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In this report, the authors trace the development of the IRS Large Business and International Division's new approach to transfer pricing enforcement, and they explain the practical implications for taxpayers and advisers.

A series of developments in recent years indicate that the IRS Large Business and International Division has been realigning its approach to transfer pricing enforcement to focus limited resources in areas that present higher compliance risks.

For example, a set of five directives on transfer pricing examinations, issued in January 2018, indicates that the IRS is taking an approach designed to conserve resources and focus on riskier cases while minimizing time spent on routine transfer pricing reviews and examinations. Those directives withdrew the requirement to issue a mandatory transfer pricing information document request (LB&I-04-0118-001), created new procedures for challenging taxpayers' selected transfer pricing method (LB&I-04-0118-006), clarified the application of section 6662(e) penalties (LB&I-04-0118-003), and brought to a halt examinations involving stock-based compensation (SBC) (LB&I-04-0118-005[1]) and multiple reasonably anticipated benefit (RAB) share (LB&I-04-0118-004[2]) issues in cost-sharing arrangements (CSAs).

More broadly, the August 2018 introduction of new transfer pricing examination guidelines confirms that the IRS is shifting to a risk-based approach, especially for transfer pricing. The August 2018 introduction of the transfer pricing examination process (TPEP), which replaced the 2014 transfer pricing audit roadmap, increases the importance of risk considerations to transfer pricing examinations. Further, a February 2019 LB&I memorandum (LB&I-04-0219-001) created a new requirement that IRS Exam teams consult with IRS advance pricing and mutual agreement personnel in cases in which tax treaties apply, which appears to be intended to increase the sustainability of IRS Exam transfer pricing adjustments. Consistent with a risk-based approach intended to conserve resources, the IRS is also trying to improve its implementation in other areas — for example, the application of

[1] Withdrawn by LB&I-04-0719-008 (July 31, 2019).

[2] Withdrawn by LB&I-04-0519-005 (May 21, 2019).

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penalties, as discussed later in the context of a Treasury Inspector General for Tax Administration report on penalties.[3]

These transfer-pricing-specific developments fit within a broader context of risk sensitivity within LB&I, which is most apparent in the division's strategy of campaign-based examinations. The campaign approach, which was announced in 2017, involves examinations centered on identified compliance issues rather than general audits of a taxpayer's return, and it reflects a strategic realignment in light of diminished budgetary and personnel resources.[4]

Together, the developments paint a cohesive picture of a risk-sensitive approach focused on identifying and addressing key compliance issues while avoiding the unnecessary expenditure of time and resources on issues that pose little risk or are unlikely to result in adjustments that can be sustained on appeal or in the competent authority process. At least theoretically, these developments should yield some benefits for taxpayers as well as the IRS: While the agency should be able to do more with less, taxpayers should benefit from reduced attention to nonissues and to theories that are unlikely to be sustained in competent authority. Yet LB&I's strategy has been marred by implementation problems, which, if not properly addressed, could allow tax returns with significant known compliance issues to escape notice while attention is focused on issues that in some cases may be more arbitrary than strategic.

Repeal of Mandatory IDR

LB&I-04-0118-001, titled "Interim Instructions on Issuance of Mandatory Transfer Pricing Information Document Request (IDR) in LB&I Examinations," eliminated the mandatory transfer pricing IDR requirement in most cases. However, an IDR requesting the taxpayer's transfer pricing documentation will still be issued in two circumstances, and the directive does nothing to curtail IRS examiners' discretion to issue an IDR requesting transfer pricing documentation when the examiner believes it is warranted by the facts.

Under prior guidance (for example, the "Langdon directive"[5]) and the IRS's 2014 transfer pricing audit roadmap, agency personnel were instructed to issue a mandatory IDR seeking section 6662(e) documentation at the commencement of all examinations involving related-party cross-border transactions. The mandatory IDR, typically sent with or shortly after the initial examination contact letter, triggered a statutory 30-day response period for the taxpayer and requested, among other things, principal documentation addressing the relevant transactions, accompanied by an index of the background documentation.

