IRS

Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs)

A. Transfer Pricing Documentation and Related Penalty Rules

There are three types of penalties described in Internal Revenue Code (IRC) § 6662(e) that may be imposed in the event of a substantial or gross valuation misstatement. One of them—the "net adjustment penalty" described in § 6662(e)(1)(B)(ii)—applies when the net § 482 transfer pricing adjustment exceeds the relevant dollar thresholds. More than one type of penalty under § 6662 may apply to an underpayment resulting from a § 482 transfer pricing adjustment. These FAQs discuss only the net adjustment penalty described in § 6662(e)(1)(B)(ii). Generally, if the dollar thresholds are met, a taxpayer may avoid the net adjustment penalty only if the taxpayer has satisfied the documentation requirements of § 6662(e)(3)(B) and Treas. Reg. § 1.6662-6. These FAQs do not cover the foreign-to-foreign exception from penalties set forth in § 6662(e)(3)(B)(iii).

Treas. Reg. § 1.6662-6(d)(2)(ii)(A) requires a taxpayer to select and apply a specified method in a reasonable manner. Treas. Reg. § 1.6662-6(d)(2) provides the documentation requirements when a specified method is used. Treas. Reg. § 1.6662-6(d)(3) provides similar, but not identical, rules in cases when an unspecified method is used.Treas. Reg. § 1.6662-6(d)(2)(iii)(A) requires a taxpayer to maintain sufficient documentation "to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's-length result under the principles of the best method rule in Treas. Reg. § 1.482-1(c)." In addition, the regulations require a taxpayer to provide the documentation to the IRS within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates. With certain exceptions, the transfer pricing documentation must be in existence when the return is filed. In combination, the requirements to select and apply a method in a reasonable manner, maintain sufficient documentation thereof, and promptly provide such documentation to the IRS are commonly referred to as the "6662(e) documentation" requirements.

Treas. Reg. § 1.6662-6(d)(2)(iii)(B) sets forth the principal documents that must be maintained by a taxpayer to satisfy the transfer pricing documentation requirement. Having 6662(e) documentation does not automatically protect against penalties. The documentation must also be assessed for adequacy and reasonableness. To satisfy the documentation requirement of the penalty regulations, taxpayers must select and apply a method in a reasonable manner and document the fact they reasonably selected and applied the best method for their analysis. Factors to consider in evaluating the adequacy of a taxpayer's transfer pricing documentation are outlined in the regulations. For example, a taxpayer cannot rely on an unreasonable selection or application of a specified method to avoid penalties (e.g., inaccurate inputs, failure to adequately search for or consider material information, failure to follow the best method rule in selecting and applying the method, results that differ significantly from the arm's length result and are sizable in relation to the controlled transaction, etc., are indications the 6662(e) documentation may be inadequate).

B. Context for Transfer Pricing Documentation Frequently Asked Questions

The penalty rules serve the dual purpose of encouraging better compliance by motivating taxpayers and their advisors to take and adequately document reasonable return positions and also giving the IRS better tools (in the form of helpful documentation) to use to evaluate and, if needed, correct transfer prices. Unless a taxpayer's 6662(e) documentation is adequate and timely, the regulations require the net adjustment penalty to be assessed in every case where the penalty thresholds are met. Inadequate, incomplete or untimely production of documentation makes it much more difficult and resource intensive for the examination team to assess a taxpayer's reporting position, which increases audit time and taxpayer burden. Reasonable and well-documented return positions may be assessed more efficiently, saving resources for both the IRS and taxpayers.

In January 2018, the IRS Large Business & International Division (LB&I) issued a Directive to LB&I employees related to the appropriate application of penalties in certain transfer pricing examinations. One of the objectives behind this Directive is to incentivize taxpayers to improve the quality of their transfer pricing documentation. These frequently asked questions (FAQs) follow on that Directive by providing reminders about the relevant rules and offering insights about documentation best practices.

In its 2018 Public Report, the Internal Revenue Service Advisory Council (IRSAC) LB&I Subgroup observed that some stakeholders in the U.S. transfer pricing community believe the quality of transfer pricing documentation has declined. The IRSAC LB&I Subgroup recommended the IRS provide information to taxpayers to promote higher quality transfer pricing documentation. These FAQs also respond to the IRSAC recommendation.

