Examples Illustrating the ALAS Economic Analysis Fee Process
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Under the draft Model ALAS Participation Agreement, the economic analysis portion of the transfer pricing fees will be billed to states in two stages. At the beginning of a fiscal year a "base economic analysis charge" will be calculated and billed to participating states. This base charge will be calculated by dividing equally among the states a projected budget for conducting economic reviews. That budget will be based on projected usage and costs for those reviews. Because actual usage and costs for each state will vary from the initial average projections, a final charge or credit will be calculated for each state as soon as possible after the close of a fiscal year. Periodic reporting during the fiscal year will enable each state to monitor its costs and usage and to make decisions concerning its use of economic reviews during the year.

It is important to recall that, as described in the draft model agreement, the ALAS fees are divided into two major parts: one for general services and the other for transfer pricing analysis. The transfer pricing analysis fee is further subdivided into two parts: one for technical reviews and the other for economic analysis. The following summarizes the fee categories, their methods of allocation, and billing schedule:

- General services fee: allocated 10% on equal shares and 90% on relative corporate and other relevant business tax revenues; billed at the beginning of a fiscal year and unadjusted thereafter.

- Transfer pricing analysis fee: sum of the two parts of the fee described below.
    - Technical Review Part: allocated on equal shares per state; billed at the beginning of a fiscal year and unadjusted thereafter.
    - Economic Analysis Part: a base economic analysis charge initially allocated on equal shares per state; billed at the beginning of a fiscal year and adjusted at the close of that fiscal year for actual economic analysis usage and costs incurred.

Thus, only the economic analysis part of the transfer pricing analysis fee is subject to the two-step adjustment process. The general service fee and the charge for non-economic, technical reviews of transfer pricing studies will be fixed and billed at the beginning of each year and will not be adjusted thereafter.

The model agreement describes the two-step billing and fee adjustment process for the economic analysis in section 3.2.7. This document provides examples to illustrate and explain the operation of that section.

Beginning Point: The Base Economic Analysis Charge

Prior to each fiscal year, the MTC will prepare a budget for conducting economic analyses of taxpayer transfer pricing documents. That budget will be based on the level of interest by states in such analyses, the anticipated capacity of staff and contractors to conduct them, and the cost of the analyses. That initial budget for economic analyses will be divided equally among the states.

The examples were derived from a projected FY 2018 ALAS budget that assumes the following:

- Ten participating states,
- A capacity to conduct analyses balanced with budget constraints that translates into 25 total analyses—13 conducted by staff and 12 by contractors. Contractors could likely conduct more analyses, but the initial amount is set to keep the budget affordable for all of the states.
- An average of three states will participate in each analysis, producing 75 state case reports—or 7.5 case reports per state.
- In terms of level of analysis, it is assumed that states can choose from among (a) an informal evaluation of the taxpayer documents, (b) a full statistical and economic analysis of the documents—referred to as the "standard analysis," and (c) the development of an alternative position to the one taken by the taxpayer in a case. An informal evaluation is weighted at 25% of the standard analysis, the standard at 100% and the alternative position at 125% in terms of time (cost) spent. Different combinations of analyses can produce the "0.5 report" assumed in the average reports per state.

The following table summarizes the budget and fee data based on these assumptions.

Estimated Costs for FY 2018 Economic Analysis Only					
Category	Taxpayer Analyses	State Reports	Total Cost	Cost per Analysis	Cost per State Report
Staff Conducted	13	39	$471,083	$36,237	$12,079
Contractor Conducted	12	36	$860,400	$71,700	$23,900
Total	**25**	**75**	**$1,331,483**	**$53,259**	**$17,753**

Based on the total costs, the initial base charge per state <u>for economic analysis only</u> will be $133,148.

As noted above, there is a non-economic, technical portion of transfer pricing analyses, which runs parallel to the economic analyses. The budget for the <u>technical</u>

reviews is estimated for FY 2018 at $179,839. An additional fee of $17,984 per state will be charged for this component at the outset of the fiscal year and will not be adjusted during the year.

Case Examples: Economic Analysis Fee Adjustments

Because it is not possible to predict accurately at the outset of the year the actual usage and cost per state of economic analyses, the base economic analysis charge will be subject to adjustment at the close of a fiscal year. States will receive periodic reports of their usage and costs during the year so they can adjust their usage, if necessary during the remainder of the fiscal year.

Examples of the adjustment are illustrated here in terms of five examples. They include examples of states that engage in average use, high use and low use. There is a separate example of a "low cost" state that incurs below average costs for the amount of usage. Finally, there is an example of a "late use" state that was not an original participant in an analysis, but decides to use the analysis after it is completed. All of the examples are summarized in the table at the close of this document.

