

Exhibit A

I. What are the greatest challenges that states might face in improving tax compliance related to intercompany transactions that distort the reporting of income to their states?

A. Introduction

As you know, the basic finance companies and intellectual property holding companies have faded and have been replaced by more sophisticated state income tax planning structures. Our firm believes that the most often used state tax planning structure today involves the hiding/bundling of royalties within a service charge or cost of goods sold in an attempt to circumvent the anti-PIC/intangible expense addback provisions.¹ We refer to these state tax planning attempts as “embedded royalties” below.

Like the states, we acknowledge that we will have limited resources and would better serve our clients by focusing on efforts that can bring the most revenue at the least cost. Therefore, in the creation of our firm, we decided to focus on those structures that could have the most impact. Using our multistate tax and transfer pricing expertise we believe we can identify the royalty within an embedded charge resulting in an addback of the entire intangible expense. We certainly have the capability to debate arm’s length principles, such as whether a royalty or interest expense should be 5% or 6%, whether a unit of inventory should be \$400 or \$500, or whether management fees should be \$5,000,000 or \$6,000,000. However, we believe the most efficient application of compliance efforts would be targeting the entire intangible expense under your existing anti-PIC provisions, where they exist.

The focus of our discussion below does not specifically refer to movement of income offshore. However, with the appropriate statutes in place, the same opportunities and challenges exist.

¹ We refer to these provisions as anti-PIC provisions, related party expense provisions, or addback provisions interchangeably throughout this document.

B. Taxpayer and taxpayer representative efforts and attitudes

Beginning with early efforts to close down the Delaware Holding Company structure, taxpayers and their representatives began to view state tax planning as a sophisticated fencing duel. In efforts to lower their taxes in separate return states, taxpayers shifted income to entities with lower separate return state effective income tax rates. Each thrust (new structure) was met with a parry (sham, economic presence assertions, anti-PIC provisions, etc.). Taxpayers and their representatives view the challenge as an intriguing intellectual exercise and have devoted considerable resources to finding a new way to garner their next point. The states seem to struggle for resources in their efforts to parry and seem to lag taxpayer structure designs by approximately 4 to 6 years. Although “embedded royalty” structures seem to pose the most pressing current threat to state revenue, new structures have already emerged that rely upon elections under Subchapter C of the Internal Revenue Code and hidden uses of various amortization provisions in the Internal Revenue Code.

C. Identification and assessment of embedded royalty structures

Existing anti-PIC provisions generally use language that appears all-encompassing and broad enough to capture the royalties hidden inside “embedded royalty” structures. However, “embedded royalty”² structures generally treat intercompany transactions as a bundling of intellectual and tangible property and do not identify the royalty or intellectual property value for tax, accounting or legal purposes.

1. Efficient identification of taxpayers with planning through enhanced reporting requirements

In the absence of a reporting requirement demanding that taxpayers identify the royalty or intellectual value in intercompany transactions, the states must rely on other efforts to identify these structures. Although current “addback exception” forms or schedules may contain some of this information, an expansion to transactions that include embedded royalties may assist in taxpayer identification. These requests could include a listing and quantification of all intercompany transactions. Such requests could also include situations where a related member uses the intellectual property of another related member regardless of whether it has paid a royalty for such use.

² Some taxpayers and taxpayer representatives often refer to these structures as supply chain structures.

Precedence for such reporting exists in federal income tax filings. For example, taxpayers with a controlled foreign corporation (“CFC”) report intercompany transactions with its CFC with considerable detail on Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations.

