

# THE IRS'S RENEWED EMPHASIS ON TRANSFER PRICING

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The IRS has designated transfer pricing as a key focus of its international compliance initiatives. Several trends have contributed to the IRS's decision to target transfer pricing. First, IRS officials are keenly aware of the huge growth in the foreign income reported by U.S.-based multinationals. It is well known, for example, that U.S.-based corporations more than tripled their foreign profits between 1994 and 2004, with more than 58% of that profit reportedly being earned in so-called "tax haven" countries.<sup>1</sup> In addition, the IRS has long been concerned that foreign-controlled U.S. corporations are potentially "stripping away" profits from the United States through non-arm's length pricing and potentially "abusive" financing structures. Further, U.S. tax treaty partners are becoming

increasingly assertive in the transfer pricing area, which has caused the U.S. Competent Authority office's workload to be dominated by foreign-initiated allocation adjustments. In 2009, roughly 85% of the cases filed with the Competent Authority office involved foreign-initiated adjustments.<sup>2</sup>


As a consequence of these trends, the IRS has determined that it is the right time for a renewed emphasis on transfer pricing enforcement. This article will outline some of the actions that the IRS has already taken, and what these actions mean for multinational taxpayers. The article will then review some steps that taxpayers can take to meet the challenge posed by the IRS's enforcement initiatives.

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## IRS Staffing challenges

Transfer pricing enforcement is primarily the responsibility of the IRS's Large and Mid-Size Business Division (LMSB). LMSB, however, is finding it challenging to reinvent its ability to identify and examine transfer pricing issues as a result of a significant number of retirements of international examiners, technical advisors, and IRS Counsel personnel who have years of experience in the transfer pricing arena. Every indication is that the IRS has a strong commitment in this area and a



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desire to overcome the challenges raised by staffing attrition.

### **LMSB selection of transfer pricing issue specialists**

Specialization among IRS international personnel in transfer pricing took place only on an informal basis in the past, and this informal specialization was limited primarily to large cities with substantial international examiner staffing. In most areas of the country, an international examiner was responsible for myriad international issues areas such as Subpart F, foreign tax credits, and other related inbound issues in addition to transfer pricing. As a practical matter, the expectation for international examiners to have a working knowledge of the gamut of international taxation issues (including transfer pricing) resulted in personnel who were “generalists” and not real experts in the complex and challenging transfer pricing area.

In contrast, accounting and law firms long ago implemented transfer pricing specialization groups within their practices. The IRS is now in the process of doing the same. The IRS is in the process of identifying personnel that have not only an aptitude for effectively dealing with transfer pricing issues, but also a desire to focus upon this specialized area. The expectation is that the issue specialists will be responsible for transfer pricing issues on multiple cases and likely receive support from international examiners and other personnel (including economists) in the identification, development, and resolution of transfer pricing issues. Unlike the current transfer pricing technical advisors who provide “advice” to the field international examiner, the issue specialists will be responsible for actually developing the transfer pricing issues on the cases to which they are assigned. The expectation is that they will be true transfer pricing experts.

### **Establishment of a new LMSB ‘transfer pricing practice’**

In addition to transfer pricing subject matter specialists, IRS Commissioner Douglas Shulman recently

announced that the IRS would be establishing a national team of transfer pricing experts who will provide expertise and coordination of transfer pricing issues on a strategic level. On 12/10/2009, the Commissioner announced that the IRS is establishing a new “Transfer Pricing Practice” within LMSB to strategically and systematically administer transfer pricing issues.<sup>3</sup> The IRS Transfer Pricing Practice will consist of transfer pricing experts who will coordinate the handling of the most important transfer pricing issues, identify emerging issues and trends, help examination personnel throughout the organization by providing technical expertise as needed, assist in the development of new risk assessment techniques to better identify the taxpayers and issues with the greatest risk, and develop examination best practices to ensure optimal resource allocation.

This new transfer pricing group is a key component of a multi-year international tax compliance initiative being implemented by the IRS. Transfer pricing is one area of focus (along with hybrid structures and withholding taxes) of the agency’s international tax compliance strategy. Commissioner Shulman stated that the decision to establish the new Transfer Pricing Practice group grew out of a realization that the IRS needed to change the way it does business in the transfer pricing area. He noted that the IRS needed more people with industry-specific and transfer pricing expertise to match up with corporate taxpayers, to develop issues fully, and to discuss these issues with taxpayers and their representatives.

