

Tax Executive

THE PROFESSIONAL JOURNAL OF TAX EXECUTIVES INSTITUTE

JULY
AUGUST
2020

Vol. 72
No. 4

OOPS, MISTAKE ON YOUR TAX RETURN—SHOULD YOU FIX IT?

A PROPOSED COMPLIANCE
FRAMEWORK

RESEARCH & EXPERIMENTATION
CREDIT: NEW ISSUES
ON THE HORIZON

ROAD MAP TO A TRANSFER
PRICING CONTROVERSY

COVID-19 DISRUPTION:
CHALLENGES FOR LIFE
SCIENCES COMPANIES

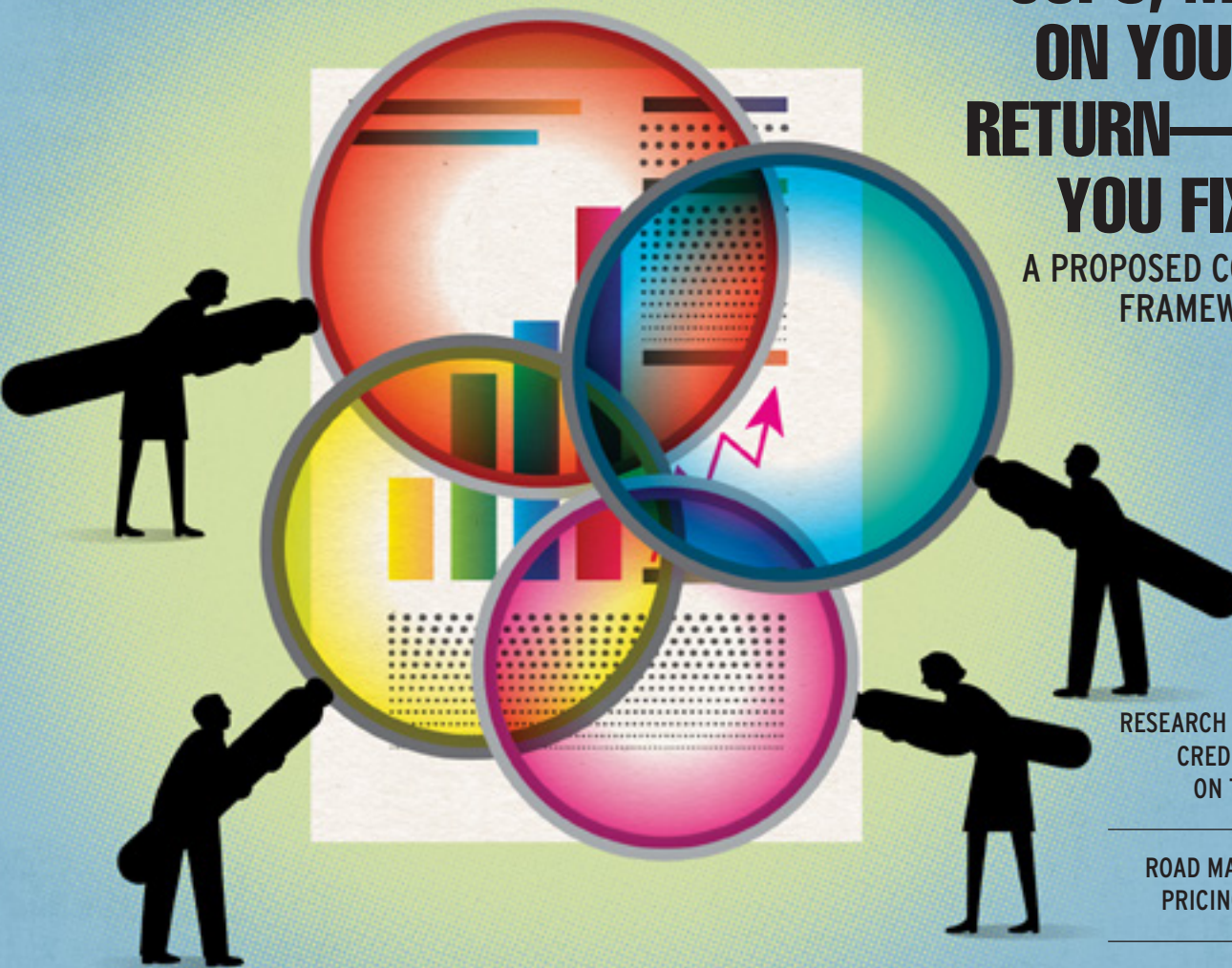
TEI ROUNDTABLE: IRS APPEALS

EMERGING LEADER:
CHRIS ANDERSON

MEMBER PROFILE:
MAKENZIE ZUERN



TEI



Road Map to a Transfer Pricing Controversy

Preparing for success in audits and litigation in a strict enforcement environment

