analysis significantly and brings this capacity into a joint agency governed by the states. It also integrates the analysis of transfer pricing studies more closely with the other components of the service.

The design assumes that through the initial senior economist and the addition of two additional economists (one each in the second and third years of the service), MTC economists would perform about 70% of the economic analyses of transfer pricing studies for the states by the fourth year of the service's operation. Staff would provide the regular and standard transfer pricing analyses, and contractors would handle more specialized issues or cases that could not be accommodated within the MTC staff workload. At the conclusion of the charter period for the service, states can evaluate this division of work between contractors and MTC staff and decide whether to continue that division into the future or change it further.

⁸ If the states do not find feasible or advisable conducting technical audits of transfer pricing studies through a combination of MTC and state staff, the options are to conduct them entirely through one of those means or the other. The MTC staff could be expanded to conduct all of the technical audits. Alternatively, the states could take full responsibility for those reviews. In the latter case, there would still need to be some coordination by the MTC to ensure full coverage and to link the work on the technical audits with the corresponding economic analysis of the transfer pricing studies.

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

Beyond analyses of taxpayer studies, economists—whether contractors or staff—would also produce alternative pricing recommendations to the extent desired by states.

Within the framework described above, there are some questions that need to be addressed concerning the organization and management of the economics consulting services. The questions include the following:

- Should the contract be entered into between the consulting firm and the MTC or the consulting firm and the multiple states within the service?
- How should the services be coordinated?
- On what basis should the consulting firms be paid and how should the financial arrangements be managed?
- Should the service engage the services of more than one consulting firm?

The first two questions regarding the contracting arrangements and coordination are intertwined with each other. The practical need for timely and effective coordination of the various elements of the service on behalf of all participating states would appear to require that the contract be entered into between the consulting firm(s) and the MTC. It is difficult to see how the necessary coordination would occur if the contract were written between the firm(s) and the several states. Meshing the contract, managerial and fiscal requirements of each state would also appear to be a major and difficult task. An MTC contracting arrangement also provides a consistent, coordinated point of accountability for evaluating the performance of a contractor. Thus, this design assumes the MTC would be the contracting party with the firm(s).

Coordination between the transfer pricing contractor's work, the in-house economists and the states would be the responsibility of the senior economist on staff. The senior economist would assign work to either the contractors or the in-house staff and, in both instances, evaluate the quality of the work performed. The senior economist and the study auditor would also coordinate the flow of technical audit results to the economists performing analyses of the same studies. The staff attorney would of course, handle legal contracting issues.

The MTC contracting arrangement carries with it certain implications for the financing of these services. The audit provisions of the Multistate Tax Compact include a requirement that services be reimbursed on a cost basis. In practice, that provision has been interpreted as requiring the Commission, in its compliance work, to avoid reimbursements tied to audit results. In this instance, a transfer pricing study is, in fact, an audit service. Thus, an MTC

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

contract would seem to require that a consulting firm be reimbursed on a cost basis and not on any contingency fee or performance basis. A cost basis would mostly likely translate into payments per hour or per study.

Sharing the pricing analysis costs among states on a basis proportionate to costs incurred may translate into the following budget process. Each year the budget for transfer pricing studies would be prepared based on an anticipated average usage of the study service. The level of projected usage would be the basis for an estimated budget that would cover the anticipated costs of consulting economists, ALAS economists, and the study auditor. That budget would be divided among the states equally, and the resulting amount would be considered the base charge to states for transfer pricing analysis. It is important to note that the "transfer pricing analysis charge" is one part of the total fee that states would pay for the service.⁹

If actual usage, and hence, costs exceed the original estimated amount, then additional charges over and above the base charge would need to be assessed to those states using the analysis service at a higher than average rate. The additional charges would allocate costs so that final state payments for transfer pricing analysis would be proportionate to each state's usage of the analytical services.

ALAS members and the MTC need to decide if states that do not use their entire base charge for transfer pricing services receive a refund (or alternatively a credit for studies in future years), or whether the unused balance of the base charge is retained as a reserve to the service to cover unanticipated costs or other contingencies.¹⁰ If the refund or credit system is used, the states may need to agree on extra payments beyond the base fee in early years of the service to build up a financial reserve for the service.

This budget process for transfer pricing studies analysis would work in the same manner whether the audits in which the studies have arisen are being performed by individual states or through the MTC Joint Audit Program. In the case of a state participating in both ALAS and the Joint Audit Program, the state would have paid for its share of the transfer pricing analysis

⁹ Please see Section VI.D starting on page 33 for a discussion of the overall fee structure for the service. The other parts of the fee would be a "general services charge" for the other components of ALAS (training, process improvement, information exchange, case resolution, and litigation support) and an administrative surcharge for states that are neither compact nor sovereignty members.

