Avoiding a Transfer Pricing Audit

Three Best Practices for Multinationals

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Transfer pricing has gained notoriety in recent years as more and more organizations conduct business internationally. With this increased activity, the Internal Revenue Service and other authorities around the globe have identified transfer pricing as an underutilized source of tax revenue. In truth, effectively navigating transfer pricing regulations is less about avoiding taxes and more about making smart decisions in growing and scaling an international business, including complying fully with fiscal requirements in the various jurisdictions in which they operate.

In broad strokes, transfer pricing is focused on how departments, companies and enterprises under common ownership handle transactions of services, goods or intangible items across national borders. Connected companies could gain a market and tax advantage by manipulating the prices they charge to move goods and services between entities under shared ownership. Regulations prevent this advantage by requiring that related entities use arm's-length pricing – meaning they charge and pay prices similar to what unconnected organizations operating at arm's length would pay. In this way, related entities are put on an equal tax footing with independent entities.

IRS Guidance Offers an Inside Look

The IRS recently offered a peek behind the curtain into how the agency decides where to focus scrutiny of transfer pricing at multinational corporations. In June 2018, the IRS issued new guidelines titled "Transfer Pricing Examination Process." The new guidance document replaces the agency's Transfer Pricing Audit Roadmap, released in 2014.

This guide is written as a resource for IRS examiners and auditors, offering rules and best practices in planning, executing and resolving transfer pricing examinations. The document is also shared with companies at the start of any examination. But organizations can benefit from this inside look at the IRS processes and priorities long before an examiner shows up at your door. With these updated guidelines in mind, here are three key insights that can be applied to transfer pricing protocols and prevent an audit from happening at all.

1. **Be as specific and consistent as possible**

   In evaluating multinational firms and gauging potential audit targets, the IRS will focus on details. It's best to maintain thorough, accurate accounts of intercompany transactions rather than rely on generic information. The more detailed information you can provide the IRS on company agreements and invoices, the more likely they will be to shift their attention elsewhere.

   These details must also be consistent among all transactions. There are multiple methods organizations can employ to determine arm's-length pricing. These methods must be used by the entire organization across all departments. This consistency must follow through to pricing results.

   Ultimately, IRS officials are looking for a narrative that runs through transfer pricing protocols. They want to see the rationale and reasoning behind transfer pricing practices with specific details and consistent arm's-length pricing determinations throughout the organization.

2. **Ensure ongoing compliance**

   As recent IRS updates demonstrate, regulatory priorities and specific directives can shift over time. Multinational corporations must stay on top of these changes to ensure they're not attracting unwanted IRS attention. And U.S. regulations are only part of the equation – more than 75 countries have transfer pricing regulations. Organizations must be current on regulatory nuances in every country where they operate and conduct transactions.

   For many firms, commissioning or conducting a transfer pricing study is a critical first step, but it is only the first step. The study needs to be analyzed, implemented and maintained. In some cases, failing to effectively implement policies based on the results of the study can actually expose multinational companies to increased regulatory scrutiny.

   Often, utilizing an external team can create consistency and accountability in complying with transfer pricing rules. Look for an outside team that can coordinate preparation of policies and documentation across multinational enterprise groups. Maintaining a centralized and consistent approach is an effective way to tell the same story across a global organization, which has never been more important.

3. **Don't raise red flags**

   Even with the right protocols in place, it pays to make sure your organization isn't raising additional red flags that attract regulatory scrutiny. Tax preparation should include robust details about transfer pricing practices and explain any activities likely to lead to questions from the IRS. These include significant intercompany transactions, retrospective adjustments and transactions with low tax jurisdictions.

   In some cases, negotiating an Advance Pricing Agreement is the best way for a multinational organization to ensure effective compliance. For companies making considerable changes to transfer pricing practices, including expanding into new regions or updating arm's-length determinations, this upfront agreement with the IRS and other tax authorities can create a more predictable and transparent tax process. Here again, a trusted external advisor is often a valuable partner in negotiating this agreement and making sure intercompany transactions don't raise additional red flags.

Conclusion

With these broad guidelines in place, a closer read of the updated IRS guidelines with internal or external transfer pricing experts can help guide a more specific plan of action. With the right approach and consistent vigilance, multinational organizations can effectively avoid unwanted attention from the IRS and other regulators.

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