By Miriam Fisher, Matt Lerner, and Royce Tidwell

In recent decades, the Internal Revenue Service has pursued numerous long-running and complex transfer pricing audits. Although many have been resolved administratively, or prior to trial, the IRS has a decidedly uneven record in its litigation of high-profile transfer pricing disputes, not infrequently finding itself in the loss column in the courtroom.

Not long after being sworn in as the new commissioner of the IRS in late 2018, Charles Rettig addressed this record by making it clear that the IRS was undeterred by its losses in court. He described litigating transfer pricing disputes as a key IRS enforcement strategy, because the agency perceives transfer pricing as an area where taxpayers often are not in compliance. He warned:

If we're in your neighborhood and that's your world, you will tighten it up going forward. . . . When we bring five transfer pricing cases and the court rules against us, you don't have a Commissioner who thinks we lost. We're going to wonder why we didn't bring ten.¹

Since his early comments, Rettig has emphasized the resources the IRS brings to bear in transfer pricing disputes, its expectations about taxpayer cooperation, and its willingness to litigate difficult cases if necessary. The Commissioner's "no backing down" message is echoed by other IRS leaders who have vowed the IRS will continue to litigate issues that remain unresolved.

This is the current environment for taxpayers facing transfer pricing disputes with the IRS. For these important high-dollar cases, the IRS is well resourced and determined and can be aggressive, procedurally and substantively. Its wealth of experience and organizational structure allows it to dedicate large multifaceted teams to handle transfer pricing audits and litigation. Coordination among global tax authorities has improved. The IRS is using new data and analytical tools, has access to economists and other experts, and does not hesitate to take forceful procedural stances and to assert penalties.

In light of this challenging environment, a taxpayer's best chance for a favorable outcome is to prepare for IRS scrutiny when planning transactions, specifically when preparing transfer pricing documentation, which will be the starting point of any examination. A well-supported valuation documented in accordance with the regulations and meeting the IRS' articulated expectations will go a long way toward starting an audit on the right foot.

Prior to an examination, it is important to preserve the transactional record, to marshal the information and key witnesses, and to shape the narrative that will ultimately support the taxpayer's position. Relevant information may come from years both prior to and after the transaction. It is also critical to understand how the IRS manages and conducts transfer pricing audits. During the examination, it is important to be responsive, proactive, and cooperative with the Exam team, working through issues to identify and define areas of agreement and dispute. Finally, a taxpayer must be prepared for the possibility that, in the case of a serious disagreement, penalties may be asserted, and the IRS may be willing to litigate.

The key to navigating a transfer pricing audit successfully is preparation.

Best Practices—Establishing the Taxpayer's Position

The key to navigating a transfer pricing audit successfully is preparation. That means properly establishing transfer pricing positions in accordance with both the governing regulations *and* IRS expectations. Although transfer pricing regulations are easy enough to identify, understanding IRS expectations for a transfer pricing audit can be more difficult. Fortunately, the IRS has provided resources to guide taxpayers in this regard. These resources include (among other items):

- “Publication 5300 – Transfer Pricing Examination Process” (available at www.irs.gov/pub/irs-utl/P5300.pdf), a detailed guide to IRS field personnel in conducting transfer pricing examinations (known as TPEP);
- Industry Practice Units (IPUs), published by the IRS to assist examiners with general tax concepts and to assist with specific transactions. Transfer pricing IPUs are available at www.irs.gov/businesses/corporations/practice-units, including “Review of Transfer Pricing Documentation by Outbound Taxpayers” and “Review of Transfer Pricing Documentation by Inbound Taxpayers”;
- LB&I Industry Directives, such as “Instructions for Examiners on Transfer Pricing Issue Examination Scope—Appropriate Application of IRC §6662(e) Penalties” (available at www.irs.gov/businesses/corporations/instructions-for-examiners-on-transfer-pricing-issue-examination-scope-appropriate-application-of-irc-ss6662e-penalties), which provides insight into the IRS' view of the documentation requirements and when penalties may be asserted; and
- LB&I's Transfer Pricing Documentation Frequently Asked Questions (FAQs) (available at www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-frequently-asked-questions-faqs), which provides a significant amount of detail around IRS expectations for transfer pricing documentation.

