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# Insights on the IRS Approach to Transfer Pricing Audits

February 9, 2017

## A Look at the TIGTA Report

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***TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION***



***Barriers Exist to Properly Evaluating  
Transfer Pricing Issues***

September 28, 2016

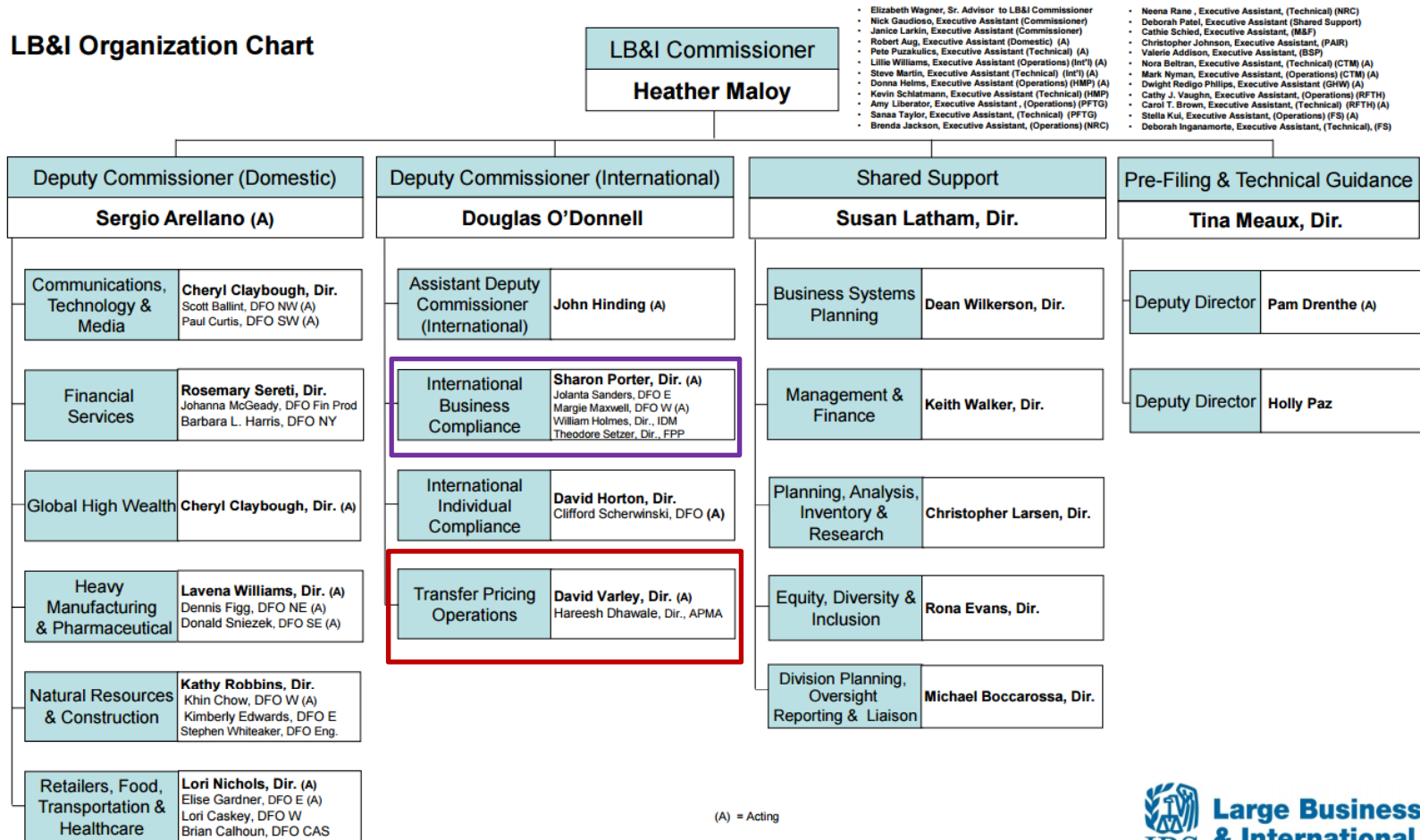
Reference Number: 2016-30-090

# TIGTA Transfer Pricing Audit Report Background

- Treasury Inspector General for Tax Administration (TIGTA) is an office that provides independent oversight on IRS activities.
- TIGTA is organizationally located within the Department of Treasury, but functions independently of the Treasury and all other Treasury offices and bureaus.
- This 2016 report is TIGTA's first audit report that has focused on transfer pricing issues.

