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Directive Limits Challenges to Transfer Pricing Method Selection

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IRS exam teams and APA teams are now required to follow new approval processes before challenging a taxpayer's selection of a transfer pricing method, but only if the taxpayer's method selection is adequately supported by relevant documentation. This article explains that the directive should limit the number of challenges to transfer pricing method selection, but cautions taxpayers to take care that their method application is proper and that their documentation sufficiently addresses method selection.

Introduction and Background Principles

On January 16, 2018, the IRS's Large Business and International ("LB&I") Division released five directives on transfer pricing examinations. With the directive titled "Instructions for LB&I on Transfer Pricing Selection and Scope of Analysis—Best Method Selection,"¹ the IRS instituted a new procedure for challenging a taxpayer's selection of a transfer pricing method.

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¹ <https://www.irs.gov/businesses/corporations/instructions-for-lbi-on-transfer-pricing-selection-and-scope-of-analysis-best-method-selection>. Although the directive is dated January 12, 2018, it was not published until the 16th.

Transfer pricing method selection under section 482² is governed by the best method rule of section 1.482-1(c), reproduced for ease of reference as follows:

The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.³

Because method selection under the section 482 regulations comes down to a judgment call about what, given the circumstances of the taxpayer's case, most accurately reflects an arm's length price, there is substantial space for disagreement. Even the flawless application of a selected transfer pricing method will not shield a taxpayer from controversy if the IRS determines that the method applied was not the best method. The new directive does not change that basic principle, but it does make it harder for the IRS to make the determination that the taxpayer's selected method is not the best one: In certain cases, IRS examination or advance pricing agreement ("APA") teams must now "[o]btain Treaties and Transfer Pricing Operations (TTPO) Transfer Pricing Review Panel approval before changing the taxpayer's selection of a Treas. Reg. §1.482 method as the best method as supported in contemporaneous transfer pricing documentation or APA submission."

Overview of the Directive

The procedures that the directive prescribes apply to two sets of taxpayers:

- ◆ Taxpayers that are both "LB&I taxpayers" with assets equal to or greater than \$10 million and required to file Forms 5471 or 5472 with their annual tax returns⁴
- ◆ All taxpayers in the APA program

To fall within its scope, the directive states that taxpayers under examination must timely provide with (or presumably within) their section 6662(e) documentation a report that clearly identifies the selection of a method, concludes that the method selected is the best method, and provides an analysis supporting this conclusion.⁵ In the APA context, these requirements must be satisfied by the APA

² 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").

³ Section 1.482-1(c)(1).

⁴ Section 1.6046-1 lays out the requirements for who must file Form 5471 and section 1.6038A-2 provides the requirements for Form 5472.

⁵ This requires contemporaneous documentation: Section 6662(e)(3)(B)(ii) provides that the documentation must have been "in existence as of the time of filing the return."

submission rather than the section 6662(e) documentation. The directive applies to IRS Transfer Pricing Practice (“TPP”) examinations; examinations involving Cross Border Activities personnel, or by Geographic Practice Area agents without TPP participation; and all APA applications, as noted above.

If the taxpayer falls into one of the specified categories and has provided adequate supporting documentation, the directive requires an IRS exam team to consult with and obtain approval from Treaties and Transfer Pricing Operations (“TTPO”) prior to changing the selection of a transfer pricing method. The choice to remove the best method determination from the sole discretion of the exam team is not grounded in any notion of deference to taxpayers’ analysis. Rather, it is motivated by LB&I’s recognition that it possesses “limited transfer pricing resources” and “needs to manage transfer pricing issues under examination and related resources in the most efficient and effective manner possible.” LB&I acknowledges that “[t]o ignore [the taxpayer’s] analysis and conclusion and start the best method selection analysis from scratch protracts the examination timeline and diverts resources.” However, “[t]he approval process is not intended to impede the proper analysis of compliance with the transfer pricing regulations.”

Thus, exam teams are directed to start with the taxpayer’s selection of the best method rather than make their own best method determinations from scratch. The directive instructs them to thoroughly analyze the taxpayer’s method application and to develop and document any changes to that application at an early date. Changes to the application of a method may result in “corrections and adjustments to the determination of the arm’s length result.” Although the directive does not directly address this, it may be that this shift towards application-based challenges rests on a sense that these changes are easier to defend than challenges to the more nebulous best method inquiry. If exam teams do consider recommending a method change, the directive suggests that they consult the examples of best method selection in section 1.482-8.