Taxpayers should review these materials thoroughly to understand the IRS perspective on establishing a transfer pricing position. The IRS penalty discussions are particularly useful because Internal Revenue Code Section 6662(e)(3) imposes a transfer pricing penalty only if taxpayers fail to document their transfer pricing positions adequately. Section 6662(e)(3), along with the accompanying regulations in Treasury Regulations Section 1.6662-6, requires that taxpayers 1) reasonably apply a transfer pricing method set forth in the Section 482 regulations, 2) maintain documentation establishing that the taxpayer's selection of and use of the method are reasonable, and 3) provide such documentation to the IRS within thirty days of a request. Of critical importance, the IRS believes that penalties are “mandatory” any time a transfer pricing adjustment exceeds the applicable thresholds and the taxpayer fails to maintain or provide adequate documentation.

In general, taxpayers should demonstrate their compliance with the arm's-length standard with adequate documentation. Depending upon the context, this may require hiring an economic expert. In any case, the documentation should clearly demonstrate that the best method was selected and

that such method was applied reasonably. That is, however, easier said than done.

Some high-level checks on the adequacy of documentation include:

1. *Is there an industry or business overview that tells the taxpayer's story in a complete, accurate, and compelling way?*

Because transfer pricing documentation is requested early in an examination, and almost always before any substantive discussions, the documentation's industry overview is frequently the first thing the IRS reads to understand a taxpayer's business and its transfer pricing. Taxpayers should use this opportunity to frame the business and intercompany transactions in a manner that accurately and clearly reflects the core economic drivers of the business. This overview should provide a framework that reconciles all of the taxpayer's transfer pricing positions and that acts as a foundation from which all future IRS questions may be answered. This section is particularly important for businesses that have unique or unexpected economic outcomes—that is, where the division of profit may, at first blush, appear uneven. Accurately establishing the business dynamics that explain such apparent anomalies is critical.

2. *Does the functional analysis explain not just which party performed which function but also how those functions relate to risk and result in value creation?*

The functional analysis is an opportunity to explain the role each controlled party plays in the taxpayer's business. Simply to list the functions each party undertakes and the risks to which each is exposed may represent a missed opportunity and cause the IRS to conclude that the documentation did not adequately justify the taxpayer's transfer pricing. It is far more compelling to describe each function in detail and explain how each function contributes to the overall value creation of the business. For example, instead of simply noting that a controlled party undertook manufacturing, a taxpayer should explain in detail the manufacturing process, the necessary inputs into that process (for example, skilled workforce, intangibles, and supply chain management), and the risks involved. Because not all manufacturing is the same (that is, some manufacturing may be excessively risky and justify significant returns), it is prudent to document the source of the risk and provide objective measures of it.

3. *Does the best method analysis include a detailed description of taxpayer's search for data and available comparables?*

One area that is often overlooked in taxpayer documentation is a detailed discussion of the search for data and comparables. Taxpayers should conduct a thorough search for data, both internally and externally, and ensure that the search

is documented. Taxpayers can be certain that the IRS will probe whether the taxpayer adequately searched for data. If, for example, a taxpayer relies upon external comparables and the IRS discovers through the information document request (IDR) process that the taxpayer had reliable internal comparables—even if those were not used as part of the taxpayer's tax compliance process—the taxpayer may be subject to a transfer pricing adjustment and penalties for failure to conduct an adequate search.

4. *Has the taxpayer conducted a sensitivity analysis around the results of the transfer pricing study? Has the taxpayer evaluated how the IRS will view its transactions and anticipated any questions?*

Inevitably, the IRS will conduct a sensitivity analysis around any significant transfer pricing position, which will include varying the comparable companies selected, adjusting the profit-level indicator, and evaluating the profit split in the controlled transaction. The taxpayer should include such sensitivity analyses in the transfer pricing documentation and explain any seemingly anomalous results to the IRS before they are “discovered” on audit.

