I.R.S. VS. O.E.C.D. – HOW ARE TAX AUTHORITIES PLANNING TO CONDUCT YOUR NEXT TRANSFER PRICING AUDIT

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INTRODUCTION

This article addresses major developments in transfer pricing practice that will affect the way advice is given to clients and their ability to implement such advice. Over the past 15 months, the I.R.S. and the O.E.C.D. separately published transfer pricing audit and administrative initiatives that will significantly impact the way controlled transactions among related parties are reported. These initiatives are consistent with overall concerns raised in the Base Erosion and Profit Shifting ("B.E.P.S.") Report of the O.E.C.D. Each stands independently of B.E.P.S. and will likely be unaffected by the ultimate actions plans implementing B.E.P.S. goals.

U.S DEVELOPMENTS - OVERVIEW

Congress has not passed any significant transfer pricing legislation in recent years, and U.S. transfer pricing regulations remain essentially unchanged. As a result, the U.S. "best method" rule of transfer pricing remains the norm. That method entails an analysis of functions and risks borne by each party engaged in the controlled transaction with particular focus on (i) the relative business risk borne by each related party, (ii) the intangible assets it has developed, and (iii) the extent to which these intangible assets are used in the controlled transaction. The analysis focuses on products and markets, competitors, vendors, customers, and distribution channels resulting in a qualitative evaluation of the assignment of function and risks.

However, technical rules have intersected with the political fallout from high profile corporate situations, such as the failure of Enron and the low effective worldwide tax rates of GE, Apple, Starbucks, Google, and Amazon. As a result, transfer pricing policy is now subject to public scrutiny, as legislators and media look at tax planning that drives down effective tax rates as a form of global tax abuse. In recent years, congress conducted hearings on the international tax practices of several prominent U.S. companies, most notably Apple, Inc. As the public debate continues over whether multinational companies are paying their "fair share" of U.S. taxes, the Obama Administration has offered several proposals to combat perceived shifting of corporate profits to low-tax countries. At the same time, the I.R.S. continues to bolster its team of transfer pricing examiners and is refining its information exchange and advance pricing agreement procedures. From a BEPS perspective,

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each of these developments is "U.S. centric" and represents a government mindset that is independent of international developments in the transfer pricing area.

U.S. DEVELOPMENTS - LEGISLATIVE

In May of 2013, the U.S. Senate raised significant public and media awareness on the ability of U.S. companies to manage worldwide taxes through their transfer pricing policies. In a somewhat unprecedented event, senior executives from Apple, Inc., including the C.E.O. and C.F.O., testified before the Senate Committee on Homeland Security and Government Affairs' Permanent Subcommittee on Investigations. The hearing focused on the cost sharing arrangement between Apple and its Irish subsidiary, which was implemented under the initial U.S. tax transfer pricing cost sharing regulations. The Irish subsidiary was not an Irish tax resident under that country's "mind and management" determination of tax residency. For Irish purposes, it was managed and controlled in the U.S. For U.S. tax purposes the Irish subsidiary's tax residence was in Ireland, the country of its incorporation. Thus the Irish subsidiary was a company with no tax residence, a highly publicized aspect of Apple's situation. Apple reflected this tax structure in its 10K filed with the S.E.C. for the 2013 fiscal year. Its overall effective tax rate was 26.2%, reflecting a 5% tax rate on $30 billion of foreign pre-tax earnings, most of which were funneled through Ireland where transfer pricing arrangements with the Irish yielded favorable results on business income and even better results on investment income generated from retained earnings. In sum, Apple reported $54.4 billion of un-repatriated earnings for both cash and book tax purposes, on which $18.4 billion in tax would be due if the funds are ever repatriated.

Hewlett-Packard, another high profile U.S. multinational, was in a similar situation to Apple. It reported on its 10K for its 2013 that it enjoyed low tax rates in China, Ireland, Netherlands, Puerto Rico and Singapore. It reported a 21.5% effective tax rate and $38.2 billion of un-repatriated earnings for both cash and book tax purposes.

What is clear, for both companies, is that no laws were broken. While Apple's executives repeatedly stated that they had complied with all U.S. tax and transfer pricing regulations, they also noted that high U.S. corporate income tax rates had been an obstacle to repatriating the company's large cash reserves held outside the U.S.

