
IRS issues guidance to examiners on important transfer pricing issues

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In brief

The IRS Large Business and International (LB&I) Division on January 12 issued five memoranda providing administrative guidance to examiners on several key transfer pricing-related examination issues (available on the [IRS website](#)):

- Instructions for examiners on transfer pricing selection — cost-sharing arrangement (CSA) stock-based compensation (SBC)
- Instructions for examiners on transfer pricing selection — reasonably anticipated benefits in CSAs
- Instructions for LB&I on transfer pricing selection and scope of analysis — best method selection
- Instructions for examiners on transfer pricing issue examination scope — appropriate application of Section 6662(e) penalties
- Interim instructions on issuance of mandatory transfer pricing information document request (IDR) in LB&I examinations.

While these memoranda are not legal guidance, they describe how LB&I intends to manage the identification and examination of certain transfer pricing issues. The memoranda also highlight certain technical transfer pricing issues that remain priorities for LB&I.

In general, the memoranda reflect the IRS's broader intent to deploy effectively its limited examination resources and to be selective and strategic in the types of transfer pricing issues it decides to pursue.

In detail

Instructions for examiners on transfer pricing selection — CSA SBC

The appropriate treatment of SBC under a CSA is an unsettled issue. In 2015, the US Tax Court in *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), invalidated the portion of the Treasury Regulations issued under Section 482 requiring related-party

participants in a CSA to share SBC costs. The IRS appealed, and *Altera* is currently pending before the Ninth Circuit Court of Appeals.

The new Directive (LB&I-04-0118-005) instructs LB&I examiners not to initiate any new examinations of CSA SBC issues while the *Altera* appeal is pending. Where an examination of CSA SBC issues already is underway, the

Directive provides that development of the issue will be suspended if the taxpayer agrees to extend the statute of limitations long enough to allow the results of *Altera* to be known. In addition, while the inclusion of SBC charges for intercompany services is not directly at issue in *Altera*, the Directive alerts IRS examiners that taxpayers are likely to contest inclusion of SBC in

services costs on the same grounds as presented in *Altera*.’ The Directive instructs that ‘examination teams should consult with LB&I Division Counsel on those issues to determine whether inclusion of SBC in services should be pursued as a strategic transfer pricing examination issue if it is factually distinguishable from the issue in *Altera*.’

Instructions for examiners on transfer pricing selection – reasonably anticipated benefits in CSAs

This Directive (LB&I-04-0118-004) addresses an issue that arises when a taxpayer has an existing CSA, makes an acquisition of an independent company, and then adds intangible property (IP) of the acquired company to the CSA through a platform contribution transaction (PCT). The issue is whether the reasonably-anticipated-benefit (RAB) share used in calculating the PCT payment for the acquired IP must conform to the overall RAB share used in the CSA, or whether an acquisition-specific RAB share may be used that reflects the proportionate benefit expected only from the particular IP being added to the CSA.

Several IRS examination teams, relying on an example provided in the Section 482 cost sharing regulations under the acquisition price method, have taken the position that the regulations mandate the use of a single RAB share for a given CSA, including for purposes of subsequent PCTs. The Directive indicates that the IRS is undertaking a review of this issue in order to develop an agency-wide position, and that, pending this review, LB&I examiners should not automatically rule out taxpayer positions based on use of multiple RAB shares in this situation. Thus, examiners are instructed not to develop adjustments *solely* based on

changing the taxpayer's multiple RAB shares to a single RAB share in this scenario until an agency-wide position is finalized. Examiners, however, are urged to continue examining ‘whether the multiple RAB shares used by taxpayers are appropriate given all the specific facts and circumstances.’

Observation: Given the recent controversies around CSAs, it is apparent that LB&I is choosing its disputes carefully in this area and watching the outcome of *Altera* closely. LB&I also appears to be steering examination resources away from controversial or uncertain issues.

Instructions for LB&I on transfer pricing selection and scope of analysis – best method selection

This Directive (LB&I-04-0118-002) limits the ability of IRS examination teams to reject the transfer pricing method selected by a taxpayer without higher-level review and approval within the IRS. The Directive mandates that examiners obtain approval from a new Treaties and Transfer Pricing Operations (TTPO) Transfer Pricing Review Panel before changing the transfer pricing method selected as the best method in the taxpayer's contemporaneous transfer pricing documentation or Advance Pricing Agreement (APA) submission. The examination team must provide specific analysis to support exam's assessment that the taxpayer's method is unreliable, address potential adjustments to improve reliability, and support exam's recommended alternate best method.

The Directive applies to examinations of LB&I taxpayers and taxpayers in the APA program. Importantly, the Directive provides an exception from the approval process for bilateral APAs once in the process of formal negotiations.

