

CHAPTER 10

When the Transaction Crosses the Border—Globalization and the Changing Face of Tax Enforcement

Steven Toscher, Esq.
Lacey Strachan, Esq.*

Synopsis

- ¶ 1000 INTRODUCTION
- ¶ 1001 TRANSFER PRICING AND THE IRS'S POWERS UNDER SECTION 482
 - ¶ 1 Background on Transfer Pricing
 - ¶ 2 Standard Under Section 482
 - ¶ 3 Potential Penalties if the IRS Makes a Transfer Pricing Adjustment
- ¶ 1002 RECENT IRS ENFORCEMENT EFFORTS
 - ¶ 1 Increasing Focus on Transfer Pricing Issues
 - ¶ 2 The IRS Audit Roadmap
 - ¶ 3 International Practice Units
 - ¶ 4 LB&I Compliance Campaigns
- ¶ 1003 PREPARING FOR A TRANSFER PRICING AUDIT
 - ¶ 1 Transfer Pricing Study
 - ¶ 2 Setoff
- ¶ 1004 CONCLUSION
- ¶ 1000 INTRODUCTION

In the past, transfer pricing cases have typically been large transactions involving large multinational corporations, often focusing on the corporation's pricing of goods and services between the U.S. corporation and its foreign affiliates. Most recently, on March 23, 2017, Amazon won a victory in the United States Tax Court against the Internal Revenue Service ("IRS") in a tax dispute relating to its method of determining

* Steven Toscher is a Principal and Lacey Strachan is an Attorney at Hochman, Salkin, Rettig, Toscher & Perez, P.C., in Beverly Hills, California. © 2017 by the authors.

payments from a foreign subsidiary for the licensing of intellectual property for online European operations.¹ The IRS determined substantial transfer pricing adjustments against Amazon, re-allocating income from its foreign affiliate to Amazon in the U.S. It was estimated that if sustained, the IRS's notices of proposed adjustments could have resulted in a tax liability against Amazon of \$1.5 billion. The Tax Court ultimately found the IRS's determinations of the amount to be re-allocated were unreasonable and disagreed with the Service's assumptions and methodology, instead holding that Amazon's methods for determining the payments owed from its foreign affiliate to Amazon in the U.S. were reasonable.²

But it is not just the Amazons of the world that face the scrutiny of the Internal Revenue Service—companies in the middle market will be seeing increasing enforcement of the IRS's power under Section 482 of the Internal Revenue Code to reallocate income between commonly controlled organizations in order to prevent evasion of taxes or to clearly reflect the income of the organizations. The landscape of transfer pricing cases has been changing. The globalization of the world economies has substantially increased the number and size of the companies engaged in cross-border transactions, making transfer pricing much more relevant to smaller corporations and their professionals.

In the past few years, the IRS has been shifting more resources to training specialized transfer pricing examiners and teaching examiners to recognize controlled transactions that may present a transfer pricing issue. The Large Business & International (LB&I) division of the IRS has established a team of transfer pricing specialists, who released a Transfer Pricing Audit Roadmap in 2014 that was designed to provide examiners with audit techniques to assist with transfer pricing examinations.³ Since 2014, LB&I has released well over 100 International Practice Units ("IPU") covering a wide array of international tax issues from how to gather foreign based evidence to the proper determination of Subpart F income. The IPUs were developed by LB&I as training materials and job aids for its examiners but have been released to the public on the IRS website.⁴ While they are not official pronouncements of law and cannot be cited as precedent, they may be very useful to practitioners in dealing with the IRS examinations.

¹ Amazon.com Inc. and Subsidiaries v. Commissioner, 148 TC No 8 (March 23, 2017).

² On July 5th, 2017, the Tax Court entered a stipulated decision in accordance with its prior opinion, which reflects a refund due to Amazon of \$9.55 million for the year 2005 and a tax due of \$2.54 million for the year 2006. Amazon.com Inc. and Subsidiaries v. Commissioner, Docket No. 31197-12, Decision (July 5, 2017).

