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Tax Notes

Update on IRS Transfer Pricing Compliance Activities

By Ralf Ruedenburg, CPA, Partner and Christopher Migliaccio, JD, Senior Manager

It may be time for multinational companies operating in the U.S. to review and analyze the quality of their existing transfer pricing documentation or start creating one if they have not done so already. In several pronouncements over the last two years, including a recent FAQs, the IRS has made it very clear that it will be increasing its scrutiny of transfer pricing arrangements to determine whether they are adequate and reasonable. The IRS has also made it clear that detailed and well-reasoned transfer pricing documents can help avoid or limit audits, while thin or non-existent documentation will encourage greater scrutiny. This article provides an overview of recent developments in IRS transfer pricing guidance.

Captive Service Provider Campaign

In April 2019, the IRS announced the Captive Service Provider Campaign to increase enforcement of the U.S. transfer pricing rules. Internal Revenue Code (IRC) §482 and the related regulations, as well as the OECD Transfer Pricing Guidelines, provide rules for determining arm's length pricing for transactions between controlled entities. The scope of these rules include transactions in which a foreign captive subsidiary performs services exclusively for its parent or other members of the multinational group. Excessive pricing for these services would inappropriately shift taxable income to these foreign entities and erode the U.S. tax base.

Thus, the goal of the Captive Service Provider Campaign is to ensure that U.S. multinational companies are paying their foreign captive service providers no more than arm's length prices. Resources have been allocated to the IRS Large Business and International Division (LB&I) to achieve the goal of this campaign.

Transfer Pricing Examination Process (Pub. 5300)

As part of the increased emphasis on transfer pricing enforcement, the IRS released an updated version of its publication on transfer pricing examinations (Pub. 5300) in May 2019. The document is a guide to best practices and processes to assist with the planning, execution, and resolution of transfer pricing examinations. Most importantly, the guide makes it clear that an Information Document Request (IDR) is mandatory if the IRS has determined that there are initial indications of transfer pricing compliance risks. That means that the IRS will be scrutinizing a multinational company's transfer pricing documentation closely.

Key Documentation Elements (New IRS FAQs)

Given the increased emphasis on documentation, the IRS recently released frequently asked questions (FAQs) describing the key elements they are looking for in transfer pricing documentation. If these key elements are present, the IRS has indicated it may result in a more efficient audit and the deselection of certain audit issues, although it will not provide a safe harbor against either continued examination or imposition of penalties.

What is the IRS looking for in transfer pricing documentation?

- A full explanation of the data used in the analysis.
- A "self-assessment" to anticipate questions from the IRS and proactively address those questions.
- A description of business risks of the transactions and how these risks were allocated among controlled participants.

- Adequate and reasonable justification for the comparable companies selected to demonstrate to the IRS that arm's length prices were used.
- The functional and risk analysis for each transaction.
- A description of the challenges of the analysis, e.g., allocate losses among controlled participants.
- An intercompany transaction summary at the beginning of the transfer pricing documentation

Reduce Audit Risk

If multinational companies are uncertain whether their existing transfer pricing documentation is sufficient to meet the announced IRS standards, they should consult with their trusted tax advisors. Multinational companies without transfer pricing documentation to support intercompany transactions clearly should start preparing transfer pricing documentation. Although transfer pricing documentation isn't mandatory, it can help protect companies from penalties from unfavorable adjustments made by the IRS by reducing the risk of a detailed audit.

Contact Us

As always, if you need any assistance, please reach out to your PKF O'Connor Davies client service team or Ralf Ruedenburg, CPA, Partner at rruedenburg@pkfod.com. We are here to help.

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