

IRS Issues New Guidance on the Conduct of Transfer Pricing Audits

Tax Alert
07.23.2018

Overview

The IRS recently issued new audit guidance to the field on the conduct of transfer pricing audits that merits attention for any taxpayers facing such audits.¹ The Transfer Pricing Examination Process (TPEP), announced in Publication 5300, replaces the now retired Transfer Pricing Audit Roadmap.² Critics questioned whether the field really embraced some of the major features of the Roadmap, released with significant fanfare in February 2014. While we remain skeptical whether some features of the new guidance will fare any better, taxpayers can use the TPEP to anticipate and perhaps influence the course of a transfer pricing audit.

On its face, the TPEP is not a major overhaul of the Roadmap. But the updated guidance reflects and builds on recent changes to the IRS's LB&I procedures and other changes implemented since 2014. The TPEP endeavors to be consistent with the three-phase LB&I Examination Process described in Publication 5125.³ Moreover, the TPEP was issued as an official publication of the IRS, which may reflect a greater institutional commitment to the process outlined therein.

Consistent with the Roadmap, the TPEP provides guidelines for the three major phases of the transfer pricing examination process: planning, execution, and resolution. The TPEP includes both a two-year and three-year timeline for a transfer pricing audit.⁴ In contrast, the Roadmap was built around a two-year example timeline.⁵ Some misread that sample timeline as creating an official expectation about the length of transfer pricing audits. The addition of a three-year timeline, coupled with a reference to discussing statute of limitation extensions at the opening conference with taxpayers, reflects the IRS view that transfer pricing issues take significant time to develop appropriately.

Planning Process

In the planning phase, which determines the scope of the audit, Exam conducts an initial transfer pricing risk assessment. The goal of the risk assessment is to identify controlled transactions that may warrant examination. In doing so, Exam is urged to develop a preliminary working hypothesis to evaluate the arm's-length charge. Continuing a recommendation from the original Roadmap, the TPEP encourages transparent information sharing, including a discussion of the Exam team's initial risk assessment and preliminary working hypothesis.⁶ Practitioners have questioned whether in practice Exam will be amenable to sharing its risk analysis and working hypothesis on the correct arm's-length price for the controlled transaction early in the examination.⁷

The TPEP's discussion of the planning process mirrors common themes in LB&I's organizational and procedural realignment throughout the past several years, including an issue-based approach to audits and an increasingly centralized approach to case selection. The TPEP endeavors to select issues that will "have the broadest impact on achieving compliance regardless of size and type of entity."⁸ Such language aligns with the stated purpose of LB&I campaigns, which seek to make the greatest use of limited resources.⁹ And the TPEP incorporates recent developments in the audit process that reflect this stated goal, as well as other international developments since the 2014 Roadmap's release. For instance, for the initial transfer pricing risk assessment, the TPEP encourages the issue team to use the taxpayer's Form 8975, Country-by-Country Report (including financial ratios derived from such information), together with other tax return information, industry information, and publicly available information, to conduct a transfer pricing risk assessment.¹⁰ In addition, the TPEP recommends that the Exam team coordinate with the Advance Pricing Mutual Agreement program as part of the initial risk assessment when the transaction under consideration involves a tax treaty country.¹¹

The TPEP also incorporates interim instructions released in January 2018 directing the field to forgo requesting section 6662(e) transfer pricing documentation at the start of an audit, and instead to request such information only following an initial risk assessment and under certain circumstances.¹² The stated purpose of this policy is to ensure that transfer pricing audits are

conducted only in circumstances where the IRS has identified risk.¹³ A practical effect of the policy is that the IRS may conduct a significant amount of analysis, and develop a working theory of its case, before requesting any information from the taxpayer.