Relatedly, it is important to review financial results as reported (or to be reported) on financial statements, Forms 5471, country-by-country reporting, and base erosion and profit-shifting (BEPS) reporting, among others, from the perspective of the IRS. Are there any results that will seem odd and need to be explained? If so, prepare the explanations contemporaneously and, as appropriate, incorporate the necessary foundations for the explanations in the transfer pricing documentation.

5. *Has the taxpayer identified and maintained all sources of information it has relied upon to establish its transfer pricing position?*

Taxpayers should collect and maintain all information necessary to understanding their transfer pricing positions.² Under the regulations, taxpayers must maintain and provide upon request both “principal documentation” and “background documentation.” Failure to do so can result in penalties. Beyond this regulatory requirement, however, it is important to maintain these materials so that the transfer pricing position can be defended. In addition to maintaining documents and data, taxpayers should record who within the organization was consulted and what information they provided.³ These proactive steps could prove valuable now that audits are lasting longer and longer and it becomes increasingly difficult to recreate the circumstances facing a business as time passes.

Best Practices—The Transfer Pricing Audit

As indicated above, handling an exam successfully requires substantial work before the audit

even commences. However, it is important that a taxpayer is not just aware of what is coming but also is in the best position possible to respond effectively to the IRS.

The taxpayer should have the transfer pricing documentation required by Treasury Regulations Section 1.6662-6 at the ready, because any delay in producing it can both limit its effectiveness at avoiding penalties and create skepticism in the Exam team's mind. This proactive step has several other benefits. First, it puts the taxpayer in a position to respond in a timely manner to IRS requests—meeting IRS deadlines and maintaining short IDR turnaround times will likely endear the taxpayer to the Exam team as it facilitates review of the issues as well as audit currency, a key goal for the IRS. Second, and equally important, doing so allows the taxpayer to determine which materials the IRS is likely to expect that can no longer be located. Knowing documents are missing prior to being asked for them allows the taxpayer 1) to locate alternative sources of information that might answer IRS questions and 2) to prepare replacements pre-audit but after-the-fact to fill in blanks.⁴

As noted, the IRS is virtually certain to ask for witness interviews when it identifies a significant transfer pricing issue. Although the IRS faces constrained budgets and is generally conservative with respect to audit travel, the agency will spare little expense in conducting both domestic and foreign interviews in large-scale transfer pricing exams. The IRS' interview list may be extensive, but many Exam teams can be convinced to carve the list back where the taxpayer can produce one effective witness to present the information sought from several witnesses or otherwise show that interviews are likely to be cumulative. It is important that the taxpayer is reasonable and tries not to avoid interviews altogether. Flexibility and collaboration are more likely than intractability is to lead to compromises.

Perhaps most important, the taxpayer should prepare the presentations the TPEP indicates the Exam team will request. The first is “a walk-through of the geographic, legal entity, tax, and functional organizational charts, and all reporting platforms that exist (for example, different management reporting platforms)” that may include, among other things, the taxpayer's country-by-country report and the “[r]econciliation from the geographic trial balance to the SEC Form 10-K consolidated financial statements.”⁵ The issue team will also likely issue an IDR requesting a transfer pricing/supply chain orientation meeting, seeking information about the taxpayer's history with special focus on past intercompany transactions. It will also ask about key intercompany transactions in the examination year(s), seeking information about the rationale for the

transactions, the key value drivers of intercompany dealings, whether an income stream has been transferred, and how the transactions were described, as well as substantial other details.⁶

Preparing this presentation is a crucial step that can take weeks if not months. It should not be viewed as a rote presentation of objective facts, but rather as the first opportunity to present one's affirmative case. It needs to be informative, engaging, and effective to support the taxpayer's ultimate position. The Exam team does an initial risk assessment of the case early in the audit, and getting this information in front of the subject matter experts before or as they are forming their initial impressions can influence their viewpoint, which can drive both the course of the examination and the vigor of their review. Conversely, every day that passes during which the Exam team is conducting the examination before the taxpayer's presentation is a day in which the team is forming its own views without the benefit of the taxpayer's insights and support. Basic psychology makes clear that once an opinion crystallizes, changing it becomes much more difficult.

