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INSIGHT: IRS Transfer Pricing Audit Memos Send Clear Signal to U.S. Multinationals

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Internal Revenue Service's Douglas O'Donnell in January issued five transfer pricing memoranda of instructions to the Service's Large Business and International Division employees (Control No. LB&I-04-0118-001 through 005).

O'Donnell, the commissioner for LB&I at the IRS, issued instructions to Field auditors on how to conduct transfer pricing examinations and handle advance pricing agreement applications, including an instruction regarding an issue that has been the subject of repeated regulatory changes and litigation.

The memoranda update the Internal Revenue Manual (IRM) and will be incorporated into the manual to provide ongoing instruction to LB&I personnel, primarily but not exclusively International Examiners (IEs).

The timing of the memoranda's release, when the attention of most taxpayers was on the potential impact of the tax reform bill, likely reduced the attention paid to them. That said, a closer look reveals some important guidance for taxpayers involved in either transfer pricing audits or APAs.

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Transfer Pricing Information Document Requests (IDRs)

All the memoranda include identical introductory language acknowledging both that transfer pricing issues make up a substantial portion of the LB&I audit inventory, and that LB&I needs to manage transfer pricing issues and related resources "in the most efficient and effective manner possible."

To that end, the first memorandum, which is described as an "interim instruction," makes the Mandatory Transfer Pricing IDR (the IDR requesting the taxpayer's transfer pricing documentation for the year at issue) no longer mandatory for all cases. The memorandum, while acknowledging that the Mandatory IDR is a critical starting point for any transfer pricing examination, limits its use to examinations that arise under an approved LB&I transfer pricing campaign, or examinations where personnel from either the Transfer Pricing Practice (TPP) or Cross Border Activities (CBA) Practice Area have been assigned.

While the memo does not explicitly connect these dots, it is clear going forward that it will be LB&I policy that all transfer pricing exams will either be part of a campaign or will have National Office involvement through either TPP or CBA personnel being assigned.

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This should be seen as a positive development for taxpayers, in that it should lead to more consistency in both case selection and case process.

High Bar for Proposing Method Different from Taxpayer's Chosen Method

Further underscoring the point that individual examiners will have less discretion in the conduct of a transfer pricing exam going forward, the second memo specifically instructs that where the examiner believes that the factual development of the case supports a conclusion that a method other than the taxpayer's selected method is, in fact, the ''best method'' within the meaning of the transfer pricing regulations, the examiner must go through a process that ultimately requires the approval of the national TTPO Transfer Pricing Review Panel.

The same rule applies to the APA process, which will be welcome news to taxpayers that have dealt with APA teams that rejected the taxpayer's proposed method and developed an alternative approach. While a change of method was not typical, in my experience in Advance Pricing and Mutual Agreement (APMA) program it was not unusual for the taxpayer and the APA team to have spirited discussions regarding method selection during the pre-file conference, and for APA teams sometimes to modify the taxpayer's chosen method if the APA submission did not follow the APA team's pre-file conference recommendations.

The TTPO Review Panel will consist of either the TPP Director (for cases in Examination) or the APMA Director (for APA applications), a Senior Advisor to the TTPO Director, and the Income Shifting Practice Network Manager.

The panel will focus on three questions: (1) why the taxpayer's method is unreliable; (2) can the taxpayer's method be modified to become more reliable; and (3) if not, what method is more reliable and why.

The method-change recommendation must answer the questions outlined above, and any further requirements will be communicated directly to the Territory Managers and APMA Assistant Directors. The memo notes that the approval process is not intended to impede the process of determining compliance with the transfer pricing regulations but is designed to support ''the best and highest use of limited transfer pricing resources.''

The memo also notes that where the taxpayer has not timely provided a report that clearly states the method that the taxpayer has chosen as the best method (whether specified or unspecified) and includes an analysis supporting that conclusion, the review process would not apply to any subsequent analysis prepared by the IE that might apply a different method. In other words, poor documentation will not protect you from the IE changing your method in exam.

As with the first memo limiting the issuance of the Master IDR to cases where there has been a preliminary determination of a transfer pricing compliance risk, this memo appears to be addressing an area of contention between taxpayers and the IRS, both in the Field and at APMA, and looking for a way to accelerate the resolution of such issues. In the Field context, typically if the IE rejected the taxpayer's method and imposed a different method it would be difficult for the taxpayer to get that issue carved out and elevated to either a territory manager or the TPP; rather, the change in method would simply be the mechanism for calculating the adjustment, and the taxpayer typically could not challenge it until the NOPA had been issued, or at least until after the IRS team had expended significant time and effort on the issue.

Likewise, in my experience when differences of opinion arose at an APA pre-file meeting over the taxpayer's proposed method, usually there was no resolution of the differences at that time, and no way for either the APA team or the taxpayer to get feedback from higher levels of the office regarding the ultimate acceptability of the taxpayer's proposed method until the taxpayer filed its submission. At that point, if the APA team proposed a different method and the taxpayer elevated the case to the team manager or APMA Director, the taxpayer would have made a significant investment in developing its submission and the APA team would have made a significant investment in developing its own alternative method, with neither side sure which approach would be approved by APMA management. By requiring review and sign-off from management up front, the squabbles about best method that could and often did take a lot of time and effort should be short-circuited. It should be noted that the memo does not have any impact on either the Field or an APA team challenging a taxpayer's set of comparables, its tested party data, or any other factor present in the chosen method, and the review process is not required for such proposed changes.

Forbearance on Cost Sharing Issues Ordered

Two of the memoranda address issues arising in the context of cost sharing arrangements (CSAs), one focused on a specific issue that has been the subject of extensive regulation and litigation, and one that appears to be a subject of significant Field activity.

