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U.S. Transfer Pricing Examinations Under the Transfer Pricing Examination Process: The More Things Change, the More They Stay the Same, Journal of International Taxation, Apr 2019

U.S. Transfer Pricing Examinations Under the Transfer Pricing Examination Process: The More Things Change, the More They Stay the Same

The TPEP, like the Roadmap, will likely continue the trend away from inquisitorial, information-gathering examinations to adversarial, results-oriented discovery aimed at supporting the issue team's pre-established positions.

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[pg. 45]

On June 29, 2018, the IRS released the Transfer Pricing Examination Process (TPEP), replacing the 2014 Transfer Pricing Audit Roadmap (the "Roadmap"). **1** The TPEP largely mirrors the Roadmap, and maintains the Roadmap's three-phase examination process: planning, execution, and resolution. **2** The TPEP specifies that statute extensions should be discussed with taxpayers during the opening conference, and includes sample timelines for 24 and 36 month examinations, so there is no suggestion under the TPEP that transfer pricing audits will conclude any faster than they did under the Roadmap. **3**

Early indications from audits opened post-TPEP corroborate that the IRS's approach has not changed, but taxpayers may experience incrementally greater challenges in advocating their positions to the "issue team." The emphasis that the TPEP places on the issue team's upfront factual development, which will largely consist of reviewing prior year work papers and publicly-available data before any

meaningful engagement with the taxpayer, encourages examiners to formulate defined positions at very early stages in the process. It is difficult for a taxpayer to convince the IRS to abandon or even materially change its positions once they have been formulated. This is unlikely to change, notwithstanding the TPEP's admonition that the issue team should "keep an open mind" to evaluate new facts.

[pg. 46]

Therefore, the TPEP, like the Roadmap, will likely continue the trend away from inquisitorial, information-gathering examinations to adversarial, results-oriented discovery aimed at supporting the issue team's pre-established positions.

A primary concern is that the issue team's factual development under the TPEP will be largely limited to publicly-available data. Experience shows, however, that publicly-available data is largely not helpful to a thorough understanding of a taxpayer's business - particularly regarding its supply chain and value propositions. Taxpayers who have historically taken a passive, or reactive, role in their transfer pricing audits must position themselves as active participants, from the outset, to ensure that their facts and issues are being properly developed as their case moves through the administrative process.

In the following sections, we briefly walk through the stages of TPEP, highlight meaningful changes from the Roadmap, and consider what is next for taxpayers in transfer pricing audits.

Planning Phase

In the Planning Phase of the TPEP, the Large Business and International (LB&I) issue team performs its initial transfer pricing risk assessment, which is supposed to determine the scope of the taxpayer's subsequent audit. Most transfer pricing-focused examinations include revenue agents, economists, and tax law specialists from various practice areas within LB&I (including the Transfer Pricing Practice (TPP) and Cross Border Activities (CBA)). LB&I Division Counsel attorneys also regularly participate in transfer pricing audits. [4](#)

The issue team's initial transfer pricing risk assessment [5](#) is intended "to identify specific transactions between the U.S. taxpayer and its affiliates warranting examination." [6](#) This assessment typically includes the IRS's review of its prior year audit materials; tax returns and forms using proprietary data analytics; data set forth in country-by-country (CbC) reports to identify alleged income-shifting behaviors; and public resources, including corporate websites, 10-Ks, and 20-Fs to understand the taxpayer's history, background, business operations, and profit drivers.

A potentially controversial aspect of the issue team's risk analysis involves the computation of financial ratios, using information databases like Capital IQ and Bureau Van Dijk, to purportedly flush out cross-border income shifting. Team members are instructed to use these analyses of the U.S. and foreign parties' financial data as "diagnostic tool[s] to help focus the examination." These ratios, as acknowledged by the TPEP, can be misleading and misapplied. [7](#) Unfortunately, once the IRS has

completed these ratio analyses, it does not require much more analysis to re-price the taxpayer's transactions using profit-based transfer pricing methodologies. Not surprisingly, this shortcutting often leads to distortive results, especially when accompanied by incomplete factual development, which becomes a real problem if the matter proceeds to one of the available vehicles for administrative dispute resolution.

The issue team first prepares a "working hypothesis" regarding the taxpayer's intercompany pricing, which the TPEP refers to as a "fluid concept" with an "issue statement that will be proved or disproved as additional information is obtained." However, the taxpayer will likely need to expend significant effort to prevent this hypothesis from becoming fixed and remaining static throughout the audit. The issue team then submits its formal risk analysis **8** to the Issue Manager and Territory Manager for approval. **9** Taxpayers should request a copy of this assessment to determine whether the IRS is relying on inaccurate assumptions, although it should be provided without the need to make a request.

