



Understanding the New Transfer Pricing Audit Map

Published on Alvarez & Marsal (<https://www.alvarezandmarsal.com>)

2014—Issue 41—In its continued effort and focus on transfer pricing, the IRS Large Business and International (LB&I) division published a “roadmap” designed to help IRS exam teams improve the efficiency and transparency of transfer pricing audits. An emphasis on early coordination and detailed fact development favors taxpayers who are proactive in developing their transfer pricing methodology.

Overview

Transfer pricing continues to be a hot topic in the IRS as well as a national debate among policymakers. Additionally, recent centralization of the IRS audit process has led to a trend where high-dollar cases are less likely to settle during the audit process, ultimately leading to litigation.

In an effort to be proactive and to streamline the audit process for transfer pricing issues, in February 2014, the IRS released a [transfer pricing audit roadmap](#) [2]. The effort focuses on improving the efficiency and effectiveness of transfer pricing examinations for the IRS. The rollout of the roadmap is now becoming evident in transfer pricing exams.

The roadmap emphasizes early communication and collaboration among taxpayers and the exam team. Taxpayers have the opportunity to address transfer pricing practices in advance of an audit, with an understanding of likely IRS approaches. Exam teams will not share working hypotheses early in the exam until the taxpayer has provided complete, sound explanations of transactions and transfer pricing methods.

Transfer Pricing Audit Roadmap

The LB&I division of the IRS assembled a team of transfer pricing specialists who developed the roadmap. This document outlines audit procedures and general guidance for transfer pricing practitioners who are conducting transfer pricing exams. The roadmap outlines phases of the exam process and charts out a proposed timeline for each phase.

A few themes emerge from the overall document that taxpayers should consider when developing their own planning and compliance effort:

Upfront planning is essential: Transfer pricing specialists will be engaged in the early stages of the audit and help address transfer pricing issues at the earliest possible stage. Specialists are used to help weed out the issues not worth pursuing and develop an audit plan and timeline.

In previous years, transfer pricing specialists were typically called in once a complicated transfer pricing issue was identified. In the new instance, transfer pricing specialists are encouraged to participate in any audit where a related-party transaction is identified.

Transfer pricing cases are usually won or lost on the facts: The key to transfer pricing cases is to develop a convincing story on what drives the taxpayer’s profit based on analysis of functions, assets and risks along with relevant financial information. If the examination team believes the tax result claimed by the taxpayer is at odds with the common-sense conclusions, chances are this will be further scrutinized.

Historically, examiners were often satisfied with the production of transfer pricing documentation by the entity; but now that transfer pricing specialists are involved, the mere representation of documentation may not be enough. Taxpayers need to make sure the documentation accurately reflects the business's functions, assets and risks.

The objective in a transfer pricing audit is to determine a reasonable result under the facts and circumstances of any given case: Early in the exam process, the exam team should articulate a “working hypothesis” based on initial basic fact development. This hypothesis should be adjusted, or discarded, if new facts arise. The iterative hypothesis development process should be well documented to develop a good foundation for formulating the economic analysis.

Exam teams are focusing on getting the facts right up front and not focusing on the results until the facts are understood. In years past, exam teams may have focused on the results and would often struggle to sustain income adjustments to taxpayers' income because they could not clearly articulate the facts. The new roadmap clearly promotes a better understanding of the facts early in the process of developing an audit case.

Effective presentation can “make or break” a case: If receiving an adjustment, the taxpayer should expect a well-crafted notice of proposed adjustment, incorporating all facts, both in support and against the adjustment, persuasive arguments and a sound conclusion.

The roadmap's focus is on quality and accuracy. The IRS is more often challenged in its adjustments when its position on audit doesn't provide a complete treatment of the facts of the case and in particular when certain facts that taxpayers consider important are omitted. The use of this roadmap is intended to provide a mechanism for the IRS to get ahead of the process and be upfront as to the facts and circumstances of their proposed adjustments.

Quality Examination Process

The roadmap proposes a notional audit timeline for the examination process to be completed. The Quality Examination Process (QEP) is carried out in three phases:

- 1. Planning (up to 6 months):** The planning phase establishes the groundwork for the examination team with an opening conference, taxpayer orientation, and preparation of an initial risk analysis and examination plan. The IRS issues a mandatory transfer pricing information document request (IDR) with the initial contact letter, allowing the taxpayer 30 days to respond.
- 2. Execution (up to 14 months):** The most time intensive portion of the exam, the execution phase involves fact-finding, information gathering and issue development. This phase involves an extensive amount of taxpayer interaction. The fact-finding step includes additional IDRs, analysis of accounting data, interviews and site visits. The functional analysis will target the economically significant activities associated with the transaction. An economically significant activity is one that materially affects a) the price charged in a transaction and b) the profits earned from a transaction. If taxpayer collaboration and communication results in new information, the IRS will reassess the risk assessment in a mid-cycle assessment.

After completing the initial economic analysis, the IRS provides a draft of the notice of proposed adjustment (NOPA) or preliminary analysis, factual findings and conclusions to the taxpayer. At this point in the process the IRS may revise the NOPA and the economist's report to incorporate the taxpayer's input.