The creation of this new group is the latest signal of the importance placed on transfer pricing enforcement at the highest levels of the IRS. With a focused national team of experts charged with driving transfer pricing enforcement, taxpayers can expect the IRS to intensify its scrutiny of transfer pricing issues. Because transfer pricing clearly has the attention of high-level tax officials as a key focus of the IRS’s long-term international tax enforcement strategy, the IRS is likely to identify this area as a priority when budget resources are allocated.

### **Expansion of LMSB economist program**

Further evidence of the increased focus in the transfer pricing area is the expansion of economist staffing. The level of hiring of new economists within LMSB is unprecedented. The IRS’s goal is to increase economist staffing by approximately 50% to a total of 120 economists, which will result in the largest staffing level of economists in the history of

<sup>1</sup> See Douglas Shulman, IRS Commissioner, Remarks before the 21st Annual George Washington University International Tax Conference (12/8/2008).

<sup>2</sup> Internal Revenue Service, *U.S. Competent Authority Statistics: FY 2009* (1/14/2010).

<sup>3</sup> Douglas Shulman, IRS Commissioner, Remarks before the 22nd Annual George Washington University International Tax Conference (12/10/2009).

the IRS's economist program. Although IRS economists have some workload in the valuation area, every indication is that this substantially increased staffing is being targeted for transfer pricing. In the short term, this hiring will initially impact the availability of experienced economists for the more complex and substantial transfer pricing issues because these economists would be expected to devote time to train the new hires. It is expected that LMSB will make every effort, however, to leverage the training process to limit the impact on coverage.

### **Establishment of the transfer pricing council**

The IRS has also acted at the executive level to address transfer pricing matters. The IRS established a Transfer Pricing Council consisting of the following members:

- LMSB Deputy Commissioner (International).
- Director of Pre-Filing and Technical Guidance.
- Selected Industry Directors or Director of Field Operations.
- Associate Chief Counsel (International).
- LMSB Counsel.

The Council will not have control over cases or specific transfer pricing issues being developed in the field. Rather, it will focus upon the following:

- Determining key operational, resource, and training approaches.
- Providing transfer pricing guidance and information.
- Developing and implementing transfer pricing initiatives.

Every indication is that the Council will focus on ensuring that the field examiners have the tools and resources they need to identify, develop, and resolve transfer pricing issues successfully. In particular, there is a focus on developing more effective tools that can be used during the risk analysis process to identify issues and ensuring that LMSB personnel target those LMSB returns and issues that are truly high-risk issues from a compliance point of view.

It is expected that detailed transfer pricing training will be provided to the newly selected issue specialists. LMSB is in the process of conducting a comprehensive review of its transfer pricing training program and is considering a number of changes as to what and how training is delivered. It is anticipated that a large percentage, if not all, LMSB personnel will participate in transfer pricing training to increase the general knowledge of various transfer pricing concepts among all LMSB personnel. LMSB

believes that all examination personnel need to have international knowledge, including transfer pricing, which is clearly the predominant international issue.

### **Establishment of Transfer Pricing Center**

LMSB is also placing emphasis upon knowledge management in the transfer pricing area, as demonstrated by the establishment of the Transfer Pricing Center. The intranet website will be the "go to" location for LMSB employees for all transfer pricing related information including:

- Personnel contact information for examiners, attorneys, technical advisors, and managers with significant transfer pricing expertise.
- Cost sharing audit guidelines.
- Section 936 exit strategy issue information.
- OECD transfer pricing guidelines.
- Training and other reference materials.
- Functional and risk analysis guidelines.
- Outside expert identification information.
- Various audit tools that examiners can employ.
- Financial ratio computation tools.
- Comparable search tools and guidelines.
- Section 6662(e) penalty computation tools.
- Field Service Advices, private letter rulings, and Revenue Rulings and Procedures.
- Internal Revenue Manual links.
- Mutual Agreement Procedure information.
- Advance Pricing Agreement information.

