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Global Tax Alert

News from Transfer Pricing

US IRS releases FAQs on transfer pricing documentation best practices

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The United States (US) Internal Revenue Service (IRS) has published new [frequently asked questions \(FAQs\)](#) describing best practices and common mistakes in preparing transfer pricing documentation. The guidance is designed to encourage and help taxpayers to prepare improved documentation with an aim to decrease the number of issues selected for examination and improve the examination efficiency for the issues that are selected.

Background

Reasonable and adequate transfer pricing documentation can help taxpayers avoid certain penalties that might otherwise apply. Among other penalties, a net adjustment penalty under Internal Revenue Code¹ Section 6662(e)(1)(B)(ii) can apply when a taxpayer's net Section 482 transfer pricing adjustment exceeds the relevant dollar thresholds for a substantial or gross valuation misstatement. A taxpayer may avoid the net adjustment penalty if it has satisfied the documentation requirements of Section 6662(e)(3)(B) and Treas. Reg. Section 1.662-6.

Under the "6662(e) documentation" requirements, taxpayers generally must select and apply a method in a reasonable manner, maintain sufficient documentation thereof, and promptly provide such documentation to the IRS. To avoid penalties, the 6662(e) documentation must also be assessed for adequacy and reasonableness.

The IRS states that the penalty rules are intended both to encourage taxpayers to take and adequately document return positions and to give the IRS better documentation to evaluate the correct transfer prices. With an aim to further incentivize taxpayers to improve the quality of their transfer pricing documentation, the FAQs follow a January 2018 [IRS Large Business & International Division \(LB&I\) Directive](#) related to the appropriate application of penalties in certain transfer pricing examinations.

FAQs

The IRS states that the recommendations in the FAQs are consistent with the regulatory requirements for providing adequate and reasonable support for arm's-length pricing. The IRS believes that taxpayers may benefit from the insights in the FAQs by helping them to increase the chances of deselection of issues for audit earlier in the examination process.

Q1. What are the benefits of investing in robust transfer pricing documentation?

In addition to protection against penalties under Section 6662(e)(3)(B), the IRS notes that transfer pricing reports that comprehensively document the reasonable selection and application of a transfer pricing method help demonstrate low compliance risk and support early deselection of the transfer pricing issue from further examination. Even if the documentation does not lead to immediate deselection of the issue, it can help the IRS raise more focused questions to address the issue more efficiently in a shorter time frame.

Q2. How can a “self-assessment” help identify potential issues?

The IRS encourages taxpayers to consider conducting a “self-assessment” of potential indicators of transfer pricing non-compliance to anticipate concerns that the IRS might raise. The self-assessment should start with a sensitivity analysis of the parameters used (e.g., would the removal of just one company from the comparable company set cause the tested party's results to fall outside the benchmark range?). The self-assessment could also include comparing the tested party's results against a variety of profit level indicators (PLIs) to ensure the taxpayer's selection of PLI is fully supported. In addition, a self-assessment might include proactively evaluating how system profits are

shared between related parties and addressing whether such allocations are reasonable based on each party's contributions.

Q3. What is the IRS's “guiding principle” in evaluating arm's-length pricing?

The IRS states that its “guiding principle” is to ensure that taxpayers are complying with Section 482 and its regulations. Under the arm's-length standard, taxpayers must determine the best method and use that method to check that the controlled prices applied achieved results consistent with those that would have been achieved if uncontrolled parties had engaged in the same transactions. The IRS acknowledges this is often complicated by the inability to find direct and close comparable companies. The IRS states that when there are imperfect, but good, comparable companies, comparability adjustments should be applied rationally and consistently and follow basic economic principles included in the Section 482 regulations. In addition, taxpayers must include a thorough analysis of how and why comparability adjustments were selected and applied.

Q4. In what areas of transfer pricing documentation has the IRS identified the need for improvement?

The IRS describes several specific areas of transfer pricing documentation that could benefit from improvement:

1. Industry and company analysis sections of the report should be clear and provide context for related-party transactions.
2. Functional analysis narratives should be robust and link facts to analysis.
3. Risk analysis should be consistent with intercompany agreements.
4. Support for best method selection must be provided, as well as the reason for rejecting specified methods.
5. Analysis should be provided to support the PLI conclusion.
6. Complete comparability analysis should be provided.
7. The impact of differences in risks or functions between the tested party and the comparable companies should be provided.
8. Detailed well-reasoned support for proposed adjustments to the application of a specified method should be provided.

The IRS notes that this list is not comprehensive. It adds that strengthening these areas does not provide a safe harbor against examination or penalties but may result in the deselection of certain audit issues and/or a more efficient audit.

Q5. How can a taxpayer present its intercompany transactions in a way that will facilitate an examiner's risk assessment?

The IRS advises, in general, that making transfer pricing documentation more “user friendly” will make the IRS’s review and assessment more efficient. Providing a simple summary of information about the intercompany transactions at the beginning of the transfer pricing documentation can help IRS examiners to understand the taxpayer’s transactions and focus on the most significant transactions. The IRS includes an [example summary presentation](#) that could be useful for risk-assessment purposes to deselect transactions from audit or establish the scope of the transfer pricing audit.

Implications

The FAQs released by the IRS seem to encapsulate broad, long-standing IRS experience that the 6662(e) documentation it is receiving during audits is deficient. The consequences of deficient transfer pricing documentation are that the IRS raises more transfer pricing issues and examinations take longer. The FAQs describe specific areas for taxpayers to focus.

The FAQs should be viewed in the context of the IRS’s continued focus on improving transfer pricing compliance and the effectiveness of its transfer pricing enforcement. While the IRS has done little to change the substantive transfer pricing rules during the last several years, it has changed to a risk-based issue identification process and has modified its examination process. It has issued several documents and directives explaining those changes; see, for example, directives related to the mandatory IDR, transfer pricing method selection, and TP penalty application, as well as a document describing the Transfer Pricing Examination Process.

Concurrent with the IRS’s desire to improve taxpayer’s transfer pricing documentation, taxpayers turned to standardization and commoditization of documentation as they struggled to comply with documentation rules in various jurisdictions.² The FAQs may reveal that some of the potential consequences of the commoditization of transfer pricing documentation may be unnecessary transfer pricing audits and longer audits as the IRS works to develop the facts and evaluate the economic analyses. Taxpayers that wish to minimize transfer pricing audit exposure and expenditures for audit defense may want to evaluate whether their transfer pricing documentation is consistent with the recommendations in the FAQs.

In addition, the current economic volatility may create challenges for companies to comply with their existing transfer pricing structures. While the FAQs do not change current substantive or penalty law, consistent with the FAQs, taxpayers need to have robust documentation and check that their facts and results are consistent with that documentation.

Endnotes

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. The Organisation for Economic Co-operation and Development (OECD) also attempted to standardize the transfer pricing documentation taxpayers prepare by preparing guidelines addressing three levels of documentation—master file, local file and country-by-country reporting.

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