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Global Tax Alert
News from Transfer Pricing

US IRS LB&I issues instructions for examiners on transfer pricing selection issues

On 12 January 2018, the Commissioner of the Internal Revenue Service (IRS) Large Business and International Division (LB&I) issued three memoranda with instructions on transfer pricing selection, instructing examiners to:

1. Halt examination of new stock-based compensation issues in cost sharing arrangements until *Altera* is decided (*Altera* Memo)
2. Obtain approval before changing taxpayers' selection of best transfer pricing method (Best Method Memo)
3. Halt development of transfer pricing adjustments based solely on taxpayer's use of multiple reasonably anticipated benefits (RAB) shares (RAB Shares Memo)

Altera Memo

In the *Altera* Memo (LB&I-04-0118-005), the LB&I Commissioner directed audit teams not to initiate any new examinations of the treatment of stock-based compensation (SBC) in a cost sharing arrangement (CSA) while the *Altera* case is on appeal. For pending CSA examinations, LB&I will halt issue development pending a decision if the taxpayer elects to extend the statute of limitations until *Altera* is resolved.

Background

In July 2002, the Treasury issued a notice of proposed rulemaking and notice of a public hearing regarding new regulations on treating SBC costs as shared costs in a CSA. During the notice and comment process, Treasury received comments arguing that SBC is not typically included in the pricing of third-party transactions, so inclusion of SBC in pricing intercompany transactions would not comport with the arm's-length standard. In August 2003, Treasury issued final regulations requiring parties to a CSA to share SBC costs.

On 23 May 1997, Altera US and Altera International entered into a CSA that was effective from that date through 2007. In allocating the costs to be shared under that CSA, Altera US included the cash compensation of its employees engaged in R&D but excluded their SBC.[1] The IRS subsequently imposed transfer pricing adjustments in each of the tax years 2004-2007, based on the taxpayer's failure to include SBC costs in its CSA cost pool. Altera challenged the adjustments.

In determining the validity of the 2003 Regulations, the Tax Court addressed whether the final rule was properly issued. The Tax Court applied the Administrative Procedure Act and concluded that the regulations were arbitrary and capricious due to Treasury's failure to: (1) support its belief that unrelated parties would share SBC costs; and (2) adequately address significant comments made during the rulemaking process. Accordingly, the Tax Court unanimously held that the regulations were invalid and that SBC costs are not among the costs shared in a CSA.

On 19 February 2016, the IRS filed a notice of appeal of *Altera* to the Ninth Circuit. Oral argument was heard in October 2017.

IRS instructions

On 12 January 2018, the IRS issued the *Altera* Memo directing audit teams not to open new examinations for taxpayers that have taken the position that SBC costs should be excluded from the costs shared in a CSA. The *Altera* Memo also directs audit teams already developing the issue to discontinue development for taxpayers that extend the statute of limitations until the Ninth Circuit ruling is issued.

Implications

The *Altera* Memo represents the IRS declining to invest further resources in developing cases around SBC costs until such time as the Ninth Circuit rules on the IRS appeal. Since the opinion is expected soon, the *Altera* Memo should be viewed as the IRS conserving its limited resources rather than abandoning the issue.

Best Method Memo

In the Best Method Memo (LB&I-04-0118-002), the LB&I Commissioner instructed LB&I examiners to obtain approval from the Treaties and Transfer Pricing Operations (TTPO) Transfer Pricing Review Panel before changing the taxpayer's selection of a transfer pricing method as the best method for its contemporaneous documentation or Advance Pricing Agreement (APA).

IRS instructions

This directive only applies when:

1. The taxpayer has provided, as part of its Internal Revenue Code[2] Section 6662(e) documentation, a report that both clearly states the method the taxpayer has selected as the best method and the analysis to support that conclusion; or
2. The taxpayer prepares and submits an APA application for consideration by the Advance Pricing and Mutual Agreement program (APMA).

In these cases, analysis of the best method conducted by the tax examiner must begin with analyzing the best method chosen by the taxpayer and the justifications for choosing that method. Once a thorough analysis of the taxpayer's selection of the best method is conducted, and it is concluded that changes in the selected method are warranted, the changes should be thoroughly developed and documented as early as possible in the examination.

Taxpayers may select unspecified methods as a best method, but should be aware that the use of an unspecified method may lead to additional scrutiny by the examination team.

If changes are recommended, the approval process outlined next must be followed:

1. Recommendations for a method change must be elevated through the issue manager's or APA team leader's management chain to the applicable Director of Field Operations (DFO) for referral to the National TTPO Transfer Pricing Review Panel.
2. The Review Panel will consist of the TPP Director or APMA Director, a Senior Advisor to the TTPO Director, and the Income Shifting Practice Network Manager.

3. The Review Panel will focus on three key questions:
    a. Why is the taxpayer's method unreliable?
    b. Can the taxpayer's method be adjusted to make it more reliable?
    c. If not, what method is more reliable, and why?

Additionally, all method-changing recommendations must include the analysis supporting the alternative method selection and provide the Review Panel with support for these questions.

If the examiner changes the application of the best method, but not the method itself, there is no need to follow this approval process. Additionally, once the APA team has begun formal negotiations with a competent authority on a bilateral APA, the approval process is also not required.

Implications

The Best Method Memo provides a formal process that IRS examiners and APA teams must follow if they wish to change the transfer pricing best method chosen by a taxpayer for its contemporaneous documentation or APA. This new process is designed to support LB&I's objective of managing its transfer pricing resources in the most efficient and effective manner possible. For companies, this means that there is less chance that the IRS will demand a method change as long as the method chosen for contemporaneous documentation or an APA submission can be sufficiently supported.

RAB Shares Memo

In the RAB Shares Memo (LB&I-04-0118-004), the LB&I Commissioner instructed LB&I examination teams not to develop transfer pricing adjustments based solely on a taxpayer using multiple RAB shares to determine the amount of platform contribution transaction (PCT) payments related to intellectual property (IP) added to an existing cost sharing arrangement (CSA) until the IRS finalizes its position.

Background

Treasury Reg. Section 1.482-7 generally permits taxpayers to enter into a CSA to share the costs and risks of developing cost shared intangibles in proportion to their RAB shares. Participants must make PCT payments when IP is contributed to a CSA. The method for valuing the PCT should yield a value consistent with the product of the value to all controlled participants of the platform contribution and the PCT payor's RAB share.[3]

In a common fact pattern in many existing CSAs, a US participant acquires an independent company with valuable IP, which it contributes to the CSA. Often, this PCT has the effect of changing the participants' respective RAB shares. A number of IRS examination teams have raised the issue of whether taxpayers may use multiple RAB shares (e.g., the pre-existing RAB share or a RAB share taking into account the effect of the PCT) in determining the PCT Payments.

IRS instructions

The IRS instructs LB&I examiners not to develop adjustments based solely on the use of multiple RAB shares until the IRS completes its review of this issue and determines a consistent IRS-wide position. IRS examiners may still, however, examine whether the RAB shares used by taxpayers are appropriate given all the specific facts and circumstances.

Implications

Taxpayers with subsequent PCTs to an existing CSA should take note of this memorandum and monitor any updates to the IRS's position on this issue. In the event a taxpayer makes a PCT payment that has the effect of changing the participants' RAB shares, the taxpayer should be prepared to support its determination of the arm's-length PCT payments by, for example, documenting the facts and circumstances of the transaction.

Endnotes

1. *Altera Corp. v. Comm'r*, 145 T.C. 91 (2015).
2. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
3. Treas. Reg. Section 1.482-7(g).

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