C. Transfer Pricing Documentation Best Practices

The following FAQs are based on the IRS' observations of best practices and common mistakes in preparing transfer pricing documentation. The suggestions and recommendations are consistent with the requirements in the regulations to provide adequate and reasonable support for the arm's length nature of intercompany pricing. Many taxpayers would benefit from insights on the information that could be provided to the IRS to increase the chance of audit deselection or more efficient audits. The IRS believes the potential for deselection of issues earlier in the examination process could be a powerful incentive for many taxpayers to improve their transfer pricing documentation. These FAQs and responses are illustrative and are being shared in the spirit of transparency to encourage cooperative compliance by taxpayers. The responses, and examples therein, are high-level only and should not be relied on to analyze actual transactions.

Q 1 What benefit(s), in addition to potential protection against penalties pursuant to IRC § 6662(e)(3)(B), might there be for taxpayers who invest in robust transfer pricing documentation?

A 1 Transfer pricing reports that comprehensively document the reasonable selection and application of a transfer pricing method, consistent with the requirements of § 6662(e), help demonstrate low levels of compliance risk and in turn help support early deselection of the transfer pricing issue from further examination. High-quality transfer pricing documentation allows the examining agent to rely on the taxpayer's analysis of functions, risks, intangibles, value drivers, etc., saving both the taxpayer and the IRS time examining low-risk transfer pricing issues. Thus, robust transfer pricing documentation facilitates more efficient transfer pricing risk assessments and examinations for both taxpayers and examiners.

As an example, a U.S. company distributes heavy machinery it purchases from its foreign parent. A review of the tax return of the U.S. distributor shows it had significant losses in 2017, the year under audit. These losses are an initial indicator the intercompany prices paid by the U.S. distributor might have been too high. Further analysis of the actual functions, assets and risks allocated between the related parties is needed to determine whether the losses were due to incorrect pricing or to business circumstances. Based on an intercompany agreement entered into in 2016, prices are set so the U.S. distributor would expect to earn a return of X% of sales under normal business circumstances. During 2017, the demand for the company's heavy machinery drops unexpectedly, and the U.S. distributor sells a lower than expected number of machines. Application of the pricing policy means this reduction in sales volume results in losses for the U.S. distributor. Assume the pricing policy in the intercompany agreement is consistent with arm's length behavior and the loss was caused by an unexpected change in the company's business circumstances, not by non-arm's length intercompany prices. In such a case, the documentation should thoroughly explain how the unforeseen business circumstances experienced by the company caused the observed financial results and how the losses were not caused by intercompany prices. This approach would address a core issue in the transfer pricing analysis and facilitate an efficient examination. By contrast, it would be counterproductive if, rather than addressing the business circumstances that caused the loss, the taxpayer instead manipulated its set of comparable companies. For example, the taxpayer might adopt an analysis in its documentation that includes companies not truly comparable to the distributor but cause the results of the distributor to fall within the interquartile range of comparable company profitability. This approach would result in additional rounds of Information Document Requests (IDRs) and a lengthy analysis of the reliability of the comparable companies selected by the taxpayer, which could lengthen the audit period considerably.

Inefficient examinations involve an investment of resources by both taxpayers and the IRS that could be better utilized elsewhere. Even if an issue is not immediately deselected, additional information provided at the outset of an examination could also permit the IRS to raise more focused questions (in the nature of clarifications) more quickly so, rather than an examination possibly taking years, issues might be raised and addressed within a much shorter time frame.

Q 2 How can a "self-assessment" help to anticipate questions and prepare better 6662(e) documentation?

A 2 Taxpayers may want to consider conducting a "self-assessment" of the potential indicators of transfer pricing non-compliance. If taxpayers undertake a basic sensitivity analysis around the parameters of their application of the best method, they can potentially anticipate and proactively address concerns the IRS might raise. A starting point is a sensitivity analysis of the parameters used. For example, if the tested party's results would fall outside the benchmark range with the removal of just one company from the comparable company set, the taxpayer should consider re-evaluating the strength of the comparability analysis of the benchmark companies.