¹⁰ There are different circumstances that could cause a state to not use its entire base fee. One circumstance is where the state participates in fewer study analyses than the base fee would allow. Another is where the state participates in an average or even greater number of analyses, but the number of states participating in each analysis was higher than the average number predicted, thus reducing the actual per state cost of the analyses. A third circumstance might be instances where the analyses were lower in cost than originally anticipated.

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

through the base charge or an additional fee for “above average” usage of the study analysis service. States in the Joint Audit Program that are not members of ALAS but wish to address transfer pricing issues in audits would be asked to pay the base ALAS transfer pricing study fee and additional fees for any “above average” usage of the study analysis service.

Another fee issue to be considered is how to deal with instances where only some states initially participate in analyzing a case, but other states subsequently use the analysis after it is completed. Would the states using the analysis later pay a share of the costs of that analysis? The answer would appear to be “yes” given the usage basis of these fees, the goal of equity among states, and the need to avoid creating a disincentive for states to participate in studies when first proposed. Would the funds from the “late cost-sharing” go into a fund to finance credits to be used by the initial participating states to help finance future analyses or other fees? Such a process would appear to be consistent with the proposed process of adjusting fees for actual usage. Or would the late payments go to reserve funds for ALAS?

The touchstone in resolving these fee issues is that the economic and technical analyses of taxpayer-provided transfer pricing studies constitute valuable intellectual property. All states that use and benefit from those analyses should share equitably in financing their costs.

Turning now to the last question involving the possibility of contracting with more than one consulting firm, this issue is definitely relevant if the service does not develop the level of in-house MTC economics staff described earlier. It may also be relevant even if there is an in-house staff of economists. The primary reason for hiring more than one firm is that a firm may encounter a conflict of interest in helping states if it has a prior or current relationship with a taxpayer under audit by states.¹¹ In that case, an alternative provider would be available. A second reason is that different firms may offer different capabilities and types of services to states. Having two firms involved increases the diversity of expertise to the states. A third reason is to ensure the availability of services if one of the firms does not have the capacity to handle the total work needed by the states at any given point in time.

Even if states commit to developing an MTC economics staff, states may still wish to engage more than one economics consulting firm if they judge that having diverse, but complementary expertise among firms and the MTC staff is necessary to address a diversity of taxpayer issues and cases.

¹¹ Florida noted the potential for conflicts of interest to arise and the possible need for more than one contractor to deal with the issue.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

One possible downside of engaging two firms is that the volume of work would be divided in some manner between the two, lessening the priority that both firms might give to the service and the needs of the states. Another possible downside might occur if the two firms use methodologies that do not mesh well with each other. The selection process for two firms would need to take into account the avoidance of inconsistencies in the approaches of these firms.

The answer to the question of the number of firms to be engaged by the service is dependent on a number of factual considerations, some of which will become evident only through the responses submitted during the contracting process. Thus, this issue might best be left open through the RFP process and resolved at the point of contractor selection.

C. Information Exchange, Process Improvement and Case Assistance

This section covers elements of ALAS that will provide support exclusively to participating states to improve their effectiveness in addressing related party transactions that undermine equitable corporate tax compliance. As with training services, these activities are not limited to the specific cases selected for joint transfer pricing analysis. They would apply to any issues or cases encountered by ALAS states involving related party transactions.

The tax manager, senior economist and attorney working together and integrating their knowledge and expertise with each other would primarily undertake the activities described in this section. The process improvement and case assistance will carry forward some of the key strategies described early in this design: encouraging joint work by professionals from different disciplines, improving compliance processes to achieve effective results, and using scarce resources efficiently.

Information Exchange

Information exchange activities will include developing a memorandum of understanding for a confidential taxpayer information exchange process through designated disclosure staff. Initially, the exchange process will ensure that states can notify each other when they encounter cases where they believe a joint economic analysis of a taxpayer's transfer pricing study is warranted. If there is sufficient state interest, service staff will convene discussions among the states to organize the technical and economic reviews of the pricing study. The exchange will also be the vehicle for sharing the actual study information and related documentation as well as the results of any joint analysis.

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

As the exchange process matures, states may choose to exchange other information concerning related party transactions. The nature and extent of those efforts will depend on state initiatives in this area.

Process Improvement

Process improvement activities are aimed at helping states maximize the efficiency and effectiveness of tax compliance efforts, anticipate and conform to evolving legal standards, and improve taxpayer understanding and convenience. The service will assist states in looking at their administrative and compliance processes to make key changes at strategic points to enhance the results they achieve. A priority will be placed on encouraging states to implement changes on a joint or consistent basis to further uniformity in tax administration and reduce compliance costs for taxpayers.