# Background: LB&I Organization, May 2015

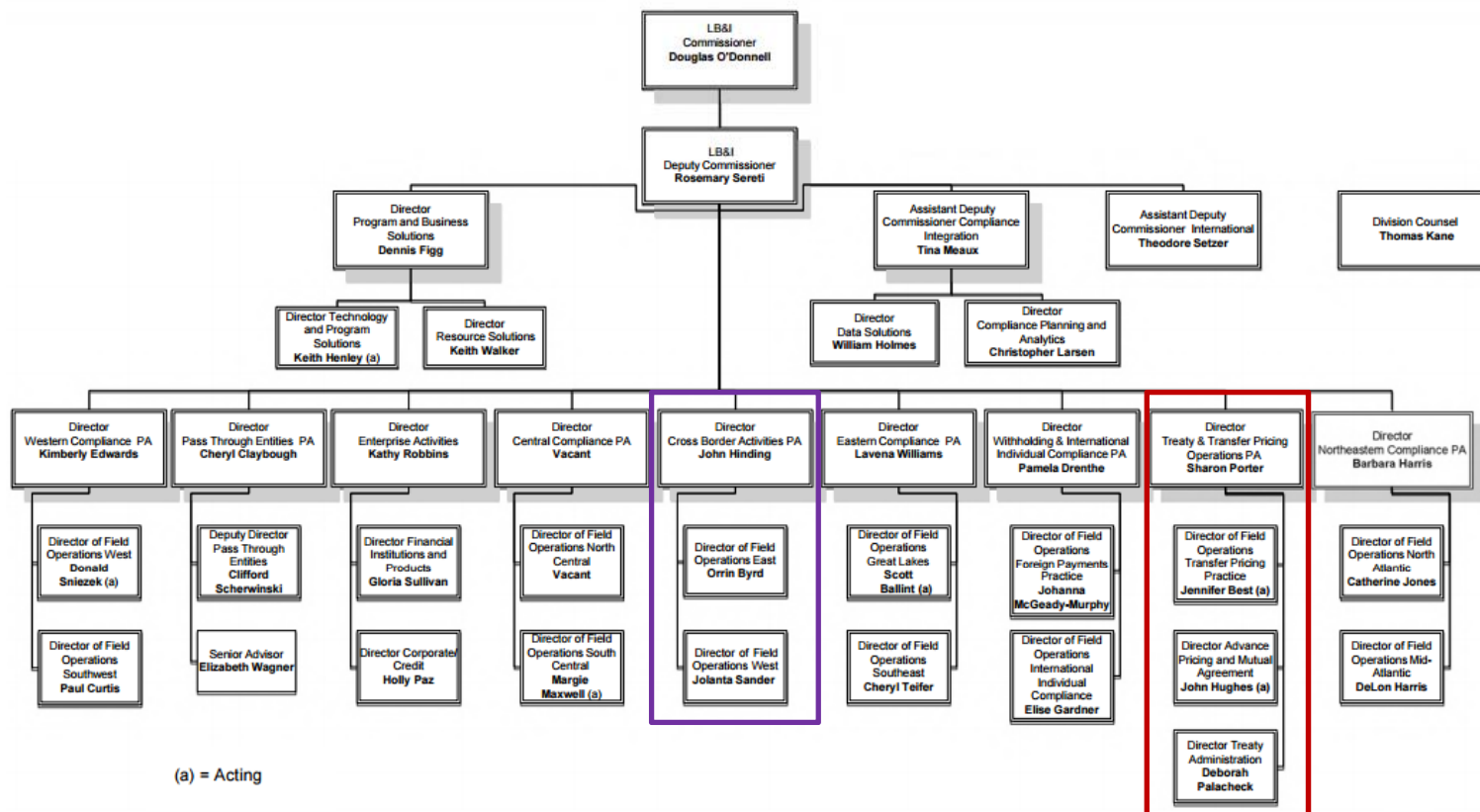
LB&I Organization Chart



Source: <https://web.archive.org/web/20150603072614/http://www.irs.gov/pub/irs-utl/lbiorgchart.pdf>

# Background: LB&I Organization, September 2016

## LB&I Organizational Chart



Source: <https://www.irs.gov/pub/irs-utl/lbiorgchart.pdf>

## TIGTA Transfer Pricing Audit Report Findings

1. Approach to transfer pricing audits is not consistent.
2. Transfer pricing issues are not always identified for specialized review.
3. LB&I does not specifically measure its transfer pricing efforts.
4. Transfer pricing adjustments are sustained at a low rate at Appeals.