Even Senate members ultimately conceded that Apple had broken no laws and that many other well-known U.S. companies, such as Hewlett-Packard, Google and Amazon, have similar tax and transfer pricing structures. Faced with this reality, the hearings then sought to call attention to the role of transfer pricing policies in effectuating these arrangements. They also called for better global transfer pricing rules, as well as stronger anti-avoidance measures such as the U.S. Subpart F rules.

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Whatever legislative proposals were made addressed the "results" of transfer pricing abuses rather than a wholesale change in rules.

Representative Dave Camp (R-Michigan), Chairman of the House Ways and Means Committee, recently introduced legislation that would tax on a current basis the income of a controlled foreign corporation ("C.F.C.") that is attributable to intangibles. The tax would be imposed on the U.S. shareholder owning more than 10% of the C.F.C. at a tax rate of 15%.

Senator Carl Levin (D-Michigan) introduced legislation, which would discourage the use of tax havens by taxing excess income earned from intangibles that have been transferred out of the U.S. To enforce these rules, country-by-country reporting of sales, profits and other financial information would be required in order to increase transparency for tax authorities. In addition, a C.F.C. viewed as being controlled and managed from the U.S. would be treated as a U.S. domestic corporation for tax purposes, thereby subjecting profits to immediate taxation.

As part of the budget process, the Obama Administration has also introduced a series of legislative proposals in both its 2014 and 2015 fiscal year budgets. The 2015 fiscal year budget proposal seeks about $276 million in increased tax revenues from U.S. multinational companies over the next ten years. By some accounts, this amounts to about 75% more than the tax increases requested in the 2014 fiscal year budget. The Subpart F rules would be extended to include certain excess income that an offshore C.F.C. earns from intangible assets transferred out of the U.S. when the C.F.C. is subject to an effective tax rate of 10% or less. The scope of intangible property that would give rise to U.S. tax under the transfer pricing rules would be expanded to include goodwill, workforce in place, and going concern value. Focus would also be placed on the provision of digital services outside the U.S., which, under current law, is not subject to U.S. taxation when and as earned.

I.R.S. INITIATIVES – AUDIT, COMPETENT AUTHORITY, ADVANCED PRICING AGREEMENTS

In the absence of legislation, the I.R.S. has significantly changed the U.S. transfer pricing landscape by exercising its administrative authority. The I.R.S. has significantly increased its examination efforts on transfer pricing matters. A dedicated Transfer Pricing Operations ("T.P.O.") group has been formed. The first Transfer Pricing Director has been appointed, and a large number of economists have been hired to assist with transfer pricing audits.

The I.R.S. has concluded that it needs to develop transfer pricing cases more thoroughly at an earlier stage in the audit process in order to identify and resolve issues without resorting to the appeals process. I.R.S. audit teams are spending more time on advance preparation. They now regularly research a company's business and industry and adopt a "big picture" approach to a case in lieu of a straightforward application of transfer pricing regulations.

As a backstop to the audit process, the I.R.S. issued Notices 2013-78 and 2013-79 setting forth proposed Revenue Procedures related to Competent Authority and Advance Pricing Agreements. The resulting proposed guidance represents the latest efforts on the part of the I.R.S. to improve its international dispute resolution programs.

The Audit Process

The T.P.O. group is part of the Large Business & International ("L.B.&I.") Division of the I.R.S. It includes field-based transfer pricing specialists and national, office-based U.S. competent authority and advanced pricing agreement program in a combined unit known as the Advanced Pricing & Mutual Agreement Program ("A.P.M.A.").

The drive to develop transfer pricing cases more thoroughly at an earlier stage is viewed by some advisers as an attempt to bypass the importance of the appeals process within the I.R.S. by placing an emphasis on building a litigation file. This approach significantly changes the dynamics of the audit process. Without the filter of good judgment, some transfer pricing audit teams are producing expansive and numerous Information Data Requests ("I.D.R.'s") that are time consuming and difficult to respond to on a timely basis.