Information management will be one focus of process improvement activities. These efforts would include assisting states with practices and procedures for securing better taxpayer information through questions concerning related party transactions on tax returns and other forms. The service will also help states develop audit protocols, possible documentation regulations, and standard information document requests that make clear to taxpayers the information required in audits to address related party and transfer pricing issues.

This element of ALAS will also assist states with using the information secured in terms of data analysis for prioritizing cases, audit selection procedures, and methods of identifying related party issues in audits.

The process improvement element will also assist states with anticipating and responding to legal process issues increasingly raised by taxpayers. Given the complexity of adjusting related party transactions, extra care is needed to avoid errors of process, protect taxpayer rights, and meet constitutional requirements in carrying out compliance responsibilities to the public.

The service will encourage states to work on process improvements in a common or consistent manner. States working together are likely to produce greater results in terms of compliance and tax equity. Further, consistent work by groups of states can simplify and make the compliance process more convenient for taxpayers than if they work separately.

In general, the ALAS staff will be prepared to assist states in reviewing their practices and procedures regarding related party transactions to help ensure that tax agencies are able to do their best in meeting their responsibility to

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

the public of ensuring equitable compliance with the law. This assistance would be available on request by states.

Case Assistance

The ALAS staff will provide information and advice to individual states concerning procedures and issues in particular taxpayer cases. For example, a state might seek advice on how to tailor an information document request to a complex taxpayer case. Or the state may be interested in an evaluation of legal issues inherent in a case. Or the state may seek an informal evaluation of positions taken by a taxpayer as an alternative or prelude to initiating a full review of the taxpayer's transfer pricing study.¹² Or a state may seek referrals to outside experts with whom the state can contract for help on particular cases. There could be hundreds of types of questions on which states might seek help. The service would seek to have available the combination of legal, economic and tax expertise necessary to respond effectively to a wide range of state requests for assistance.

Much of the thrust of the case assistance work will be to advise and coach states on steps taken early in an audit to ensure that opportunities are not missed to secure necessary information and evaluate issues so that the case can be brought to its most appropriate and equitable conclusion. Another emphasis will be methods of linking together the expertise and perspectives of auditors, economists and attorneys working on cases.

ALAS staff would provide the same type of assistance as needed to the MTC audit program as it conducts audits for participating states that involve related party transactions.

D. Case Resolution and Litigation Support Services

Voluntary Disclosure Process

Early in its operation, the service could support on behalf of participating states a voluntary disclosure process for taxpayers seeking to resolve related party issues.¹³ For this purpose, states would need to establish their own individual settlement requirements as well as joint terms they might offer taxpayers. For example, the states might choose to limit eligibility to taxpayers that have not been contacted for audits in order to qualify for penalty or other relief as a part of disclosure settlements. Assuming that states would be settling prior periods, they would also need to decide if they

¹² Georgia and Alabama have both noted the potential value of these "less formal" evaluations as a less costly, but effective means of resolving cases with a taxpayer. Georgia has also noted the need for referrals to outside experts for these types of evaluations.

¹³ New Jersey suggested the addition of an early voluntary disclosure process to the project design. Iowa identified key issues and policies that should be addressed in establishing this process.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

would entertain agreements for how the taxpayers will file returns for specified future periods—assuming no changes in the facts. Although state laws and established practices may produce variations in the terms offered by each state, standardization of the terms among the states will likely make the voluntary disclosure process more convenient and potentially more attractive for taxpayers.

A successful voluntary disclosure opportunity will require sufficient time for participating states to consult on settlement procedures and terms. Further, both the senior economist and the staff attorney will need to be hired to evaluate taxpayer disclosure proposals and provide advice to states on their terms.¹⁴With these factors in mind, the taxpayer application period for a voluntary settlement could start on July 1, 2016, and end six months later on December 31, 2016. The service would process disclosure applications with a target of completing agreements by March 31, 2017.

For taxpayers uncertain about positions they have taken on related party issues, this early voluntary disclosure period would provide an opportunity for achieving certainty in tax treatment without having to undergo audit and appeals processes. For states, resolving issues for these cases achieves early results and conserves scarce compliance resources for other cases.

MTC Alternative Dispute Resolution for Ongoing Case Resolution

To resolve disputes in ongoing cases, the service would offer a taxpayer and multiple states the opportunity to use the MTC Alternative Dispute Resolution (ADR) program to resolve disputes over related party transactions at one time. While often used after a taxpayer has received assessments, the ADR process can be used at any stage in the tax administrative process.

The MTC ADR process has its own well-established procedures and mechanism for sharing the cost of dispute resolution. It is ideally suited for use by ALAS and appears to require no modification for this purpose.

Finally, on an informal basis, case resolution between a taxpayer and multiple states also occurs within the Joint Audit Program process.