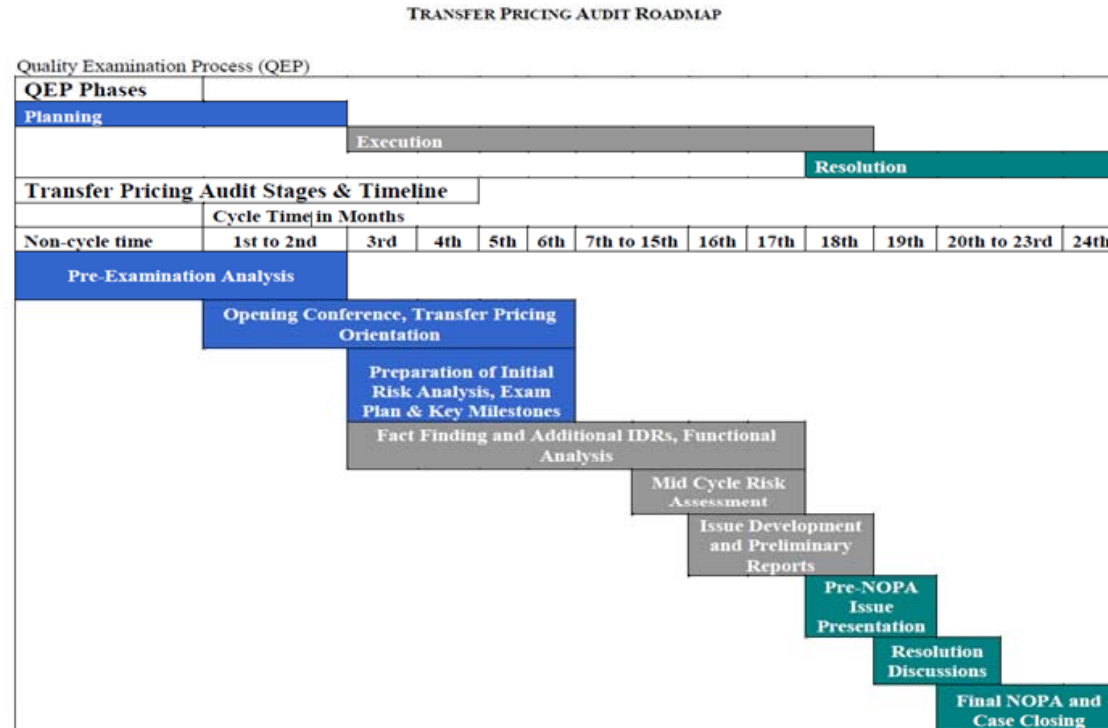
## **Employees Are Not Consistently Following the Transfer Pricing Audit Roadmap**

# **Background: Transfer Pricing Audit Roadmap**

- Planning Phase
  - Pre-Examination Analysis
  - Opening Conference
  - Taxpayer Orientations (Financial Statement, Transfer Pricing)
  - Preparation of Initial Risk Analysis and Examination Plan
- Execution Phase
  - Fact Finding and Information Gathering
  - Issue Development
- Resolution Phase
  - Issue Presentation
  - Issue Resolution
  - Case Closing



# Background: Transfer Pricing Audit Roadmap



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“It is not intended as a template—every transfer pricing case is unique, and the team will need to exercise its own judgment about how to best use these guidelines.”

Source: Transfer Pricing Audit Roadmap, page 3

## **Key Themes: Transfer Pricing Audit Roadmap**

- Upfront planning is important; the IRS should involve transfer pricing specialists early.
- Transfer pricing cases are “won and lost” on the facts; the IRS needs to develop facts.
- The goal of the audit is to determine reasonable result; the IRS should keep an open mind to the taxpayer’s position.
- Effective presentation is important; the IRS should structure NOPA logically.

## Transfer Pricing Audit Roadmap Not Followed Consistently

- TIGTA: “Education and outreach have been provided to taxpayers with transfer pricing issues, but some employees may not be consistently following the transfer pricing audit roadmap.”
- 40% of TPP and IBC survey respondents said they “sometimes” use the Roadmap; 19% “never” use it.
- 38% of TPP and IBC survey respondents did not believe they are responsible for referring the auditee to the Roadmap.

# Transfer Pricing Audit Roadmap Not Followed Consistently

- Recommendation 1: “Employees follow the Roadmap and include this as an attribute of the quality review process.”
  - IRS Management disagreed.
  - IRS stated Roadmap is not a one-size-fits-all tool and it is not possible to monitor use of Roadmap.
  - As opposed to making use of Roadmap an attribute of the quality review process, IRS will finish revising Roadmap and develop mandatory Roadmap training for employees involved in examining transfer pricing issues.

## Transfer Pricing Audit Roadmap Not Followed Consistently

- Recommendation 2: “Taxpayers undergoing examinations with a transfer pricing issue have a clear understanding of the Roadmap. This should include providing them a copy of the Roadmap prior to the beginning of the examination engagement and requiring employees to be consistent in its use.”
  - IRS Management partially agreed.
  - IRS said it will provide taxpayers with information to access Roadmap, at beginning of examination engagement. IRS will encourage but not require employees to use Roadmap.
  - IRS said it cannot ensure taxpayers have a clear understanding of Roadmap.

## TIGTA Finding on Transfer Pricing Audit Roadmap: Observations

- When following the Roadmap, the IRS will issue the mandatory transfer pricing documentation IDR with the IRS's initial contact letter. Prior to the Roadmap, this IDR was issued later in the audit process.
- Taxpayers can expect to receive information about how to access the Roadmap online at the Opening Conference.
- If IRS employees are trained on how to use the Roadmap, taxpayers can expect the Roadmap to be followed more often. Taxpayers may need to prepare earlier at the outset with more detail on transfer pricing to correspond with Roadmap steps.

# TIGTA Finding on Transfer Pricing Audit Roadmap: Takeaways

- Be active during the planning phase in identifying main issues and providing documentation to support your narrative.
- Know the publicly available information on the company.
- Have robust transfer pricing documentation, and check that transfer pricing documentation is consistent with tax returns and financial statements.
- Gather relevant documentation, and have your narrative ready for the taxpayer orientations. Evaluate your materials to anticipate strong and weak positions.
- Timetable in the Roadmap might not be strictly followed.