2. Effective parry may ultimately require regulation

Although the anti-PIC statutes generally appear all-encompassing, the states currently lack judicial authority interpreting their statutes. Although some states have specifically written regulations that incorporate potential embedded royalty structures,³ other states have not chosen to do so. In the absence of such regulations, taxpayers would likely argue that their intercompany charges are not within the current meaning of the statute.⁴

D. Discovering planning

In our conversations with states to date, we heard your frustration when you described your efforts to identify taxpayers with planning structures in place. Unfortunately, no simple methodology, algorithm or formula can effectively point you to taxpayers with planning. Public data does not yet exist that can “weed out” the planners from the universe of all taxpayers. However, a combination of experience and research can assist states in narrowing their focus to a more refined group. The research involved would likely include effective rate analysis, a focus on certain SIC or NAICS codes, USPTO searches, a review of public company subsidiaries lists in SEC filings, and a review of existing decided cases. Merely, plugging existing state data into a database cannot replace the hard work and experience of trained professionals.

E. Proving the royalty

Taxpayers and their representatives generally use transfer pricing experts to determine the potential savings in their structures and support the arm’s length nature of the transaction. In other words, taxpayers and their representatives already believe that the arm’s length principles of section 482 of the Internal Revenue Code and its interpreting regulations apply to their

³ See, e.g., 830 CMR 63.31.1 (defines embedded royalty and provides an example).

⁴ We anticipate that taxpayers would point to their financial statements, legal documents, and tax returns as evidence that the transactions do not involve a direct or indirect royalty.

intercompany transactions. However, the transfer pricing methodology often chosen buries the royalty further.⁵ Therefore, the states require transfer pricing expertise to extract the amount of the royalty from the embedded royalty. In the absence of this expertise, proving the existence and amount of the royalty would prove to be a daunting task.⁶

F. The next new thing is here already and growing

As described above, taxpayers and their representatives have already begun a search for the “next new thing.” New structures have already emerged that rely upon elections under Subchapter C of the Internal Revenue Code and hidden uses of various amortization provisions in the Internal Revenue Code. Although less common, taxpayers using these structures have found ways to convert royalties to amortization expense resulting in additional federal income tax deductions in excess of a billion dollars over a 15 year period. Understanding and identifying these structures presents a challenge that would likely require the states to accept outside assistance.

II. What are some of the best ways for states to meet those challenges?

A. Training and assistance

With your current resource constraints, our firm believes that the states would require training and assistance as defined below in section III.

B. Additional reporting requirements

As described in section I.C.1 above, shining a light on all intercompany transactions would further the states’ efforts in discovering embedded royalty transactions.

⁵ The transfer pricing methodology most often chosen by taxpayers is the comparable profits method. This method provides a price for the entire intercompany charge (cost of goods sold and intellectual property, for example) and does not specifically identify the amount of the charge related solely to the intellectual property.

⁶ The extraction of the royalty/addback amount is best achieved through transfer pricing methods delineated in the transfer pricing regulations and approved by the federal courts. We believe this for three reasons: 1.) taxpayers have accepted the application of the US treasury regulations to their intercompany transactions; 2.) courts are more likely to approve methods approved by federal courts; and 3.) mere statistical analysis may suffer from the taint of the decision in *Microsoft Corporation, Inc. v. Office of Tax and Revenue*, D.C. Office of Administrative Hearings, Case No.: 2010-OTR-00012 (May 1, 2012).

C. Regulations interpreting anti-PIC statutes

As described in section I.C.2 above, promulgating regulations that specifically incorporate embedded royalty structures into the anti-PIC provisions would both support the states' position and have a chilling effect on further implementation of these structures.

D. Penalty provisions

As the states already know, the willingness of taxpayers to change their behavior is often based on a risk assessment. Taxpayers and taxpayer representatives estimate the potential savings and discount for potential state challenges. This effort is followed by a comparison of the costs involved in implementing any change. Where the savings after discounts for risk exceed a certain multiple of the costs, taxpayers are more often willing to implement the changes. Penalty provisions factor into the potential cost of the transaction and, of course, have a chilling effect on the overall implementation of the planning. In addition, penalty provisions may also trigger ASC 740 discussions and activate an unusual ally of the states, financial statement auditors.

E. Information sharing

As the states already know, sharing information through the Multistate Tax Commission or directly with participant states can assist in the identification and understanding of planning structures. In other words, each of you is a great resource for the group. Coordination of that planning with updates and trainings would ensure an effective discovery and examination methodology.