LB&I-04-0118-001 effectively removes the mandatory IDR requirement for many audits. Under the new procedures, a transfer pricing documentation IDR will be issued in only two instances: (1) examinations operating under an approved LB&I campaign that calls for the issuance of a mandatory transfer pricing documentation IDR, and (2) examinations in which transfer pricing practice (TPP) or cross-border activities (CBA) practice area personnel have been assigned to the case, either as consultants or team members, and have determined that an IDR is needed. These procedures are an attempt by the IRS to "manage transfer pricing issues under examination and related resources in the most efficient and effective manner possible."

One natural byproduct of the directive will likely be a reduction in the number of transfer pricing documentation IDRs issued, at least for low-risk taxpayers with few related-party transactions. TPP and CBA assistance should generally be used only in cases in which the IRS believes there is appreciable transfer pricing risk. Thus far, the treaty and transfer pricing operation campaigns address only inbound distributors and captive service providers, although some other LB&I compliance campaigns also bear on related-

[3]TIGTA, "Few Accuracy-Related Penalties Are Proposed in Large Business Examinations, and They Are Generally Not Sustained on Appeal," 2019-30-036 (May 31, 2019) (TIGTA penalties report).

[4]*See, e.g.*, TIGTA, "Initial Compliance Results Warrant a More Data-Driven Approach to Campaign Issue Selection," 2019-30-066 (Sept. 27, 2019) (TIGTA campaigns report).

[5]So called after Larry R. Langdon, then-commissioner of the IRS Large and Midsize Business Division (now LB&I), who issued a memorandum titled "Transfer Pricing Compliance Directive," dated January 22, 2003.

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party transactions, and the IRS plans to announce more campaigns in the future.[6] It appears that LB&I was intending to coordinate transfer pricing inquiries with its campaign-based examination strategy.

However, a recent TIGTA report on LB&I's campaign approach found that despite initial expectations, LB&I has been slow to implement its campaign-based strategy, with only 15 percent of exams generated by campaigns as of February 2019.[7] Moreover, TIGTA found that issues were often selected as the basis for campaigns based on employee suggestions or available training materials, and that LB&I did not use data regarding past compliance results and projected compliance impacts to formulate campaigns.

While LB&I agreed with TIGTA's recommendations and endeavors to improve the campaign process, it remains to be seen how the use and effectiveness of campaigns will develop.

Therefore, the delays in fully rolling out a campaign-based examination approach may have made the withdrawal of the mandatory IDR requirement premature.[8]

Because mandatory IDRs will be issued only in the context of specific campaigns or by TPP or CBA personnel, taxpayers will have an early indication of whether the IRS believes their circumstances pose a significant transfer pricing risk, and they may be able to anticipate whether an IDR will be issued. LB&I campaigns — to the extent the IRS decides to mandate the issuance of a transfer pricing documentation IDR in cases covered by the campaign — represent instances in which the IRS has decided in advance that particular risks exist. For non-campaign cases, mandatory IDRs must be issued by TPP or CBA personnel, and thus should have a TPP or CBA prefix (as opposed to, for example, IE or EC prefixes) and therefore will provide an early indication whether TPP or CBA personnel are involved and whether the IRS views the fact pattern as involving higher compliance risk.

Note, however, that IRS Exam teams do not always follow these directives precisely. Thus, despite the inconsistency with LB&I-04-0118-001, when TPP or CBA personnel are merely consulting on a case and/or approving an IDR issuance, it would not be surprising to see mandatory IDRs issued under IE or EC prefixes by the international examiner or economist. Taxpayers should be prepared to challenge mandatory IDRs that do not follow the rules set forth in LB&I-04-0118-001. However, the directive is not a source of formal authority, so taxpayers have limited ability to make Exam teams follow it. Nevertheless, in appropriate situations, we have seen some success in addressing these issues with IRS management personnel, who tend to be more concerned that Exam teams are following internal directives.