³ Available at <https://www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf> (hereinafter "Roadmap").

⁴ <http://www.irs.gov/Businesses/Corporations/International-Practice-Units>.

10-3

GLOBAL TAX ENFORCEMENT

¶ 1001.1

In January 2017, the IRS announced its most recent efforts to scrutinize international transactions, with the Large Business and International division of the IRS launching 13 compliance campaigns in a move toward issue-based examinations.⁵ A compliance campaign may not be a full audit, but it will be a concerted effort by LB&I to focus on addressing what are considered to be significant issues concerning cross border transactions—especially transfer pricing issues. Among the 13 compliance campaigns announced in January 2017, two focus specifically on transfer pricing issues: the “Related Party Transactions Campaign” and the “Inbound Distributor Campaign.”

With the increased scrutiny by the IRS of international transactions, now is the time for all corporations that engage in transactions with foreign controlled entities to make sure they have a transfer pricing policy and supporting documentation in place to ensure that the transfer prices are set at arm’s length.

¶ 1001 TRANSFER PRICING AND THE IRS’S POWERS UNDER SECTION 482**¶ 1 Background on Transfer Pricing**

Transfer pricing refers generally to the setting of prices for property and services sold between controlled entities, such as a parent corporation selling goods to a subsidiary. The IRS is especially interested in a taxpayer’s transfer pricing policies when those corporations are in different tax rate jurisdictions, or other situations where there may be an advantage to a taxpayer for having income in one controlled company instead of another. In such situations, the IRS wants to ensure that the income associated with such transactions reflects the economic reality of the transaction.

The rules for determining whether a transaction has been reported consistent with the economic reality of the transaction is set forth in the regulations under Section 482, which provides the IRS authority to make any adjustments, such as reallocating income or deductions, so that it clearly reflects the income of the taxpayer consistent with the economic reality of the transaction. The rules under Section 482 apply to transactions between all controlled corporations, even those where the related organizations are both domestic. For example, the interest rate charged on related-party loans is an issue that comes up between related domestic entities. However, because of the potential for companies to take advantage of foreign jurisdictions with a more favorable tax system, transfer pricing cases are more commonly a part of the IRS’s international enforcement efforts.

⁵ See “Compliance Campaign Webinars,” available at <http://www.irs.gov/businesses/compliance-campaign-webinars> (2/27/2017).

¶ 1001.2

U.S.C. TAX INSTITUTE

10-4**¶ 2 Standard Under Section 482**

The critical question under in the Section 482 regulations is whether the amount charged in the controlled transaction is arm's length. Section 482 of the Internal Revenue Code is designed to prevent income-shifting through controlled transactions, by allowing the IRS to adjust the amount charged in related-party transactions (where two or more businesses are owned or controlled directly or indirectly by the same interests), for purposes of determining a related party's taxable income if the amount charged is determined to not be "arm's length."⁶ Under the regulations, a transaction meets the arm's length standard if "the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances."⁷ The regulations set forth extensive guidelines on the methods to be used to determine the arm's length range for a transaction, in order to place "a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer."⁸

¶ 3 Potential Penalties if the IRS Makes a Transfer Pricing Adjustment

If a transfer pricing examination results in an adjustment, the adjustment may be subject to a substantial (or gross) valuation misstatement. A 20% substantial valuation misstatement penalty is triggered in transfer pricing cases in two situations: (1) where the price for any property or services subject to Section 482 is 200% or more (or 50% or less) of the arm's length amount;⁹ or (2) if the net Section 482 transfer price adjustment exceeds the lesser of \$5,000,000 or 10 percent of the taxpayer's gross receipts.¹⁰ While the reasonable cause exception under Section 6664(c) generally applies to substantial valuation misstatement penalties, it does not apply to the second situation—a penalty triggered by a net Section 482 transfer price adjustment. Instead, the penalty can be avoided only if certain documentation requirements are satisfied. Thus failure to maintain the documentation in effect allows for a strict liability penalty—a rarity in the Internal Revenue Code.

