Transfer pricing audit adjustments and penalties may surprise middle-market companies that are not prepared

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In brief

Changes in the IRS's structure, staffing practices, and audit procedures, coupled with the international expansion of many businesses, have led to an increase in audits of middle-market companies (i.e., those reporting less than $10 billion in assets), especially in the area of transfer pricing. Some of the transfer pricing issues in the spotlight for middle-market companies include cross-border intercompany financial transactions, management services, and intangibles transfers.

Companies with significant intercompany transactions like these should make sure they have (1) identified and categorized all of their intercompany transactions, (2) established and properly applied acceptable IRS 'arm's-length' pricing policies, and (3) prepared a contemporaneous transfer pricing report (TP report) for use upon audit.

A principled and thoughtful TP report that is in compliance with the applicable regulations will help companies bolster their positions upon audit and may help them avoid penalties.

In detail

Structure and policy changes help the IRS focus on transfer pricing

The US government, like many of its trading partners, is concerned that taxable income is slipping through the cracks by way of complex legal entity structures and intercompany transactions established to support various financial, business, and investment arrangements. In response, the IRS has hired more transfer pricing specialists, many of whom are able to use sophisticated tools to trace the flow of funds through the complex legal structures that the IRS believes have been employed by corporations to manage their taxable income.

The IRS also has organized its transfer pricing specialists under a Chief Economist and hired over 800 economists and international auditors. The audit team now must include an international auditor if a Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) or Form 5472 (Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) is included in the taxpayer's federal income tax return, and specific Information Document Requests (IDRs) involving the company's transfer pricing documentation must be issued. When an adjustment is proposed, the team managers either must assess a penalty of up to 40% of the tax owed on

the adjustment, or complete a form justifying the reason for no penalty.

Because of the IRS's increased focus on transfer pricing, audit adjustments are on the rise, and penalties are being assessed. Moreover, agents are returning in subsequent years to seek additional adjustments. It is not uncommon to see a middle-market company's audit result in numerous hours of lost productivity or adviser costs that exceed $100,000 for a single issue.

Global collaboration and new information reporting rules allow the IRS to identify more transfer pricing issues

Transfer pricing issues are under scrutiny in many countries, including the United States. Some countries are in the process of developing their first set of transfer pricing policies, while others are updating existing policies to account for new types of transactions or to conform to global guidance. Whether a country's current focus is on policy or enforcement, it is clear that collaboration and information sharing is becoming more common.

Global focus on transfer pricing spurs collaboration

The US and many of its trading partners are members of the Organization for Economic Cooperation and Development (OECD), a policy organization in which over 40 countries participate worldwide, and which has developed guidelines for use or modification by its member countries. The OECD guidelines on transfer pricing are updated regularly. The most recent OECD draft tackles Base Erosion and Profit Shifting (BEPS) among countries, and has set an aggressive schedule for developing policies to prevent profit shifts with no significant business purpose other than to reduce tax. The potential for tax authorities to use these policies to view existing structures in 'hindsight' is causing many multinational companies to re-evaluate their existing transfer pricing policies and associated legal structures.

Like the OECD, the United Nations (UN) has drafted guidelines on appropriate transfer pricing policies, with a focus on less-developed countries. Many less-developed countries are using the UN recommendations to guide regulatory changes. Those countries modifying their regulations to be consistent with global guidance also are implementing and enforcing documentation standards that require a TP report to be generated contemporaneously with the filing of an audit report or tax return each year, or within a short time after a request from the tax authority. To ensure that a company's operations, pricing policies, and taxable income are reflected consistently on both sides of an intercompany transaction, countries increasingly are using treaty powers and other mechanisms, like information reporting and withholding, to share information.