The taxpayer's first meaningful contact with the issue team will likely occur at the opening conference. The opening conference provides taxpayers an opportunity to begin steering the audit towards evidence supporting its reporting positions. **10** During these discussions, the taxpayer may wish to present its transfer pricing policy, key facts, and industry data to properly educate the audit team about its business, risks, and structure, as well as its place within the marketplace.

Execution Phase

The IRS is expected to engage with the taxpayer more frequently and directly during the execution phase to resolve any factual issues, understand all aspects of the taxpayer's business and intercompany transactions, and update its risk assessment. **11** The issue team will also review the taxpayer's section 6662 transfer pricing documentation and identify areas that it believes require further development or investigation. **12** The TPEP also requires examiners to consider whether there are any potential subpart F concerns that may be implicated. **13**

Taxpayers can help shape the narrative during this phase by affirmatively engaging the issue team, marshaling key facts and documentary evidence, and correcting any inaccurate assumptions before they are embedded in the IRS's final economic analysis. Taxpayers are expected to prepare two critical presentations for the examination team during this phase: (1) a

[pg. 47]

financial statement orientation, and (2) a transfer pricing / supply chain orientation. **14**

The supply chain discussion would likely be more useful if it were held prior to the financial statement orientation, to give more meaning to the financial data. Nevertheless, taxpayers should proactively use this early interaction to ensure that the relevant facts relating to its business and business model are made part of the administrative record. This is a significant opportunity for the taxpayer to tell its story,

and it should be held early in the examination. While it may be challenging to coordinate and marshal resources at this stage, taxpayers have an opportunity to help frame the narrative and address potential weaknesses before the IRS's views become embedded and difficult to change.

Taxpayers will likely receive numerous Information Document Requests (IDRs) from the issue team, which may include requests for intercompany agreements, **15** interviews, plant tours, and site visits. **16** This phase of the process can take months, and even years, depending upon the complexities of the matters at issue and the issue team. As a practical matter, different issue team members (*e.g.*, international examiners, tax law specialists, economists, etc.) may all issue these requests during the same period, with overlapping response times, creating a management and control concern for taxpayers, especially if the requests require significant data mining or compilation. But, for taxpayers, this factual development is key to a successful resolution, whether on audit, at Appeals, before Competent Authority, or in litigation.

The TPEP also indicates that the issue team should "consider whether the characterization of the transaction is framed appropriately." **17** This instruction suggests that the IRS's institutional position to re-characterize arrangements that otherwise have economic substance - a position that has been reflected (and rejected) in most recent transfer pricing litigation in the U.S. Tax Court - unfortunately persists. The IRS may be emboldened by the recent addition to the statutory language of section 482 that permits the agency to consider "realistic alternatives" to intercompany transfers of intangible property if those alternatives provide "the most reliable means of valuation of such transfers." Taxpayers should anticipate and be prepared to respond to questions from the IRS about realistic alternatives.

Resolution Phase

During the resolution phase, unless the taxpayer and the exam team reach an agreement, the issue team will issue a Revenue Agent Report / 30-Day Letter package. The TPEP also discusses the other options available to the taxpayer to settle the matter in administrative, or extrajudicial proceedings (*e.g.*, Appeals, Competent Authority, Simultaneous Appeals Procedures). **18**

Shifts from the Roadmap and Broader Implications

The TPEP, in many ways, represents the Roadmap in new clothing, but with an expanded waistline. Many of the TPEP's exam items perfectly align with the Roadmap's in both sequence and emphasis, but there are subtle shifts and departures that will affect how audits are conducted. Taxpayers should respond accordingly, modifying their audit strategies to address the slight shifts in exam dynamics.

Greater Emphasis on Isolated Issue Team Activity in the Planning Stage.

The TPEP provides for greater issue team evaluation of available

[pg. 64]

taxpayer information in the planning stage of the audit. Although thoughtful consideration of information and issues at the beginning of an audit would not, by itself, be cause for alarm, there is a real concern that this may inform an examiner's bias against the taxpayer's return position. The TPEP all but instructs examiners to view the taxpayer's intercompany pricing with a jaundiced eye by, for example, having examiners analyze the taxpayer's CbC report, prepare a ratio analysis, and review prior year work papers *before* considering the taxpayer's transfer pricing documentation or engaging in any discussions or planning meetings with the taxpayer. It also appears likely that issue teams will prepare their initial risk analyses before contacting taxpayers. This one-sided approach can ground issue team misperceptions of the taxpayer's intercompany pricing that can linger well into the audit, if not throughout it.