The taxpayer should analyze the issues it is likely to face, understand the legal standards, gather the facts, and package them as an accurate explanation of the taxpayer's position. The presentation should not be openly argumentative or obvious advocacy, but it can present nuanced facts in a way most helpful to the taxpayer. The presentation also provides an opportunity to confront obvious issues head-on before the IRS digs in and thereby ensure that the Exam team understands the taxpayer's position. For example, if the taxpayer is aware of an apparent issue in its country-by-country reporting (for example, substantial income in a country where the number of personnel or amount of physical assets seems inconsistent with such income), explaining it up front may be a good idea. Similarly, one can explain the pricing methodologies selected and justify them before the IRS has begun solidifying its own views.

Another key step is to evaluate publicly available statements from throughout the relevant period to identify potential issues and ensure everyone speaking for the company is presenting information accurately and in the best possible light. Exam teams will look at securities filings and information available on the internet. Where publicly filed reports appear to contradict positions taken in transfer pricing analyses, being prepared with explanations can facilitate audit success. Furthermore, Exam teams may look, for example, at the LinkedIn pages of key employees to understand their functions. The taxpayer should encourage employees to maintain accurate (and uncontroversial) social media postings so that the

IRS does not rely on faulty or incomplete information to form a viewpoint inconsistent with the facts that will have to be corrected.

In addition, the taxpayer may wish to retain an economist to review all transfer pricing analyses, both to validate the prior work and identify potential problem areas. Wherever possible, the consulting economist should be retained under a *Kovel* engagement, where counsel hires an expert to assist counsel in rendering legal advice to the company, making the expert's work subject to attorney-client privilege. The taxpayer must also be prepared for the IRS to engage its own economists and other experts at the audit stage to advise and produce reports that challenge the taxpayer's positions.

Recent experience indicates certain common challenges taxpayers are likely to confront on audit. First, the IRS will focus intensely on whether transactions have been properly aggregated or disaggregated. Often, where a parent company provides a number of services and property to a foreign subsidiary, the contemporaneous transfer pricing document will segregate each transaction and price it individually. The IRS typically argues that the whole is greater than the sum of the parts and demands that all transactions be aggregated. It then concludes that the value transferred is far greater than reported. The taxpayer should be prepared to counter those concerns and justify the choices it made on both a functional and economic theory basis.

Second, because the Tax Cuts and Jobs Act (TCJA) broadened the definition of intangibles for which compensation may be due, Exam teams are following suit and seeking to impose additional intercompany charges for more amorphous items than were previously included in transfer pricing requirements. But the definition of intangibles is not infinite, so taxpayers should be prepared to explain how their pricing captures all items for which compensation is required.

Third, as noted above, the IRS has more sources available than ever before to use in performing transfer pricing analyses. A taxpayer should expect the IRS to review country-by-country reports as well the Organisation for Economic Co-operation and Development's BEPS documentation, looking for facts that may undercut the taxpayer's reporting or reveal inconsistent positions. Ideally there will have been appropriate coordination in preparing that documentation to ensure accuracy and consistency, but close scrutiny should be expected. Relatedly, joint audits and requests for exchange of information with foreign countries occur more and more often. To be prepared, taxpayers should work with local country tax teams to coordinate audit responses and develop an overall strategy,

avoiding at all costs presenting conflicting narratives to two different taxing authorities.

As a transfer pricing examination continues, taxpayers must be cognizant of the role the Advance Pricing and Mutual Agreement and Competent Authority teams may play. Taxpayers working with either office should keep it informed of the progress of the audit. Not only will the personnel there appreciate the effort, but they may weigh in in a manner that facilitates a favorable outcome. Likewise, a taxpayer must consider the possible need to enlist competent authority to obtain relief from double taxation. A taxpayer under exam must be mindful of applicable statutes of limitations in all countries involved and be sure to take steps to preserve rights in the event of an unfavorable outcome.

In general, taxpayers should demonstrate their compliance with the arm's-length standard with adequate documentation.

As a general matter, throughout the audit a taxpayer should always look for opportunities to meet and discuss issues with the Exam team and encourage the team to share preliminary observations and engage in discussion. Once reports are written, Exam teams are much more likely to become attached to their positions and show less flexibility. By addressing concerns as they arise, a taxpayer may be able to change minds more easily and to suggest information sources to which the Exam team may turn to validate the taxpayer's positions.