New reporting rules result in information sharing

The IRS has implemented a number of new or updated Information Reporting and Withholding (IRW) rules that outline the obligations of US and non-US entities to report and withhold on certain payments to individuals and entities that are subject to IRW laws. Foreign Account Tax Compliance Act (FATCA), Foreign Bank Account Reporting (FBAR), Cost Basis Reporting (CBR), Section 1441 (non-resident alien reporting), Section 6050W (merchant card reporting), and Form 1099 are examples of the new sources of information on intercompany transactions or transactions between US and non-US entities that are providing additional insight to the IRS. Information reporting is now an enterprise-wide issue that affects accounts payable, procurement, legal, IT, and treasury, among other functional areas. Failure to report and withhold accurately can expose the company to significant tax liabilities, plus penalties. These penalties may significantly impact a company's financial statements, making this issue a concern for CFOs and Controllers. Any required remediation efforts may involve multiple business units and various systems, making the issue a concern for COOs and CIOs, too.

Other schedules and forms provide insight

The IRS is in its second year of reviewing Uncertain Tax Positions (UTPs) for middle-market companies, and it continues to view Schedule UTP as a good source of information for identifying transfer pricing issues. The IRS also finds Forms 5471 and 5472 helpful in identifying issues, therefore, companies should make sure those forms are consistent with other internal documents and the company's TP reports. If the company has not prepared a TP report, then fact-finding interviews with personnel in each department of the company may be another way to identify information related to intercompany transactions that may be scrutinized by the IRS.

My company has significant intercompany transactions – What should I be doing?

Companies with intercompany transactions should make sure they have identified each relevant transaction, as well as the parties to the transaction. In identifying these transactions, it may be helpful to review the general ledger, Forms 5471 and 5472, legal agreements, and other

documents. Once the intercompany transactions have been identified, they should be categorized by type of transaction. Some transaction may relate to management services or sales of assets, while others may relate to loans or leasing arrangements. These categorizations are important because each type of transaction often requires the use of a different transfer pricing methodology.

After the intercompany transactions have been identified and categorized, an appropriate transfer pricing policy should be adopted. The appropriate transfer pricing policy will depend on the specific facts and circumstances. Prior IRS audit results and the regulations under Section 482 should be taken into account when determining the appropriate transfer pricing policy. Any potential risks or exposures related to adopted policies should be evaluated and accounted for accordingly. Internal policies and procedures, along with effective internal controls and systems, will help ensure that the policies adopted are consistently applied.

Most importantly, the company should document all of this in a formal TP report. If the company has not prepared a formal TP report, then it can prepare a file using the best available information. The file should be designed to provide the same information as a TP report and to demonstrate that a reasonable attempt was made to ensure that the company's transfer pricing policy was consistent with the regulations under Section 482. Regardless of the approach taken, documentation ideally should be contemporaneous. If done in hindsight, the information might not be as readily available and will be given less credence by the IRS.

The audit has started – How can I effectively manage it?

The following audit management practices may be helpful in preventing or mitigating a potential transfer pricing adjustment:

First, it is best to provide the IRS with a copy of the contemporaneous TP report. If created properly, this report should prevent penalties from being sustained. Second, request a meeting with the IRS team to explain the report, so the audit team has a better understanding of the company's business operations, intercompany transactions, and related results. Finally, provide timely and complete responses to IDRs issued by the IRS team. If the IRS team understands the transaction, and is presented with a principled and thoughtful report, it will be much more difficult for an auditor to sustain a transfer pricing adjustment.

The NOPA has been issued – What are my options?

If the audit team issues a Notice of Proposed Adjustment (NOPA), there are six alternative strategies that can be utilized by US companies in trying to resolve a transfer pricing tax dispute. The following strategies are listed in order of the time it typically takes to complete the process, and the potential associated expense, from least to greatest: (1) Fast Track Settlement, (2) Traditional Appeals, (3) Competent Authority, (4) Simultaneous Appeals/Competent Authority Proceeding, (5) Advance Pricing Agreement (for future years with the possibility of a rollback of the selected transfer pricing method to earlier years), and (6) Litigation. Each of these alternatives has unique benefits and costs.