In October 2013, the I.R.S. revised its policy on I.D.R.'s in an attempt to clarify the intent of information gathering burden for taxpayers. The revised policy states that for each I.D.R. issued in a transfer pricing audit, the I.R.S. exam team and the taxpayer will discuss a reasonable due date for the response, rather than a blanket 30-day deadline. In addition, the I.R.S. exam team is now required to explain the intent and significance of the information being requested. The intent is to achieve greater transparency for taxpayers undergoing a transfer pricing audit and also provide for more reasonable expectations regarding the delivery of information.

In February, the I.R.S. released its Transfer Pricing Audit Roadmap (the "Roadmap") which is intended to provide audit techniques and tools to plan, execute and resolve transfer pricing examinations. The Roadmap anticipates up to a 30 month timeline (6 months of planning and 24 months of audit) for the planning, execution and resolution of a "quality examination process" ("Q.E.P."). The Q.E.P. is based on certain fundamental assumptions. First, up-front planning is essential. Second, transfer pricing cases are usually won or lost on the facts. Third, a reasonable result under the facts and circumstances of any case should be attained. Finally, effective presentation can "make or break" a case.

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Regarding up-front planning, the Q.E.P. emphasizes early identification and prioritization of transfer pricing issues. This will determine proper staffing and scope of the audit given the anticipated complexity of the case. Regarding the existence of facts to justify an adjustment, the Q.E.P. notes that the key is to put together 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. From the experience of the authors, many mid-sized taxpayers have been doing this in their transfer pricing reports. The analysis of the taxpayer's business model (value chain, market position and financial results) should drive the quality of its transfer pricing decisions. The Q.E.P. will be looking for scenarios that it believes are too good to be true. Similarly, the Q.E.P. notes that the transfer pricing team should avoid adjustments where the taxpayer's financial results are reasonable and the taxpayer's transfer pricing method fits its profile.

Regarding the reasonableness of the result, the Q.E.P. anticipates that the transfer pricing team's working hypothesis will serve as a guide to further detailed examination subject to new data. The Q.E.P. discourages fishing expeditions and encourages a commitment by the transfer pricing team to address in full the taxpayer's analysis. In this way, the Q.E.P. acknowledges that the taxpayer may have the more compelling position on the issue.

As to effective presentation, the Q.E.P. focuses on the notice of proposed adjustment. The Q.E.P. intends that the notice should serve as a persuasive argument for the accuracy of the transfer pricing team's position over the taxpayer's position. It should contain all of the relevant facts, both good and bad, and should lead to a conclusion that is self-evident. The Q.E.P. assumes that a well-presented notice of proposed adjustment will increase the odds of early resolution or a favorable result on appeal. Some advisers believe that, based on this assumption the transfer pricing team should prepare a position paper that is at least as good as the transfer pricing report of the taxpayer. One wonders about the standard that was used prior to the Q.E.P.

While the Q.E.P. process may seem reasonable on its face, further consideration raises two key questions:

1. Is this an audit or preparation for litigation? Notable in the Q.E.P. detail is an emphasis on documentation of the audit steps taken, facts discovered, preliminary risk assessment, ongoing factual analysis and ongoing coordination with various T.P.O. personnel and counsel. Preparation of a mid-cycle risk assessment to update the initial risk assessment and analysis is considered an important component of the Q.E.P. Finally, participation of the audit team in the appeals process itself with a view towards understanding of the appeals rationale and consideration of future years' risk assessments could be considered an expansion of normal audit team participation at that level.

2. Is the Q.E.P. approach consistent with current transfer pricing law and regulations? Remember that current transfer pricing law and regulations remain the same. The Q.E.P. "big picture" view may or may not align with existing transfer pricing laws and regulations that do not necessarily require a focus on overall economic or financial results.

Nevertheless, the facts that the T.P.O. organization is now the key I.R.S. transfer pricing administrative function and that the Q.E.P. represents the T.P.O.'s key transfer pricing enforcement mechanism imply that taxpayers will need to consider the goals and objectives of Q.E.P. in managing audits and in establishing or revising their future transfer pricing policies. This is especially true with respect to intangible property. The T.P.O. Director has repeatedly indicated that transfer pricing for intangibles will be the top priority for T.P.O. activities and that the exam approach should consider the overall economic outcomes achieved by the intercompany transactions involving intangibles and not just whether those transactions have complied with specified methods in the regulations. According to the T.P.O. Director, many related party intangible transactions achieve unrealistic results that would never be observed between independent entities. Whether this view will ultimately prevail may well depend on the quality of the Q.E.P. presentation, rather than the expectation of the T.P.O. Director.

