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IRS Instructs Exam Teams to Hold Transfer Pricing Documentation to a Higher Standard

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Exam teams reviewing transfer pricing documentation have been told to strictly enforce existing section 6662 regulations[1] when considering the imposition of transfer pricing penalties. This article explains the recent guidance and what it may mean for transfer pricing documentation and examinations.

On January 16, 2018, the IRS's Large Business and International Division ("LB&I") published five directives on transfer pricing exams. The directive titled "Instructions for Examiners on Transfer Pricing Issue Examination Scope—Appropriate Application of IRC §6662(e) Penalties," dated January 12, 2018, instructs LB&I examiners to apply a heightened level of scrutiny to section 6662(e) transfer pricing documentation.

Assuming there is an adjustment, the directive clarifies that the penalty commonly referred to as the "transfer pricing penalty" should apply when: (1) taxpayers failed to create documentation contemporaneously, (2) taxpayers failed to provide the documentation within 30 days of an IRS

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

request, or (3) the documentation was "unreasonable or inadequate." That is, the directive requires section 6662(e) documentation to be both timely (contemporaneously produced and timely provided to the IRS) and adequate in order to provide protection against the transfer pricing penalty.

Historically, transfer pricing penalties rarely have been asserted when some material level of documentation was contemporaneously produced and provided. In fact, practitioner experience is that penalties are rarely applied even in the absence of any contemporaneous documentation. Therefore, while this directive is in line with the statute, regulations, and congressional intent, its apparently higher standard is a significant shift in the practical interpretation and enforcement of the section 6662(e) documentation rules.

The LB&I directive limits the definition of "section 6662(e) documentation" solely to documentation that was prepared before filing the return and provided to the IRS within 30 days of its request. Taxpayers may not defend against penalties by relying on documents that were either prepared after the filing of the return or that were not provided to the IRS within 30 days of request. Therefore, taxpayers should ensure that documentation is timely for it to be effective protection; before the return filing date, they should confirm that documentation is complete. Taxpayers and tax advisors should also retain evidence of transmittal of the complete and final documentation.

Not only does section 6662(e) documentation have to be timely, but the documentation also must be adequate for the documentation to be effective protection against transfer pricing penalties. The directive refers to the regulations for the factors that examiners should consider in evaluating the adequacy of section 6662(e) documentation. Although no new requirements are implemented by this directive, there is a shift in focus and sufficiency.

The directive indicates that section 6662(e) documentation should include an explicit analysis and conclusion that the method used is the best method. Failure to do so means the transfer pricing penalty may be imposed upon transfer pricing adjustments. Furthermore, the LB&I directive instructs examiners to begin their own analysis with the taxpayer's timely analysis and conclusion for selecting the best method.

This heightened focus on the best method analysis means that taxpayers should exercise care to explicitly include a detailed and well-reasoned best method analysis and conclusion, rather than simply a rote recitation of the methods selected and rejected and boilerplate language on the methods. Including a robust best method discussion serves two purposes: (1) It protects the taxpayer against automatic application of the transfer pricing penalty, and (2) It provides the advantage of shaping examiners' starting analysis.[2]

Examiners are instructed by the directive to consider sources of information beyond the section 6662(e) documentation to determine if the information contained in the taxpayer's documentation is adequate.

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[2] Please review the new LB&I directive entitled "Instructions for LB&I on Transfer Pricing Selection and Scope of Analysis—Best Method Selection," released on January 16, 2018, and a separate What's News in Tax article on this subject for more detail.

For example, examiners should consider what information was or should have been available to the taxpayer to determine whether the taxpayer adequately incorporated and addressed these data points in the section 6662(e) documentation analysis. For taxpayers and advisors, this may mean that information typically included in background documentation, due diligence, or workpapers also should be included in the primary section 6662(e) documentation.

This overall heightened scrutiny of the sufficiency of documentation has significant implications for both taxpayers and advisors. They should confirm that robust, well-reasoned, and detailed documentation has been produced in a timely fashion. The IRS just raised the bar for documentation—taxpayers and tax advisors would be well advised to meet the heightened standard.

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