Fast Track Settlement

The Fast Track Settlement (FTS) program is designed to reach a compromise. A taxpayer probably will not walk away with a 'no change' once it enters into FTS. The process is completed within 120 days of receipt of the taxpayer's request. Both the IRS audit team and the company present their positions to the FTS program team. The FTS team then evaluates both positions and offers a settlement. The FTS team shuttles between the taxpayer and the IRS audit team until both sides agree to a compromise. The process is completed within one to two days, and the final documents reflecting the compromise are completed shortly thereafter. Double taxation on some amount of the settlement value is likely because there is no double taxation relief under this program. One major advantage of the FTS program is that if, after the negotiations have concluded, the taxpayer is not satisfied with the results, it may withdraw and continue with the more traditional appeals process.

Traditional Appeals

Traditional Appeals (Appeals) is a process that typically takes two to three years to complete. Both the audit team and the taxpayer generate their position papers, and the audit team presents its case to Appeals. In a subsequent series of meetings, the Appeals team meets with the taxpayer's team and listens to their presentation, discussing the Appeals team's questions about the taxpayer's position. The Appeals team may reduce the proposed assessment after considering the taxpayer's position, the IRS's position, and the hazards of litigation. The Appeals team may reject proposed penalties, as well. Like FTS, double taxation on some amount of the settlement value is likely because there is no double taxation relief under this program.

Competent Authority

The issue of double taxation has led many taxpayers to apply directly to Competent Authority (CA). The CA process is a negotiation between the Competent Authorities of the respective countries involved in the

taxpayer's intercompany dispute. The availability of CA and its terms are specified by the tax treaty between the two countries. Generally, a taxpayer can apply for CA relief upon receiving a NOPA from the IRS or its equivalent in another country. As a part of this process, position papers are provided by the IRS and the other country's tax authority, follow-up questions are asked of the taxpayers, and the CAs from both countries negotiate a settlement, which subsequently is announced to the taxpayers. The taxpayer can accept or reject the settlement.

Simultaneous Appeals and Competent Authority

To try to reduce the time it takes to complete both the Appeals and CA processes, taxpayers can request simultaneous Appeals and CA. Both processes proceed as described above, but in concert with one another. A settlement is negotiated between the two countries and announced to the taxpayers, who can accept or reject the settlement.

Advance Pricing Agreements

Due to continued uncertainty surrounding transfer pricing transactions, taxpayers increasingly are seeking Advance Pricing Agreements (APAs), which give taxpayers certainty that the tax authority on one or both sides of the transaction (unilateral or bilateral APA) will respect the transfer pricing policy and related results as long as there is no material change in facts. The taxpayer (in both countries, if a bilateral APA is requested) must apply to the APA program and pay a fee to participate. The typical APA term is five years, over which the taxpayer has certainty that its position will be respected. A position paper is prepared by the taxpayer and submitted to the APA team (the paper is submitted concurrently to both tax authorities for a bilateral APA). Meetings and responses to clarifying questions, as well as annual reports to confirm that the taxpayer has met its commitment to achieve the agreed upon target financial results are necessary. The tax authorities agree to a transfer pricing methodology and related results, and present both to the taxpayer, who may accept or reject the offer. Typically, the taxpayer will work with the tax authorities to get to a mutually acceptable outcome.

Litigation

When all other avenues fail, litigation is available. Many transfer pricing cases have been and continue to be litigated in the US Tax Court, which is a lengthy process. The trial may take three to five years, and if the trial decision is appealed, it may take an additional two to three years.

The takeaway

Transactions involving transfer pricing undertaken by middle-market companies can be as complex as those undertaken by large multinational companies. The primary difference is the size of the transactions and the availability of internal resources to document and defend the company's intercompany pricing policy.

Because the IRS and other taxing authorities around the world are focusing more on transfer pricing, companies with significant intercompany transactions should make sure they have (1) identified and categorized all of their intercompany transactions, (2) established and properly applied 'arm's-length' pricing policies, and (3) prepared a contemporaneous TP report for use upon audit.

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Additional resources

For an archived recording of the PCS webcast on July 17, 2013 on this topic, please see: A Perfect Storm: Trends in Controversy Affecting Private Companies and High Net Worth Individuals.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC Private Company Services representative, or one of the subject matter professionals listed below:

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