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Transfer Pricing Compliance Alerts: What to Do Now

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Many US subsidiaries of large foreign corporations that distribute goods in the US and report losses or low margins every year have received IRS transfer pricing "compliance alerts," and companies should carefully weigh the consequences of their responses, says Steven Wrappe of Grant Thornton.

The Internal Revenue Service (IRS) is increasing its compliance efforts with regard to US subsidiaries of foreign companies that distribute goods in the US and report losses or low margins year after year. On October 20, 2023, the IRS announced its new initiative, the Large Foreign-Owned Corporations Transfer Pricing Initiative, whereby it sent "compliance alerts" to approximately 150 subsidiaries of large foreign corporations to reiterate those companies' tax obligations and encourage self-correction (IR-2023-194 (Oct. 20, 2023)). On January 12, 2024, the IRS announced its progress with regard to this initiative, stating that over 180 compliance alerts had been sent as of mid-November 2023 (IR-2024-09 (Jan. 12, 2024)).

Many taxpayers are unsure of what to make of these compliance alerts. This article describes what a compliance alert is, what it's not, the taxpayer alternatives, and the consequences of those alternatives.

What Is a Compliance Alert?

A compliance alert is a one-and-a-half-page form letter from the IRS to certain taxpayers (Letter 6608) that identifies the taxpayer as:

- A filer of Form 1120, *U.S. Corporation Income Tax Return,* and Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation*,
- Engaged as a distributor in the purchase and resale of tangible goods from a foreign related party, and
- Reported losses or low margins on its tax return for tax years 2017 through 2021.
  The alert indicated that those losses or low margins might indicate that the taxpayer's transfer pricing did not comply with §482 of the Internal Revenue Code because the IRS does not expect distributors with limited function, asset, and/or risk profiles to report losses or low margins for multiple years.

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The alert states that taxpayers are not required to respond and that the alert does not constitute an examination under §7605(b) or a contact regarding an examination under Treas. Reg. §1.6664-2(c)(3)(i)(A) for purposes of filing a qualified amended return. However, the alert does encourage a taxpayer receiving the alert to evaluate its transfer pricing policy, intercompany agreements, financial results, and Form 1120 to confirm its compliance with §482.

Following the evaluation of its transfer pricing, the alert advises the taxpayer of two alternatives:

- If the taxpayer believes that it has fully complied with §482, the taxpayer need not take further action, or
- If the taxpayer does not believe it has fully complied with §482, the alert recommends that the taxpayer file an amended return to correct the error.

A potential third alternative not mentioned in the alert would involve seeking an advance pricing agreement (APA) requesting rollback to all open years.

Consequences of the Taxpayer Response to the Alert

Most of the taxpayer exposures represented by the compliance alerts already exist for taxpayers. These include:

- Transfer pricing adjustment,
- §6662 penalty (the IRS has recently increased its commitment to asserting §6662 penalties, when warranted),
- Double taxation,
- Customs valuation impact (these are tangible goods imported into the US), and
- The substantial internal and external costs of resolving a transfer pricing dispute.
  However, the taxpayer's receipt of the alert and the monitoring of the taxpayer's tax returns may indicate an increased likelihood that a taxpayer will be examined and face these exposures.

Do Nothing. The taxpayer that receives an alert and chooses to do nothing should believe that the explanation for its 2017 to 2021 results will satisfy the IRS team, if in fact the IRS were to open a transfer pricing examination.

Amend Return. The taxpayer that amends its return will be changing its exposure. A taxpayer-initiated upward adjustment to US income would turn the exposure into reality; unfortunately, the IRS might still see that adjustment as inadequate. If the amended return is filed before the IRS initiates an examination (a qualified amended return), then the post-adjustment amount would be the starting point for any §6662 calculation. An upward adjustment to US income would create double tax, and the mutual agreement procedure (MAP) would generally be available to resolve any double tax with a treaty partner. A change to the transfer price may require reporting of the adjustment to Customs, but a Customs refund might be available in certain circumstances. Finally, an amended filing to increase taxable income may reduce the taxpayer cost and effort in any transfer pricing examination.

Seek an APA with Rollback. An APA with rollback could be an effective way to address all of the transfer pricing issues raised by a compliance alert, especially if that APA is bilateral. An APA with rollback to all

open years essentially guarantees that no further adjustment would be sought by the IRS. Assuming the APA is requested before an examination is initiated, the APA outcome is a qualified amended return, eliminating exposure to §6662 penalties. Double tax could be eliminated during the process by a bilateral APA. The need to report any adjustment to a Customs valuation issue would still exist. Finally, the cost of a bilateral APA with rollback is unlikely to exceed the cost of the regular dispute process.

Conclusion

Although the compliance alerts are not self-executing, they are an effective way for the IRS to point out that taxpayer results are inconsistent with IRS expectations and encourage taxpayers to evaluate their transfer pricing determinations and possibly self-adjust. The opportunity to avoid or reduce penalty exposure may be incentive enough for taxpayers to take a hard look at their existing transfer pricing policies and determinations.