Competent Authority

The proposed Revenue Procedure would allow the Competent Authority to request a pre-filing conference to discuss the case at hand. A pre-filing memorandum is now required for: (i) a foreign-initiated adjustment of more than $10 million, (ii) a taxpayer-initiated position (*e.g.*, a request for refund), (iii) the taxation of intangibles, and (iv) requests for discretionary limitations of benefits relief. The pre-filing memorandum must, in the case of a foreign-initiated adjustment, explain the factual and legal basis of the action and describe the steps undertaken in the foreign country and any communications with the foreign competent authority regarding the matter. Additionally, the pre-filing memorandum must state whether the taxpayer wishes to have a pre-filing conference with the Competent Authority and propose at least three possible dates for such a conference, whether or not the taxpayer wishes to have a conference.

The proposed guidance also greatly increases the Competent Authority's ability to expand the scope of a particular matter brought to its attention. Competent Authority would not be required to obtain I.R.S. field office consent or even wait for a taxpayer's request for an expanded scope. Instead, the proposed guidance permits the Competent Authority to seek to include other years where it is feasible, practicable, and in the interest of sound tax administration to do so. The proposed guidance further provides that the Competent Authority may expand the scope of issues in light of a strong interest in resolving all potential issues in a timely manner.

The new procedure makes timing a key issue, particularly where an examination resolution (fast track audit, closing agreement, etc.) has been agreed with the I.R.S. In this case, Competent Authority will accept a request for its assistance relating to a U.S.-initiated adjustment memorialized in such an examination resolution only if the terms are agreed to by the Competent Authority, in writing, prior to its execution. If the Competent Authority disagrees with the examination resolution, the Competent Authority will request that the examination team and the taxpayer amend the terms accordingly. With respect to fast track settlement proceedings, the Competent Authority will accept a request relating to a U.S.-initiated adjustment only if the Competent Authority was named as a participant and given a reasonable opportunity to participate in the proceeding (and related I.R.S. meetings).

Timing remains a key issue where Appeals is involved through the Simultaneous Appeals Procedure ("S.A.P."). Through S.A.P., as the procedure's name suggests, the I.R.S. appeals officer considers the same issues simultaneously with the Competent Authority. Current guidance provides that a taxpayer may request I.R.S. appeals assistance, at any time, after filing for Competent Authority assistance. Under the proposed guidance, a taxpayer has only 60 days after the Competent Authority accepts the taxpayer's request for assistance.

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The proposed guidance is intended to make the Competent Authority process more efficient. However, taxpayer's will be required to have "skin in the game" for this, in the form of a pre-filing memorandum, a conference, and timing considerations. They will also have to agree to the wider scope of Competent Authority involvement and ability to expand the scope of its assistance.

The Advanced Pricing Agreement Process

The proposed Revenue Procedure concerning advance pricing agreements ("A.P.A.'s") focused on (i) taxpayer-initiated adjustments, (ii) statutes of limitations, (iii) documentation, (iv) roll-backs, and (v) unilateral versus multilateral agreements.

As with the Competent Authority procedures, taxpayers may seek a roll-back involving taxpayer-initiated transfer pricing adjustments, such as correlative adjustments or adjustments to the income of a foreign controlled party. Taxpayers are required to extend the U.S. statute of limitations for assessment of tax with respect to all years subject to the A.P.A. request, including any roll-back years. The filing of a complete A.P.A. request is a factor taken into account in determining whether the taxpayer satisfied the transfer pricing documentation provisions of U.S. tax law for the proposed A.P.A. years. A.P.A. roll-back to filed years that predate the proposed term of the A.P.A. is now a distinct possibility. Unilateral A.P.A. requests are discouraged while bilateral, and multilateral A.P.A. requests are encouraged; pre-filing memorandums will be required. Transparency will be sought through more robust informational requirements imposed on taxpayers seeking the A.P.A.

