In Practice

What to Expect in a Transfer Pricing Audit

By Robert J. Misey Jr.

Many aspects of the Internal Revenue Service audit process, particularly as it relates to international tax, likely always will remain a mystery to taxpayers. However, as the IRS continues to increase its staffing in the international tax area and continues to add experts, such as economists, to assist it in transfer pricing,[1] more and more multinational taxpayers will gain experience with this process.

This article outlines the steps of a transfer pricing audit and the issues taxpayers can expect to confront during the course of an examination.

Pre-Examination Conference

The first "official" meeting between the taxpayer and the examination team often will occur, or should occur, at a pre-examination conference. During this meeting, the case manager meets with the taxpayer for purposes of obtaining basic data, establishing the scope and depth of the audit, and arranging for computer assistance.[2]

The taxpayer will learn who has been assigned to its audit, and may want to begin its own investigation into IRS team members to better prepare for the audit ahead.

Taxpayers may want to be certain that international issues are addressed separately to recognize both the difficulty that often results in obtaining relevant information from foreign sites (not to mention the difficulty of translating such information if necessary) and the breadth and complexity of the data often requested.

Audit Personnel

When an audit involves transfer pricing issues, a taxpayer can expect to encounter a variety of new players, new procedures, and new informational requests from the IRS.

In the category of new players, transfer pricing audits often involve, in addition to the international examiner, an economist and an industry specialist, or engineer.

The economist is brought into a case at the request of the IE. Therefore, a taxpayer can face a transfer pricing adjustment that may or may not have been derived by an economist (*e.g.*, the IE may make the adjustment on his or her own, if they so chose). An economist entering a case will have responsibility for either drafting, or reviewing the IE's draft of the proposed transfer pricing adjustment.

The IE may also request an engineer to enter a case. At times, they may seem to be acting as economists. Experience with engineers appears to be very mixed at the Examination level, in terms of their involvement in the audit process and their ability to understand a taxpayer's business and then focus on a particular area relevant to an issue.

The Internal Revenue Manual (IRM) recognizes that audits of transfer pricing issues require substantial time to develop and document,[3] and further provides IEs (and essentially, the transfer pricing team) with instructions on how to approach transfer pricing audits as well as detailing pre-audit preparation procedures.[4]

Scope of Examination

First, the case manager and the IE formulate the scope of the examination.[5]

The IRM directs them to become familiar with the taxpayer's operations. This requires studying all available information. In particular, the IRM suggests reviewing all Forms 5471 and 5472. Other sources of information include:

- reports filed with U.S. Customs and Border Protection;
- public information, including that available on the Internet; and
- industry specialists.

Customs reports may be used to verify transfer prices for imports because Section 1059A forbids transfer prices on import transactions between related parties to exceed the values or prices used for U.S. Customs purposes. Public information may come from annual reports filed with the Securities and Exchange Commission, articles in trade journals, and reports prepared by the taxpayer's employees outside of the tax department. Industry specialists identify unique indus-

[1] IRS officials said March 30 that as many as 700 of the 3,500 frontline enforcement employees the agency plans to hire will deal with international issues, and the IRS Large and Mid-Size Business Division has been authorized to hire 100 personnel as international examiners, financial products specialists, and economists (17 *Transfer Pricing Report* 890, 4/2/09).

[2] IRM 42(11)30.

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[3] IRM 42(10)10.1.

[4] IRM 42(10)7.1.

[5] IRM 42(11)7.1.

  TMTR ISSN 1063-2069

try issues, the economic conditions in the industry, and accounting practices peculiar to the industry.

Preliminary Work

The IE will conduct preliminary audit work. To the extent possible, the case manager reviews basic tax records, such as reconciliation of book income to taxable income, corporate minutes, internal controls, internal reports, and accounting manuals.

IEs often make a preliminary determination of whether a transfer pricing issue exists by using tax return data to calculate certain key financial ratios, such as:

- gross profit/net sales;
- net profit/net sales;
- operating expenses/net sales;
- gross profit/operating expenses (Berry ratio); and
- operating profit/average total assets.

The IEs compare the taxpayer's relevant ratios with the industry standard ratios for the same Standard Industry Classification code.[6] If the taxpayer's ratios differ significantly, then "an in-depth probe of the taxpayer's transactions is warranted." The relevance of these ratios for a multi-product line business may be questionable and it is unclear whether these are actually being computed prior to any audit activities.