Because examiners retain the authority to issue IDRs requesting transfer pricing documentation after developing the factual context of a case, it remains to be seen whether a significant reduction in the number of transfer pricing documentation IDRs will result from this directive. In theory, this development should allow IRS Exam to better focus its resources on cases in which there are significant related-party transactions, and any reduction in IDRs may therefore be only for taxpayers that should not have received transfer pricing scrutiny in the first place. In any event, the IRS's clear objective is to prioritize the review of transfer pricing documentation in higher-risk cases over broad coverage and review of all LB&I taxpayers' documentation.

Still, the fact that many taxpayers' transfer pricing documentation may go unrequested and unexamined under this new approach does not mean that taxpayers should forgo preparing documentation, especially given the heightened standards laid out in the transfer pricing penalty directive (LB&I-04-0118-003), discussed next. Of course, some taxpayers with de minimis or low-risk related-party transactions may decide that the expense inherent in preparing documentation is no longer justifiable, but those conclusions should be based on a cost-benefit analysis after careful consideration.

Heightened Scrutiny of Documentation

LB&I-04-0118-003, titled "Instructions for Examiners on Transfer Pricing Issue Examination

[6] LB&I, "Large Business and International Active Campaigns" (updated Feb. 27, 2020). Other existing campaigns include the microcaptive insurance and the related-party transactions campaigns, both of which are run by the enterprise activities practice area.

[7] TIGTA campaigns report, *supra* note 4.

[8] *See id.*

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Scope — Appropriate Application of IRC Section 6662(e) Penalties," directs IRS Exam personnel to apply a heightened level of scrutiny to section 6662(e) transfer pricing documentation. While the directive does nothing to change the current state of the law under section 6662 and the applicable regulations, it instructs examiners to tighten their scrutiny of section 6662(e) documentation. The IRS's objective is to ensure that the agency is "properly using a legislative tool intended to encourage taxpayer compliance" and to increase the "incentive for taxpayers to initially provide adequate and timely documentation."

Assuming that a transfer pricing adjustment is made, the directive clarifies that the section 6662 transfer pricing penalty should apply when taxpayers (1) failed to create documentation contemporaneously,[9] (2) failed to provide the documentation within 30 days of the IRS's request for it, or (3) furnished documentation that was "unreasonable or inadequate."

That is, LB&I-04-0118-003 clarifies that to provide protection against the transfer pricing penalty, section 6662(e) documentation must be both timely (meaning contemporaneous and timely provided to the IRS) and adequate (sufficient to show that the taxpayer reasonably concluded that its method selection and application provided the most reliable measure of an arm's-length result). Historically, transfer pricing penalties have rarely been asserted when some material level of documentation has been contemporaneously produced and timely provided. In fact, practitioner experience has been that penalties are rarely applied even in the absence of any contemporaneous documentation. Therefore, although the directive is in line with the statute, regulations, and congressional intent, this apparently higher standard is a significant shift in the IRS's practical interpretation and enforcement of the section 6662(e) documentation rules.

LB&I-04-0118-003 says that section 6662(e) documentation is defined such that it is limited to documentation that was (1) prepared before the return was filed and (2) provided to the IRS within 30 days of request. Taxpayers may not defend against penalties by supplementing section 6662(e) documentation with documents that were either prepared after the return was filed or not provided to the IRS within 30 days of request. Therefore, taxpayers should ensure that their section 6662(e) documentation is timely created and provided if they want it to be effective. Taxpayers and advisers should ensure that documentation is complete, and they should retain evidence of its completion before the return filing date.

Not only does taxpayers' section 6662(e) documentation have to be timely, it must also be adequate to be effective protection against a proposed penalty. The directive refers to "the regulations" — presumably, reg. section 1.6662-6(d)(2)(ii)(A)(1) through (7) — for the factors that examiners should consider in evaluating the adequacy of taxpayers' section 6662(e) documentation. Thus, there are no new requirements implemented by this directive, and no change in the framework for assessing the adequacy of documentation, but there is a shift in focus and sufficiency.

