Bloomberg Tax

Tax Management
International Journal™

September 12, 2023

Transfer Pricing and §6662 Penalties: The IRS Means It This Time

Steven C. Wrappe and Nina M. Nelson*
Grant Thornton LLP

For over 30 years, §6662(e) and (h) have provided for 20% and 40% penalties, respectively, for certain §482 transfer pricing adjustments made by the Internal Revenue Service ("IRS" or "Service"). For much of that period, the IRS did not apply the penalty provisions as assertively as the statute and regulations would allow. That has begun to change.

In 2018, the IRS Advisory Council observed in a Public Report (the "2018 Report") that although the quality of some transfer pricing documentation possibly fell short of the §6662 requirements, the IRS had not consistently asserted the penalty. In the years subsequent to the 2018 Report, the IRS produced guidance regarding common flaws in transfer pricing documentation and best practices and expressed a renewed commitment to applying §6662 penalties more frequently and rigorously. In recent years, IRS executives have repeatedly announced the Service's intention to apply these penalties more frequently than in the past, specifically stating that documentation must be of a sufficient quality to prevent imposition of the penalty. In light of this changed enforcement environment, taxpayers should self-assess their current transfer pricing documentation and determine whether any change is needed.

US TP Penalties and Enforcement

In order to improve taxpayer compliance with the arm's length standard and encourage taxpayers to make reasonable efforts to determine and document arm's length transfer prices, Congress enacted the §6662 penalties in 1989 which have been finalized, in most respects, since 1996 (*See* T.D. 8656, 61 Fed. Reg. 4876 (Feb. 9, 1996)). These penalties may be asserted on both a transactional and net adjustment basis and may produce a 20% or 40% penalty. The U.S. transfer pricing penalty regime provides for a reasonable cause and good faith exception that allows taxpayers to avoid the application of the 20% and 40% penalties if valid contemporaneous transfer pricing documentation is provided within 30 days of an IRS request (§6662(e)(3)(B)(i)). The documentation must demonstrate the reasonableness of the taxpayer's choice of pricing methods and must objectively contain certain information and fulfill certain

* Steven C. Wrappe is the National Technical Leader of Transfer Pricing in Grant Thornton's National Tax Office and an adjunct professor in the New York University and University of California- Irvine tax programs. Nina M. Nelson is a Transfer Pricing Manager in Grant Thornton's National Tax Office.

requirements. The ten criteria specifically enumerated in the U.S. transfer pricing rules for documentation include (Treas. Reg. §1.6662-6(d)(2)(iii)(B)):

1. Overview of taxpayer's business, including an analysis of the economic and legal factors affecting pricing;
2. Taxpayer's organizational structure;
3. Any documentation explicitly required under §482 (situation dependent);
4. Description of transfer pricing method selected;
5. Explanation as to why alternative methods were rejected;
6. Description of the controlled transactions and any internal data used in analyzing those transactions;
7. Information on comparables, including how comparability was evaluated and what (if any) adjustments were made;
8. Economic analysis and any financial projections relied upon;
9. Any pertinent data from after the end of the tax year but before the filing of the tax return; and
10. An index of the principal and background documents.

Historically, we have seen a limited number of §6662(e) and (h) penalties assessed by the IRS. In 1996, the IRS established the Penalty Oversight Committee to ensure the uniform application of the transfer pricing reasonableness and documentation standards on a national basis. The Committee reviewed all cases in which an IRS district office considered a penalty and collected data about cases where the penalty thresholds were met but no penalty was proposed. For the fiscal year ended September 30, 2006, 54 penalty years were approved. For the fiscal years ending September 30, 2007, 2008, 2009, and 2010, only 15, 21, 25, and 19 penalty years were approved, respectively. In 2011, the Committee was dissolved, as it was seen as no longer needed to provide awareness and consistent application of the transfer pricing penalty regime.

IRS Re-Thinks §6662 Enforcement

In November 2018, the IRS Advisory Council issued the 2018 Report addressing transfer pricing enforcement (p. 115). The 2018 Report cited the legislative history to Omnibus Budget Reconciliation Act of 1993 stating, "the penalty rules serve the dual purposes of holding taxpayers accountable for the reasonableness of their return positions and helping to motivate taxpayers and their advisors to not only take reasonable return positions but also to adequately document them." It went on to say "[d]uring recent years, the IRS and some external practitioners have observed that the quality of some transfer pricing documentation has declined to levels possibly falling short of the requirements of the statute and regulations, but the IRS has not consistently asserted the penalty."