**Not All Transfer Pricing Issues Are Identified for  
Specialized Review**



## Transfer pricing issues are not always identified for specialized review

- TIGTA: “There is no process to ensure that all transfer pricing issues are identified for specialized review.”
- Most of the Transfer Pricing Practice’s transfer pricing inventory comes from Coordinated Industry Cases. Only 20% of the Transfer Pricing Practice’s transfer pricing inventory is received through the Specialist Referral System.
- The Transfer Pricing Practice does not have access to the Specialist Referral System, so they rely on International Business Compliance to refer cases with transfer pricing issues.

## Background: Specialist Referral System

- The Specialist Referral System facilitates two different kinds of requests for assistance on international issues:
  1. a formal request for assignment of an international examiner to the case, or
  2. an informal request seeking a response to a specific question.
- Any returns meeting mandatory referral criteria (*see* IRM 4.60.6.2) must be referred to an international examiner through the Specialist Referral System.
  - *E.g.*, transactions over \$25,000 where taxpayer has foreign branches or subsidiaries, or has subsidiary or affiliated or related entity in Puerto Rico

## Transfer pricing issues are not always identified for specialized review

- Recommendation 3: “Ensure that TPP employees have full access to the SRS and that they work collaboratively with the IBC function to ensure that transfer pricing issues are consistently identified and directed for specialized review.”
  - IRS Management disagreed.
  - IRS said that geographic practice areas should be responsible for referring cases with international aspects.
  - IRS will recommend that Transfer Pricing Practice managers have access to review a return with potential transfer pricing issues for assignment.

## Transfer pricing issues are not always identified for specialized review

- The Transfer Pricing Practice relies on International Business Compliance to refer cases with transfer pricing issues.
- The Rules of Engagement between the Transfer Pricing Practice and International Business Compliance are not being followed.

# Background: Rules of Engagement



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## IBC - TPP Rules of Engagement

September 30, 2013

**MEMORANDUM FOR** INTERNATIONAL BUSINESS COMPLIANCE (IBC) EMPLOYEES  
TRANSFER PRICING OPERATIONS (TPO) EMPLOYEES  
DEPUTY COMMISSIONER – INTERNATIONAL  
LB&I DOMESTIC INDUSTRY DIRECTORS

**FROM:** Sergio E. Arellano  
Director, International Business Compliance

Samuel M. Maruca  
Director, Transfer Pricing Operations

**SUBJECT:** IBC - TPP Rules of Engagement

**IBC AND TPP RULES OF ENGAGEMENT FOR TRANSFER PRICING ISSUES**

**General Guidelines**

This document provides general guidelines and rules of engagement for IBC and TPP. It does not prescribe rules for every possible situation. In the absence of specific instructions, decisions will be made with these general guidelines in mind.

It is imperative that TPP and IBC work transfer pricing issues together, as a unified team. This means that responsibility for the selection, identification, development and resolution of transfer pricing issues is shared. Neither TPP nor IBC "controls" transfer pricing issues; in every case, the best answer from the standpoint of the U.S. government will prevail. Open and inclusive communication by all IBC and TPP personnel is expected. Meetings and conference calls will be scheduled so as to accommodate all personnel required to be involved under these guidelines. Any disagreements that remain after full discussion and debate, whether substantive or procedural, will be elevated to the next level of management. In all cases, disagreement will be addressed and resolved internally, never in front of the taxpayer.

The TPP is not able to assist in every transfer pricing case, and in many cases, examination teams will examine transfer pricing issues without the direct involvement of the TPP. However, the TPP must have visibility into the entire inventory. TPP will advise IBC of any direct request for assistance received by TPP from the Industries, and vice versa.

References herein to the "International team" refer collectively to all TPP and IBC personnel involved in the pertinent matter.

**Case Selection, Risk Assessment, and Staffing**

Any referral of transfer pricing work will be treated as a joint referral to IBC and the TPP. In the event one organization receives the referral and the other does not, it is incumbent on the receiving organization to reach out to their counterpart in the other organization. IBC and the TPP will jointly perform an initial risk assessment and, if they determine that the case is meritorious, IBC and the TPP will make the appropriate staffing decisions.

It is understood that, in many or even most cases, the TPP, as a result of its limited resources, will have no involvement in the day-to-day management of the issue. However, the IBC and TPP management teams have joint responsibility for the national transfer pricing inventory. Accordingly,

## **Background: Rules of Engagement**

- The Transfer Pricing Practice and International Business Compliance should work on transfer pricing issues together “as a unified team.”
- The Transfer Pricing Practice should have visibility into the entire transfer pricing inventory.
- Levels of Transfer Pricing Practice Involvement:
  - Specific
  - Moderate
  - Limited

## Transfer pricing issues are not always identified for specialized review

- Recommendation 4: “Ensure that TPP and IBC function employees follow the Rules of Engagement and include this as an attribute of the quality review process.”
  - IRS Management agreed.
  - IRS stated it incorporated Rules of Engagement into Principles of Collaboration under LB&I Examination Process.

## Transfer pricing issues are not always identified for specialized review

- LB&I Domestic and Small Business/Self-Employed (SB/SE) IRS employees do not feel adequately trained in identifying transfer pricing issues.



