

Review of and Insights on the IRS Transfer Pricing Examination Process

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Reprinted from *Tax Notes International*, March 18, 2019, p. 1177

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In this article, the authors discuss various IRS publications that can help taxpayers be better prepared for transfer pricing exams.

IRS transfer pricing examinations can be unpleasant for taxpayers. Chances are, an international business in the United States — whether headquartered there, or a subsidiary of a foreign parent — will have its transfer pricing examined by the IRS.

IRS officials have long cited transfer pricing as one of their most important enforcement priorities. But as a direct result of the OECD's base erosion and profit-shifting project,¹ tax authorities around the world are revising and tightening their expectations and requirements regarding transfer pricing. The prospect of thorough examinations of taxpayers' transfer pricing positions grows every day.

Fortunately for multinational companies operating in the United States, an important document can help taxpayers better prepare for the eventual IRS transfer pricing exam: Publication 5300, "Transfer Pricing Examination Process" (the TPEP). Originally released by the Treaty and Transfer Pricing Operations² group of

the IRS Large Business and International Division on June 29, 2018, the TPEP is a 37-page guide to audit steps, best practices, and resources to assist with transfer pricing examinations, consistent with Publication 5125, "LB&I Examination Process" (the LB&I manual). Prepared by the IRS to help its issue teams be better prepared to examine taxpayers' transfer pricing positions, the TPEP details the process and expectations surrounding an examination. With its issuance, the transfer pricing roadmap, which was not an official IRS publication, was retired.

All three publications — the LB&I manual, the TPEP, and the former roadmap — are similarly structured with three main phases: planning, execution, and resolution. The TPEP provides a framework for transfer pricing examinations and is intended to be shared with taxpayers to facilitate an understanding of the process and provide insight into what is expected. That transparency is intended to help improve communication and efficiency. Although the TPEP is not mandatory or enforceable, taxpayers can refer to it in discussing a particular transfer pricing exam with an IRS issue team³ or when elevating an issue within the IRS when an examination departs from the TPEP.

The TPEP acknowledges that transfer pricing examinations "are resource intensive for both the IRS and taxpayers." That acknowledgment is a key motivation for the TPEP in providing guidance to assist the IRS in identifying situations that warrant transfer pricing examinations through a risk assessment. According to the TPEP, "If the facts of the case show that the taxpayer's results fall within an appropriate arm's length

¹ A key aspect of the project is to align transfer pricing outcomes with value creation. See Kash Mansori and Guy Sanschagrín, "Assessing Value Creation for Transfer Pricing," *Tax Notes Int'l*, Mar. 28, 2016, p. 1123.

² In 2017 Transfer Pricing Operations became Treaty and Transfer Pricing Operations.

³ IRS transfer pricing issue teams typically comprise an economist, a tax law specialist, and IRS agents.

range, then our resources should be applied elsewhere.” If the IRS team determines that a transfer pricing examination is warranted, the TPEP serves as a guide to specify leading practices, data requests, analytics, and available resources in all three exam phases.

Treaty and Transfer Pricing Operations will continue to review the TPEP and make changes as new techniques arise or additional reference materials become available.⁴

Planning Phase

The planning phase determines the scope of the transfer pricing examination. The TPEP states, “Issues selected for examination should have the broadest impact on achieving compliance regardless of the size or type of entity.”

Most of the planning occurs before the opening conference, which marks the transition from the planning phase to the execution phase. Important steps in the planning phase are:

- the initial transfer pricing risk assessment;
- issuing the section 6662 documentation information document request;
- IRS internal planning meetings;
- developing the exam plan, timelines, and milestones; and
- the opening conference.

Issue teams are to conduct an initial transfer pricing risk assessment to identify specific controlled transactions between the U.S. taxpayer and its affiliates that warrant examination. The TPEP outlines that initial assessment as an eight-part process that includes extensive analysis and research to be performed by the issue team.

Issue teams are instructed to use the information on Form 8975, “Country-by-Country Report,” and the accompanying Schedules A (“Tax Jurisdiction and Constituent Entity Information”) for economic and statistical analysis and to assess high-level transfer pricing and BEPS-related risks. The initial risk assessment also involves a review of tax return information, documents from prior exams, and publicly available information such as taxpayer websites, investor relations materials, and SEC filings. The

TPEP instructs issue teams to compute key financial ratios for multiple years, make industry comparisons, and consider whether there is potential cross-border income shifting contrary to the arm’s-length standard.

The TPEP instructs issue teams to seek input from the advance pricing and mutual agreement program regarding transfer pricing transactions between the U.S. taxpayer and related parties in U.S. treaty-partner countries that may generate adjustments for which a taxpayer may request U.S. competent authority assistance. Also, the issue team will consider obtaining foreign-based documentation (BEPS action 13 master files, local files, and CbC reports)⁵ from treaty partners using collateral requests, information requests under treaties, and the simultaneous examination program.