For example, LB&I-04-0118-003 says that section 6662(e) documentation should include an explicit analysis and conclusion that the method used is the best method.[10] Failure to include that analysis and conclusion will result in imposition of the transfer pricing penalty if the penalty thresholds are met. Further, it echoes the best method directive (LB&I-04-0118-006), discussed later, by providing that examiners' analysis should start with the taxpayer's selection of the best method, assuming this is supported by timely and adequate section 6662(e) documentation.

Moreover, LB&I-04-0118-003 instructs examiners to consider sources of information beyond the section 6662(e) documentation to determine if the information in the documentation is adequate. For example, examiners should consider what information was or should have been available to the taxpayer to determine whether it adequately incorporated and addressed those data in the analyses in its

[9] To be effective, documentation must be contemporaneous — that is, it must be in existence as of the filing of the taxpayer's return. Reg. section 1.6662(e)(3)(B)(ii).

[10] *Cf.* reg. section 1.6662-6(d)(2)(ii)(A) and (iii)(A).

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section 6662(e) documentation. Taxpayers and advisers may wish to consider whether more information typically included in background documentation, due diligence, or workpapers should be included as part of the primary section 6662(e) documentation.

In addition to penalties and method selection, transfer pricing documentation now feeds more broadly into a formal risk assessment process, because the TPEP instructs examiners to look to documentation with an eye on identifying and pursuing risk. This heightened scrutiny into the sufficiency of transfer pricing documentation — both in terms of defending against penalties and persuading the IRS that the taxpayer's transfer pricing is arm's length — has significant implications for both taxpayers and advisers, who should ensure that strong, well-reasoned, and detailed documentation is produced in a timely fashion. Without changing the letter of the law, the IRS has raised the bar for section 6662(e) documentation, and taxpayers and advisers would be wise to meet that new standard.

Pause in Single RAB Share Adjustments

LB&I-04-0118-004, titled "Instructions for Examiners on Transfer Pricing Selection — Reasonably Anticipated Benefits in Cost Sharing Arrangements," instructed LB&I examiners, until an IRS-wide position on the issue could be finalized, to stop making adjustments to CSAs by changing a taxpayer's multiple RAB shares to a single RAB share when subsequent platform contribution transactions (PCTs) are added to an existing CSA. On July 26, 2018, the IRS Office of Chief Counsel finalized the IRS's position, releasing a memorandum (AM 2018-003) concluding that multiple RAB shares may be used in a single CSA, but only if that is the most reliable approach.[11] This rendered the RAB share directive effectively moot, and the issuance of LB&I-04-0519-005 in 2019 formalized its withdrawal in light of the chief counsel memorandum, thus ending the saga.

[11] AM 2018-003 states: "This advice may not be used or cited as precedent." *See also* section 6110(k)(3) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent."). However, as a practical matter, it appears that it would be difficult for the IRS to disavow the position taken in the memorandum.

The initial directive and the later memorandum address situations in which a U.S. participant in an existing CSA acquires intangible property and makes it available to a foreign CSA participant through a subsequent PCT. The PCT may generate profits to the participants in proportions different from the preexisting RAB shares. When this is the case, a taxpayer has three potential RAB share ratios under the CSA: (1) the preexisting RAB shares; (2) the RAB shares related to the intangible property made available by the subsequent PCT; and (3) updated RAB shares resulting from combining the newly acquired intangible property with the preexisting intangible property covered by the CSA.

Practically, this leaves taxpayers with the options of (1) having multiple RAB shares (that is, one ratio for the preexisting intangible property covered by the CSA and a different ratio for the newly acquired intangible property made available by the subsequent PCT); or (2) updating their preexisting RAB shares to take into account the newly acquired intangible property and using that single updated RAB share ratio.