Litigation Support

In cases that go forward into tax appeals and court processes, ALAS staff would be available to provide legal advice and support to states in related party transaction cases. It could assist states in evaluating the positions taken by the parties in a case and advise on possible courses of action. It would

¹⁴ The senior economist is scheduled to be hired on January 1, 2016, and the attorney two months later on March 1.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

arrange for expert witnesses from the economists—contractors or MTC staff—who evaluated the transfer pricing issues in the case. While reimbursement of contractor's time serving as an expert witness would likely be necessary, that would not be the case with regard to MTC staff.

Evaluation of Advanced Pricing Agreement Procedures

In the future, the ALAS states and staff could also explore the feasibility and desirability of developing and using an advance pricing agreement process with taxpayers.

E. Optional Joint Audits

ALAS states seeking to expand audit coverage of related party and transfer pricing issues would be invited to join the corporate income tax portion of the MTC Joint Audit Program. The objective would be for the audit program to provide joint audits with the same training, transfer pricing analysis, and case assistance available for individual states audits. The costs of transfer pricing analysis for ALAS states in joint audits would be financed through the portion of the ALAS fees for that purpose. Non-ALAS states in the Joint Audit Program interested in addressing these same issues in audits would be asked to pay the same fees for transfer pricing analysis as the ALAS states.

As ALAS becomes operational, the MTC Joint Audit Program would begin to develop the ability to address transfer pricing and other related party issues as the states themselves address them. Periodic meetings between the ALAS Committee and the Audit Committee would help to facilitate the process of expanding the treatment of related party issues in joint audits.

Initially, audit cases involving such issues would arise out of audits that were not selected for that purpose. Over time, the Audit Committee will consider a number of issues concerning transfer pricing audits. Those issues will involve matters such as coordinating the timing of work on transfer pricing issues with other issues in the joint audits and the role that transfer pricing criteria might play in future audit selection. These issues are not unusual for the Audit Committee. It has addressed similar questions and adapted the Joint Audit Program to meet the changing audit needs of the states on a continuous basis over several decades.

The expectation is that the MTC Joint Audit Program would increasingly expand the scope of its treatment of related party issues in corporate income tax audits and would fully cover those issues by the third year of the service, if not earlier.

VI. Developing, Operating and Funding the Service

A. Service Timeline

The service will be developed through three stages: a “pre-launch” stage from January through June 2015, a “developmental” stage extending over the first half of the charter period from July 2015 through June 2017 and a “fully operational” stage for the last half of the charter period from July 2017 through June 2019. One exception to these stages is the voluntary disclosure opportunity for taxpayers from July through December 2016. That is proposed as a one-time activity in the developmental stage that will not recur in the last stage.

Pre-Launch Stage

This design proposes a timeline for the service that begins with preliminary implementation activities between January and June 2015 with the goal of launching the service in July 2015 with a sufficient number of states committed to the service. The following are key activities in the pre-launch phase:

- Recruiting participating states and securing state appointments to the ALAS Committee,
- Finalizing the service design,
- Early distribution of information about the potential recruitment of staff positions and formal circulation of the job announcement for the tax manager position once the MTC Executive Director determines that sufficient funding commitments are available with the goal of having this position filled at the outset of the service,
- Early distribution of information about the forthcoming RFP process for consulting economists,
- Development of draft performance objectives and measures as well as preliminary documents for staff recruitment, for an RFP process to secure economics consulting services, and for the exchange of information process, and
- Offering an “Identifying Related Party Issues” course for auditors through the MTC Training Program using outside consulting experts as faculty.

Recruiting participating states in the pre-launch period is the critical activity if the service is to move forward on the proposed schedule. If that is successful, it should be possible for the service to have an Arm's-Length Adjustment Service Committee appointed and a tax manager on staff in time for an initial meeting at the 2015 MTC Annual Meeting. If a sufficient number of states do not commit by July 2015, but prospects remain for achieving that

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

number, all of the stages and dates in this design would need to be adjusted until the requisite state support is attained.

The “Identifying Related Party Issues” course for auditors will be a precursor of an expanded course on “Identifying Issues and Securing Documents” to be offered once the service is activated.

Developmental Stage—July 2015 through June 2017

During the developmental stage, the service will sequentially implement elements of the service, lay the foundation for the operational stage, and conduct the one time taxpayer disclosure opportunity.

The key objectives in the first fiscal year, FY 2016, will include:

- Establishing information exchange procedures,
- Organizing and completing an initial round of economic analyses of taxpayer transfer pricing studies,
- Conducting high priority, initial training activities for states,
- Working with the MTC Joint Audit Program to begin expanding the treatment of related party transaction issues in joint audits,
- Laying the foundation, by recruiting staff on a planned schedule, to provide the full elements of the service in the second year,
- Initiating case assistance and case resolution services the latter part of the fiscal year.
- Confirming the performance objectives and measures to guide and evaluate the project in the first year.