## Transfer pricing issues are not always identified for specialized review

- Recommendation 5: “Coordinate with the Commissioner, SB/SE Division, to ensure that adequate transfer pricing training is provided. The LB&I Division should require mandatory transfer pricing specific training for TPP and IBC function employees and managers. The LB&I and SB/SE Divisions should ensure that LB&I (Domestic) and SB/SE Divisions’ Examination function employees and managers with potential exposure to transfer pricing issues be adequately trained to identify, refer (as necessary), and work transfer pricing issues appropriately. Detailed training plans should be implemented and include documentation and tracking of all employees’ successful completion of the mandatory training.”
  - IRS Management partially agreed.
  - IRS said Transfer Pricing Practice and International Business Compliance employees already take transfer pricing specific training.
  - LB&I and SB/SE will develop training for SB/SE employees.

## TIGTA Finding on Specialist Referrals: Observations

- The IRS may lack adequate resources and coordination between the different LB&I organizations to effectively audit transfer pricing issues.
- If Transfer Pricing Practice becomes involved in more exams, it is more likely you will be working with a team with more transfer pricing expertise.
- If you are not in a Coordinated Industry Case, the TIGTA report makes it more likely than before to have Transfer Pricing Practice personnel involved in your exams.

# TIGTA Finding on Specialist Referrals: Takeaways

- Taxpayers should ask the exam team to identify their team members and management chains.
- If the Transfer Pricing Practice is involved, taxpayers may want to ask if the exam team foresees involvement at extensive or moderate level. Extensive or moderate means the Transfer Pricing Practice participates in, contributes to, or reviews:
  - Setting Estimated Completion Date.
  - Risk analyses, audit timeline, NOPA.
  - IDR modifications.
  - Quarterly, opening, and status meetings.
  - Accepting or declining settlement offers.
  - Decision whether to assert transfer pricing penalties.
  - Fast Track proceedings.
  - Reviewing transfer pricing issues in closing agreements.
  - Appeals matters and processes, if case goes to Appeals.
  - Selection and management of outside experts.

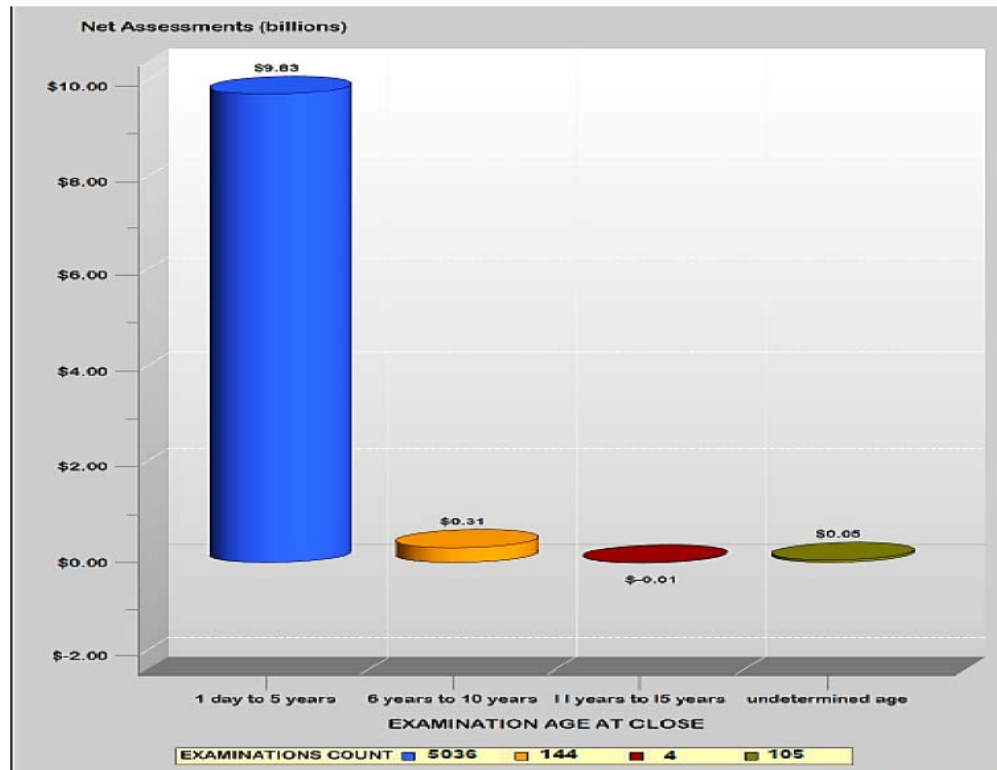
**No separate, quantifiable performance measures to  
determine success of IRS's transfer pricing efforts**

## LB&I does not measure its transfer pricing efforts quantitatively

- TIGTA: “Separate Performance Measures Related to Quantifiable Results Are Needed to Determine the Success of Transfer Pricing Efforts.” The Transfer Pricing Practice does not have measures to monitor performance to ensure its priorities are met. The IRS needs outcome-focused performance metrics.
- The IRS needs to develop a strategic plan regarding transfer pricing. LB&I has no formal action plan or timeline for its transfer pricing strategies.
- LB&I management does not specifically track or monitor the results or outcomes of transfer pricing examinations.