Comparing the tested party's results against a variety of profit level indicators (PLIs) is another form of self-assessment. Taxpayers should ensure their selection of PLI is fully supported in comparison to other PLIs that might indicate a different conclusion about the arm's length nature of the intercompany transactions. For example, a foreign subsidiary of a U.S. company licenses technology from its U.S. parent to manufacture widgets for sale in Europe. The foreign subsidiary earns an operating margin that on its own does not necessarily indicate high transfer pricing risk. However, based on data available on the foreign subsidiary's form 5471, the foreign subsidiary earns a higher return on assets (ROA) than the comparable companies used in the taxpayer's operating margin analysis, suggesting the royalty paid by the foreign subsidiary may be too low. The taxpayer should be prepared to address potential inconsistencies between PLI results.

Finally, a taxpayer self-assessment may also benefit from proactively evaluating how system profits are shared between related parties and addressing whether such allocations are reasonable based on each party's contributions.

Q 3 What is the IRS's guiding principle in establishing arm's-length prices were charged in intercompany transactions?

A 3 The IRS's guiding principle is to ensure taxpayers are complying with § 482 and the regulations thereunder. Under the arm's length standard, related taxpayers must report income based upon intercompany prices unrelated parties would have charged under the same circumstances.

In this paradigm, taxpayers determine the best method and use that method to check the controlled prices applied during the year achieved results consistent with those that would have been achieved if uncontrolled parties had engaged in the same transactions.

Where the same information for evaluating pricing is available to both taxpayers and the IRS, it follows compliance with the transfer pricing regulations should be *self-enforcing* because the taxpayer and the tax authority should reach a materially similar conclusion about the arm's-length nature of the intercompany pricing. Under such (ideal) conditions of information symmetry, a transfer pricing report prepared in good faith by the taxpayer would be sufficient to demonstrate compliance. In the ideal case, once the documentation report is reviewed by the tax authority and after a small number of clarifying questions, the transfer pricing audit would be over.

In reality, the world is not as perfect as described above. For example, it might be very difficult to find direct and close comparable companies, or they might not exist. Where there are no perfect comparable companies, there may be good comparable companies for which it is necessary to make adjustments to compensate for the imperfect comparability. In other cases, there may be no comparable company close enough to allow reliable adjustments, and another transfer pricing method must be used. When there are good, yet imperfect, comparable companies, comparability adjustments should be applied rationally and consistently and follow basic economic principles that are clearly spelled out in the § 482 regulations. Inclusion of a thorough analysis of how and why comparability adjustments were selected and applied is required by the regulations, and that analysis facilitates risk assessment and examination.

Q 4 What are some areas the IRS has identified in transfer pricing documentation reports that could benefit from improvement?

A 4 Below are some, but by no means all, of the areas the IRS has identified that could benefit from improvement. Strengthening the sections identified below will not provide a safe harbor against either a continued examination or imposition of penalties but may result in the deselection of certain audit issues and/or a more efficient audit. The more complex the transaction, the greater the need for detailed analysis and documentation.

Industry and company analysis sections of the report should be clear and provide context for related party transactions. These sections educate the IRS about the industry in which the taxpayer operates and how the relevant related parties fit into the taxpayer's operations. They are, in effect, a place (along with the functional analysis narrative) for a taxpayer to "tell its story." This analysis of the context in which the intercompany transactions take place should provide a sense of the total value the multinational enterprise has created.

For example, the number of years of analysis used in the application of the CPM could be different depending on the taxpayer's industry. In this part of the report, it may be helpful to provide information as to expectations versus reality. For example, is the industry experiencing a downturn? If so, adjustments may be needed to separate the effects of bad risk realization from the effects of intercompany pricing. The IRS's ability to efficiently and effectively conduct and rapidly conclude transfer pricing risk assessments and examinations should be better in situations where the taxpayer's transfer pricing documentation, consistent with the § 6662 regulations, includes a robust analysis of:

- Special business circumstances that might have affected results,
- Effects of discrepancy, if any, between the pricing policy and documentation method analysis (e.g., cost plus policy but test is CPM on distributor returns) and any year-end adjustments, and
- Any comparability adjustments made to the CPM (e.g., excess capacity).