If the initial risk assessment determines that the taxpayer has a potential transfer pricing issue, the TPEP advises the issue team to prepare the initial transfer pricing IDR under Treas. reg. section 1.6662-6(d)(2)(iii). That documentation includes principal documents, which should be included in a taxpayer’s contemporaneous transfer pricing documentation report, and background documents as requested, such as geographic, legal, and personnel organizational charts, worldwide geographic and segmented accounting data, and financial statements.

Under the statute, the taxpayer has 30 calendar days to respond, which starts on the date the initial transfer pricing IDR is issued.⁶ The issue team is instructed to use that period to analyze available information, which should include prior tax returns and financial statements. The issue team should review the taxpayer’s transfer pricing documentation for the year at issue before the taxpayer orientation meetings. It also should develop a working hypothesis — described as a “fluid concept” that should include an issue

⁵ BEPS action 13, “Transfer Pricing Documentation and Country-by-Country Reporting,” contains revised standards for transfer pricing documentation incorporating a master file, local file, and a template for CbC reporting of revenues, profits, taxes paid, and specific measures of economic activity.

⁶ Before 2014 it was common for the IRS to extend IDR deadlines beyond 30 days. However, as a result of LB&I directives issued in 2013 and 2014, agents now have limited discretion to extend an IDR deadline by at most 15 business days if a taxpayer fails to respond or provides an incomplete response.

⁴ The most recent version was released in August 2018.

statement to be proved or disproved as additional information is obtained — on the transfer pricing issue identified in the initial risk assessment.

The planning phase concludes with the issue team participating in the formal opening conference with the taxpayer. Opening conference discussion items can include potential section 6662(e) penalties, preliminary scope and examination timelines, IDR processes, the possible need for site visits and interviews, resolution processes, the potential for double taxation, and expectations for meetings.

Execution Phase

The execution phase follows the opening conference and consists of continued risk assessment, fact-finding, information gathering, and issue development. Stages of issue development include determining the facts, applying the law to those facts, and understanding the various tax implications of the issue. The issue team is advised to make every effort to resolve factual differences with the taxpayer.

Although the transfer pricing IDR is no longer mandatory at the beginning of the planning phase, issue teams are advised to submit the request early in the process and review and analyze the taxpayer's transfer pricing documentation before the taxpayer orientation meetings, which occur during the execution phase.

Generally, the TPEP advises the issue team to determine whether all documentation requirements of Treas. reg. section 1.6662-6(d)(2)(iii) have been met and whether the documentation and its conclusions are reasonable. In particular, the team is instructed to evaluate the taxpayer's selection and application of the best method for each relevant controlled transaction.

The orientation meetings are to be conducted within 30 days of the opening conference. The issue team will prepare extensive IDRs to request a financial statement orientation and then a transfer pricing or supply chain orientation. Generally, a financial statement orientation meeting will walk through CbC reports; geographic, legal entity, tax, and functional organizational charts; all reporting platforms (for

example, management reporting); and all relevant aspects of the financial statements, such as reconciliations, roll-ups to consolidated financial statements, book or tax differences, and any other relevant taxpayer accounting policies and practices.

The transfer pricing or supply chain orientation meeting generally includes background and business reasons for the intercompany transactions, persons responsible for structuring the transactions, the functional analysis of each controlled party and how the person who prepared the transfer pricing report gained knowledge for the functional analysis, total profits or losses associated with each material controlled transaction and each controlled party's share of the total profits or losses, and the selection and application of the best method.

IDRs or summonses may be issued after the orientation meetings for further factual development and requests for interviews, plant tours, and site visits. Before issuing a final notice of proposed adjustment and economist report, the IRS issues an acknowledgement of facts IDR to ensure the issue team and taxpayer agree (in writing) on the relevant facts underlying all potentially unagreed issues. Those facts must be consistent with the facts in both the economist report and notice of proposed adjustment.

Resolution Phase

The goal of the resolution phase is to reach agreement on the tax treatment of each transfer pricing issue examined. Important parts of the resolution phase include IRS presentation of the issues and resolution; case closing; and when necessary, issuing a revenue agent report with adjustments and tax liability. The resolution phase may also include appeals and a request for U.S. competent authority assistance.

The issue team should give the taxpayer an opportunity to agree or disagree with the findings for each transfer pricing issue developed during the examination. For an issue to be resolved, there must be an open discussion between the issue team and the taxpayer regarding factual development, the law that applies to the facts, and each party's interpretation of the law.

Before finalizing the notice of proposed adjustment and economist report, the issue team

should meet with the taxpayer to discuss all issues and determine whether a principled resolution can be reached. If a field resolution is not reached, the issue team should then finalize the notice of proposed adjustment and economist report.