Although these ratios offer a "smell test" to the IE, they may not be the basis of an adjustment.[7]

The IE is expected to essentially perform a functional analysis of the taxpayer's business before proceeding to determine whether non-arm's-length transactions have occurred. To do this, the IRM suggests that the IE interview the company's tax personnel and line function personnel to learn more about its operations. There also are extensive documentation requests for the IE to consider, and checklists of the types of data to receive and analyze.[8]

Information Document Requests

Section 6001 and the regulations thereunder require all persons liable for taxes imposed by the United States to keep books and records sufficient to determine their proper tax liability. Furthermore, Section 7602 authorizes IRS personnel, in ascertaining the correctness of any tax return filed, to examine any relevant books and records of the taxpayer.[9]

Requested on Form 4564, the information document request (IDR) provides a convenient means to seek information and simultaneously yields a permanent record of what was requested, received, and returned to the taxpayer.[10] Often, the IE will have a local IRS attorney review the IDRs.

One of the largest problems for foreign-owned U.S. taxpayers is that some foreign corporations do not have records that are in a usable format. Records are often stated in foreign currency and may be prepared in a foreign language. Language should not be a problem for most foreign corporations. The U.S. taxpayer may have to spend a large amount of time and money translating and explaining the documents to the IRS.

This problem was confronted in *Nissei Sangyo America Ltd. v. U.S.*,[11] which involved the audit of a U.S. subsidiary of a Japanese parent.

In *Nissei Sangyo*, the U.S. subsidiary, in response to a summons, had randomly selected documents relating to the issue under examination and provided full translations. The Japanese parent also had randomly selected and translated documents. In addition, it translated the subject matter headings or titles of 1,441 pages of Japanese correspondence and prepared English translation keys for the travel expense authorization forms.

The IRS demanded that all documents described in the summonses be translated into English, which the U.S. subsidiary estimated would cost from $850,000 to $1.5 million. The court held that the general summons standard[12] applied and thus the IRS could not compel the translation of documents that were not relevant to the tax liability or that the IRS already had in its possession. Although the IRS lost this case, it clearly indicates that the IRS will aggressively pursue documents and their translation.

Formal Document Requests

If IDRs do not produce enough foreign information to conduct an examination, the IRS may issue a formal document request (FDR). The FDR is not intended to be used as a routine tool at the beginning of an examination, but instead as a mechanism for securing information that could not be obtained through normal IDRs.[13]

The rare use of the FDR is indicated by the fact that the IRS does not have a specific form for the request. Instead, the IRS will issue a Form 4564 titled "Information Document Request" with the notation "Formal Document Request."

If the taxpayer does not furnish the requested information within 90 days of the mailing of the FDR, the taxpayer cannot later introduce the requested documents at trial. *Flying Tigers Oil Co., Inc. v. Comr.*[14]

Section 982(d) defines foreign-based documentation as "any documentation which is located outside the U.S. and which may be relevant or material to the tax treatment of the examined item." As a result, the IRS has broad authority to request virtually any relevant information. The intent of section 982 is to discourage taxpayers from delaying or refusing disclosure of certain foreign-based documentation. In order to avoid the application of the section, the taxpayer must substantially comply with the FDR. Whether there has been substantial compliance will depend on all the facts and circumstances. For example, if the taxpayer submits nine out of ten requested items and the court believes the missing item is the most substantial, the taxpayer could be found to have failed to comply substantially with the FDR.

Any taxpayer to which an FDR is mailed has the right to begin proceedings to quash the request within 90 days after the request was mailed. In this proceeding

[6] While the use of industry ratios is discouraged by the regulations, IEs often use such ratios from sources such as Robert Morris to make this initial comparison.
[7] Regs. §1.482-1(d)(2).
[8] IRM Exhibit 500-6.
[9] IRM (42)110.
[10] IRM 403(23).
[11] 95-2 U.S.T.C. ¶ 50,327 (N.D. Ill.).
[12] *U.S. v. Powell*, 379 U.S. 48 (1964).
[13] *See* Joint Committee on Taxation, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982.
[14] 92 T.C. 1261 (1989).

the taxpayer may contend, for example, that the information requested is irrelevant, that the requested information is available in the U.S., or that reasonable cause exists for the failure to produce or delay in producing the information.