At the outset of the service’s operation, the tax manager, with the assistance of the general MTC legal staff, would initiate, in consultation with the ALAS Committee, information exchange procedures among the states and a contracting process for economics consultants leading to the engagement of consulting economists before January 1, 2016.¹⁵ The staff would also have conducted a solicitation of the states for transfer pricing study candidates. The information exchange procedures are a necessary prerequisite to undertaking the joint analysis of transfer pricing studies.

The MTC will also recruit a senior economist in the first six months of the service so that the economist is on board in time coordinate the work of the selected contractor(s) with the states. In the latter half of FY 2017, the project target is that the service would complete nine joint economic

¹⁵ The analysis of transfer pricing studies would be the primary service being contracted for; however, training services, assistance with the voluntary disclosure process and support services for states would also be included in the contracting process.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

analyses of transfer pricing studies, which at an estimated three states participating in each analysis translates into twenty-seven state reports.

Key training activities in the first year will be two-fold: (1) conducting an "Identifying Issues and Securing Documents" course for auditors, and (2) convening the first interstate training conference of state front-line staff. The first two events would most likely be held in the third quarter of the first year and could be scheduled with each other.

The Identifying Issues and Securing Documents course is the expanded version of the course offered in the pre-launch stage. It will share in common with that initial course coverage of audit skills to identify related party issues. However, this version will also extend to the subject of how to secure documents from taxpayers to develop those issues.

The training conference for front-line staff would be the inaugural session of what is intended to be a semi-annual event for state staff to share experiences, review cases of mutual interest and hear presentations on relevant special issues. Beyond developing practical knowledge among state front-line staff, the larger purpose of these training conferences is to develop a community of staff among the states who consult and work together when relevant.

Early in the first year, ALAS and the MTC Joint Audit Program would begin the process of expanding the scope of joint corporate income tax audits with regard to related party issues. The ALAS tax manager and the audit program director would begin working together on this process and the ALAS Committee and Audit Committee would confer with each other on the practical steps and procedures necessary to expand that issue coverage by providing ALAS economics expertise and training to the audit program.

As a foundation for the further development of the service, a staff attorney would be hired by March 2016 and a pricing study auditor a month later. The attorney would focus initially on working with the states to prepare policies and procedures for the upcoming voluntary disclosure opportunity, enhancing training activities, and preparing (along with the economist and tax manager) to provide case assistance and case resolution services to states. Case assistance and case resolution activities would be actively offered to states before the close of the first year.

The pricing study auditor would work with the states to establish the network of state staff designated to perform technical reviews of transfer pricing studies. In the last quarter of FY 2016, the service would ask the states to identify the staff assigned to conducting such reviews. The pricing

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

auditor would develop and plan the training course for the designees, with the first part of that course offered in the first part of the next fiscal year.

The ALAS Committee, whose members are appointed by the tax administrators of participating states, would be established at the beginning of the service. An early task would be to review the suggested performance objectives and measures drafted during the pre-launch phase and confirm a version for use in guiding and evaluating the service. Other first year priorities would include conferring with the Audit Committee on joint auditing for related party issues and guiding the ongoing development of the service.

The second year of the service would begin with the voluntary disclosure opportunity. The taxpayer application period for the voluntary disclosure process would open on July 1, 2016, and close on December 31, 2016. The target date for the service to complete processing voluntary taxpayer agreements with the states would be March 31, 2017.

Two major changes would occur in the second year with regard to the analysis of transfer pricing studies. The first change would involve the initial development of sufficient in-house staff to conduct the first staff-completed analyses. Of the eighteen joint analyses targeted for completion in the second year, the ALAS senior economist and the second economist hired on October 1, 2016, would complete three and the contract economists would produce fifteen. The eighteen analyses would translate into an estimated fifty-four state reports.

The second major change for transfer pricing analyses will be the initiation of technical, non-economic reviews of the pricing studies. The ALAS pricing study auditor would organize the two-part training program for state staff designated to help perform those reviews. The actual reviews would begin by December 2016.

With the expanded economics staff, case assistance in the second year would include informal evaluations for states of taxpayer positions with regard to transfer pricing and related party issues. In some cases, states may find the informal evaluations sufficient to resolve a case without a full analysis of a taxpayer's transfer pricing studies. Technical audit coverage would expand until all analyses of transfer pricing studies would include a technical review by the third year of the service's operation.

With more economic analyses being completed, the optional joint audits would continue to expand their scope of coverage of transfer pricing and other related party issues.