Functional analysis narratives should be robust and link facts to analysis. Sometimes taxpayers include a list of facts in their documentation with no real analysis to connect the business description to the method selection. For example, some taxpayers present a "functional analysis" checklist of who does what with very little attention to the "analysis." Failing to link the business operational structure to the subject transactions and intercompany pricing or not explaining how and where the value is created that supports the allocation of profits among the parties does not substantially advance an examination toward a conclusion. The functional analysis should be well-supported factually and should not rely on broad assumptions about the business. Strengthening this analysis can benefit a taxpayer by answering questions before they are asked by the IRS.

Risk analysis should be consistent with intercompany agreements. Every business faces risks. From a transfer pricing perspective, risks must be identified and then allocated between the controlled parties. Intercompany agreements and the assignment of rights and responsibilities between the parties generally establish how risks are allocated. For example, under an intercompany agreement, a distributor may have the right to return all unsold inventory to the related supplier, thus shifting some risk to the supplier. The transfer pricing documentation should address such allocations of risk, how the risk allocations compare to the comparable companies used, and why the resulting pricing is consistent with the agreement. If an adjustment is made to the comparable companies based on risk allocations, the quantification of the risk and method for computing the adjustment should be clearly explained.

Support for best method selection must be provided, as well as the reason for rejecting specified methods. In many cases, the best method analysis and conclusions should be more robust and more specific to a taxpayer's circumstances. For example, a sentence that simply states "there are no Comparable Uncontrolled Prices (CUPs) so we did not apply the CUP method" is not helpful. Instead, a description of why such comparable transactions do not exist and/or how such determination was made should be included.

When eliminating methods, documentation should include a complete description of the search for internal and/or external data. Multinationals often maintain internal databases of legal agreements with unrelated parties. Documentation of a thorough method selection process should describe as clearly as possible the internal and external data requested and reviewed in the process of selecting a method. Preparing this documentation contemporaneously should facilitate preparation of the transfer pricing report and could be helpful to a taxpayer in the future, including in its interactions with the IRS.

For example, assume a taxpayer determined a royalty using a residual profit split method ("RPSM") after concluding, based on a search of an external royalty database, there were no Comparable Uncontrolled Transactions (CUTs) available. The taxpayer's legal department maintains a list of hundreds of internal uncontrolled agreements in which royalties are paid and that could have potentially served as internal CUTs, but the tax department and outside advisors did not request this internal information as part of their documentation analysis. Instead, the taxpayer's documentation simply stated that a dated § 6662(e) analysis had concluded no internal CUTs existed without any discussion of the prior search process or how that determination was made. In this example, the taxpayer's failure to adequately consider and address the availability of internal data would call into question whether the selection of the RPSM method was reasonable.

In addition, use of an unspecified method requires a reasoned basis for rejection of specified methods pursuant to the penalty regulations. However, frequently taxpayers fail to provide a reasoned basis for rejection of the specified methods when an unspecified method is selected. There may be very good reasons to reject specified methods. Those reasons must be provided in order to satisfy the requirements of Treas. Reg. § 1.6662-6(d)(3).

Analysis should be provided to support the PLI conclusion. Conclusive statements such as "We selected the Operating Margin as the PLI in the application of the CPM, because distributors typically measure their profits as a function of sales" are not helpful. The examiner's evaluation of the taxpayer's pricing may very well depend on the choice of PLI, which should therefore be substantively supported as thoroughly as possible.

Complete comparability analysis should be provided. Taxpayers often fail to thoroughly address the comparability criteria enumerated in the regulations. For example, in cases where taxpayers use the CUT method, they often do not thoroughly address profit potential. While profit potential may be a difficult criterion to analyze in some cases, it may not be ignored. Even if a numeric analysis of profit potential may not be possible, strong indications the profit potential of controlled and uncontrolled transactions is similar (e.g., the controlled brand and brands of the comparable company are middle of the road brands) would improve the usefulness of the analysis. While different methods impose different comparability requirements, differences between the controlled transaction or party and the uncontrolled transactions or parties should always be addressed. For example, if the purportedly comparable companies distribute different products from a different industry, an explanation should be provided to support the appropriateness of the comparability conclusion.

The impact of differences in risks or functions between the tested party and the comparable companies should be provided. One of the purposes of performing a risk analysis is to ensure the risks borne by the tested party are comparable to those borne by comparable companies. For example, in a CPM analysis, if the risk analysis establishes the tested party does not bear inventory risk and the selected comparable companies do bear that risk, the report should either demonstrate the effect of the difference in risk is inconsequential or perform an adjustment that would increase the reliability of the CPM analysis, if possible. The same logic applies to differences in functions.