Reasonable cause does not exist where a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer for disclosing the requested documentation. In a proceeding to quash, the IRS has the burden of proof to show the relevance and materiality of the information requested.[15] During the period that a proceeding to quash or any appeal from that proceeding is pending, any statute of limitations under sections 6501 and 6531 is suspended.[16]

The legislative history to Section 982 specifies the three factors to consider in determining whether there is reasonable cause for failure to furnish the requested documentation. These factors are:

- whether the request is reasonable in scope;
- whether the requested documents are available within the United States; and
- the reasonableness of the requested place of production within the United States.

Foreign Plant Tours, Site Visits

IEs appear to have taken an increased interest in foreign site visits and plant tours over the past few years. While recent IRS budget constraints may affect the number or duration of such visits that might be requested, taxpayers should expect such requests and be prepared to respond. Note that it is a request, not an order, and that any request may be negotiated in terms of what facility may be visited (you may want to substitute a U.S. plant for a foreign one), the duration of the visit, the timing of the visit and the number of IRS people involved.

Plan any such trip carefully. It may be a wonderful opportunity to, in effect, present your case and your facts, but watch for surprises. Prepare the plant personnel for the visit. Pre-screen the tour and determine whether it covers processes or procedures relevant to the audit cycle. Pre-interview all involved personnel, sensitize them to potential issues and develop any strategies.

The following list[17] contains instructions given to IEs for foreign plant tours:

- Obtain information about departmental cost sheets or schedules.
- Learn the training requirements of each type of production employee.
- Obtain any records regarding sales to all customers.
- Ascertain the extent of product development performed at the plant.
- Interview plant employees. Plant interviews will bring a sense of reality to the case. Interviews should flesh out the employee's ability to alter the production process and the technical training each production employee received.
- Obtain all company manuals regarding the operations of the plant.
- Obtain all job descriptions prior to the plant tour.
- Obtain all annual evaluations of the employees to be interviewed.
- Obtain all company "programmer" manuals. This manual offers guidance to the programmer to construct his program, so that software can be readily translated.

Summonses

A summons can result in a court order requiring the taxpayer to provide information. When issuing a summons, the IRS has to follow the standards of *U.S. v. Powell*,[18] which requires the IRS to show that:

- the investigation will be conducted pursuant to a legitimate purpose;
- the inquiry may be relevant to the purpose;
- the information sought is not already within the IRS's possession; and
- the IRS has followed all the administrative steps the Internal Revenue Code requires.

However, the IRS is aware that a regular summons is ineffective if the statute of limitations expires during summons enforcement.

Designated Summons

If, after issuing a summons, the IRS does not obtain the desired information in a timely manner, the IRS may consider issuing a designated summons.[19]

A designated summons tolls the running of the statute of limitations during the period in which judicial enforcement proceedings are pending, and for either 60 or 120 days thereafter, depending on whether or not the court orders compliance with the summons. The legislative history of the designated summons indicates Congress was concerned that taxpayers made a practice of responding slowly to IRS requests for information without extending the statute of limitations. Congress did not intend to extend the statute of limitations in a large number of cases, but to encourage taxpayers to provide requested information on a timely basis by realizing that the IRS had this tool available.

The internal procedures the IRS personnel must follow to issue a designated summons are a major impediment to their issuance. In addition to the IE and the case manager, both the Division Commissioner and the Division Counsel as well as the Associate Chief Counsel (International) generally approve a designated summons. The IRS has not announced the new path for approval under its reorganization.

Even a cooperative taxpayer may receive a designated summons.[20]

Section 6038A

Congressional perception that foreign-owned U.S. subsidiaries were not paying their proper share of U.S. tax and the inability of the IRS to obtain foreign-based documentation caused Congress to expand greatly the application of section 6038A. The section places the reporting burden for intercompany transactions on the 25-percent-or-greater foreign-owned corporation with a U.S. branch.

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[15] *See* Joint Committee on Taxation, *supra* note 13.
[16] I.R.C. §982(e).
[17] IRS International Continuing Professional Education materials, Chicago, Illinois.
[18] 379 U.S. 48, 57-58 (1964).
[19] I.R.C. §6503(j).
[20] *U.S. v. Derr*, 968 F.2d 943 (9th Cir. 1992).

