



IRS Issues New Roadmap for Transfer Pricing Examinations

On June 29, 2018, the Internal Revenue Service (“IRS”) released Publication 5300 (06-2018), *Transfer Pricing Examination Process* (“TPEP”), a 37-page document intended to guide IRS agents in the planning, execution and resolution of transfer pricing examinations (“TP Audits”). Additionally, TPEP is intended to provide taxpayers with enhanced audit transparency, so they may better understand the process and can work effectively in collaboration with the IRS’s examination team.

TPEP replaces the Transfer Pricing Audit Roadmap (“Roadmap”), which was issued in 2014 to provide IRS examiners with best practices, audit techniques, advice, links and reference materials regarding the administration of TP Audits. In many respects, TPEP mirrors the Roadmap; however, TPEP contains additional new materials on items such as Country-by-Country (“CbC”) reporting and recently-developed Practice Units (additional guides on various transfer pricing aspects designed to assist IRS examiners during TP Audits). TPEP is a detailed and lengthy document that will play an integral role in the selection, execution and resolution of TP Audits going forward.

Below is BT’s Top Ten TPEP Takeaways for Taxpayers:

1. TP Audits are Lengthy and Costly

TPEP openly asserts that TP Audits will be a lengthy, costly process for both the IRS and the taxpayer. TPEP provides illustrative TP Audit timelines that indicate a 2- to 3-year audit process. In addition to costs paid to outside advisors who assist with the TP Audit, taxpayers should be cognizant of the significant amount of time their internal resources will also need to devote to TP Audits. Providing the IRS with transfer pricing documentation that complies with the provision of IRC 6662-6(d) drastically reduces the resources required to defend a transfer pricing position in a TP Audit. The IRS typically moves on to other issues once presented with a compliant transfer pricing study.

2. The IRS Eyes Large Adjustments

TPEP’s directives imply the IRS is evaluating expected costs and benefits of TP Audits when selecting taxpayers to audit. Consequently, large multinational taxpayers should be cognizant of their larger volume intercompany transactions as the IRS aims to target transactions that are likely to produce the largest volume adjustment. Similarly, small, private multinational companies (e.g., taxpayers that do not file 10K/20F or required to produce a CbC report), should focus their attention to the types of intercompany transactions that are susceptible to scrutiny. Having complete transfer pricing documentation is the first line of defense against a TP Audit and will likely dissuade the IRS from further investigation given the high cost associated with disproving the reasonableness of a taxpayer’s transfer pricing policy(ies).

3. The IRS Publicizes Use of Data Analytics for Selecting Taxpayers to Audit

TP Audits will be triggered by actual OR *perceived* abnormalities identified through the IRS’s electronic data analytics tools. Such tools are used to analyze data from tax forms, such as Forms

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1120, 1065, 1120S, 4797, 5471, 5472, 8858 and 8865. Additionally, the IRS will utilize ratio analyses derived from data as initial gauges to whether there are potential transfer pricing issues that may need further investigation. Though not a definitive indicator, ratio analyses can broadly determine whether intercompany pricing is conducted at arm's length. Taxpayers should perform ratio analyses to anticipate results that the IRS may perceive as an indicator that the transfer pricing of the company is not at arm's length, so that taxpayers can proactively prepare adequate documentation to support their positions.

4. IRS References Website Content in TP Audits

The IRS will analyze a taxpayer's website as an initial resource to evaluate a taxpayer's business operations. Taxpayers should be cognizant of website content that could potentially mislead the IRS (i.e., sales office or manufacturing in a given location) or misrepresent the taxpayer's actual intercompany dealing (i.e., the use of certain words may trigger the IRS to characterize an entity in a way that the company did not intend). Time is of the essence for reviewing and modifying language on the website to avoid any misunderstandings.

5. Bullseye on Hybrid Structures

The IRS explicitly states there will be increased scrutiny of transfer pricing involving hybrid entities. The IRS's increased focus on hybrid structures is aligned with the Base Erosion and Profit Shifting ("BEPS") Action 2 report which aims to "neutralize the effects of hybrid mismatch arrangements."

6. IRS Emphasizes New Expectations and Scrutiny of Supply Chains

The IRS demands that supply chain analysis be a comprehensive presentation that covers business operations, key functions, worldwide structure, title flow, product / service flows, cash flow and transfer pricing policies. Traditionally, the IRS's focus on evaluating supply chains, for transfer pricing purposes, emphasized the functions performed by entities and the distribution of risks associated with business operations. Going forward, TPEP specifies that IRS examiners will consider the cash flow, product/service flow AND title flow of a given transaction. Taxpayers should be cognizant that all flows associated with the business are appropriate and intentional. For example, a taxpayer with the intention of having a commission agent in a jurisdiction may have that position challenged if the title of products flows through such an entity (e.g., commission agent is recharacterized as a limited / full-fledged distributor).

7. The IRS to Respect Taxpayer Method Selection

TPEP explicitly states that IRS examiners are to evaluate a taxpayer's selected transfer pricing method by considering whether the taxpayer's selected transfer pricing method reflects, either as applied or with adjustments, an arm's length result, rather than examining all available methods (as the case was before in the Roadmap). This point further demonstrates the IRS's focus on prudent allocation of limited resources.



8. *IRS Practice Units are Best Indicator of IRS Positions*

TPEP instructs IRS transfer pricing examiners to reference IRS Practice Units when auditing transfer pricing arrangements. There are currently more than 40 Practice Units available on the IRS website, with new units being continually added. As a best practice, taxpayers (and their consultants) should reference these Practice Units when planning and evaluating their transfer pricing dealings as an indication of the IRS' position on a given topic.

9. *IRS Expecting Uptick in MAP Requests*

For transactions that involves a tax treaty country, transfer pricing examiners are instructed to coordinate with the Advance Pricing Mutual Agreement ("APMA") program throughout a TP Audit, with contact initiated during the initial risk assessment phase within the planning stage. With this directive, IRS is seemingly attempting to involve the APMA early in the TP Audit process as a means to consider potential Mutual Agreement Procedure ("MAP") requests that could follow any proposed adjustment. MAP, a lengthy and costly undertaking, is a process through which competent authorities consult to resolve disputes regarding the application of double taxation conventions.

10. *OECD Guidelines Themes Sneaking into TPEP*

The IRS incorporates language and concepts derived from the Organization for Economic Co-operation and Development's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("OECD TP Guidelines") into TPEP. The incorporation of OECD TP Guidelines language and concepts signals a shift towards global integration and cooperation with more and more countries, and specifically OECD member countries.

Final Thoughts

TPEP confirms BT's longstanding belief that the first and best line of defense for taxpayers in a transfer pricing audit is the ability to provide IRS with proper transfer pricing documentation immediately upon request. While navigating the transfer pricing regulatory environment can be complex, the Transfer Pricing team at Bennett Thrasher has the expertise and resources to assist with preparing appropriate transfer pricing documentation for companies of all sizes. For more details, please contact Ben Miller by calling 770.396.2200.