Notwithstanding the taxpayer's efforts to be reasonable, tensions and seemingly unreasonable demands can arise. In such cases, the taxpayer should consider elevation. Having conducted oneself properly in the exam will facilitate invoking the assistance of IRS management. It is far easier to ask for help when the taxpayer has established its credibility with a record of complying with requests and going the extra mile. These circumstances demonstrate the importance of fostering a relationship with IRS regional management long before seeking to obtain its assistance. In addition, in a transfer pricing exam, IRS Transfer Pricing Operations (TPO) may be controlling certain issues, so establishing a relationship with TPO in advance is a good idea. IRS leaders may have a natural predilection to believe their own employees and discredit taxpayer complaints, so relationships and credibility will help if and when problems arise. Importantly, taxpayers should elevate in the

appropriate order, for example, by not going to the IRS director of field operations before seeking relief from the territory manager. The IRS respects its hierarchy and expects taxpayers to do so as well; bypassing that hierarchy can undermine relationships with field management. Finally, consider that elevation of issues of national IRS policy—such as standard IDRs—is unlikely to be effective.

A Note on the Unagreed Case

Over several decades, large transfer pricing disputes have often been resolved only through trial and appellate litigation. This is not surprising, given their legal and factual complexity as well as the significant dollars typically at issue. And, as noted, the IRS continues to broadcast its willingness to fight in appropriate cases. Thus, the best-prepared taxpayers with the most efficiently run audits may nevertheless end up in tax disputes so substantial or contentious that they cannot be resolved at the examination or IRS Appeals stage.

The substantial risks of an unagreed transfer pricing exam include delay, distraction, expense, and prolonged uncertainty. The IRS assertion of, and the taxpayer's need to defend against, penalties of twenty to forty percent is increasingly common in unagreed cases. In recent years, transfer pricing disputes have required litigation of summons enforcement actions and procedural challenges—including over whether an unagreed case could proceed to Appeals—even before a deficiency or refund proceeding commences. Typically, after what could be many years in the administrative stage, many more years in trial and appellate litigation are likely, with years of uncertainty and staggering expense, even when the taxpayer ultimately prevails.

These significant risks underscore the importance of informed audit preparedness and good audit management with respect to transfer pricing issues to optimize a taxpayer's chances for early resolution of disputes. ●

Miriam Fisher is a partner and global chair of tax controversy at Latham & Watkins, **Matt Lerner** is a partner and global chair of tax controversy at Sidley Austin, and **Royce Tidwell** is a partner, tax litigation and controversy, at Skadden, Arps, Slate, Meagher & Flom.



Miriam Fisher



Matt Lerner



Royce Tidwell

Endnotes

- 1 "IRS Will Fight Transfer Pricing, Even If It Loses, Official Says," *Law360 Tax Authority*, December 13, 2018, www.law360.com/articles/1110720/irs-will-fight-transfer-pricing-even-if-it-loses-official-says.
- 2 Taxpayers should consider whether to implement a "litigation hold," requiring employees to preserve relevant documentation. Doing so effectively can be challenging and expensive but may ensure that needed materials do not disappear, either through neglect or the operation of normal document retention policies. Furthermore, where documents are lost, the IRS may be less likely to draw a negative inference if preservation efforts were made.
- 3 Although it is premature to prepare employees for witness interviews before the audit has commenced, making a list of likely candidates is advisable. For employees who may leave the company over time, the tax audit team should have a system for notification upon any departure, so there is an opportunity to preserve testimony. Similarly, where possible and permitted by law, a taxpayer should include cooperation agreements as a condition to any severance arrangements, so that the employees remain accessible, if needed.
- 4 For example, where a memo describing certain pricing justifications is known to exist but cannot be located, the taxpayer can recreate that document before it is requested, so long as the newly created document is *not* backdated or otherwise made to appear to be the original, but accurately captures the information known to be in the prior document.
- 5 Internal Revenue Service Publication 5300 – Transfer Pricing Examination Process (TPEP), *Internal Revenue Service*, rev. June 6, 2019, www.irs.gov/pub/irs-utl/P5300.pdf, 19.
- 6 *Id.*, 20–21.