III. What type of services is your firm prepared to provide states to assist with transfer pricing tax compliance and in what manner might those services be provided?

A. Introduction

We believe that the most effective way to implement our services would begin with a two-day intensive training program to ensure that all impacted persons have the same base of knowledge in this area and we speak with a common language. Following that initial training, we would provide our services as a comprehensive package or as requested. The categories of potential services follow our discussion of the initial training below.

B. Initial training

We would begin our training with basic principles and a history of state income tax planning from a taxpayer representative's point of view, but quickly move to more complex topics including the basics of arm's length pricing in accordance with the US treasury regulations interpreting section 482 of the Internal Revenue Code. The training uses live "redacted" examples as case studies for the group and the presenters would identify applicable adjustments and potential taxpayer arguments.

Auditors and appeals officers would be given a glimpse of the ordinary taxpayer's approach to planning structures and negotiating. As a result of the training and some insight into the taxpayer's point of view, personnel would improve their ability to ask good questions, identify planning, analyze transactions, and prepare their cases for further review.

Topics Covered

- Fundamental elements of state income tax planning;
- Embedded royalties and the next generation of planning;
- How taxpayers sell, design and implement state income tax planning;
- Transfer pricing principles and studies including a discussion as to why the federal transfer pricing rules are applicable and the required contents of transfer pricing studies;
- Coordination of transfer pricing and anti-PIC rules;
- Identification of planning structures; and
- Audit essentials including IDRs, studies, taxpayer arguments, etc.

C. Categories of potential services

1. Identification

We would assist you in the identification of those taxpayers that have developed multistate tax planning structures. Our identification methodology relies on years of experience and would likely involve an effective rate analysis, a focus on certain SIC or NAICS codes, USPTO searches, a review of public company subsidiaries lists in SEC filings, and a review of existing decided cases. Our experience shows that knowing where to look is superior to using statistical analyses. Merely, plugging existing state data into a database cannot replace the hard work and experience of trained professionals.

2. Audit support

Once identified, we would assist your auditors by securing the facts. This may take the form of our drafting the appropriate information requests for their consideration. As part of this process, we would also assist in securing the appropriate 3rd party documents supporting the existence of intangibles and/or other documents needed to support the disallowance of the related party expense.⁷ In essence, we would help build and execute the audit plan.

3. Transfer pricing analysis

Armed with this information, we would then prepare a comparable set of economic data supporting the selection of the arm's length transfer pricing method utilizing the "best method" rules in justifying the transfer pricing method selected. In effect, we would prepare a transfer pricing study to support the disallowance. This study would support the disallowance using court-approved transfer pricing methodologies.

4. Appeals support

From conversations with states, we understand that taxpayers often produce studies supporting a "royalty amount" that differs from proposed deficiencies at the appeals level.⁸ We would be available to participate in hearings, review documents provided by taxpayers at that level, and consult with appeals officers as needed.

5. Litigation support

Similar to appeals support, we would be available to participate in taxpayer conferences, review documents provided by taxpayers at that level, and consult with counsel as needed. We anticipate that this may also involve expert testimony and feel comfortable participating in that capacity.

⁷ These documents would necessarily include principal and background documents required to conduct a transfer pricing study in accordance with the US treasury regulations interpreting IRC section 482.

⁸ Generally, taxpayers assert that the inventory or services value inherent in the intercompany transaction is higher resulting in a lower expense subject to addback.

IV. Given the fact-intensive nature of transfer pricing work, how might states best integrate expertise in economics and statistical analysis with their audit and legal staffs in the tax administrative process?

A. Timing

Many attorneys would say that at least part of your question is leading . . . a “fact-intensive” process requires integration when the facts are being developed. The involvement of transfer pricing experts at the conclusion of an audit, during an appeal, or just prior to litigation could require requests of information that could or should have been gathered at the audit stage.⁹ Should the states decide to delay integration until later stages, we would suggest that greater time and attention be given to training, IDR development, and audit planning to reduce or eliminate the need to return to information gathering at later stages.

