THE DO'S AND DON'TS OF I.R.S. TRANSFER PRICING STORYTIME

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Earlier this year, the I.R.S. updated its Transfer Pricing Documentation Best Practices F.A.Q. list with a response to Q. 4, What are some areas the I.R.S. has identified in transfer pricing documentation reports that could benefit from improvement?[1]

Given the uncanny resemblance of the I.R.S. list of documentation pet peeves to my many years of review notes written for transfer pricing documentation drafters in the U.S., Canada, and elsewhere, it seemed that this would be a good time of year to recap the state-of-the-art of transfer pricing documentation.

The F.A.Q. also appears at the time when U.S. taxpayers must take clear factual and analytical positions in the face of increasingly frequent claims of foreign tax authorities concerning the purported local "value creation" that gives rise to increased foreign income allocations. Given the I.R.S. may deal with such foreign tax authority claims in Competent Authority negotiations at a later date, companies should consider this F.A.Q. instalment as constructive I.R.S. transfer pricing documentation drafting comments.

SETTING THE SCENE

A description of the company's business and the industry in which it operates provides important context for the understanding of a transfer pricing position. This part of the company's documentation might be thought of as the response to the common I.R.S. international examiner's question, "What is the business, and how does it work?"

A response delivered in the context of the controlled transaction at issue should describe the company's business operations, and then place the business in the appropriate industrial organization context of competitors, suppliers, factor markets, and product or service markets. This is critical information, especially when applying the comparable uncontrolled transaction method and using transactional data. Without information on the factors of comparability, there can be no useful comparability analysis.

The I.R.S. encourages drafters of the industry and company analysis sections of a documentation report to tell the company's story, and to include factual information that informed the company (or its advisor or expert) in their selection and application of a transfer pricing method or methods. The ever-important discussion of expectations-versus-actual outcomes or budget-versus-actual is particularly relevant in the present recession, and can assist in an effective identification and disaggregation of "effects of bad risk realization from the effects of intercompany pricing."

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[1] Q 4 available here.

Correctly, the F.A.Q. notes that robust documentation assists with the rapid conclusion of an I.R.S. transfer pricing risk assessment. Effective and thorough drafting can alleviate the need to manage an extensive and lengthy transfer pricing examination.

ROBUST NARRATIVE, PLEASE

The I.R.S. does not favor a functional analysis checklist, and critiques this presentation as a functional analysis without the analysis. The binary responses in a checklist or a subjective percentage of responsibility for a particular function are targets of this I.R.S. comment. This style of documentation does not allow for the connection of the description of a business function to an explanation of the relative merits of specified transfer pricing methods. Those who use it as part of a DYI attempt at transfer pricing have been warned. Critically, a checklist approach cannot explain which functions are relatively important to the success of particular business or line of business, or how certain functions create value in the context of a "value creation" argument likely to be the focus of a foreign transfer pricing examination or a Competent Authority matter.

RISK, AS EXPECTED?

Where they exist – and it is advisable that they do exist – intercompany agreements establish a transactional framework within which counterparties will take certain risks. The presentation of a risk analysis should be consistent with the risks outlined in the intercompany agreement, link company or tested party risks to the comparability analysis presented later in the report, and explain in basic terms the need for a comparability adjustment brought about by a significant difference in risk between the controlled transaction and the selected comparable transaction or transactions.

MORE NARRATIVE, THIS TIME ABOUT METHOD

The requirement to describe and explain the transfer pricing method selected, as well as alternative methods considered, but not selected, is codified in the principal documents requirement of Treas. Reg. §1.6662-6(d)(2)(b). Despite this, the F.A.Q. finds these two elements of documentation lacking. In particular, where internal inquiries about the availability and appropriateness of third-party transactions or pricing data have been made to evaluate the applicability of a particular transfer pricing method, a written summary of this inquiry should be included in the documentation. It informs the I.R.S. that the inquiry has been made in sufficient depth and that the conclusion reached concerning the inapplicability of a transfer pricing method is based on the lack of suitable data, and for that reason, is well-founded.

A description of the company's or tested party's customers or suppliers in advance of the discussion of method selection allows for an orderly rejection of a particular transfer pricing method. In managing a transfer pricing examination of the tax year, the description is preferable to an unsupported concluding statement cited by the F.A.Q. to the effect that "there are no comparable uncontrolled prices (CUPs) so we did not apply the CUP method."