The issue team should begin preparing a pre-appeals presentation immediately after closing the case. The TPEP affirms that the taxpayer has 365 days to request appeals consideration. The TPEP also discusses other options to pursue in conjunction with, or following, the examination if a tax treaty country is involved, including U.S. competent authority requests, accelerated competent authority procedures to cover later tax years, and simultaneous appeals procedures. Taxpayers may request competent authority assistance after receiving a notice of proposed adjustment and are not required to wait until the conclusion of an examination to file that request. If the APMA group accepts a competent authority request, it will assume jurisdiction over the transfer pricing issues. Otherwise, the case remains under the jurisdiction of the examination team.

Departures From the Roadmap

As the saying goes, “The more things change, the more they stay the same.” While broadly true of the TPEP, it departs from the roadmap in several important ways.

The TPEP is an official IRS publication and is thus official guidance, whereas the roadmap was a toolkit designed to provide IRS examiners with audit techniques and resources for transfer pricing exams. The examination steps, resources, best practices, and other guidance in the 37-page manual are generally more comprehensive than those listed in the 26-page roadmap.

The TPEP includes both 24- and 36-month timelines for a transfer pricing examination (neither is mandatory for Treaty and Transfer Pricing Operations or enforceable by taxpayers), whereas the roadmap was based on a 24-month timeline. The roadmap included detailed steps for a 24-month audit cycle. The TPEP — outside the sample 24- and 36-month timeline charts in its exhibits, which seem to be afterthoughts — provides little detail on timing; rather, it emphasizes examination best practices and resources.

The TPEP includes new content and instructions on administering the initial transfer pricing IDR, exhibits regarding recently developed practice units, and new material on CbC reports.

Under the TPEP, an issue team typically conducts an initial risk assessment before requesting transfer pricing documentation, so taxpayers who receive the initial transfer pricing IDR can assume the issue team has identified an issue that might create compliance risks. In contrast, under the roadmap, transfer pricing documentation was requested at the start of the planning phase with the 30-day letter (whether a specific risk was identified) and reviewed before the completion of an initial risk assessment.

The TPEP advises the issue team to reference IRS practice units when examining transfer pricing arrangements. The IRS develops those units, which serve as job aids and training materials on tax topics. The IRS has been adding about 40 practice units per year since 2014, although only 19 were added in 2018. There are 190 practice units available on the IRS website, with new units being continually added.

The TPEP instructs the issue team to use the CbC reports to find information to analyze high-level transfer pricing risk, BEPS-related risk, and for conducting economic and statistical analysis. The CbC reports are also an important part of the financial statement orientation meeting.⁷

Lastly, the TPEP limits the transfer pricing or supply chain orientation meeting to selected intercompany transactions in the years under examination, rather than include all intercompany transactions, as stated in the roadmap.

Insights

The TPEP can and should be used by taxpayers to their benefit. Taxpayers can use it as a tool to conduct an internal assessment of their preparedness to respond to IRS transfer pricing inquiries. Whether used proactively or reactively,

⁷ CbC reports did not exist at the time the roadmap was published. Accordingly, the CbC report data in Schedule A is now easily accessible to the IRS and it can use this data to evaluate a taxpayer's transfer pricing. As such, taxpayers should prepare for this by anticipating how the IRS might use the CbC data to evaluate the arm's-length nature of the company's controlled transitions.

the TPEP provides an understanding of the transfer pricing exam process, which taxpayers can use to develop approaches that will improve the likelihood of a successful outcome.

The IRS tries to enhance its processes and optimally allocate its resources. The TPEP is published with a stark message of reasonableness, saying IRS issue teams “should keep an open mind during the examination to new facts as they are identified,” and should not focus on cases if the facts show that the taxpayer’s results fall within an appropriate arm’s-length range. Issue teams also “should continually assess opportunities for issue resolution with taxpayers during the examination process.” While that type of language brings to mind the concept of “individual results may vary” — a common legal disclaimer — it also shows effort toward reason and practicality.

Reliable transfer pricing documentation remains the first and best line of defense against an examination. Providing the IRS with contemporaneous transfer pricing documentation — specifically, the 10 principal documents under Treas. reg. section 1.6662-6(d)(iii) — can prevent penalties if the taxpayer was reasonable in its evaluation, selection, and application of the best method, and it reduces the resources required to defend a transfer pricing position in an examination.

Further, contemporaneous documentation allows the taxpayer to proactively explain the reasonableness of its transfer pricing, increasing the chances of a favorable exam outcome with less time and effort. While quality documentation can dissuade the IRS from further investigation, given the high cost associated with disproving the reasonableness of a taxpayer’s appropriately documented transfer pricing, taxpayers without it might be surprised by the aggressive positions the IRS can take — especially in “greenfield” situations in which taxpayers kept limited or no documentation.