B. Integration

We describe our services in section III, but would also provide these additional comments in response to your question. We believe the process would work best by integrating our firm with dedicated professionals responsible for each administrative stage (audit, appeals, and litigation). The identification, by state (for example), of one or two professionals at each stage would be the first step in initiating the program. This would be followed by the creation of an audit plan, selection of taxpayers for examination, and the start of the examination. We believe that the selection of a very targeted/refined group of taxpayers for the program would further our aims of efficiently raising revenue and providing a test case for litigation, if necessary. We would follow the selected taxpayer group through to the end of its appeals process and repeat the process with a new group as requested.

⁹ The further we remove the transfer pricing experts from the fact-gathering process, the less confidence we would have in the accuracy of our findings. Proper fact-gathering involves more than just formulating and asking questions. The ability to ask follow-up questions and assess the validity and reliability of taxpayer responses is often essential to fully understanding the facts. Similarly, we suspect that is precisely the reason you have asked us to speak with you today rather than merely requesting written responses.

V. What objections will states face from taxpayers as they increase their compliance work? Which of those objections is a legitimate concern? How can states best respond to those criticisms?

A. Introduction

For purposes of the discussion that follows, we have limited our comments to situations of tax motivated transactions. Not every legal entity structure involves tax planning. Consider the company that grew by acquisition and sells inventory to an acquired related member. The taxpayer did not create the structure in a tax motivated transaction and the subsidiary may have previously purchased goods from its parent. Should the anti-PIC provisions reach these transactions, extract a charge equivalent to a royalty, and burden the taxpayer with additional compliance requirements? Although transfer pricing principles would demand arm's-length pricing, these are questions for another day.

B. Criticisms and assessment of their validity

1. Cost of transfer pricing

a) Taxpayer burden

Like the states, corporate tax departments rarely have employees with substantial experience in transfer pricing. Those few large corporate tax departments with that expertise may still outsource the conduct of transfer pricing studies. Fees for transfer pricing studies fall within a very broad range and are dependent upon numerous factors. These factors include the availability of data, cost of the database accessed for purposes of conducting the study, number of intercompany transactions, number of related members involved, the availability of comparable transactions and entities, etc. In other words, transfer pricing studies can fall with a range of \$25,000 to greater than \$1 million. Once completed, transfer pricing studies require regular updating to ensure accuracy. Unless there are material changes, these updates generally involve fees in the range of \$25,000 to \$100,000.

b) Assessment of the taxpayer burden

In recent years, corporate tax departments have been burdened with tight budgets leaving them with limited resources. Many corporate tax department leaders find themselves allocating limited resources to their most pressing matters. Although states may argue that the companies should increase their tax budgets, corporate tax department requests for increased budgets

often fall on “deaf ears” forcing tax executives to make difficult decisions. Assessment of the burden will depend on budget availability, the cost of the transfer pricing, and the availability of less expensive means of compliance, if any.¹⁰

History provides some insight with respect to compliance with additional transfer pricing requirements. Until section 6662 of the Internal Revenue Code imposed penalties for inaccurate transfer pricing, taxpayers were reluctant to conduct expensive studies. The penalties imposed were subject to a reasonable cause exception made applicable when taxpayers conducted studies complying with the provisions of the Internal Revenue Code and US treasury regulations. Today, taxpayers use the studies as protection from penalties and corporate tax departments look to the studies for job security.¹¹

c) Potential response

This is a cost of doing business and should receive the same attention given US transfer pricing necessities. The states may also wish to consider providing an alternative filing methodology for those complaining loudly. Would it be appropriate to offer a combined return to entities unwilling to comply with the need for a transfer pricing study?