# LB&I does not measure its transfer pricing efforts quantitatively

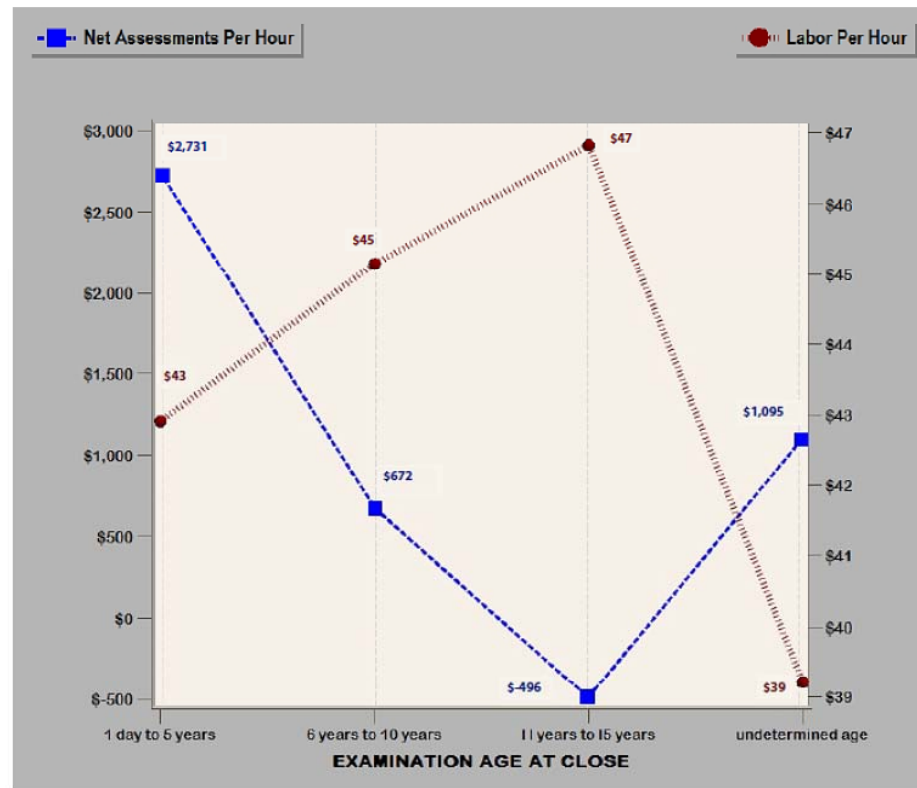
**Figure 4: Net Total Assessments by Age for Examinations That Included at Least One Transfer Pricing Issue Closed in Calendar Years 2012 Through 2014**



Source: TIGTA analysis of the Issue Based Management Information System information provided by the IRS and matched to the Audit Information Management System (AIMS) and the Examination Returns Control System (ERCS) for examinations that included at least one transfer pricing issue closed during Calendar Years 2012 through 2014.

# LB&I does not measure its transfer pricing efforts quantitatively

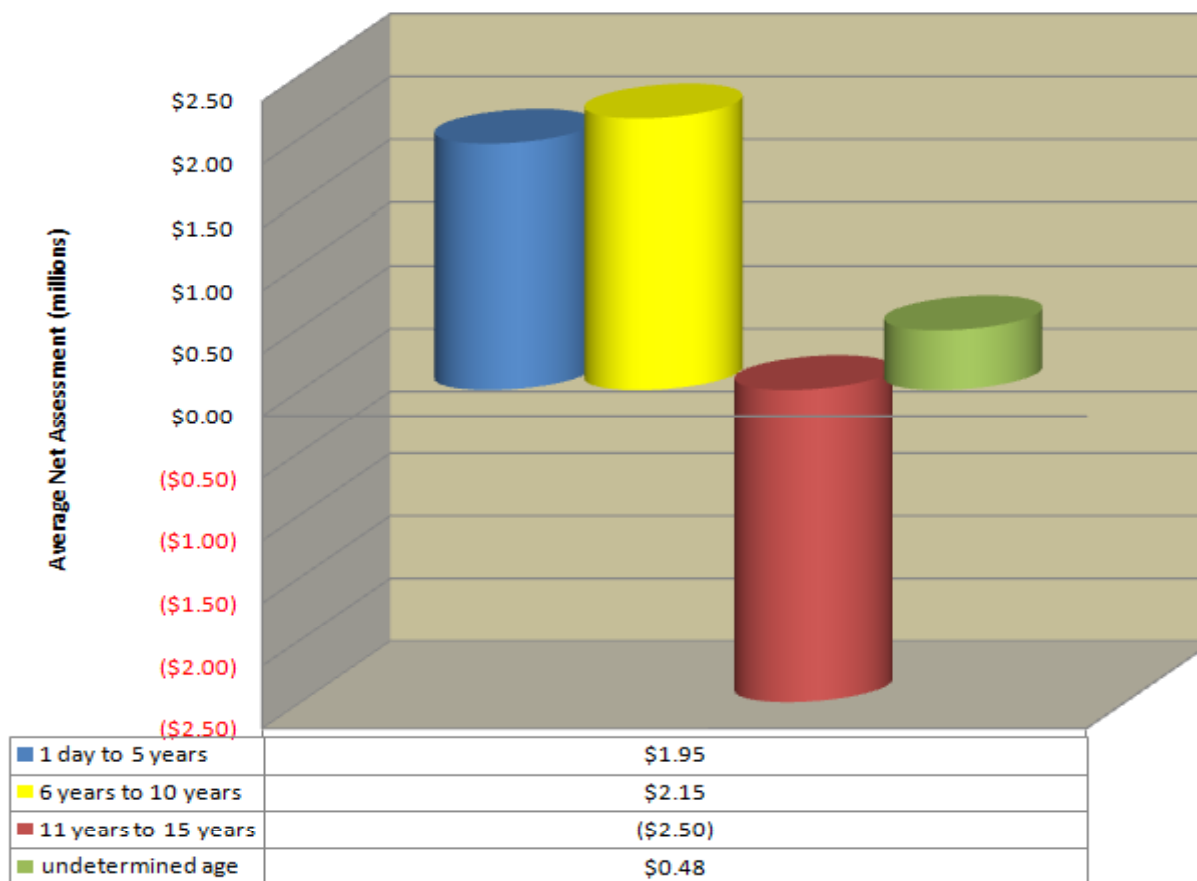
Figure 5: Net Assessments Per Hour Versus Labor Costs Per Hour<sup>23</sup>