To avoid a substantial valuation misstatement penalty triggered by a net Section 482 transfer price adjustment, three conditions must be satisfied: (1) the taxpayer determined the price in accordance with a specific pricing method allowed under the

⁶ IRC § 482; Treas Reg § 1.482-1(a).

⁷ Treas Reg § 1.482-1(b).

⁸ Treas Reg § 1.482-1(a).

⁹ IRC § 6662(e)(1)(B)(i). There is a 40% gross valuation misstatement if the price is 400% or more or 25% or less. IRC § 6662(h)(2)(A)(ii)(I).

¹⁰ IRC § 6662(e)(1)(B)(ii). There is a 40% gross valuation misstatement if the net adjustment exceeds the lesser of \$10 million or 20% of the taxpayer's gross receipts.

10-5

GLOBAL TAX ENFORCEMENT

¶ 1002.1

regulations and use of that method was reasonable (or, the taxpayer used another pricing method that was likely to result in a price that would clearly reflect income, if the pricing methods in the regulation would not be reasonable); (2) the taxpayer has documentation that was in existence at the time of filing the return setting forth the determination of the price and establishing that the use of the method was reasonable; and (3) the taxpayer provides such documentation to the IRS within 30 days of a request—which will happen at the outset of each transfer pricing audit.¹¹

¶ 1002 RECENT IRS ENFORCEMENT EFFORTS**¶ 1 Increasing Focus on Transfer Pricing Issues**

Back in 2012, the U.S. Senate Permanent Subcommittee on Investigations on “Offshore Profit Shifting and the U.S. Tax Code” held a hearing examining what it considered to be abuses in the area.¹² The subcommittee confronted a number of high-tech companies regarding what it considered to be abusive practices in the transfer pricing area, both the pricing of intangible property and financing arrangements among foreign affiliates. Importantly, and not surprising, Senator Carl Levin, the chairman of the Permanent Subcommittee, labeled the transfer pricing practices of the multi-national firms as “gimmicks,” “dubious transactions,” and “legal fictions.”¹³ Many of us remember Senator Levin’s comments regarding the tax sheltered structured transactions of the Big Five and how they motivated both the IRS and the Department of Justice to engage in a war on “listed transactions,” which is still being fought in some quarters today.

The IRS has also expanded its transfer pricing enforcement resources under the reorganized LB&I operating division. In times of limited enforcement resources, one could ask why the IRS is expanding into this area when other areas need to be attended to. The answer is found in the old question asked to the famous bank robber Willie Sutton of why he robs banks—the answer is: “That’s where the money is.” With the ever-expanding globalization of economies and what some politicians (and no doubt tax enforcement individuals) believe are areas filled with “gimmicks,” “dubious transactions,” and “legal fictions”—that may be where the money is. In May 2013, the focus of the Permanent Subcommittee on Investigations turned to Apple, with Senator

¹¹ IRC § 6662(e)(3)(B). The Audit Roadmap advises examiners to issue a “§ 6662(e) mandatory Information Document Request” at the beginning of the audit.

¹² Hearings / Homeland Security & Governmental Affairs Committee, Permanent Subcommittee on Investigations, “Offshore Profit Shifting and the U.S. Tax Code—Part 1 (Microsoft & Hewlett-Packard),” <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code>.

¹³ Carl Levin, Opening Statement at PSI Hearing: Offshore Profit Shifting and the U.S. Tax Code, September 20, 2012.

¶ 1002.2

U.S.C. TAX INSTITUTE

10-6

Carl Levin inquiring into how Apple “shifts billions of dollars in profits offshore.”¹⁴ This second hearing on “Offshore Profit Shifting and the U.S. Tax Code” brought further attention to transfer pricing issues and demonstrates the Government’s focus on transfer pricing issues.

