US IRS issues set of FAQs for transfer pricing documentation

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Summary

The US Internal Revenue Services (IRS) has issued Frequently Asked Questions (FAQs) as an additional guidance to bring clarity and assist taxpayers in preparing a robust transfer pricing (TP) documentation and mitigate the risk of net adjustment penalties.

These FAQs are based on IRS's assessment of best practices to be followed and common mistakes to be avoided in TP documentation. These will help both taxpayer and the tax authorities to utilise their resources more efficiently and increase chances of audit deselection for taxpayers and more efficient audits.

Background

In January 2018, the IRS had issued directives to its employees related to appropriate application of penalties in certain TP examinations. One of the objectives behind the directives was to incentivise taxpayers to improve the quality of their TP documentation.

In this regard, the IRS received recommendations to issue FAQs to provide guidance to the taxpayers to improve their TP documentation. In line with the recommendations, the IRS has now issued FAQs.

Summary of FAQs

What are the benefits of good documentation beyond penalty protection?

A comprehensive and high-quality TP documentation helps to demonstrate low levels of compliance risk and thus assists in early deselection of the TP issue from further examination.

It allows the examining agent to rely on the taxpayer's analysis of functions, risks, intangibles, value drivers, etc., saving both the taxpayer and the IRS time in examining low-risk transfer pricing issues.

Thus, robust TP documentation facilitates more efficient TP risk assessments and examinations for both taxpayers and examiners.

What is the importance of self-assessment in preparing better documentation and anticipating questions from IRS?

Taxpayers may conduct a 'self-assessment' to identify potential indicators of TP non-compliance and proactively address concerns that the IRS might raise.

Taxpayers can undertake a basic sensitivity analysis by evaluating:

- parameters of application of the best method
- the strength of the comparability analysis of the benchmark companies[1]
- comparison of the tested party's results against a variety of profit level indicators (PLIs)
- how profits are shared between related parties and addressing whether such allocations are reasonable based on each party's contributions.

What are the guiding principles of IRS for approving arm's length price as determined?

IRS is guided by the principle enshrined in § 482 and the regulations thereunder, which includes the adequacy and reasonableness of TP documentation.

Taxpayers must apply best method to compare the results in controlled transactions with uncontrolled transactions.

- Where same information is available for analysis to both taxpayers and revenue authorities and documentation is prepared based on applicable regulations, the taxpayers and tax authority should materially reach similar conclusions.
- However, where perfect comparables are not available, comparability

[1] i.e. what happens to the range if a company is removed from the analysis

adjustments are required to improve comparability.

- Where comparables are not good enough to allow comparability adjustments, other TP methods should be evaluated.

What are the areas identified by the IRS for improvement in the TP documentation?

A comprehensive TP documentation can provide holistic outlook for ease of evaluation by way of following:

- **Industry overview vis-à-vis company's performance:** This section in a TP documentation shall provide details about the performance of taxpayer vis-à-vis comparable companies operating in same industry. It will help in evaluating whether any adjustments[2] are required.
- **Nexus of functions:** A detailed note on functions performed by each related party should be captured that establishes value driver and corresponding decision making for pricing of an inter-company transaction.
- **Identification of risks borne by each entity:** A strong TP documentation can be established if the risks related to the business are identified along with demonstration of actual onus if such risk is mitigated or backed by other entity. This shall assist in justifying the appropriate inter-company pricing aligned to actual risk bearing.
- **Selection/rejection of TP methods for benchmarking:** Narration for selecting the most appropriate method can be improved by way of documenting in-depth analysis such as reasonable efforts were made to identify comparable uncontrolled transactions or if some specific functions incline towards adopting a particular method such as PSM etc. Not only is the selection of one TP method essential but the rejection of

[2] such as economic adjustments related to pricing, capacity utilisation, special business circumstances or bad debts, etc.

other less suitable methods should also be documented.

- **PLIs:** A profit level indicator (PLI) plays a key role in comparability analysis. Adoption of an appropriate PLI for benchmarking the transaction, with necessary support to use such PLI, shall contribute to improved documentation.
- **Complete comparability analysis should be provided:** Taxpayers often fail to thoroughly address the comparability criteria enumerated in the regulations. While different methods impose different comparability requirements, differences between the controlled transaction/party and the uncontrolled transactions/parties should always be addressed.

  For example, if the purportedly comparable companies distribute different products from a different industry, an explanation should be provided to support the appropriateness of the comparability conclusion.
- **FAR reaching impact:** One of the primary and vital portions of a TP documentation is Function, Asses and Risk (FAR) analysis. Hence, impact of differences in such functions/risk should also be documented.

  This can assist in building a stronger and objective documentation with ease of intercompany pricing analysis and evaluation of economic adjustments.
- **Adjustments for precise comparability:** For establishing accurate comparability, certain adjustments may be required. IRS recommends that such adjustments be documented along with reasons in order to justify the need for same.

What are the features of most useful (detailed) documentation?

A robust documentation should have the following features:

- **Capture latest available information:** A robust TP documentation will contain latest possible information for accurate comparability.
- **Adoption of segmental vis-à-vis entity wide margins:** Depending on the relevance and nexus between business

operations, segmental accounts can be adopted for precise comparability. Complete explanation will provide a comprehensive view to evaluate efficiently and conclude on TP positions.

- **Risk analysis and allocation of risks:** A strong documentation should expressively detail out general risks vis-à-vis specific risks undertaken by each entity and attribution of such risks to revenue earned by each such entity.
- **Profit allocation:** Appropriate capturing of value chain analysis to provide right mix of profit allocation.
- Other features of most useful TP documentation are a detailed functional analysis, capturing of special/abnormal circumstances etc.

Inter-company transaction summary is a win-win

- An inter-company transaction summary can be prepared in the form of an executive summary capturing details of value of transaction, method adopted, benchmarking results vis-à-vis tested party's margin. It helps in defining a risk-based assessment by ensuring evaluation of transaction which has significant impact.

Our comments

The FAQs reiterate the importance of adequate and reasonable documentation and provides guidance to improve the quality of TP documentation.

It highlights some of the best practices that would make TP documentation robust and more useful to the stakeholders. This will also help businesses to focus on improvement of their documentation in line with the expectations of IRS to avoid protracted IRS audits.

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