While the directive notes that the use of unspecified methods may be subject to increased scrutiny at the exam stage, TTPO approval is still required before an unspecified method can be changed.

In the APA context, the directive indicates that the APA team must follow the same approval process in order to change the appropriately documented selection of a method as the best method (or, in a bilateral APA request, the “most appropriate method” under the OECD transfer pricing guidelines⁶). Again, the directive is concerned with the efficient use of resources: “Practical tax administration and efficient use of limited APMA resources mean we should not ignore the analysis provided by the taxpayer and start from scratch to develop the best method analysis.” However, if formal competent authority negotiations concerning a bilateral APA are underway, the directive provides that the competent authorities may change the method selection without consulting with or securing approval from TTPO.

⁶ Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*. Paragraph 2.2 of the OECD guidelines provides that “[t]he selection of a transfer pricing method always aims at finding the most appropriate method for a particular case.”

The specific procedure for securing TTPO approval requires elevating the recommendation for a method change through the applicable management chain until it reaches a Director of Field Operations, who is responsible for referring it to the national TTPO Transfer Pricing Review Panel. The panel consists of the TPP Director or, if the issue arises in the context of an APA, the APMA Director; a Senior Advisor to the TTPO Director; and the Income Shifting Practice Network Manager. The panel will look at “(1) Why the taxpayer’s method is unreliable, (2) Whether the taxpayer’s method can be adjusted to make it more reliable, and (3) If not, what method is more reliable, and why.” To facilitate this process, the initial recommendation from the exam or APA team must address these questions and be accompanied by an analysis supporting the alternative method selection. The IRS plans to provide more specific information on the review process internally.

Implications of the Directive

The restraints that the directive imposes on exam and APA teams’ ability to dispute method selection clearly benefit taxpayers. LB&I’s reluctance to continue expending scarce resources in difficult-to-win fights over the best method determination should mean that more taxpayers will survive examination or APA negotiations with their desired transfer pricing method intact.

Still, taxpayers must take care under the new regime. Section 6662(e) documentation has become even more critical to reducing controversy exposure, as taxpayers with documentation that lacks a clearly identifiable analysis and conclusion on method selection will find themselves open to challenge without the need for TTPO approval. Further, the directive may not result so much in a decrease in transfer pricing controversy as in a shift in focus: While fewer method selection challenges are to be expected, the directive’s guidance may result in more disputes over method application.

Of course, there always remains the possibility of changes to a taxpayer’s best method determination with TTPO approval, and in theory such changes should be well substantiated and thus potentially harder for taxpayers to overcome than past method selection disputes. Moreover, since the directive “is not an official pronouncement of law and cannot be used, cited or relied upon as such,” a taxpayer would not be able to make any formal challenge in the event that an exam or APA team deviated from the directive and made an unapproved method change, although, as is frequently the case, involving IRS management personnel could be helpful in resolving disputes.

The directive should generally limit “one-size-fits all” comparable profits method (“CPM”) approaches from IRS exam teams. It is common that IRS exam teams and economists test the taxpayer’s transfer pricing on a CPM basis, regardless of method. Likewise, IRS exam teams frequently ignore related party contractual arrangements and key facts in support of their CPM-based approaches. IRS management is clearly focused on avoiding this CPM obsession and moving IRS exam teams to consider pricing in a more efficient manner.

Moreover, many taxpayers test their related party arrangements on a CPM basis, at least in documentation, due to the ease and cost-effectiveness of such an approach. This directive, especially coupled with the best method analysis focus and heightened standards for avoiding penalties in the

simultaneously released transfer pricing penalty directive, may indicate that taxpayers should re-evaluate their transfer pricing methods—on a transactional basis and especially in their documentation process. While putting in more effort and thought up front regarding a transfer pricing method has always been best practice, this directive means that this approach could pay off even more going forward.

In short, the directive should limit the number of IRS challenges to taxpayers' method selection, but taxpayers must take care that their method application is proper and that their documentation sufficiently addresses method selection. Taxpayers should not rely on the directive to shield against challenges to aggressive stances on method selection, but may benefit from the procedures it requires, which should reduce controversy with respect to defensible method selections that are properly applied and documented.

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