### **What taxpayers can expect from LMSB**

There will be a significant increase in the number of transfer pricing examinations initiated in the future. The additional economic resources hired last year as well as the selection of Transfer Pricing Issue Specialists will create an increased demand for workload. It is expected that both inbound and outbound taxpayers will receive additional scrutiny. In addition, taxpayers located in areas of the country where there has been significant economist hiring will have an increased likelihood of facing transfer pricing examinations.

For many years, international examiners have been directed to request pricing-related information in an up-front information document request (IDR). Now, examination teams will have additional resources to investigate this information. Further, the transfer pricing penalties under Section 6662(e) are also receiving additional scrutiny. Examinations that produce adjustments exceeding the penalty thresholds without the assertion of transfer

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pricing penalties are being returned to the examiners for further consideration by the Office of the LMSB Deputy Commissioner (International). Consequently, examiners are becoming much more familiar with the law and regulations in the penalty area. As a result, taxpayers can expect additional penalty assertions, even if they have contemporaneous documentation.

LMSB is increasing the number of tools available to personnel to deal with transfer pricing issues. More complete and timely resources are available on the Transfer Pricing Center website, which will assist the examiners in the identification, development, and resolution of transfer pricing issues. Further, Competent Authority personnel are increasingly available to field examiners to ensure that they understand the Competent Authority process and the level of documentation necessary to put the U. S. Competent Authority analyst in the best position to succeed in negotiating issues with foreign governments.

There is also increased cooperation among tax treaty countries and a greater willingness to share information under the applicable tax treaties. In fact, the IRS Commissioner recently emphasized that the U.S. government is working with countries around the world to establish a “new paradigm of transparency and information exchange.”<sup>4</sup> Indications are that information exchange under tax treaties is being used much more frequently by IRS examiners (as well as examiners in other countries) to obtain information for transfer pricing examinations. The process for IRS examiners to obtain information from foreign jurisdictions has been significantly streamlined, which has resulted in increased activity. Moreover, the United States is also working on a protocol to conduct joint audits with some U.S. tax treaty partners.

LMSB has completed its training of all personnel in various international technical areas, including transfer pricing topics. Consequently, there is a greater awareness of international issues among all LMSB personnel. Also, consideration is being given to developing a focused transfer pricing course to be delivered to domestic personnel.

### **What taxpayers can do to meet the challenge**

Taxpayers would be well advised to review their transfer pricing policies and documentation to ensure that they will withstand the expected

scrutiny they will receive from a more educated and focused IRS transfer pricing examination program. In appropriate situations, taxpayers should consider supplementing the documentation by compiling a “defense file” for use in an examination. Such a defense file would contain additional information and documents related to the intercompany transactions, such as corporate policies, intercompany contracts, interview notes, business reasons for the structures chosen, sources of financial data, lists of company personnel with direct knowledge of the relevant operations and transactions, and similar information. It is generally more effective and efficient to collect and compile this information on a contemporaneous basis rather than trying to recreate the information during an examination. Such a file would act as a resource that is readily available to respond to IRS questions on examination.

Further, in those situations where a taxpayer does not have Section 6662(e) penalty protection, it may be appropriate to conduct a risk analysis of cross-border transactions. Although examiners are pursuing transfer pricing issues with respect to transactions between “high-tax” countries, increased scrutiny is given to transactions involving “low-tax” countries. Particularly for transactions where there is significant risk, taxpayers should consider preparing non-contemporaneous documentation that can be provided to the IRS within 30 days of receiving the transfer pricing IDR. Although penalty protection cannot be secured after the return is filed, the front-end investment may pay dividends once an IRS audit is initiated. Experience has shown that for those cases where the taxpayer provides high-quality documentation (produced internally or externally) to the IRS timely upon request, the probability of a transfer pricing issue being pursued by the IRS is significantly reduced.

Other strategies for managing the increased risk of transfer pricing scrutiny should also be considered. For example, in some situations it may be advantageous for a taxpayer to pursue an advance pricing agreement (APA) on a unilateral or bilateral basis. An APA coupled with a “rollback” request can be an effective way to deal with transfer pricing exposures for prior years. Similarly, taxpayers that have the opportunity may consider participating in the IRS’s Compliance Assurance Program (CAP), in which IRS examinations are conducted in real time before the tax return is filed. In the right situations, CAP can be an effective way to resolve transfer pricing and other tax issues up front. ■

<sup>4</sup> *Id.*