Source: TIGTA analysis of the Issue Based Management Information System information provided by the IRS and matched to the AIMS and the ERCS for examinations that included at least one transfer pricing issue closed during Calendar Years 2012 through 2014.

# Alternative Graph

**Net Average Assessments by Age for Examinations  
that Included At Least One Transfer Pricing Issue  
Closed in Calendar Years 2012 to 2014**





## LB&I does not measure its transfer pricing efforts quantitatively

- Recommendation 6: “The Commissioner, LB&I Division, should develop a comprehensive transfer pricing strategy that includes outcome-related strategic goals, a description of how the LB&I Division intends to achieve those goals, and an action plan with a timeline for implementation. This strategy should measure the success and productivity of the examinations of transfer pricing issues. This should include, but is not limited to, the amount of the examination adjustments and the taxes ultimately assessed.”
  - IRS Management partially agreed.
  - IRS agreed with comprehensive strategy, but did not believe strategic plan should exist at practice area level, because LB&I is already implementing campaign approach.
  - IRS disagrees with implementing record system linking exam adjustments and amounts assessed.

## **Background: LB&I Campaigns**

- LB&I's campaign approach is an issues-based approach.
- Campaigns are intended to focus personnel, time, and resources on issues with higher compliance risk.
- Issues for campaigns will be identified from data analysis and feedback from IRS compliance employees and the tax community.
- Campaigns can involve issue-focused exams, as well as guidance, forms and instructions, published practice units, and outreach to practitioners. The IRS may also issue soft letters to taxpayers with particular items or issues on their returns.

## Background: LB&I Campaigns

- On January 31, 2017, LB&I announced the initial rollout of its campaigns.
  - IRC 48C Energy Credit
  - OVDP Declines-Withdrawals
  - Domestic Production Activities Deduction, Multi-Channel Video Program Distributors, and TV Broadcasters
  - Micro-Captive Insurance
  - Related Party Transactions
  - Deferred Variable Annuity Reserves and Life Insurance Reserves
  - Basket Transactions
  - Land Developers – Completed Contract Method
  - TEFRA Linkage Plan Strategy
  - S Corporation Losses Claimed in Excess of Basis
  - Repatriation
  - Form 1120-F Non-Filer
  - Inbound Distributor

## Performance Measures and Campaign Approach: Observations

- LB&I's response to TIGTA's recommendation relies on the campaign approach, instead of developing strategic plans at the practice area level.
- As TIGTA pointed out in its comment, LB&I has agreed in its response to a different TIGTA audit report to provide compliance results by issue in the development of its issues-based approach.
- The campaign approach might coincide with a move away from the Coordinated Industry Cases approach.