The TTPO Transfer Pricing Review Panel will consist of the TPP Director or APMA Director (depending on whether the case is in APA or Exam), a Senior Advisor to the TTPO Director, and the Income Shifting Practice Network Manager.

Instructions for examiners on transfer pricing issue examination scope – appropriate application of Section 6662(e) penalties

This Directive (LB&I-04-0118-003) provides guidance to LB&I examiners on the appropriate circumstances to assert Section 6662(e) penalties.

Importantly, the Directive advises examiners that a taxpayer's provision of Section 6662(e) documentation does not automatically protect against penalties. Rather, the documentation must be assessed for ‘adequacy and reasonableness.’ Thus, for example, the Directive provides that in assessing whether Section 6662(e) penalties should apply, LB&I can and should consider whether there are other sources of relevant data that the taxpayer had access to or should reasonably have identified and considered.

The Directive states that appropriate application of penalties when documentation is inadequate maintains accountability and encourages reasonable and well-documented return positions.

Observations: The Section 6662(e) Directive appears directed at ensuring the penalty is applied by examiners in appropriate circumstances. Importantly, the directive reminds examiners that taxpayers' Section 6662(e) penalty protection is retained if they have reasonable cause for their positions and adequate documentation support that considers relevant data, facts, and circumstances.

Interim instructions on issuance of mandatory IDRs in LB&I examinations

This interim instruction memorandum changes the existing procedure under which examiners are required to issue mandatory transfer pricing Information and Document Requests (IDRs) when an examination commences. The changes communicated by the interim instruction are effective until the Internal Revenue Manual (IRM) is updated.

Under the current mandatory IDR process, examiners must issue a mandatory IDR requesting taxpayers to provide contemporaneous transfer pricing documentation in all cases with international attributes. The memorandum makes a procedural change providing a two-step process for determining whether to issue IDRs for Section 6662(e) documentation:

1. For examinations arising under approved LB&I campaigns, examination team members will follow the specific guidance for the Mandatory Transfer Pricing IDR provided for within the campaign. If no such guidance is provided, the procedures under item 2, below, will apply.
2. For examinations with initial indications of transfer pricing compliance risk (considering the volume and type of transactions), Transfer Pricing Practice (TPP) and/or Cross Border Activities (CBA) Practice Area employees will issue the Mandatory Transfer Pricing IDR if assigned to the case. If TPP or CBA resources are not assigned as a consultant or team member to the case, the Mandatory Transfer Pricing IDR will not be issued.

Observations: It appears that LB&I is seeking to manage its allocation of exam resources across all issues and

to use its examination resources devoted to transfer pricing audits efficiently. These procedural directives reflect that LB&I leadership desires to have a strategic outlook on what resources are devoted to transfer pricing issues and what actions the field teams are taking in transfer pricing audits. The mandatory transfer pricing IDR memorandum will result in greater control over which taxpayers receive an IDR and aligns with LB&I's movement toward issue-focused examinations and campaigns, reiterating the role that upfront issue identification and risk analysis will play in LB&I resource allocation and subsequent issue development.

For both exams and APAs, the best method selection memorandum notes that, due to practical tax administration and limited resource limitations, examiners should not 'start the best method selection analysis from scratch' or 'ignore the analysis provided by the taxpayer,' but must give full consideration to the taxpayer's selection and application of the best method. This signals more open-mindedness toward working with the taxpayer in its documented transfer pricing method framework. The memorandum clarifies that the approval process does not apply to exam's development of issues related to the taxpayer's assumptions or to the application of its selected transfer pricing method; as a result, both a robust best method selection and thorough application of that method remain important when preparing transfer pricing documentation.

The takeaway

LB&I has taken significant steps to improve the efficiency of managing transfer pricing controversies through issuing this set of guidance. Transfer pricing continues to be a high priority for LB&I, and many controversial issues remain unresolved both within

the agency and the courts. The recent Directives reinforce LB&I's commitment to examining transfer pricing issues in an effective manner.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

APMA & Transfer Pricing Controversy

Joe Murphy, *Washington, DC*
+1 202 414 1013
w.joe.murphy@us.pwc.com

Gregory J. Ossi, *Washington, DC*
+1 202 414 1409
greg.ossi@us.pwc.com

David Ernick, *Washington, DC*
+1 202 414 1491
david.ernick@us.pwc.com

Mike Danilack, *New York*
+1 646 471 4001
mike.danilack@us.pwc.com

Transfer Pricing Global and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Paige Hill, *New York*
US Transfer Pricing Leader
+1 646 471 5192
paige.hill@pwc.com

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