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

The service, staffed with a tax manager, attorney and economists, would begin to work with states on process improvement activities in the first half of the second year.

Training would expand in the second year to include two new courses:

- Fundamentals of Related Party Compliance Methods in the fall of 2016, and
- Fundamentals of Related Party Federal and State Law in the late winter or early spring of 2017.

The service would also conduct two training conferences for front-line staff, one in the fall of 2016 and the other in the spring of 2017.

By the end of the second year, all of the planned elements of the service will be operating in some form—although some may not be at full scale. It would also have completed the voluntary disclosure opportunity for taxpayers.

Full Operational Stage—July 2017 through June 2018

In the third and fourth years, ALAS would operate all of its planned elements on a regular and routine basis—with some phased enhancements for certain activities.

At the beginning of the third year, the service would employ an additional staff economist to again expand the in-house capacity for economic analysis of pricing studies. The target level of economic analyses of pricing studies would be twenty-four studies—split evenly at twelve completions apiece by the MTC staff economists and the contract economists. If not attained in the prior year, 100% of the studies should have undergone technical audits prior to economic analysis. The twenty-four studies would, assuming three states per study, translate into seventy-two state reports.

Optional joint audits would address the full range of related party and transfer pricing issues. Process improvement, case assistance, case resolution, and litigation support activities should occur on an active and regular basis.

Training courses on Identifying Issues and Securing Documents, Fundamentals of Related Party Compliance Methods, and Fundamentals of Related Party Law would continue on a regular schedule. Advanced versions of the “Fundamentals” courses may be developed and offered. Training conferences for front-line staff would proceed on semi-annual basis. The service would also offer a refresher course in methods of technical auditing of transfer pricing studies in the third or fourth year.

Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014

The ALAS Committee at this stage should be providing feedback to the staff and the states on progress in meeting performance objectives. In the third year, the committee could evaluate the scope and methods for information exchange activities and consider its expansion.

In the fourth year the target analyses would be twenty-seven studies, nineteen completed by MTC staff and eight by consulting economists. Full technical audit coverage should occur. The twenty-seven studies would, assuming three states per study, translate into eight-one state reports.

All other services—training, process improvement, case assistance, case resolution and litigation support—should continue at an active, full pace in the final year of the charter period.

The ALAS Committee should in this year complete its evaluation of all service components. A consultation process would be undertaken among tax commissioners of participating states, the ALAS Committee, the MTC Executive Director, and the Executive Committee concerning the renewal of the ALAS charter and modifications in the extent, nature and direction of any of the ALAS activities.

B. Staffing

This section of the design summarizes the responsibilities and nature of ALAS staff positions.

The core ALAS staff would consist of a tax manager with expertise in audit processes, an attorney with related party and transfer pricing expertise, and a senior economist with transfer pricing experience. Other staff would include a pricing study auditor to conduct non-economic audits of transfer pricing studies and to train and coordinate with state staff devoted to similar non-economic audits of such studies. At the fifteenth and twenty-fourth months of the service, the design proposes adding one transfer pricing economist each time to expand the in-house staff devoted to transfer pricing analysis.

The tax manager will be responsible for key, regular communication between state staff and the service, including major requests for assistance and the selection of transfer pricing studies for analysis. The tax manager will coordinate with other ALAS staff the responses to state requests for assistance. The manager will assist in staffing the ALAS Committee and be the primary organizer of the semi-annual interstate consultation sessions among front-line state staff. The manager will have lead responsibility for

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

coordinating the information exchange, training and case assistance services. This position may also supervise the pricing study auditor (or the senior economist may do so). The tax manager will bring audit expertise to the process improvement activities, will serve as faculty for audit topics in training courses and will provide case assistance on audit methods to state staff.

The attorney will provide legal support for the administration of the service, including information exchange procedures, contracting with outside experts, and the voluntary disclosure process. The attorney will serve as faculty on legal matters for training courses and provide advice on the law to states in case assistance activities. The attorney will provide leadership for the service's case resolution activities and provide litigation support to states in disputed cases. The attorney will participate in process improvement efforts with the states, focusing on ensuring that legal process standards are attained.

The senior economist will supervise the service's economic analysis of transfer pricing studies. The senior economist will play a lead role in selecting, supervising and evaluating both consulting economists and staff economists. This position will also conduct some analyses of pricing studies and review and approve the analyses performed by other ALAS economists. The position will coordinate with the tax manager and technical pricing auditor on pricing studies in process. The senior economist, with possible assistance from outside consultants, will also review and advise states on the economic aspects of taxpayer proposed voluntary settlements in the first year. This position will serve as faculty on economics subjects in training courses and provide case assistance to states on economic issues—including informal evaluations of taxpayer positions on transfer pricing and related party issues. In process improvement activities, this position will focus on how to best develop information in a case to ensure quality economic analysis and how states can effectively use economic analysis throughout their compliance processes. The position would provide economics expertise in case resolution efforts and serve as an expert witness in litigation.