It should be noted that while many of the year-end economic analysis charges and credits will balance each other out among the states, that balance does not occur entirely within the five-state table below. That is because some of the countervailing changes are assumed to occur with the other half of the ten states not shown on that table.

Average Use State

This example is of a state that requests the average number of analyses, 7.5, and experiences factors that both increase and decrease the costs assigned to it. While this state experienced a modest cost increase for one case in which it participated, overall it received a credit to carryover to the next fiscal year. This credit carryover arose from the benefit of developing with other states cases of common interest that result in above average participation by states—cutting costs for all involved. The case illustrates the value of what might be termed the "interstate cooperation" effect.

This state participated in one taxpayer case where the standard analysis by the contractor took 10% more time than the average projected amount. The higher cost amounted to an added charge to the state of $2,390.

This extra charge was more than offset by two other events—both reflecting the fact that this state had worked with other states to select cases that were of interest to a number of states. This "average use" state was part of two cases that another state (the "high use" state described below) joined at the outset as the fourth participant. With these cases shared by four instead of three states, the total costs per state were reduced by $8,995. (Note: staff conducted one of the analyses and contractors the other. Thus, the cost savings differed per case.)

This state also benefited from a request by the "late use" state to secure a standard analysis in a separate case where the "average use" and "high use" states were two of three participants. The net result again was a reduction in the cost per state for these states.

Overall, because of the interstate cooperation effect, the "average use" state received a credit of $9,625 to carryover to its FY 2019 base economic analysis charge. Its average cost per report declined by $1,283, or 7.23%, due to effective, above average cooperation with other states.

High Use State

The "high use" state intensely uses the ALAS economic analysis capability and in the process generates a high level of interstate cooperation among cases. It becomes somewhat of a hub of ALAS activity. While it incurs a $34,563 charge due to higher costs and to participating in 10 cases instead of only 7.5, this state makes efficient use of the program and lowers its per report costs by $982, or 5.53%.

The "high use" state participated in four cases that each incurred higher costs of 10% to 15%. The extra time worked added $8,995 to this state's costs. More importantly, this state increased its program usage. It became the fourth state in two cases and expanded two other high cost cases from standard to alternative position cases. This additional usage added $37,177 to its costs.

Two of the cases in which this state was a prime mover generated quality results and attracted the attention of the "late use" state that requested the analyses after they were completed. The payment by the "late use" state generated a credit to this state of $11,609. It also generated late use credits for other states.

Because this state used the program to analyze one-third more taxpayer cases than the average and did so in a high quality manner that expanded state participation, it reduced its cost per report even while incurring additional costs. Stated differently, its usage of economic analyses increased by 33%, but its costs rose only by 26%. In the process, it generated productive interstate cooperation.

Low Use State

The "low use" state uses the economic analysis capability of ALAS in a different way. It concentrates on a few standard analysis, but mainly requests informal evaluations for cases involving three states per case. Thus, the cases did not attract extra, above average state participation. This example illustrates well the flexibility ALAS provides states to tailor their use of the service to fit their particular needs and tax administrative processes.

In FY 2018, this state is assumed to have underutilized the program by 1.5 cases—one standard analysis and two informal evaluations. As a result, the state receives a low use credit of $26,630 (1.5 times the average charge of $17,753 per state report). Because its usage fell below the average projected use of 7.5 reports for each state, the state is subject to the 10% low use charge of $2,663. The net result is a carryover credit to FY 2019 of $23,967. Although this state's total costs decreased, it incurred the highest "per report" costs of any state at $18,197 due to the low use charge.

Low Cost State

This state is the beneficiary of participating in a less complex case and also of some good fortune. One of its cases is assumed to have taken 18% less time, generating a saving of $4,302. More significantly, its mix of cases included one more staff analysis, but one less contractor analysis. Because of the cost differential between the two cases, the state saved an additional $11,821. The net result was a credit carryover to FY 2019 of $16,123. It also attained the lowest cost per report of any of the five states at $15,603.

Late Use State

This state participated in the full complement of 7.5 cases at the average projected cost. In addition, the state also decided to request on a delayed basis use of two analyses (technically 2.25) in which it did not originally participate. One was a standard analysis and another was an alternative position case that also took more time than average to complete—a high cost case. In both cases this state was the fourth participant, reducing the per state cost of these cases for all participating states, including itself. It incurred additional charges of $34,826. Because it reduced the per state cost of the two "late use" cases, its average cost per state decreased by $525.

This example illustrates how a provision for late use with appropriate cost sharing works to the mutual benefit of ALAS member states—encouraging interstate cooperation and improving overall cost-effectiveness.

Conclusions

A substantial portion of the adjustments from the base economic analysis in terms of charges or credits will be driven by choices states make in terms of usage of the program. While higher than average usage will incur additional charges, effective interstate cooperation in terms of states per taxpayer analysis conducted improves the efficiency of the entire effort—lowering relative costs per state report. Overall, the states' own usage decisions will play a major role in driving the fee adjustment process.