The 2018 Report cited the then-recent IRS January 2018 LB&I Directive, "Instructions for Examiner on Transfer Pricing Issue Examination Scope-Appropriate Application of IRS §6662(e) Penalties" (the "Directive"), stating "unless a taxpayer's §6662(e) documentation is adequate

and timely, the regulations require the net adjustment penalty to be assessed in every case where the penalty thresholds are met" (LB&I-04-0118-003). The 2018 Report then commented that "merely maintaining and providing transfer pricing documentation is insufficient. Rather, the documentation must meet the requirements of section 6662(d) and the regulations thereunder … it is fair to anticipate that this Directive may increase the incidence of imposition of penalties and that it indirectly put taxpayers on notice that failure to satisfy the documentation requirements set forth in Treas. Reg. §1.662-6(d)(2)(iii) would result in penalties" (p. 114-115).

This trend of improper penalty enforcement by the IRS was also highlighted in a May 31, 2019 report issued by the Treasury Inspector General for Tax Administration (the "TIGTA Report") based on an audit conducted of 50 sample tax returns that had been audited by the IRS's Large Business & International Division ("LB&I") (Report 2019-30-036). TIGTA found that out of the 50 returns, there were 10 instances where examiners had not considered penalties, 10 instances where examiners did not justify their decision regarding penalties, 13 instances where there was no evidence of supervisor approval of penalty decisions and 13 instances with "substantial understatements" of income where there was no evidence of supervisor involvement in penalty development, all of which are violations of IRS policy.

IRS Executive Statements on TP Penalty Enforcement

Possibly in response to the reports described above, IRS officials have recently made public statements stating the IRS intention to more vigorously enforce transfer pricing penalties. On September 20, 2022, at the Tax Executives Institute Seminar, James B. Anwyll, the IRS Transfer Pricing Practice Director of Fields Operations said, "We're not doing enough of asserting penalties where the documentation reports are not sufficient and not reasonable" (*See* Kiarra Strocko, *IRS May Assert More Penalties for Transfer Pricing Documentation*, Tax Notes Today (Sept. 21, 2022)). Similarly on November 1, 2022, at the American Institute of CPAs National Tax Conference, Holly Paz, the IRS LB&I Acting Commissioner stated, "We continue to look more closely at cases, even those with transfer pricing documentation, to determine when it's appropriate to assert penalties." This sentiment was echoed again by Holly Paz, the IRS LB&I Acting Commissioner on November 15, 2022 at the American Bar Association Tax Section's Philadelphia Tax Conference when she was quoted as saying, "[w]e are thinking about economic substance, of sham transactions, and also assertion of penalties."

What's a Taxpayer to Do?

The 2018 Report recommended that the IRS provide more direct guidance to taxpayers with regard to "best practices and common flaws in transfer pricing documentation" and tasked the IRS with issuing frequently asked questions ("FAQs") around this topic. In response, the IRS published "Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs)." On its website, the IRS states how the FAQs are meant to provide taxpayers with reminders

about the relevant rules and offer insights about documentation best practices and that the FAQs are based on the IRS's observations of best practices and common mistakes in preparing transfer pricing documentation. The website also mentions how the suggestions and recommendations provided in the FAQs are consistent with the requirements in the regulations.

The six specific FAQs are:

1. What benefit(s), in addition to potential protection against penalties, pursuant to §6662(e)(3)(B), might there be for taxpayers who invest in robust transfer pricing documentation?
2. How can a "self-assessment" help to anticipate questions and prepare better §6662(e) documentation?
3. What is the IRS's guiding principle in establishing arm's-length prices were charged in intercompany transactions?
4. What are some areas the IRS has identified in transfer pricing documentation reports that could benefit from improvement?
5. What are some features of the most useful transfer pricing documentation reports?
6. Can you provide an example of a presentation of a company's intercompany transactions that would be a helpful summary for examiners to use in risk assessment?

These FAQs send the message that many studies are below standard and may not afford penalty protection. Per the FAQs, transfer pricing documentation must sufficiently demonstrate all of the following:

- Industry and company analysis sections of the report should be clear and provide context for related party transactions;
- Functional analysis narratives should be robust and link facts to the analysis;
- Risk analysis should be consistent with intercompany agreements;
- Support for best method selection must be provided, as well as the reason for rejecting specified methods;
- Complete comparability analysis should be provided;
- The impact of differences in risk or functions between the tested party and the comparable companies should be provided; and
- Detailed well-reasoned support for proposed adjustments to the application of a specified method should be provided.

Implications

The IRS has clearly indicated its intention to apply penalties under §6662(e) and (h) in transfer pricing assessments where documentation does not meet the standard. Although these penalties have been in place since the 1990s, the Service did not historically assert them as often as they could have. In the past five years, IRS messaging has changed significantly and

taxpayers should expect an increased likelihood of the IRS's application of penalties in the transfer pricing context.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.