The pricing study auditor will conduct technical audits of taxpayer transfer pricing studies prior to economic analysis. The auditor will also organize and train a network of state staff persons who will undertake the same type of efforts to ensure coverage of all pricing studies.

The two staff economists—the first hired on October 1, 2016, and the second on July 1, 2017—will conduct economic analyses of taxpayer transfer pricing studies. As available and appropriate, they will also assist with training, case assistance, process improvement and case resolution work. They will also

**Preliminary Design for an MTC Arm’s-Length Adjustment Service
December 2, 2014**

provide states with informal evaluations of taxpayer positions on transfer pricing and related party issues. As they gain experience and expertise, the economists may also serve as expert witnesses in litigation.

Table 1 summarizes the projected staffing of the Arm’s-Length Adjustment Service as it develops and operates in the Charter Period. The timing of staff hiring is the result of three design objectives:

- Developing the service on an expeditious basis to respond to state needs and to operate all the elements of the service fully during the last two years of the charter period to enable the states to evaluate its work.
- Pacing the employment of the staff in the first year in the interest of orderly development and reducing first year budget costs.
- Reducing the cost of economic analyses of transfer pricing studies by substituting, in part, in-house staff economists for contract economists as the number of cases increase and implementing a technical, non-economic review of such studies (which also improves the quality of the overall analyses).

Table 1—Summary of ALAS Staffing in Charter Period			
Fiscal Year	Positions	Est. Hire Date	FTE
FY 2016	Tax Manager	July 1, 2015	1.00
	Senior Economist	January 1, 2016	.50
	Attorney	March 1, 2016	.33
	Pricing Auditor	April 1, 2016	.25
	Total		2.08
FY 2017	Staff in FY 2016		4.00
	Economist	October 1, 2016	.75
	Total		4.75
FY 2018	Staff in FY 2017		5.00
	Economist	July 1, 2017	1.00
	Total		6.00
FY 2019	Staff in FY 2018		Total 6.00

C. Budget Considerations

Table 2 presents the estimated costs of the service for the charter period based on the Advisory Group’s recommended version. It is divided into two broad categories of services: general and transfer pricing analysis. The general services include the training, information exchange, process improvement, case assistance, case resolution, and litigation support elements of the service. These activities are aimed at continuously improving the ability of states to effectively, efficiently and equitably address

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

related party tax issues, including making effective use of transfer pricing analyses. The transfer pricing analysis budget item presents the estimated costs of producing economic and technical analyses of taxpayer-provided transfer pricing studies and positions.

Some costs are not included in these budget projections. The costs not accounted for include specific training course fees, MTC audit fees for optional joint audits, separate state costs for contractors used as expert witnesses, and mediation costs for alternative dispute resolution.

Table 2—Estimated ALAS Budget for Charter Period					
(Nearest \$1,000—Totals Do Not Add Due to Rounding)					
Category	FY 2016	FY 2017	FY 2018	FY 2019	4-Yr.Total
General Services	\$ 534,000	\$ 789,000	\$701,000	\$ 717,000	\$ 2,741,000
Transfer Pricing Analysis	\$ 720,000	\$ 1,462,000	\$ 1,511,000	\$ 1,236,000	\$ 4,929,000
Total	\$1,254,000	\$2,250,000	\$2,213,000	\$1,954,000	\$7,670,000

The projected total costs for the service are highest in the second year because of the proportionally greater use of contractors for both general services and transfer pricing analysis in that year. In the second year the new staff will be organizing a variety of service elements, but relying on relatively more help from outside experts to carry out those elements than will be the case in later years. Contractor costs fall significantly for general services in the third year—reducing total costs.

Transfer pricing analysis costs increase in the third year, even though staff economists will complete a greater share of those analyses, because the total number of cases analyzed will increase. In year four the rising share of staff, as compared to contractor, analyses will reduce both transfer pricing and total service costs.

As in-house transfer pricing analysis substitutes for contractor analysis, the average costs of an individual state analytical report will fall. At the levels of activity projected in this design, the average cost of a state report would likely decline from about \$27,000 per report in year two to about \$15,000 in year four. The target number of reports would also rise substantially from about fifty-four in year two to about eighty-one in year four. Table 3 presents the number of analyses and state reports (estimated at an average of three state reports per analysis).