The F.A.Q. alludes to difficulties that arise during an examination upon the discovery of an internal company database of legal agreements with unrelated parties. The existence of internal data that has been shielded from the transfer pricing economist can be problematic. The economist preparing the study must be given access to all sources of information within the company extending beyond the tax department and the accounting department to operations and legal departments.

TELL THE WHOLE STORY OF COMPARABILITY

The F.A.Q. points to the absence of any analysis of the relative profit potential of comparable transactions as the most common shortcoming of comparability factor evaluation, especially in the context of pricing intangible property transactions under the comparable uncontrolled transaction method. This is often a very difficult factor to quantify and more detailed disclosure of the approach applied to evaluate this comparability factor becomes important if a disagreement arises between the examiner and the taxpayer over differing views of future profitability or profit potential. More generally however, it seems the F.A.Q. addresses a broader concern held by the I.R.S. over the lack of explicit evaluation of all factors of comparability.

Again, the requirement to explain how comparability was evaluated is a requirement that is codified in the transfer pricing documentation regulations. It is not uncommon that company or transaction comparability is evaluated in a deductive manner, taking a very large set of data and applying an increasingly refined set of comparability criteria until a robust level of comparability is achieved. The F.A.Q. commentary relates most directly therefore to the later stages of comparability evaluation, raising the question of the compliance value of intensive screening on all elements of an often very large data set.

IMPACTS OF DIFFERENT FUNCTIONS OR RISKS

Evaluating comparability based on many functional and risk factors presents a challenge from the standpoint of documentation. The F.A.Q. calls for more disclosure of the observed levels of comparability for each functional and risk factor, and for a more accurate enumeration of the comparability shortfalls that would require some form of adjustment. This comment appears to reflect closer harmonization of qualitative comparability evaluation with the updated O.E.C.D. standard. The interesting consideration here is the compliance effect of more detailed disclosure. It is not at all clear that additional detailed disclosure will result in a lower likelihood of the examination proceeding past the risk assessment stage. The same may be said with regard to the likelihood of concurrence by the I.R.S. with an income allocation position for the sole reason that the taxpayer's comparability analysis has been meticulously documented.

EXPLAIN COMPARABILITY ADJUSTMENTS

Finally, the F.A.Q. asks that better documentation of comparability adjustments should be included in the report. In particular, the I.R.S. commentary notes that the reasons for an adjustment should be explained, which is a particularly helpful disclosure to make where it is understood that an I.R.S. examiner must understand the logic of the adjustment in order to understand the broader logic of the income allocation.

A great many pointy-headed debates over the theory and practice of comparability adjustments have taken place without making a significant contribution to the resolution of a transfer pricing dispute. The F.A.Q. does not signal that these debates could become more useful or efficient with the disclosure of further information, but only that taxpayers should explain themselves more thoroughly.

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EVERY STORY IS UNIQUE

The F.A.Q. states clearly that the items outlined above are not all of the areas which the I.R.S. has identified as suboptimal when evaluating a transfer pricing report. Moreover, additional effort and expense to strengthen or improve the quality of a report prior to the filing of a tax return will not provide a safe harbor against the imposition of penalties. While the F.A.Q. is not binding on the I.R.S., it is not unusual to find in practice that the absence of identified shortcomings set out in the F.A.Q. affects I.R.S. deselection of certain audit issues and leads to a more efficient I.R.S. examination.

The F.A.Q. makes it clear that more complex transactions call for more detailed analysis and documentation. It is obvious in the current business environment that international transactions do not necessarily begin as simple transactions. Understanding that complex transactions lead inevitably to a trade-off between compliance benefit and compliance cost, companies must search for the point at which a marginal benefit of expenditure to manage examination risk begins to diminish. This point is unique to each business at each point in time, and must be located rather un-scientifically by divining the effort level that likely results in penalty protection and the effort level that limits cost and disruption from transfer pricing controversy. In practice, this decision is made by determining how much quality documentation can be bought with a certain budget.

The F.A.Q. list describes many requirements that go beyond the penalty protection threshold. In today's high-controversy environment, the tendency is to over-document to manage the risk of income adjustments, penalties, and reputation risk. Finding the optimal amount and type of documentation is further frustrated by the asymmetric application of transfer pricing principles, and indeed asymmetric transfer pricing principles in many G20 countries. In this context, the FAQ informs the U.S. company of the opening bargaining position of the I.R.S. when intercompany pricing is a material item in the tax return.

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