Contemporaneous documentation should contain a complete functional analysis. Despite the practices of some taxpayers, a functional analysis is not optional for contemporaneous documentation that is intended to withstand an IRS transfer pricing exam. During the execution phase, the issue team must conduct a functional

analysis that identifies the economically significant activities⁸ performed for the controlled transactions, which is also a required section of the IRS economist report.

The TPEP references section 4.61.3.4.11.2 of the IRS Internal Revenue Manual, which states that “a functional analysis is a critical aspect of any transfer pricing examination” and contains an extensive list of taxpayer questions and items to be included in a functional analysis of functions, assets, and risks. Because a functional analysis is part of the execution phase, taxpayers engaging in high-value controlled cross-border transactions are advised to include a functional analysis in their transfer pricing documentation. Doing so allows them to proactively guide the issue team to the desired understanding of the controlled transactions and related functions, assets, and risks.

The TPEP heavily emphasizes the importance of the best method selection and application in its risk assessment, fact-finding and information gathering, economic analysis, and penalties sections of the execution phase. The penalties section specifies that contemporaneous documentation does not automatically protect against penalties because it must be assessed for adequacy and reasonableness.

Taxpayers must document how they reasonably selected and applied the best method to meet the reasonable cause exception of the penalty regulations. The TPEP advises the issue team to evaluate the taxpayer’s best method selection and the potential applicability of other methods, as well as the application of its selection, including inputs and assumptions. The heavy emphasis on the best method underscores the view that the reasonable selection and application of that method is the core of the transfer pricing analysis and documentation.

Taxpayers should maintain intercompany legal agreements that accurately reflect the functions, assets, and risks of their transfer pricing. During the execution phase, the issue team is to review and analyze relevant intercompany agreements in coordination with

⁸ An economically significant activity is one that, at arm’s length, materially affects the price and profits or losses from a controlled transaction.

LB&I Division counsel. One goal is to determine if the parties' conduct is consistent with the written agreements. Taxpayers should ensure they have intercompany agreements covering their controlled transactions, and that those agreements accurately detail how contractual risks are assigned and how the parties are compensated.

The transfer pricing orientation meeting continues to provide the most effective opportunity for a successful resolution. The transfer pricing or supply chain orientation meeting during the execution phase is often the taxpayer's best and last opportunity to present its transfer pricing positions.

The TPEP specifies that weekly or biweekly discussions between the examination team and the taxpayer should be held to support communication and ensure common expectations regarding examination progress, IDRs, and timelines. Many taxpayers and issue teams might view that as burdensome because it is unlikely there will be new information to discuss every one or two weeks during a typical two- or three-year exam. In practice, those meetings can be in some abbreviated form, but taxpayers should be aware of the potential time involved with IRS transfer pricing exams that extend into the execution phase.

The IRS updates to the TPEP have made it vaguer. In August 2018 it amended section 5 of the planning phase, "Prepare Ratio Analysis," to remove specific subscription data resources used by Treaty and Transfer Pricing Operations (namely, S&P's Capital IQ and Compustat, Bureau Van Dijk's international company databases, ktMINE, Moody's Analytics RiskCalc, and Thomson Reuters LoanConnector). The new listing of data resources contains only items that are proprietary to the IRS (contained in its Tax Information Gateway, Auditor's Workbench, and Campaign and Case Built File). It also says the

third-party subscription listings were removed because subscription services "change over time" (even though the TPEP is periodically updated) and that Treaty and Transfer Pricing Operations has subscriptions to "other helpful tools."

Treaty and Transfer Pricing Operations likely continues to use all those specific subscriptions — and others. While the TPEP itself is intended to provide greater transparency and efficiency, the removal of the specific third-party subscription resources could have the opposite effect. For instance, when faced with a choice between competing subscriptions, taxpayers and transfer pricing advisers often prefer to use the same transfer pricing data subscriptions as Treaty and Transfer Pricing Operations to better align with the examination process.

IRS practice units allow taxpayers to achieve parity with the IRS and its issue teams on understanding tax concepts. Exhibit A of the TPEP devotes considerable space to discussing 46 practice units, which are reference and training tools for evaluating and developing potential issues in the planning, execution, and resolution phases. As a best practice, taxpayers should reference the relevant practice units when planning and evaluating their transfer pricing dealings as an indication of IRS positions on given topics. For example, a U.S. parent company taxpayer that has selected the residual profit-split method could benefit from reading and understanding the 48-page "Residual Profit Split — Outbound" practice unit, which references 13 related units with necessary knowledge and could merit some level of review.

In practice, IRS issue teams might know significantly less or more than what is in the relevant practice units, but a taxpayer who does not have a base level of understanding is a taxpayer who invites more prolonged exams, unfavorable adjustments, potential double taxation, and penalties. ■