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

Table 3—Transfer Pricing Analyses and Costs Per State Report				
Item	FY 2016	FY 2017	FY 2018	FY 2019
Contractor Analyses	9	15	12	8
Staff Analyses	0	3	12	19
Total Analyses	9	18	24	27
State Reports	27	54	72	81
Average Cost Per State Report	\$26,700	\$27,100	\$21,000	\$15,300

The training, process improvement, information exchange, case assistance, case resolution and litigation support—elements designed to enhance the ability of states to effectively use transfer pricing analyses in addressing taxpayer cases—will comprise a minority of project costs in the first four years.

One means for trimming budget costs would be to decrease the number of analyses of pricing studies conducted in years two and three, by reducing the expenditures for consulting economists. While the number of analyses would be fewer in those two years, the number analyzed in year four would remain the same as initially projected due to the expanded in-house capacity to conduct that work.

A second cost-cutting strategy would be to eliminate the technical audits of taxpayer transfer pricing studies. That, however, would likely have a detrimental impact on the cost-effectiveness of economic analysis by diverting economists' time to non-economic issues and decreasing the quality of analysis due to non-economic issues that may be neglected. Without technical audits to improve the quality of data for the economic analysis, there is a substantial risk of encountering the familiar "garbage in, garbage out" problem for the analytical work.

Postponing or reducing staff for general services does not seem advisable. The states have identified a well-designed mix of services that help ensure that they can effectively use the results of the economic expertise to address related party and transfer pricing issues in the cases they confront. These elements of the service are also designed to help states keep pace with the inevitable, new complexities that will occur as taxpayer practices change. It does not make sense to produce expensive transfer pricing analysis without

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

also being prepared to use those analyses in the most effective ways possible in addressing cases.

For these reasons, if cost cutting is needed, the strategy of reducing the number of contracted transfer pricing analyses in the second and third years is the approach that might well be given first consideration.

D. Potential ALAS Fee Structure

As noted above, part of the fee structure for the service might be calculated on a cost basis for transfer pricing analysis services. A “base charge” for services would be paid at the beginning of the year, with adjustments made near the end of year for differential usage by states of the analytical services. This would cover the cost of consulting economists, MTC staff economists, and the study auditor. The statutory touchstone for the cost approach to allocating these costs is Article VIII of the Multistate Tax Compact on interstate audits. It requires reimbursement to the Commission for specific audit services on a cost basis. A transfer pricing analysis is a service that is a component of a specific audit. Thus, this design assumes that basis is the appropriate starting point for discussion of the allocation among states of these analytical services.

That leads to consideration of the fee structure for the elements of the service aimed at strengthening the capacity of states to address related party transactions and transfer pricing issues. These elements include training (to the extent not covered by course fees), process improvement, information exchange, case assistance, case resolution, and litigation support. These services are generally analogous to the general services that the MTC provides to its compact and sovereignty members. Again, the Multistate Tax Compact provides a possible basis for allocating these costs among states.

The Compact provides that general services be financed by a formula consisting of 10% on equal shares and 90% on relative revenues. The assumption appears to be that the relative value or benefit received from services strengthening the capacity of states is a primarily a function of the size of a state. Hence, this design suggests the general services formula of the Compact as the starting point for allocating the cost of the capacity building work of the ALAS. In this case, the relevant revenues to consider would be corporate income or business tax collections.

Beyond these fees, MTC policy requires that states that are not compact or sovereignty members pay a 20% administrative surcharge on the direct fees. Further as referred to at various points in this design, training course fees are also charged, but are less for ALAS members than for non-member states

**Preliminary Design for an MTC Arm's-Length Adjustment Service
December 2, 2014**

due to the exclusion of ALAS staff member faculty costs from the course fees for ALAS members. States joining the MTC Joint Audit Program will incur the regular costs for that purpose. Finally, participation in an alternative dispute resolution process will likely require payment of a share of the costs of a mediator.

VII. Measuring ALAS Performance

The draft mission statement, goals and objectives in Section II above are a first step in establishing a well-understood, common focus for the service, its participating states, MTC management, ALAS staff and contractors. Refining and ultimately ratifying those statements through the advisory group and future ALAS Committee are vital steps in establishing a management framework for the service. The framework provided by the mission statement, goals and objectives can and should be used to establish measurable performance objectives and benchmarks so that states and the MTC can effectively and fairly evaluate the work of this service.

As this design is refined and completed, the advisory group could focus on developing a draft of those performance measures to help accelerate the work of the ALAS Committee and staff once the service is launched. This design recommends that work as a key next step in this development effort.

VIII. Alternative Approaches

The document, "Comparisons Among Three Design Scenarios: Recommended, Accelerated, and Contractor Focus Versions," dated December 2, 2014, outlines three approaches to the proposed Arm's-Length Adjustment Service. The design described above is the "Recommended" version. The comparisons document includes tables of information summarizing the features, timing, estimated budgets, and staffing under each scenario.