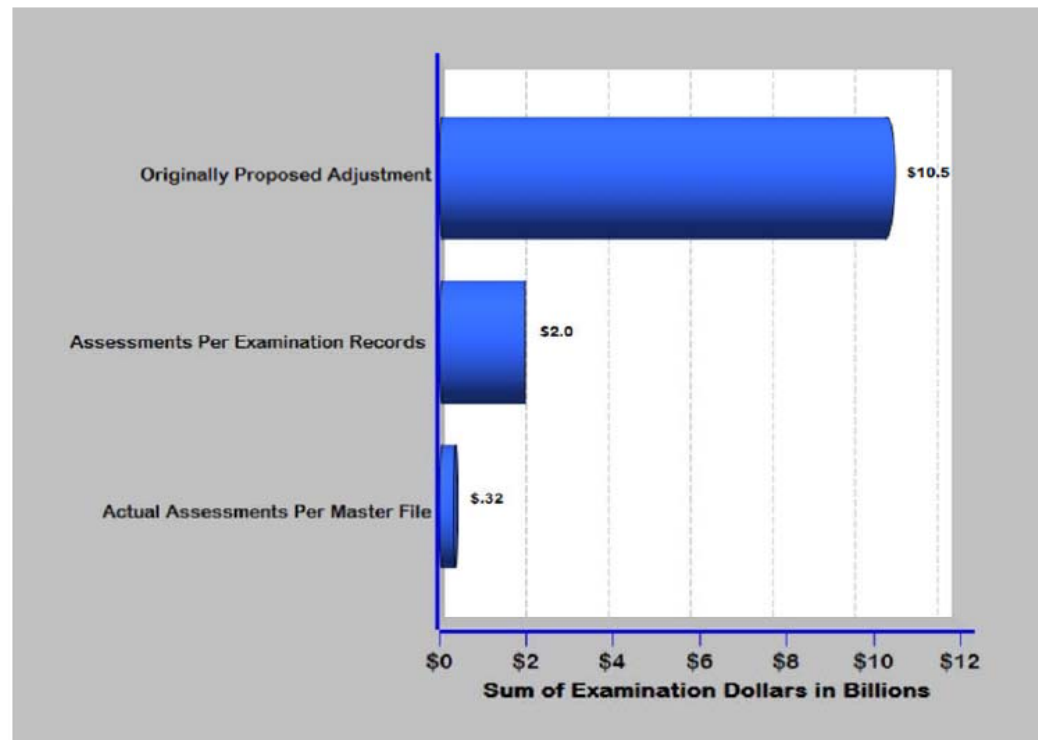
## **Low Rate of Sustaining Transfer Pricing Adjustments Through Appeals**

## Transfer pricing adjustments are sustained at low rate at Appeals

- TIGTA: “Appeals Determination Information Could Be Used to Better Refine the Approach for Identifying and Working Cases.”
- The IRS has no performance measures to track Appeals determinations, which could be used to improve how the IRS identifies and works transfer pricing cases.
- 54% of TPP and IBC respondents said they were not informed when their proposed transfer pricing adjustments were reduced by Appeals.

# Transfer pricing adjustments are sustained at low rate at Appeals

**Figure 6: Proposed Examination Adjustments With at Least One Transfer Pricing Issue Before and After Appeal**



*Source: TIGTA analysis of the Issue Based Management Information System information provided by the IRS and matched to AIMS, ERCS, and Appeals Centralized Database System (ACDS) data for examinations that included at least one transfer pricing issue closed during Calendar Years 2012 through 2014.*

## Transfer pricing adjustments are sustained at low rate at Appeals

- Recommendation 7: “The Commissioner, LB&I Division, should implement a postmortem review of examinations with transfer pricing issues that went through the Appeals process. These results should be shared in training efforts to improve the accuracy and quality of future transfer pricing examinations.”
  - IRS Management agreed.
  - IRS says LB&I already reviews Appeals Case Memoranda.
  - LB&I will continue reviewing Appeals Case Memoranda and disseminate results of reviews to Cross Border Activities and Transfer Pricing Practice managers.



## TIGTA Finding on Appeals Sustention Rate: Observations

- A low sustention rate suggests that either Exam is overly aggressive in pursuing transfer pricing audits, or Appeals is more permissive than they should be.
- TIGTA is slated to audit the reasons behind this low sustention rate.
- An Appeals change to adjustment shows explicitly what the adjustment changes are, using Exam's adjustment as a baseline. There are concerns that the dissemination of Appeals results to examiners, especially combined with this format, might affect independence of Appeals.

# Background: Appeals Change to Adjustment

<i>Issue</i>		<i>Appeals</i>			
<i>#</i>	<i>Description</i>	<i>Tax Period</i>	<i>Examiner's Adjustment</i>	<i>Change to Adjustment</i>	<i>Appeals Adjustment Code</i>
1	Income from debt cancellation	2010	42,000	(37,000)	5,000
2	Schedule C gross income	2010	32,000	(4,000)	28,000
		2011	25,000	(15,000)	10,000
3	Passive activity loss from S corp.	2010	27,900	0	27,900 A
		2011	14,500	0	14,500 A
4	Self-employment tax	2010	4,521	(565)	3,956 D
		2011	3,071	(1,843)	1,228 D
5	Self-employment tax deduction	2010	(2,261)	283	(1,978) D
		2011	(1,536)	922	(614) D
6	Itemized Deductions	2010	1,993	(815)	1,178 A / D
		2011	759	(281)	478 D
7	Exemption Deduction	2010	3,650	0	3,650 A
		2011	3,700	0	3,700 A
8	Accuracy related penalty - <i>Substantial Understatement</i>	2010	applies	conceded	conceded
9	Accuracy related penalty - <i>Negligence</i>	2011	applies	sustained	sustained
Reason Codes:					
A	taxpayer now agrees	C taxpayer substantiated			
B	accepted by examiner	D computational adjustment			

Source: Internal Revenue Manual 8.6.2.3.5

# QUESTIONS?