Over the past five years, we have seen the IRS amp up its resources and enforcement efforts in transfer pricing cases—not only in cases involving Amazon, Apple, and similar multinational corporations, but also in middle market companies that engage in business with affiliates overseas. With the IRS’s general increase in international enforcement areas, including its offshore voluntary disclosure programs beginning in 2009, more and more cross-border transactions have come to the attention of the IRS.

¶ 2 The IRS Audit Roadmap

The IRS Transfer Pricing Audit Roadmap (the “Roadmap”) was developed by a team of transfer pricing specialists established by LB&I to set forth guidelines for agents conducting examinations of cases involving transfer pricing issues.

The Audit Roadmap sets forth a two-year timeline for transfer pricing examinations, including the initial planning stage.¹⁵ The roadmap places great emphasis on the planning stage, before an audit is officially commenced. Examiners will begin by reviewing information about a taxpayer in order to determine whether there are potential transfer pricing issues worth pursuing. Examiners are instructed to review tax returns and information returns to identify controlled transactions and to compute financial ratios that the examiner will use to help determine potential non-arm’s length transfer pricing issues.¹⁶ The following ratios are computed by examiners and compared to industry standards: gross profit to net sale; operating profit to net sale; operating expenses to net sale; gross profit to operating expenses; and operating profit to average total assets.¹⁷

During the planning phase, the examiner will also research the background, history, and core business operations of the taxpayer, including SEC filings. Because of the relevance to common transfer pricing issues, an examiner will pay particular attention to information on the company’s research and development activities; patents, trademarks and other intellectual property; the geographic and organizational structure of the taxpayer; and segmented operational and profitability levels of the company.¹⁸

¹⁴ Carl Levin, Opening Statement of Sen. Carl Levin, “Offshore Profit Shifting and the U.S. Tax Code, Part 2 (Apple Inc.)”

¹⁵ Roadmap at 3.

¹⁶ Roadmap at 5.

¹⁷ Internal Revenue Manual (“IRM”) 4.61.3.4.1 (05-01-2006).

¹⁸ Roadmap at 6.

10-7

GLOBAL TAX ENFORCEMENT

¶ 1002.2

The examiner will try to gain an understanding of the relationship between the taxpayer and its affiliates in other countries and the role each entity plays in carrying out the activities of the controlled group.

As part of their pre-examination planning, examiners will also develop a preliminary working hypothesis and transfer pricing risk assessment, taking into consideration the company's worldwide effective tax rate and whether the taxpayer's overall tax position is such that income shifting would be beneficial from a financial accounting or cash flow standpoint, the potential applicability of a tax treaty, the source of income and tax credit availability, the potential impact of Subpart F, and the potential impact of other considerations such as collateral adjustments.¹⁹ This hypothesis will guide the examination and will be adjusted as necessary during the course of the audit. The increased focus in the roadmap on early communications with the taxpayer as to the IRS's audit plan and working hypothesis allows the taxpayer and practitioner to benefit from increased transparency in the audit and the opportunity to work with the IRS as it is identifying potential transfer pricing issues.

One of the key themes the IRS emphasizes in the roadmap is that transfer pricing cases are usually won and lost on the facts. The IRS will be focused on preparing a "compelling story of what drives the taxpayer's financial success, based on a thorough analysis of functions, assets and risks, and an accurate understanding of the relevant financial information."²⁰ This is where the skilled advocate can assist the taxpayer in properly developing the facts. The key inquiry in transfer pricing cases is whether the reporting of income reflects the economic reality of the transactions—that is, whether the prices involved in related party transactions reflect an arms-length price. Transactions that are "too good to be true" will invite further scrutiny by the IRS.²¹ If instead the IRS determines that the taxpayer's financial results on a transaction are reasonable, the examiner may choose to not pursue the issue.²²

The roadmap explains that the objective in a transfer pricing audit is to determine a reasonable result under the facts and circumstances and that the effective enforcement of the arm's length standard requires the exercise of judgment.²³ Agents are instructed to look for only substantial deviations from the arm's length standard that result in a significant shifting of income—agents are not to make *de minimis* adjustments under section 482.²⁴ The roadmap also reminds examiners that it is critical

¹⁹ Roadmap at 8–9.