I.R.S. INITIATIVES - CONCLUSIONS

Glass Half-Full Perspective

The IRS finally appears to be coming around to a new, more modern, strategic approach to tax management involving the systematic assessment of tax risk and the corresponding targeting of resources and efforts accordingly. The approach is modeled after findings from the O.E.C.D.'s tax assessment and compliance research over the last 15 years, and programs implemented in Australia and the United Kingdom, thus reflecting the more positive international transfer pricing developments.

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This new approach envisions a more engaged, more cooperative style of examination and a greater use of prescriptive tools, including the development of profiles, or templates, of required information and/or outcomes (based on statistical and other metrics), against which taxpayers can be measured and evaluated, with prescribed remedial action depending how the company matches up against the profile. Such action ranges from no action, to follow-up questions, and to a more detailed request. The I.R.S. has indicated that they have already developed several profiles.

The expectation, based on experiences in other countries, is that companies that fit the profile in terms of timeliness and completeness will experience a lighter, quicker and less costly I.R.S. examination. On the other hand, the approach is intended to quickly identify issues that can be given greater attention by more resources and more effective resources.

Glass Half-Empty Perspective

No I.R.S. administrative initiatives can be implemented in isolation of the overall paranoia, generated by Congress, the Administration and the press, that transfer pricing strategies should be categorized as inappropriate tax avoidance on a *per se* basis. The Q.E.P. reliance on profiling taxpayer business models in connection with the development and use of intangible property in a global business environment will result in a pre-determination of taxpayer transfer pricing issues and related assessments without consideration of taxpayer-specific arguments. The Q.E.P. profiling will almost certainly result in the compilation of lists of "hidden comparables," and taxpayers will be benchmarked against data that is not in the public domain.

In addition, the Q.E.P. essentially represents a reordering of the decision making process in regard to litigation. The effort that will be made in connection with the decision to proceed with a notice of proposed adjustment means that once a decision is made to issue the notice, the role of the appeals officer in resolving transfer pricing controversies will be reduced because the facts gathered by the transfer pricing team will be clear and convincing. The end result is that the risk of litigation assessment by the appeals officer will be perfunctory.

O.E.C.D. INITIATIVES

Not long before the release of the Roadmap, the O.E.C.D. released two documents that set out the current guidance to its 34 member states (as well as G-20 member states) on pre-audit risk assessment, transfer pricing documentation and country-by-country ("C-b-C") reporting.

The *Draft Handbook on Transfer Pricing Risk Assessment* (O.E.C.D., April 30, 2013) (the "Draft Handbook") is a collection of recent country procedures, methods and approaches intended to help tax administrations improve performance. The objective of the Draft Handbook is to promote more efficient audits by tax authorities in order to avoid the waste of resources by tax administrators when unsustainable positions result in litigation Competent Authority cases. While there are no mechanical rules prescribed by the Draft Handbook, countries are encouraged to follow regular and structured risk assessment steps. The Draft Handbook is not law, administrative practice, or even necessarily prescriptive in its approach. The O.E.C.D. makes it very clear that each country will need to develop its own approach to risk assessment.

The intent of risk assessment is to help an O.E.C.D. member tax authority determine the factual inquiries that it will make during the course of a transfer pricing audit, if a full audit is to be conducted. There is clear reference to the trade-off between the understanding of risk and the extent of information available for review at the risk assessment stage.

The Draft Handbook deals only with recommended pre-audit procedure. Chapter 4 of the O.E.C.D. Transfer Pricing Guidelines deals specifically with examination practices, albeit briefly.

The January 30 *Discussion Draft on Transfer Pricing Documentation and C-b-C Reporting* (O.E.C.D., January 30, 2014) ("the Discussion Draft") proposes a working version of a new standard of documentation and C-b-C information reporting that is considerably more extensive than the present Chapter 5 guidance.

As one of 15 BEPS Action Plan steps taken in a time of fiscal crisis, the Discussion Draft recalls the approach to serious crime in occupied North Africa taken by police Captain Renault in the classic film *Casablanca*: "Realizing the importance of the case, my men are rounding up twice the usual number of suspects." The volume and utility of the information requested in the Discussion Draft, as well as information security and confidentiality, has been roundly criticized by the tax community. The Discussion Draft states that information submitted to tax authorities (either documentation or the new C-b-C factual and financial reporting) can be used in either the pre-audit or case selection phase of a transfer pricing audit, or can be used in the early stages of an audit for the purpose of focusing such audits on the most important issues. Irrespective of how or if the information will be used, the Discussion Draft calls for more C-b-C reporting information that can be obtained by a tax authority before review of the transfer pricing documentation.

