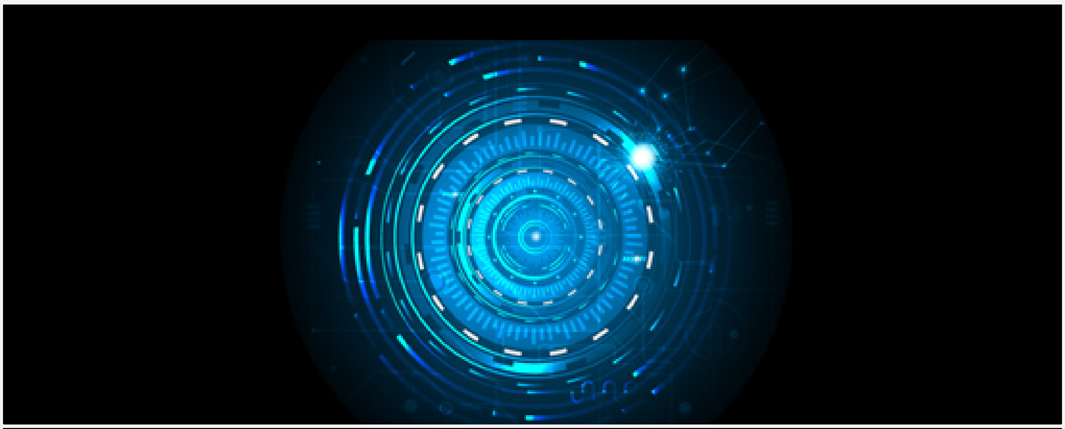
Global Transfer Pricing | 20 April 2020



IRS releases transfer pricing documentation "frequently asked questions"

Global Transfer Pricing Alert 2020-010

The IRS on 14 April posted on its website a list of frequently asked questions (FAQs) discussing the standards that transfer pricing documentation must satisfy to avoid a net adjustment penalty under IRC §6662.

The net adjustment penalty described in IRC §6662(e)(1)(B)(ii) applies when the net IRC §482 transfer pricing adjustment exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts. Generally, if the dollar thresholds are met, a taxpayer may avoid the penalty only if the taxpayer has satisfied the documentation requirements of IR §6662(e)(3)(B) and Treas. Reg. §1.6662-6.

The recent release follows a 2018 Large Business and International (LB&I) Division directive that instructed examiners to scrutinize the adequacy of taxpayers' transfer pricing documentation, and a 2018 report by the IRS Advisory Council (IRSAC) that recommends more detailed guidance on how taxpayers can improve the quality of their transfer pricing documentation.

Summary of FAQs

The FAQs document includes six questions and answers, summarized below.

Question 1: "What benefit(s), in addition to potential protection against penalties pursuant to IRC §6662(e)(3)(B), might there be for taxpayers who invest in robust transfer pricing documentation?"

According to the IRS's answer to this question, "robust transfer pricing documentation facilitates more efficient transfer pricing risk assessments and examinations for both taxpayers and examiners."

To illustrate this point, the FAQ provides an example of a US company that distributes heavy machinery it purchases from its foreign parent. A review of the tax return for the US distributor shows it had significant losses in 2017, the year under audit. Based on an intercompany agreement entered into in 2016, prices are set so the US distributor would expect to earn a return of X% of sales under normal business circumstances. However, during 2017, demand for the company's heavy machinery drops unexpectedly, and the US distributor sells a lower than expected number of machines. Application of the pricing policy means this reduction in sales volume results in losses for the US distributor.

According to the FAQ, "the documentation should thoroughly explain how the unforeseen business circumstances experienced by the company caused the observed financial results, and how the losses were not caused by intercompany prices." By contrast, the IRS calls it counterproductive if, rather than addressing the business circumstances causing the loss, the taxpayer instead altered its set of comparable companies to include companies that are not truly comparable but that cause the distributor's results to fall within the interquartile range of comparable company profitability. Such an approach, according to the FAQ, "would result in additional rounds of Information Document Requests (IDRs) and a lengthy analysis of the reliability of the comparable companies selected by the taxpayer, which could lengthen the audit period considerably."

It is important to recognize that this example is based on a fact pattern that involves an inbound US distributor and may not be pertinent to any particular taxpayer's actual situation. Thus, taxpayers should conduct a detailed functional and risk comparability analysis pursuant to the Sec. 482 regulations and the OECD transfer pricing guidelines. Moreover, taxpayers should consult with a local transfer pricing adviser if the tested party is a foreign taxpayer.

Question 2: "How can a 'self-assessment' help to anticipate questions and prepare better §6662(e) documentation?"

In its answer to this question, the IRS indicates that "taxpayers may want to consider conducting a 'self-assessment' of the potential indicators of transfer pricing noncompliance." As a starting point, the FAQ mentions several types of analysis that can be performed to evaluate the taxpayer's results:

1. Sensitivity of results to the removal of certain companies in the set of comparable companies;

2. Sensitivity of results to the profit level indicator (PLI) selected (operating margin, mark-up on total cost, return on assets, etc.); and

3. Evaluation of how system profits are allocated between related parties in the value chain and whether such allocations are reasonable in light of each party's contributions.

The IRS also states that if taxpayers undertake a sensitivity analysis of their application of the best method, they may anticipate IRS concerns, and address those concerns before the IRS raises them.

Question 3: "What is the IRS's guiding principle in establishing arm's length prices were charged in intercompany transactions?"

The IRS answers this question by stating that its "guiding principle is to ensure taxpayers are complying with §482 and the regulations thereunder. Under the arm's length standard, related taxpayers must report income based upon intercompany prices unrelated parties would have charged under the same circumstances."