²⁰ Roadmap at 1.

²¹ *Id.*

²² *Id.*

²³ Roadmap at 2.

²⁴ IRM 4.61.3.1 (05-01-2006).

¶ 1002.3

U.S.C. TAX INSTITUTE

10-8

for the transfer pricing team to address in full the taxpayer's analysis, because the taxpayer may have the more compelling position on the issue.²⁵

¶ 3 International Practice Units

The IRS began issuing International Practice Units ("IPUs") in December 2014, and has since released 44 IPUs in 2014, 40 in 2015, 49 in 2016 and so far 10 in 2017, as of March 1, 2017.²⁶ IPUs are a tool for collaborating and sharing knowledge among IRS employees, designed to serve as both job aids and training materials on specific tax issues.

Many of these IPUs have related to issues pertaining to transfer pricing examinations, demonstrating the IRS's focus in this area. These IPUs sometimes focus on general issues relevant to transfer pricing examinations, such as an IPU issued on December 15, 2014, on the "Arms Length Standard," an IPU issued on August 28, 2015, on an "Overview of IRC 482," and an IPU issued on April 6, 2016 on "Three Requirements of IRC 482." The Arms Length Standard IPU provides a basic introduction to the arm's length standard, focusing on the purchase of tangible products by a U.S. subsidiary from a foreign parent.²⁷ The Overview of IRC 482 IPU addresses instead "outbound transactions," which are transactions that involve a U.S. parent company doing business with a foreign controlled entity, with a focus on the sale of tangible goods to a controlled foreign corporation.²⁸ The "Three Requirements of IRC 482" focuses on the three basic prerequisites that must exist before Section 482 can be applied: (1) There must be two or more organizations, trades or businesses; (2) There must be common ownership or control, either directly or indirectly of such entities; and (3) The IRS must determine that an allocation is necessary either to prevent evasion of taxes, or to clearly reflect the income of any of those entities.²⁹

Other IPUs provides specific guidance on how particular methods under the Section 482 regulations are applied or how particular transactions should be approached under Section 482. For example, on February 4, 2016, the IRS released an IPU on "Intercompany Interest Rates under the Situs Rule of IRC Section 482," which provides guidance on how to examine whether the rate charged on a loan by a foreign parent company to a U.S. subsidiary is arm's length.³⁰ More recently, the IRS released two IPUS on September 23, 2016: "Comparison of the Arm's Length Standard with

²⁵ Roadmap at 2.

²⁶ See "Practice Units" available at <https://www.irs.gov/businesses/corporations/international-practice-units>.

²⁷ https://www.irs.gov/pub/int_practice_units/ISI9422_09_06.pdf.

²⁸ https://www.irs.gov/pub/int_practice_units/ISO9411_07_01.pdf.

²⁹ https://www.irs.gov/pub/int_practice_units/ISI9422_09_02.pdf.

³⁰ https://www.irs.gov/pub/int_practice_units/ISI9422_08_01.pdf.

10-9

GLOBAL TAX ENFORCEMENT

¶ 1002.4

Other Valuation Approaches—Outbound”³¹ and “Comparison of the Arm’s Length Standard with Other Valuation Approaches—Inbound.”³²

These are just a few of the IPUs that have been issued relating to transfer pricing issues. These demonstrate that the transfer pricing area is an important area of focus for the IRS in its enforcement efforts going forward.