Cost variations are another factor in the adjustments. Although states are more likely to experience these costs changes as opposed to creating the changes through usage decisions, regular and careful reporting to the states can enable them to make choices to keep their costs within their budget targets.

Over time as the proportion of analyses performed by ALAS economists increases, the size of the end-of-the-year dollar adjustments will decrease. That is because the hourly cost of staff-conducted analyses will be nearly half of the hourly cost of contractor-conducted analyses.

Effective communication and cooperation among the states in the case selection process will have a clearly beneficial impact on the efficiency of this program.

EXAMPLES OF ECONOMIC ANALYSIS FEE ADJUSTMENTS--FY 2018					
State by Type of Use ➔	**Average Use**	**High Use**	**Low Use**	**Low Cost**	**Late Use**
🡻 Use & Cost Data					
Base Number of Weighted Reports	7.5	7.5	7.5	7.5	7.5
Base Fee per Report	$17,753	$17,753	$17,753	$17,753	$17,753
Base Economic Analysis Fee-FY 2018	$133,148	$133,148	$133,148	$133,148	$133,148
Actual Number of Weighted Reports	7.5	10	6	7.5	9.75
High Cost Charge	$2,390	$8,995			
High Use Charge		$37,177			
Low Cost Credit	($8,995)			($16,123)	
Low Use Credit			($26,630)		
10% Low Use Charge			$2,663		
Late Use Charge					$34,826
Late Use Credit	($3,020)	($11,609)			
FY 2018 Additional Payment		$34,563			$34,826
FY 2019 Carryover Credit	($9,625)		($23,967)	($16,123)	
Net Accrued Final Cost for FY 2018	**$123,524**	**$167,711**	**$109,181**	**$117,025**	**$167,974**
Final Cost Per Report	**$16,470**	**$16,771**	**$18,197**	**$15,603**	**$17,228**

Notes and Assumptions

1. Reports Weighted by Analysis Level	Standard Analysis=1, Informal Evaluation=.25, Alternative Position=1.25. Examples assume a combination of analyses yielding an average of 7.5 reports per state--e.g. 7 standard + 2 informal, or 5 standard + 2 alternative.
2. Average Base Costs of Analyses	Staff: Standard, $36,237; Informal, $9,059; Alternative Position, $45,296 Contractor: Standard, $71,700; Informal, $17,925; Alternative Position, $89,625. Actual costs will vary.
3. States per Analysis	Base numbers estimated at 3 states per analysis; actual numbers vary.
4. Average Use State Notes	This state incurs a <u>high cost charge</u> of $2,390 due to a contractor analysis taking 10% more time. This states receives <u>low cost credits</u> of $8,995 due to the High Use State becoming the 4th participant in two of this state's cases. This state also receives <u>late use credits</u> as explained in the Late Use State notes.
5. High Use State Notes	<u>In terms of higher costs</u>, one contractor analysis is assumed to take 10% more time, adding $2,390, another contractor analysis 15% more, adding $3585, one staff analysis 15% more time, adding $1,812, and another staff analysis 10% more, adding $1,208. <u>In terms of higher use</u>, this state joins two additional standard analyses, one conducted by staff and one by contractors, adding $9,059 and $17,923 respectively. This state is the 4th state in these cases, reducing the per state cost for all participants. This state also converts two high costs cases, one conducted by staff and one by a contractor, from standard to alternative position analyses, adding $3,322 and $6,871 in costs. This state also receives <u>late use credits</u> per the explanation in the Late Use State notes.
6. Low Use State Notes	This state participates in 1.5 fewer analyses (one standard and two informal evaluations counted as .25 of an analysis each). It receives a <u>low use credit</u> of $26,630 calculated at 1.5 times the initial FY 2018 base fee per report. This credit is offset by a <u>low use charge</u> of 10%, or $2,663.
7. Low Cost State Notes	This state is assumed to have participated in, on average, one more staff analysis and one less contractor analysis than other states, saving $11,821, and to have participated in one standard contractor analysis that took 18% less time than the average such analysis, saving $4,302.
8. Late Use State Notes	On a delayed basis, this state requests use of (1) a standard staff analysis in which the Average Use and High Use States had initially participated, adding $9,059, and (2) use of the high cost, alternative position contractor analysis in which the High Use State had initially participated, adding $25,767. These costs are calculated at 1/4th of the total cost of each analysis due to there now being 4 participating states. In each case, the 3 initial participating states get credits equal to the difference between 1/3 and 1/4 of the cost of each analysis. While the late charges and credits balance out, that does not appear on the spreadsheet because some credit-receiving states are not shown here.