The presence of LB&I Division Counsel during the early stages of the planning process also preemptively injects a litigation element into the examination. While Counsel's involvement may provide direction for the audit, there is a real concern that its advocacy focus may further transform the examination into an adversarial proceeding, particularly if it has an interest in litigating the matter.

This concerted IRS planning activity is unfortunately left largely unbalanced by taxpayer input. Even procedurally, taxpayers appear to begin in a defensive posture. Under the TPEP, the issue team issues to the taxpayer its initial risk analysis, audit timeline, and audit plan *before* taxpayer orientations. In the Roadmap, these materials were provided after the taxpayer orientations. This slight shift may complicate early response efforts and require taxpayers to continuously adapt in response to a changing audit scope, which could be prevented by engaging the taxpayer earlier.

More Communication with Taxpayers During the Execution Stage

The TPEP acknowledges that taxpayer involvement in the audit will provide for more accurate factual development and there are many more points of engagement between the IRS and the taxpayer during the execution phase. The TPEP also at least tacitly approves of "issue discussion meetings" between the issue team and the taxpayer. These meetings are designed to allow the issue team to describe why certain issues were selected for audit and the taxpayer to respond. [19](#) Nonetheless, it is left to the issue team's discretion whether to conduct these meetings. [20](#)

More Formalized Fact-Finding Process

The TPEP similarly supports and advances the Roadmap-initiated trend of a more structured fact-finding process. This is most clearly evident in the interview process. Under the TPEP, the issue team is now

instructed to consider the need for a court reporter at interviews. ²¹ This is in contrast to the IRS's historical practices, but furthers the IRS's goal of creating a clear and complete record for Appeals and, potentially, use in litigation. It also moves the audit one step closer to an adversarial proceeding, although the taking of sworn testimony provides well-prepared and well-represented taxpayers the opportunity to make a compelling factual showing.

The TPEP also strongly encourages issue teams to reference various practice units as they conduct their audits, which were designed to enable examiners to use consistent (albeit largely cookie cutter) audit approaches.

Conclusion

The IRS continues to tinker with its approach to transfer pricing examinations. While the TPEP's impact is still uncertain, early indications suggest that an increase in U.S. transfer pricing controversies will follow, as they followed the issuance of the Roadmap.

¹ Publication 5300, Transfer Pricing Examination Process (August 2018).

² Publication 5125, Large Business & International Examination Process (May 2016). The TPEP folds the LB&I Examination Process, Publication 5125 ("LEP"), into its general procedures-with particular emphasis on LEP's structured interactions between and among IRS team members and advisors.

³ The Roadmap was designed around a two-year example examination timeline.

⁴ The TPEP indicates that, as a best practice, LB&I Division Counsel should be consulted early in the examination process.

⁵ The TPEP, like the Roadmap, highlights available guideline resources and materials that should be relied upon by team leaders to aid this effort. This includes publicly-disseminated practice units, specifically those titled "Arm's Length Standard," Overview of **IRC Section 482** " and "Three Requirements of IRC 482." See TPEP at 33 (list of practice units).

⁶ TPEP at 10.

⁷ See TPEP at p.9 "The issue team should perform analysis to compute key financial ratios for multiple years, make industry comparisons, and consider whether cross border income shifting is occurring. Ratios should be based on both tax and financial data. The ratios are useful as a diagnostic tool to help focus the examination. However, they do not provide a definitive indication as to whether

the prices for a taxpayer's controlled transactions achieve arm's length results. To determine whether ratios indicate potential transfer pricing issues, the team should appropriately develop the relevant facts to support a transfer pricing adjustment, a subpart F adjustment, or both."; *see also id.* at 11 ("Treasury Regulation Section ... 1.482-1(d)(2) states that 'unadjusted industry average returns themselves cannot establish arm's length results.' Therefore, unadjusted industry average returns should only be used to assess transfer pricing risk and on their own should not be used to make a transfer pricing adjustment.").

8 The risk analysis is prepared on Form 13744-I, though other forms such as Forms 4764, 4764-A, 4764-B, 4764-IC, and 13745 may still be used in certain circumstances. *See id.*

9 *Id.*

10 TPEP at 14.

11 TPEP at 16.

12 *Id.*

13 *Id.*

14 TPEP at 14-15, 17-18.

15 *See* TPEP at 20-22.

16 TPEP at 20.

17 TPEP at 19.

18 TPEP at 30-32.

19 IRM section 4.46.3.7 (03-14-20 16).

20 *Id.*

21 If court reporters are used in interviews, the issue manager and case manager must execute a request form and submit it to the "Issue Territory Manager" and "Territory Manager" for approval.

TPEP advises to allow 45 days to process the request. TPEP at 22.