¶ 4 LB&I Compliance Campaigns

On January 31, 2017, the IRS LB&I division announced the identification and selection of 13 campaigns, in its move toward issue-based examinations. The IRS has explained that the campaigns “are the culmination of an extensive effort to redefine large business compliance work and build a supportive infrastructure inside LB&L.”³³ The IRS’s goal with the compliance campaigns is to improve return selection, identify issues representing a risk of non-compliance, and make the greatest use of limited resources.³⁴

Among the 13 campaigns rolled out by LB&I, two focus on issues relating to transfer pricing. The first is the “Related Party Transactions Campaign,” in the “Enterprise Activities” practice area.³⁵ The IRS explains that this campaign “focuses on transactions between commonly controlled entities that provide taxpayers a means to transfer funds from the corporation to related pass through entities or shareholders. LB&I is allocating resources to this issue to determine the level of compliance in this related party transactions of taxpayers in the mid-market segment.”³⁶ The IRS explains that the treatment stream for this campaign is issue-based examinations.

Although the description of the compliance campaign does not reference transfer pricing, the inquiry called for by this compliance campaign necessarily calls into question whether the related party transaction satisfies the arm’s length requirement of Section 482. This campaign is not focused on strictly cross-border transactions, but includes all related party transactions.

The second campaign is the “Inbound Distributor Campaign,” in the “Treaty and Transfer Pricing Operations” practice area.³⁷ This compliance campaign also calls for issue-based examinations and focuses on one segment of controlled transactions that

³¹ https://www.irs.gov/pub/int_practice_units/iso_c_01_03.pdf.

³² https://www.irs.gov/pub/int_practice_units/isi_c_06_04.pdf.

³³ “Large Business and International Launches Compliance Campaigns,” available at <https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns>.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

¶ 1003.1

U.S.C. TAX INSTITUTE

10-10

occur between U.S. corporations and their foreign affiliates. The compliance campaign identifies the problem of U.S. distributors of goods sourced from foreign-related parties that have incurred losses or small profits on U.S. returns, where those returns are not commensurate with the functions performed and risks assumed by the entities.³⁸ In these cases, the IRS believes that the U.S. taxpayer would be entitled to higher returns in arm's-length transactions. The IRS explains that "LB&I has developed a comprehensive training strategy for this campaign that will aid revenue agents as they examine this IRC Section 482 issue."³⁹

¶ 1003 PREPARING FOR A TRANSFER PRICING AUDIT**¶ 1 Transfer Pricing Study**

Obtaining a transfer pricing study with contemporaneous documentation is critical to avoiding penalties and may help to avoid a lengthy audit. A transfer pricing study must determine the best method for determining the amounts charged or paid in controlled transactions, in accordance with the regulations under Section 482. This requires determining the price in accordance with a specific pricing method allowed under the Section 482 regulations if the use of that method was reasonable, or if not, another method that would clearly reflect income. The *Amazon* case demonstrates the value in putting the resources into doing a proper transfer pricing study at the outset to ensure prices are determined under a reasonable method.

In addition to determining the best method for setting a price in a controlled transaction, it is also essential to ensure that documentation requirements are met in order to reduce the risk of penalties if a transfer pricing adjustment is ultimately made. The documentation should accurately and completely describe the basic transfer pricing analysis that was conducted and must include:

- (1) An overview of the taxpayer's business;
- (2) A description of the taxpayer's organizational structure covering all related parties engaged in controlled transactions;
- (3) An explanation of the transfer pricing methods considered and how the method chosen was selected;
- (4) A description of the controlled transactions;
- (5) An explanation of the comparables used and how comparability was evaluated;
- (6) An explanation of the economic analysis and projections relied on;
- (7) A description of any relevant data obtained between the end of the year and

³⁸ *Id.*

³⁹ *Id.*

10-11

GLOBAL TAX ENFORCEMENT

¶ 1003.2

the filing of the tax return; and

- (8) A general index of the documents.