Detailed well-reasoned support for proposed adjustments to the application of a specified method should be provided. Adjustments should be made for differences in comparability factors, characteristics that would likely have an impact on prices in uncontrolled transactions. Those adjustments, including the reasons for the adjustments, should be explained in the report. For example, if the tested party's operating expenses to sales ratio is higher than that of the comparable companies, an adjustment might be appropriate for the differences in operating expenses. In this case, a taxpayer might show first the larger expenses of the tested party would be remunerated in the marketplace. What are these excess expenses? Are they related to additional services provided to customers or inefficiencies? Is it just an expense classification issue (e.g., treatment as cost of goods sold versus operating expenses)?

Q 5 What are some features of the most useful transfer pricing documentation reports?

A 5 Notwithstanding that IRC § 6662(e) penalty protection is limited to the information and analysis provided in the 6662(e) documentation, the IRS can and should consider whether there are other sources of relevant data. For example, the examination team should be probing what data and information the taxpayer had access to or should reasonably have identified and considered at the time of the transaction. Knowing what information was or should have been available to the taxpayer assists the examination team in determining if the taxpayer adequately searched for, considered and applied the relevant body of information and whether the taxpayer adequately incorporated and addressed that data in its 6662(e) documentation analysis.

Below are some, but by no means all, of the most useful features the IRS has identified. Including these features will not provide a safe harbor against either a continued examination or imposition of penalties but may result in a more efficient audit and an increased likelihood of deselection of certain audit issues to the taxpayer's benefit.

Full explanation of the data used in the analysis. If segmented data is used, include a description of how the data was constructed, tie data used in the analysis to financial data, and provide complete income statements and balance sheets of the tested party (not just sales, total costs, and profits). When documentation is requested, taxpayers should provide data in a functional format that preserves their calculations (e.g., spreadsheets rather than pdf files), which can speed up the examiner's review.

Descriptions of the general business risks of the transaction and then more detailed descriptions of how these risks are allocated among the controlled participants to the transaction based on the intercompany policies/agreements. For example, if manufacturing volume is a risk to the profitable operations, a policy that "ensures" the distributor makes a fixed profit margin allocates more volume risk to the manufacturer/supplier.

Allocation of profits among all parties. Results from the application of a particular method must be reasonable. If they are not, there is something missing in the analysis. After the application of the selected method, one of the parties may end up with returns that may seem too high or too low. For example, a manufacturer sells to a related distributor. The taxpayer selects the CPM as its pricing method with the distributor as the tested party based on the taxpayer's position that the distributor performs less complex and more benchmarkable functions. In fixing the return of the distributor by using the CPM, the controlled manufacturer ends up with much higher returns than suggested by its manufacturing contributions. The relative contribution of manufacturing activities to distribution activities may not be enough to entitle the related party manufacturer to such high returns. In this example, the documentation should explain where the excess returns come from and which controlled party is entitled to these returns. This issue is not limited to the application of the CPM but also is present in applications of the CUT method or the RPSM.

Other useful features of a transfer pricing documentation report:

- Reports that provide a functional and risk analysis for each transaction.
- Analysis of special business circumstances that may have affected profitability.
- Description of challenges of the analysis (e.g., the combined profits were negative, and the challenge is to allocate losses among the controlled participants).

Q 6 Can you provide an example of a presentation of a company's intercompany transactions that would be a helpful summary for examiners to use in risk assessment?

A 6 In general, making transfer pricing documentation more "user friendly" will make the IRS's review and assessment of the return positions as efficient as possible. Providing something as simple as a summary of information about the intercompany transactions at the beginning of the transfer pricing documentation helps IRS examiners understand the taxpayer's transactions. An intercompany transaction summary can help focus review and examination on the most significant transactions. This example PDF shows a summary presentation that would be very useful for risk assessment purposes to deselect transactions from audit or establish the scope of the transfer pricing audit, which can save a significant amount of examiner time at the beginning of an audit. This is an illustrative example only and is not intended to show transfer pricing compliance or non-compliance for any type of transaction. This sample should not be interpreted or used as representative of any actual intercompany transactions.

Page Last Reviewed or Updated: 03-Oct-2023