The U.S. developments with Q.E.P. have been independent of the C-b-C dialogue and, in fact, U.S. officials have expressed some reservation as to the logic of certain aspects of the C-b-C reporting requirements. This is an easy assessment for the U.S. to make, as it already has in place a robust reporting regime for international business operations of U.S. taxpayers. This regime is an integral part of the Q.E.P. planning phase which contemplates a detailed tax return review including: (i) Forms 5471 and 5472, regarding information on intercompany transactions, (ii) Form 8833, regarding treaty based return positions, (iii) Form 8858, regarding information on disregarded entities, (iv) Form 8865, regarding U.S. controlled foreign partnerships, (v) Schedule UTP, regarding uncertain tax position disclosures, and (vi) worldwide book to taxable income reconciliation Schedule M-3 of the Form 1120. Examination of the overall data requests required by these forms would reveal that a material amount of the information requested in the C-b-C reporting has been compiled. Note though that these forms demand the greatest amount of information from U.S.-based groups. The question arises whether the same degree of information should be demanded of local subsidiaries.

Also at issue are the usual suspects: (a) transactions with related parties in low-tax jurisdictions, (b) intra-group services, (c) excessive debt and/or interest expense, and (d) transfer or use of intangibles to/for related parties. Rather than setting out a risk-assessment process framework like the Audit Roadmap, the Draft Handbook places emphasis on fact patterns regarding the company and its transactions that are likely to increase transfer pricing risk.

The Audit Roadmap sets out a facts seeking theory approach to transfer pricing with the audit process as means of organizing fact gathering and formation of a theory of a case, as opposed to a theory seeking facts approach. We believe this is generally the correct way conduct a transfer pricing examination. To some extent, the increased information requirements of the proposed O.E.C.D. C-b-C reporting and the prescriptive issues lists in the Draft Handbook promote a theory seeking facts approach to transfer pricing risk assessment. We expect double tax issues between the I.R.S. and the tax authorities of its treaty partners will require further effort and time to align the fact development and robustness to the theory of the case where the treaty partner has reassessed tax based on a usual suspects approach.

Taxpayers may want to closely examine their tax situations in 2014 both historically to open years and prospectively to future years so that they may measure the anticipated effect of the I.R.S. initiatives described above.

THE BOTTOM LINE

From the I.R.S. perspective, whether the glass is half full or half empty, there will be an expanded access to the I.R.S. audit team and other administrative personnel. Taxpayers may want to closely examine their tax situations in 2014 both historically to open years and prospectively to future years so that they may measure the anticipated effect of the I.R.S. initiatives described above. A robust transfer pricing report that tells a story and builds a case may be an elixir that ultimately provides a quicker, more cost-effective means to resolve their tax issues.

From the O.E.C.D. perspective, we anticipate that there may be information shortages in certain O.E.C.D. member countries, but expect that the matter will be solved with the introduction of more focused foreign reporting forms. In many ways, the O.E.C.D.'s emphasis on information requirements is understandable. Reliable information is required to assess risk and responsibly, select taxpayers, and further select particular tax positions for a robust examination. As the Draft Handbook remains in draft while other BEPS Action Plan items receive attention from the O.E.C.D. Centre for Tax Policy and Administration, we hope that the Audit Roadmap and other procedural developments will be finalized with double tax minimization in mind.

In sum, multinational businesses with a taxable presence in both the United States and in O.E.C.D. member states should be mindful of the similarities and differences between O.E.C.D. guidance and I.R.S. field guidance. Areas of difference are relevant to exam approaches, documentation approaches, and differences in the perspective of tax authorities conducting Simultaneous Examination Program audits. Tax authorities and the politicians to whom they report have determined that it is time for countries to take control of their tax borders. Transfer pricing examinations that focus on the use of intangibles and the provision of capital are to be expected.