2. Cost of additional reporting requirements

a) Taxpayer burden

In sections I.C.1 and II.B we discussed additional compliance suggestions. Implementation of the suggestions would demand a transfer pricing study and likely require the completion of additional form(s). The completion of the additional form(s) would add some cost and time to the completion of returns.

b) Assessment of the taxpayer burden

The overall burden will depend on the extent of the information requested. More importantly, taxpayers operating in multiple states will face a significant burden should the states be inconsistent in their additional filing requirements.

¹⁰ Clearly, corporate tax departments will struggle with transfer pricing study demands if the cost of the study outweighs any savings from the structure.

¹¹ As you would expect, penalties often grab the attention of company executives.

c) Potential response

This is a cost of doing business and should receive the same attention given US reporting requirements similar to those in Form 5471. The states may also wish to consider providing an alternative filing methodology for those complaining loudly. If possible, multistate uniformity in filing requirements would certainly ease the burden.

VI. What lessons can the project states learn from other taxing authorities with regard to transfer pricing enforcement?

A. Form 5471

As we describe in section I.C.1 above, the Internal Revenue Service receives Form 5471 from taxpayers. Form 5471 requires substantial documentation of intercompany transactions facilitating the audit of numerous issues including subpart F income, transfer pricing, earnings and profits calculations, and indirect tax credits. Similar information reporting requirements requested by the states for offshore and US income-shifting may produce promising results. Taxpayers failing to file Form 5471 are subjected to substantial penalties.

B. Accuracy related penalties

As we describe in section II.D, the enactment of accuracy related penalties applicable to transfer pricing prompted conformity. Taxpayers previously reluctant to conduct transfer pricing studies decided to comply to avoid the penalties.

VII. What remedies are most effective in correcting income manipulation associated with intercompany transactions?

We group our response in accordance with three overall methodologies used by states to challenge income-shifting and describe each separately.

A. Anti-PIC states

For those states with anti-PIC statutes, we believe the suggestions in section II above provide the most effective manner of dealing with income shifting through intercompany transactions. In summary, we believe the states will benefit from further training, transfer pricing expertise, additional information reporting on tax returns, promulgation of regulations, adoption of penalty provisions, and information sharing.¹²

B. Combined return states

Although tax planners often walk away from potential opportunities where taxpayers have substantial apportionment to combined return, many tax planners spend considerable time attempting to identify ways to shift income to entities outside the combined group (non-unitary entities or foreign entities). Previous efforts have involved the use of sophisticated special purpose entities and other means of creating non-includable corporations. With respect to these efforts, identification of the planning and statutory or regulatory fixes must follow the initial set up of these structures quickly.¹³

C. Combination when taxpayer distorts income attributable to the state

Although we see this adjustment less frequently than in earlier years, we are aware that several forced combination states still exist. We believe these states have the least effective tools to combat state income tax planning as they offer no means by which the taxpayer can undo the benefits of state income tax planning in the absence of an audit. This contrasts with combined return states that effectively eliminate income-shifting and anti-PIC states that disallow the income-shifting. When properly reported by taxpayers, anti-PIC states and combined return states should automatically eliminate tax benefits from planning.

¹² See section II for further details on each of these items.

¹³ We are aware of new legislation and proposed legislation targeting the shifting of income offshore.

VIII. What other issues are important for states to consider in designing the project MTC Arm's-Length Adjustment Service?

Although we briefly touched some of these items above, we believe they are worth summarizing here.

A. Different rules will demand different approaches

As the project progresses and participation is determined, we would suggest that states be grouped by the methodology used in challenging state income tax planning. This provides for a consistent approach in the integration of transfer pricing experts with the laws of the states.

B. Efficiency can be gained through information sharing/joint audits

If the states were to adopt our approach of selecting a select group of initial taxpayers for audit, we believe they will gain efficiencies by extending those audits to other similar states as described immediately above in section VIII.A.

C. Continue training

As you know, state income tax planning does not stand still. Although we cannot always predict the “next new thing” we can be certain that it will come. This will require states to stay in contact with new developments and continue training staff in the identification and audit of such developments.