  TMTR ISSN 1063-2069

These U.S. taxpayers, the "reporting corporations," must furnish certain information annually and maintain records necessary to determine the correctness of the intercompany transactions. The reporting corporation must also furnish the required information by filing Form 5472 on an annual basis.

The regulations provide that "[a] reporting corporation must keep the permanent books of account or records as required by Section 6001 that are sufficient to establish the correctness of the Federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct U.S. tax treatment of transactions with related parties."[21] Such records may include cost data, if appropriate, to determine the profit or loss on intercompany products and services.

Failure to maintain or timely furnish the required information may result in a penalty of $10,000 for each taxable year in which the failure occurs for each related party.[22]

If any failure continues for more than 90 days after the reporting corporation receives notice of the failure, the IRS can impose an additional penalty of $10,000 per 30-day period. The IRS can impose additional penalties after determining that the taxpayer failed to maintain records after the 90-day notification.[23]

Within 30 days after a request by the IRS, a foreign related party must appoint the reporting corporation as its limited agent. Failure to appoint such an agent can result in penalties for noncompliance.

Section 6038A(e) allows the IRS—in its sole discretion—to reduce the cost of goods sold when a foreign parent does not appoint its U.S. subsidiary to be an agent for the request of certain documents. The IRS is prepared to follow the letter of Section 6038A and its regulations as shown in *Asat Inc. v. Comr.*[24]

In *Asat*, the Tax Court literally applied section 6038A(e) against the taxpayer, upholding the IRS's reduction to the cost of goods sold. Adhering to the legislative history, the Tax Court further found it irrelevant that the foreign parent during the year in issue was not the parent at the time of the audit.

Requests for Documentation

If the IRS determines that an intercompany transfer price was less than 50 percent or more than 200 percent of an arm's-length price, or the transfer pricing adjustment increases taxable income by $5 million or more, the taxpayer must pay a penalty equal to 20 percent of the additional tax. The penalty increases to 40 percent if:

- the intercompany transfer price was less than 25 percent or more than 400 percent of an arm's-length price; or
- the transfer pricing adjustment is $20 million or more.[25]

A taxpayer can protect itself against a penalty by contemporaneously documenting its transfer pricing practices.[26] Contemporaneous means documented when the return is filed.

The documentation must state the reasons for believing the prices are at arm's length, and must be in place when the return is filed, but does not have to be provided to the IRS until requested on audit. The documentation must provide a business description, a thorough analysis of the intercompany transactions, a detailed functional analysis of the relevant parties, a review of the transfer pricing methods resulting in the method chosen and an economic analysis showing the arm's-length nature of the transfer pricing.

The transfer pricing documentation not only protects the taxpayer from a penalty, but also often persuades the IRS that a transfer pricing adjustment is not necessary. As a result, even if a taxpayer previously failed to contemporaneously document its transfer pricing for an open year, it should consider preparing documentation if it expects an examination of the year.

Exchanges of Information

Under the exchange of information provision in U.S. income tax treaties, the IRS can generally request information from the foreign country that is either in the foreign tax authority's possession or available under the respective tax laws of the foreign country. These provisions generally do not require the exchange of information that would disclose any trade or business secret.

The IRS exercises discretion and judgment in both requesting and furnishing of information. In general, the IRS will not request information from another country unless:

- there is a good reason to believe that the information is necessary in the determination of the tax liability of a specific taxpayer;
- the information is not otherwise available to the IRS; and
- the IRS is reasonably sure the requested information is in the possession of, or available to, the foreign government from whom the information is being requested.

The IRS's internal guidelines require that information sought from a foreign country must specifically describe the information desired and the reason why the information is necessary.[27]

Conclusion

When seeking information in a transfer pricing audit, the IRS has many tools available beyond the standard IDRs. Successfully resolving the audit requires an understanding of the intricacies of these tools and the development of strategies to effectively deal with them.

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[21] Regs. §1.6038A-3(a)(1).
[22] Regs. §1.6038A-4(a)(1).
[23] Regs. §1.6038A-4(d)(1).
[24] 108 T.C. 147 (1997).
[25] I.R.C. §6662(e).
[26] Regs. §1.6662-6(d)(2)(iii).
[27] IRM 42(10)10.