For the first, the memo provides the specific instruction to ''Stop opening issues related to stock-based compensation (SBC) included in cost-sharing arrangement (CSA) intangible development costs (IDCs) until the Ninth Circuit issues an opinion in the Altera case on appeal.'' Regarding SBC and intercompany service charges outside of a CSA, the memo states that Examination teams ''should consult with LB&I Division Counsel on those issues to determine whether inclusion of SBC in services should be pursued as a strategic trans-

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fer pricing examination issue if it is factually distinguishable from the issue in Altera.'' Clearly the IRS has not given up the issue and with this instruction might be looking for a case to revisit the SBC issue that, as noted, would be factually distinguishable from Altera and possibly yield a different result.

In the second CSA-related memorandum, Exam teams are instructed to ''Stop developing adjustments to cost sharing arrangements (CSAs) based on changing the taxpayer's multiple reasonably anticipated benefits (RAB) shares to a single RAB share when subsequent platform contribution transactions (PCTs) are added to an existing CSA until a Service-wide position is finalized.''

The memorandum notes that it is a common fact pattern for taxpayers to establish a CSA, then acquire an independent company with valuable IP that is contributed to the CSA thereby triggering a PCT, and as a result the company establishes a RAB share for the subsequently acquired IP that is different from the RAB share established for the original IP. The memorandum explains that some exam teams are taking the position that the cost sharing regulations require the use of a single RAB share for each CSA and are developing adjustments in cases where the taxpayer has more than one RAB share included in a single CSA.

Since the CSA regulations clearly anticipate that taxpayers can choose to establish multiple CSAs with different RAB shares, the memorandum notes that incorporating subsequent IP and RAB shares into a single CSA appears to be conceptually comparable with the regulations. That said, the Service appears to be reviewing the issue to develop a consistent Service-wide position, therefore exam teams should not develop adjustments based solely on this issue. This does not mean that examiners are precluded from closely examining whether the multiple RAB shares are appropriate given all the specific facts and circumstances of the case, but until the Service-wide position is developed exam teams may not make an automatic adjustment based solely on their reading of the regulations.

Field Encouraged to Impose Penalties ''If Appropriate''

For the most part the memoranda give taxpayers positive news about how the IRS intends to audit transfer pricing issues and seem to rein in some inefficient and often counterproductive actions that were used by some exam teams and APA teams. That said, LB&I-04-0118-003, labeled ''Instructions for Examiners on Transfer Pricing Issue Examination Scope—Appropriate Application of IRC § 6662(e) Penalties,'' provides guidance to examiners that taxpayers should also read and understand, because it could have the effect of changing the dynamics of a transfer pricing audit in some significant ways.

In my work at Competent Authority I had the opportunity to attend meetings with IEs and work with some of them on case development. In discussing penalties, it was clear that when the taxpayer provided documentation, even when such documentation was not adequate or reasonable, it was challenging for IEs to obtain approval for the imposition of penalties. Sometimes examiners would gather as much information as they could, and if the ECD (Estimated Completion Date) of the exam was approaching, they would include all the information in the file to give the next IE a head start on the issue. It was rare to have a taxpayer provide no documentation that met the requirement of being ''in existence'' at the time of the return filing, but it was not rare to have documentation that was inadequate but that was supplemented by later analysis that did provide the support described in the regulations for the taxpayer's return position. In such cases it was often decided not to pursue penalties on a subsequent adjustment, in part (I believe) because there was a sense, founded or unfounded, that it would be extremely difficult for the IE to make the case for penalties that would survive either managerial review or the Appeals process. In other words, late compliance is better than no compliance.

In this context, then, the memorandum provides strong direction to IEs to pursue penalties even where the taxpayer has met the initial burden of providing some timely documentation, where such documentation is not reasonable or complete. The memo notes that the failure to apply penalties where appropriate ''has adverse consequences,'' because the IRS might not be properly using a legislative tool intended to encourage taxpayer compliance. The House Report for the bill that strengthened the penalty rules stated that the Committee ''does not believe that a section 482 adjustment that exceeds the threshold generally should escape the penalty unless the taxpayer can show that the return position was arrived at after bestowing a reasonable amount of attention to the issue.'' Thus, the memo notes, unless the section 6662(e) documentation is both adequate and timely, the regulations require the imposition of the penalty where the thresholds are met. Appropriate application of penalties when the initial documentation is inadequate ''maintains accountability and encourages reasonable and well-documented return positions that may be assessed more efficiently, saving resources for both the IRS and taxpayers.''

The bottom line of the memo is, if a taxpayer provides documentation that does not meet the minimum standards of the regulations, but later submits information that might meet such standards, the taxpayer is not protected from penalties. The memo instructs examiners, in cases where supplemental information is provided, to consider whether such information was available or could have been developed before the return was filed, which can help the team determine if the taxpayer adequately searched for, considered and applied the relevant information in preparing its documentation. The memo closes by reminding examiners that the ''often long and complex transfer pricing analysis'' must be completed with ''a diligent penalty analysis.'' It is likely, then, that more attention will be paid to the adequacy of the initial documentation and a supplemental analysis might no longer be a get out of jail free card.

Conclusion

As noted at the outset, the late December signing of a U.S. tax reform bill that has significant impact on U.S. multinationals' cross border transactions, and the need to focus on those changes, explains how the release of the memoranda in January could fly under the radar. As discussed above, however, the memoranda include important guidance to both IRS Field examiners and taxpayers regarding how transfer pricing audits will be

conducted going forward and heeding their advice can prove beneficial to taxpayers that find themselves facing such audits.

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