The Execution Phase

The execution phase involves issue development through determining facts, applying the law to those facts, and understanding the various tax implications of the issue. During this phase, the issue team will continue to evaluate its initial risk assessment and working hypothesis as additional facts come to light, and will ultimately develop economic reports and a Notice of Proposed Adjustment. One important change reflected in the TPEP is the requirement for Treaties and Transfer Pricing Operations's (TTPO's) Transfer Pricing Review Panel's approval if an Exam team proposes to change the taxpayer's transfer pricing method where the taxpayer's TPM is supported by documentation.¹⁴ The TPEP instructs Exam to issue IDRs requesting the taxpayer to provide an orientation to its financial statements early in the audit, and later to request a separate presentation on the taxpayer's transfer pricing structure and supply chain.¹⁵ Exam is also advised to give the taxpayer the opportunity to voluntarily walk the issue team through its Country-by-Country Report.¹⁶ Taxpayers should carefully consider these presentations and the extent to which they can be used to appropriately frame the issues under consideration. Consistent with Publication 5125, Exam is also advised to issue so-called Acknowledgement of Facts IDRs for all transfer pricing issues before finalizing the NOPA and economist reports.¹⁷ Such IDRs are particularly problematic for taxpayers if Exam has not communicated its theory supporting a proposed adjustment.

Resolution Phase

In the resolution phase, the Exam team and the taxpayer either reach an agreement or an RAR is issued to the taxpayer.¹⁸ The issue team is encouraged to discuss the results of all issues with the taxpayer in an effort to reach a conclusion before finalizing the NOPA and economic reports.¹⁹ Traditionally, Exam teams—and perhaps taxpayers as well—have been reluctant to engage in meaningful substantive dialogue before a NOPA is issued. The TPEP also discusses other available options to pursue contemporaneously with the examination or after it is complete, including Appeals and, when a tax treaty country is involved, U.S. Competent Authority requests, Accelerated Competent Authority Procedures, and Simultaneous Appeals Procedures.²⁰

Conclusion

The new TPEP includes features that should help the IRS better deploy scarce resources on transfer pricing audits. As with the prior Roadmap it replaces, however, the extent to which Exam follows these procedures and best practices depends upon the institutional commitment to them at all levels of the IRS. Knowledge of the new TPEP will allow taxpayers to understand what to expect in a transfer pricing audit and to use the TPEP as a tool to correct course if it appears Exam is not meeting those expectations.

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¹Dept. of the Treasury, I.R.S., *Transfer Pricing Examination Process* (TPEP), Pub. 5300 (June 2018), <https://www.irs.gov/pub/irs-utl/P5300.pdf>.

²Dept. of the Treasury, I.R.S. *Transfer Pricing Audit Roadmap* (Feb. 2014).

³Dept. of the Treasury, I.R.S., *Large Business & International Examination Process*, Pub. 5125, (May 1, 2016), <https://www.irs.gov/pub/irs-utl/p5125.pdf>.

⁴TPEP at 36-37.

⁵*Transfer Pricing Audit Roadmap* at 3.

⁶TPEP at 14-15, 22-24.

⁷*Id.* at 8-11, 13-15. All section references are to the Internal Revenue Code of 1986 (the Code), as amended and currently in effect.

⁸TPEP at 5.

⁹See, e.g., Department of the Treasury, IRS, *IRS Announces Rollout of 11 Large Business and International Compliance Campaigns* (Nov. 3, 2017), <https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns-0>.

¹⁰TPEP at 9; Form 8975, *Country-by-Country Report* (June 2017), <https://www.irs.gov/pub/irs-pdf/f8975.pdf>.

¹¹TPEP at 7-8.

¹²Douglas W. O'Donnell, *Memorandum for All Large Business and International Division Employees Re: Interim Instructions on Issuance of Mandatory IDR in LB&I Examinations* (Jan. 12, 2018), <https://www.irs.gov/businesses/corporations/interim-instructions-on-issuance-of-mandatory-transfer-pricing-information-document-request-idr-in-lbi-examinations>.

¹³*Id.*

¹⁴TPEP at 28; Douglas W. O'Donnell, *Memorandum for Large Business and International Division Employees Re: Revised Instructions for LB&I on Transfer Pricing Issue Selection and Scope of Analysis - Best Method Selection* (Jan. 29, 2018), <https://www.irs.gov/businesses/corporations/instructions-for-lbi-on-transfer-pricing-selection-and-scope-of-analysis-best-method-selection>.

¹⁵TPEP at 17-18.

¹⁶*Id.* at 17.

¹⁷*Id.* at 27.

¹⁸*Id.* at 28-30.

¹⁹*Id.* at 28-29.

²⁰*Id.* at 28-32.

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