In this FAQ, the IRS states that, when no perfect comparables exist, there may be "good comparables" that require adjustments to account for the imperfect comparability. The FAQ goes on to say that "comparability adjustments should be applied rationally and consistently and follow basic economic principles that are clearly spelled out in the §482 regulations." In addition, the FAQ states that "inclusion of a thorough analysis of how and why comparability adjustments were selected and applied is required."

Question 4: "What are some areas the IRS has identified in transfer pricing documentation reports that could benefit from improvement?"

In its response to this FAQ, the IRS provides a non-exhaustive list of areas where the quality of transfer pricing documentation could be improved.

1. Industry and company overview

    - These sections of the documentation report should provide context for the related-party transactions and are a place for a taxpayer to "tell its story" and provide information as to "expectations versus reality." For example, according to this FAQ, if the industry is experiencing a downturn, the IRS acknowledges that adjustments may be needed "to separate the effects of the realization of bad risk realization from the effects of intercompany pricing."

2. "Functional analysis narratives should be robust and link facts to analysis"

    - The functional analysis narratives should be robust and link the facts to a transfer pricing analysis that connects the business operational structure to the subject intercompany transactions. This section should explain how and where the value is created in a way that supports the allocation of profits among the parties.

3. "Risk analysis should be consistent with intercompany agreements"

    - The risks facing a consolidated business must be identified and then allocated between the parties. Furthermore, intercompany agreements and the assignment of rights and responsibilities between the parties generally establish how risks are allocated.

4. "Support for best method selection must be provided, as well as the reason for rejecting specified methods"

    - The FAQ states that support for the best method selection must be provided, as well as the reason for rejecting specified methods if an unspecified method is used. If a taxpayer claims that no comparable uncontrolled prices exist, the IRS would expect "a description of why such comparable transactions do not exist, and how such determination was made." For example, documentation should include a complete description of the search for internal and/or external data, including references to any internal databases of legal agreements with unrelated parties that were searched.

5. PLI selection

   - The IRS would like to see an analysis to support the selection of the PLI, as opposed to conclusive statements such as "We selected the Operating Margin as the PLI in the application of the CPM, because distributors typically measure their profits as a function of sales."

6. "Complete comparability analysis should be provided"

   - To determine the comparability between a controlled and an uncontrolled transaction, the FAQ expresses a preference for a comparability analysis that specifically addresses each criterion enumerated in the regulations (e.g., profit potential, economic conditions, etc.). With respect to profit potential related to a license, the IRS notes that "even if a numeric analysis of profit potential may not be possible, strong indications the profit potential of controlled and uncontrolled transactions is similar (e.g., the controlled brand and brands of the comparable company are middle of the road brands) would improve the usefulness of the analysis."

7. The impact of differences in functions and between the tested party and comparable companies should be provided

   - Differences in functions and risks should be provided. For example, in a comparable profits method (CPM) analysis, if the risk analysis establishes the tested party does not bear inventory risk and the selected comparable companies do bear that risk, the FAQ advises that "the report should either demonstrate the effect of the difference in risk is inconsequential or perform an adjustment that would increase the reliability of the CPM analysis, if possible."

8. Comparability adjustments for differences in risk or functions

   - The IRS emphasizes the importance of a thorough analysis explaining how and why certain comparability adjustments were selected and applied.

Question 5: "What are some features of the most useful transfer pricing documentation reports?"

The IRS states that the below features may result in a more efficient audit and an increased likelihood of deselection of certain audit issues.

1. Explanation of the data

    - When segmented data is used in the analysis, the IRS recommends including a description of how the data was constructed, to tie data used in the analysis to financial data, and to provide complete income statements and balance sheets of the tested party (not just sales, total costs, and profits). In addition, "taxpayers should provide data in a functional format that preserves their calculations (e.g., spreadsheets rather than pdf files), which can speed up the examiner's review."

2. Descriptions of risk

    - Descriptions of risk should cover general business risks and then provide more detailed descriptions of how these risks are allocated among the controlled participants based on the intercompany policies and agreements.

3. Allocation of profits

    - The IRS again suggests an analysis that looks not only at the percentage of system profits allocated to each related party, but also the profitability and rates of return of each of the related parties based on their respective contributions.

4. Other useful features of a documentation report

    - A functional and risk analysis for each transaction

    - Analysis of special business circumstances that may have affected profitability

    - A description of challenges of the analysis (e.g., "the combined profits were negative, and the challenge is to allocate losses among the controlled participants").

Question 6: "Can you provide an example of a presentation of a company's intercompany transactions that would be a helpful summary for examiners to use in risk assessment?"

According to the IRS's answer to this FAQ, "making transfer pricing documentation more 'user friendly' will make the IRS's review and assessment of the return positions as efficient as possible." For example, a summary of information about the intercompany transactions at the beginning of the transfer pricing documentation report (for example, of each transaction in tabular form) can help IRS examiners understand the taxpayer's transactions correctly and focus review and examination on the most significant transactions.

Conclusion

The IRS FAQs on transfer pricing documentation contain many insights that may help taxpayers strengthen their transfer pricing documentation reports to avoid adjustments and penalties and expend less resources upon audit.

Contacts

Keith Reams (Washington DC)

Jamie Hawes (Washington DC)

Joe Wood (Houston)

Back to top

Useful links

Resources

- Arm's length standard
- Transfer pricing alerts

Get Connected

- Deloitte tax@hand
- Join Dbriefs
- Follow @Deloitte Tax
- www.deloitte.com/tax

Back to top

Get in touch