- 3. Resolution (up to 6 months):** Finally, the resolution phase incorporates presentation of issues, issue resolutions and case closing. After meetings with the taxpayer, the exam team will provide a finalized NOPA. The IRS will also conduct a risk assessment to evaluate the strength of their position and consider pre-appeals resolution opportunities. The next step of the resolution phase is the revenue agent's report (RAR/30-day letter), followed by a taxpayer protest and IRS rebuttal. If the protest contains new factual information, the IRS will consider re-engaging the examination process.

After examination and the issuance of the 30-day letter, if the taxpayer does not agree with the adjustment, then the final step is the appeals meetings.

When Facing Adjustments After Audit

If the taxpayer is assessed a NOPA, it has the right to pursue an appeal. [IRS Publication 556](#) [3] outlines taxpayers' rights to appeal a proposed adjustment from the IRS examination team.

It is important to note that penalties under IRC Section 6662(e) and (h) are not applicable if:

- Contemporaneous documentation was provided within 30 days of request by IRS; and
- There is a reasonable basis to conclude that the selected transfer pricing method produced the most reliable measure of an arm's-length result.

Taxpayers should consider the risk of litigation during an audit. From the IRS perspective, there is a greater inclination to move a case towards litigation if a result cannot be achieved through the appeals process. Field staff agents are less likely to settle high-dollar disputes without approval of upper management, particularly in cases where counsel in the national office is inclined to litigate. IRS exam and appeals team attrition rates are in the range of 30 to 50 percent. As a result, the IRS is often left with inexperienced teams who are typically less likely to resolve an issue during audit and more likely to take an issue to appeals and/or litigation. Additionally, greater centralization of decision-making has led to issues that were previously resolved during the field examination going through to appeals.

Alvarez & Marsal Taxand Says:

Transfer pricing examinations are beginning to reflect the recent updates in the transfer pricing audit roadmap. Because transfer pricing issues are complex and expensive, taxpayers must engage in continuous communication beginning in the early stages of the audit. Transfer pricing cases are usually won and lost on the facts, so taxpayers should retain good transfer pricing records and must be able to present facts consistent with tax returns and financial statements. Contemporaneous transfer pricing documentation provides the best defense for the taxpayer and is the best way for the taxpayer to present the facts and circumstances of the related-party transactions up front. For the well-intentioned taxpayers prepared to present the relevant information, the efficiency of the roadmap is a welcome change. However, for unprepared taxpayers or taxpayers with something to hide, this is not the case.

Andy Scripps, Director, and Dan Varley, Senior Associate, contributed to this article.

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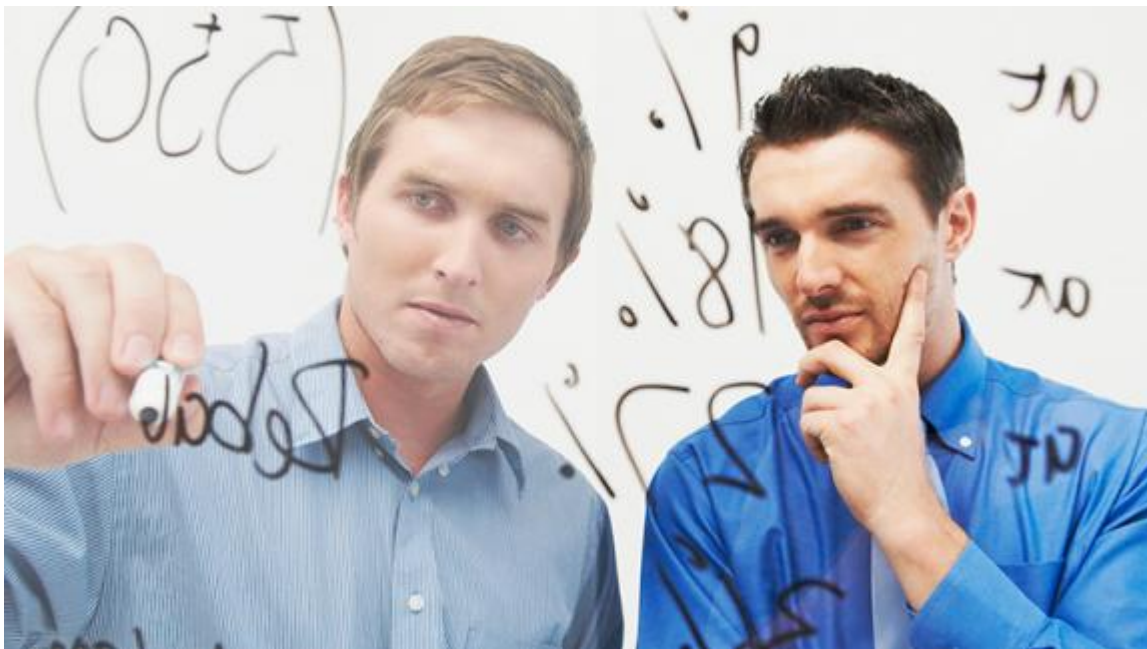
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[7]

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[8]

Survey of Transfer Pricing Issues in U.S. Business Restructurings [8]

Business restructurings achieve economic benefits through a broad array of strategies. Cost savings and operational improvements are often key drivers. The primary mechanisms used to achieve the company's goals involve the redeployment of functions, assets or risks. Therefore, a restructuring exercise may offer significant tax planning opportunities through transfer pricing.

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[2] <http://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf>

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