¶ 2 Setoff

While the best course of action is to do a transfer pricing policy before setting prices in a controlled transaction, it is important for taxpayers to be aware of the IRS's setoff rules in the event a company's prices charged in a controlled transaction are examined by the IRS. The setoff rules acknowledge that where you have two related or commonly controlled entities, while a transaction viewed in isolation might not be arm's length, the overall economic arrangement between the entities might still be arm's length, with multiple transactions offsetting each other so that when viewed together, the allocation of income and deductions between the organizations does in fact clearly reflect income. The regulations under Section 482 allow for a setoff when the combined effect of the multiple related-party transactions reflect an arm's length relationship, even though each transaction considered individually may not be arm's length. While Section 482 is generally a section that can be invoked by only the IRS—that is, a taxpayer cannot use Section 482 to disavow the economic arrangement it has established with a related organization—a taxpayer may raise a setoff argument if the IRS is proposing a Section 482 adjustment in a situation where the transaction being adjusted by the IRS is only one piece of the puzzle.⁴⁰

The requirements for claiming a setoff are set forth in Revenue Procedure 2005-46 and Treasury Regulation Section 1.482-1(g)(4)(i), which explain the procedure taxpayers must follow to provide evidence of any other non-arm's length transaction that offsets an adjustment the IRS has determined under Section 482. The rules require that a taxpayer notify the IRS of the setoff and provide the required support within 30 days of the issuance of a 30-day letter or a notice of deficiency. For example, if the taxpayer has received a 30-day letter, the required documentation and proof should be provided to the IRS with the Protest.

The IRS will take into account a setoff only if the taxpayer timely notifies the IRS of the setoff and follows the following procedures:

- (1) Establish that the transaction that is the basis of the setoff was not at arm's length;
- (2) Establish the amount of the appropriate arm's length charge; and
- (3) Document all correlative adjustments resulting from the § 482 setoff (that is, document all corresponding adjustments that must be made to the other member of the group.⁴¹

⁴⁰ Treas Reg § 1.482-1(g)(4).

⁴¹ Treas Reg § 1.482-1(g)(4); Rev Proc 2005-46.

¶ 1004

U.S.C. TAX INSTITUTE

10-12

The notification requirement requires that the non-arm's length transactions upon which the amount of the appropriate arm's length charge is based be sufficiently identified in the notification to the Commissioner so as to constitute a reasonable foundation for the claimed § 482 setoff and to permit verification by the Commissioner. The listed requirements involve the proving of the § 482 setoff. Taxpayers must establish or document the requirements described in this section with reasonable specificity.⁴² Although the regulation and the Revenue Procedure do not elaborate on how a taxpayer must establish that the basis of the setoff was not at arm's length and the amount of the adjustment, presumably the methods specified in the Section 482 regulations for determining the arm's length charge should be applied and documented to support the claimed setoff. While Revenue Procedure 2005-46 requires that the setoff notification be raised no later than 30 days after the issuance of the 30-day letter, it could often be advantageous to raise the setoff issue much earlier with the examiner. While it could lead the examiner to keep looking for adjustments, it might also bring the examination to a prompt closure. It is a judgment call.

¶ 1004 CONCLUSION

While the Audit Roadmap, International Practice Units, and the Compliance Campaigns were developed by the IRS for use by the LB&I division in coordinating and conducting issue-based audits focused on transfer pricing examinations, these resources are relevant to all taxpayers with transactions with controlled affiliates. We know where these efforts are leading—more examination activity of more and more taxpayers, not just large companies. While these resources are not official pronouncements of law and cannot be cited as precedent, they are tools that give taxpayers an insight into issues the IRS is focusing on and what to expect if the IRS chooses to conduct a transfer pricing examination.

The best way for taxpayers to prepare for a transfer pricing audit is before the taxpayer's return is filed and ideally before the transactions are even entered into—by obtaining a transfer pricing study that determines an arm's length price and maintaining the documentation required by Section 6662(e). While a taxpayer will be able to defend its pricing transactions in an examination without a having done a transfer pricing study and maintaining the required documentation, it becomes an uphill battle for the taxpayer and unnecessarily exposes the taxpayer to what amounts to strict liability penalties.

⁴² Rev Proc 2005-46.