The IRS issued the initial directive because some examination teams had taken the position that reg. section 1.482-7 requires the use of a single RAB share if subsequent PCTs occur. That position was based on an example in reg. section 1.482-7(g)(5)(v) that addresses the use of the acquisition price method to determine the PCT. It states that each participant's preexisting RAB share is "not reasonably anticipated to change" as a result of the acquisition. Presumably, the inference Exam teams were making rested on the fact that the example specifically notes that the RAB share is not expected to change, which could imply that the preexisting RAB share should change when the circumstances require this, and thus that multiple RAB shares are impermissible.

The Office of Chief Counsel, however, disagreed with those arguments, instead finding that reg. section 1.482-7(e)(1)(ii)'s requirement that RAB shares "be determined by using the most reliable estimate" mandates the use of multiple shares when doing so provides the best estimate and, conversely, requires the use of a single blended share when doing so is more reliable. AM 2018-003 went beyond the scope of the RAB share directive, concluding that multiple RAB shares may be used both in the context of a

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subsequent PCT added to an existing CSA and in the context of separate cost pools under a single CSA.

Although the RAB share directive provided relative certainty that the use of multiple RAB shares would go unchallenged, at least for an interim period, this is no longer the case after the publication of AM 2018-003 and the subsequent formal revocation of the directive. While the memorandum generally continues the approach articulated in the directive, the announcement of an IRS-wide position on the issue means that Exam teams are no longer barred from changing multiple RAB shares into a single share if they conclude that the latter alternative more reliably estimates RAB. Indeed, the more recent directive (LB&I-04-0519-005) specifically instructs Exam teams to "continue with the application of the most reliable method depending on the facts and circumstances of each case to determine the appropriateness of using single or multiple RAB shares with respect to a single CSA," and to consult with the TPP network and IRS chief counsel when needed.

The acceptability of a taxpayer's use of RAB shares ultimately turns on what provides the most reliable estimate, which is an inherently factual inquiry. Under the new IRS position, taxpayers with CSAs — even if they use only a single RAB share — need to consider whether their approach provides the most reliable estimate in order to assess and address controversy risk.

SBC Exams and *Altera* Result

LB&I-04-0118-005, titled "Instructions for Examiners on Transfer Pricing Selection — Cost-Sharing Arrangement Stock Based Compensation," directed examiners in January 2018 to temporarily stop opening issues related to SBC included in CSA intangible development costs until the Ninth Circuit issued an opinion in the *Altera* appeal. The course of the *Altera* litigation has been tortuous: Although the Ninth Circuit released an opinion in July 2018 reversing the Tax Court,[12] it withdrew that opinion two weeks later,[13] only to again reverse the Tax Court in a second opinion, issued June 7, 2019.[14] Before that opinion became final,[15] the IRS issued a second directive (LB&I-04-0719-008) formally withdrawing the SBC directive after considering the June 7, 2019, opinion.

While in effect, LB&I-04-0118-005 stated that "no new examinations of CSA SBC issues" would be started until *Altera* was decided. For examinations already underway, it instructed examiners to discontinue development of SBC issues only if the taxpayer agreed to extend the statute of limitations for a period long enough to allow for the final outcome of *Altera* to be known and for any additional issue development work. If the taxpayer did not agree to extend the statute of limitations, the Exam team would continue to pursue the SBC issue. Examinations and adjustments concerning issues other than the inclusion of SBC in the cost pool under a CSA were not limited by the directive.

LB&I-04-0118-005 also acknowledged the related issue of inclusion of SBC in charges for intercompany services. As noted in the directive, the IRS expected that taxpayers would rely on the reasoning of the Tax Court opinion in *Altera* to argue that SBC should not be included in services costs because it is not included by third parties in services contracts. For those cases, LB&I-04-0118-005 did not require examiners to refrain from opening this issue in an exam, but instead directed them to consult with LB&I counsel to determine whether the issue was factually distinguishable from the SBC issue in *Altera* and decide whether to pursue it as part of an examination.

Although no longer in effect, the directive's overall approach displays a valuable awareness that resources should not be squandered in developing a large number of contentious cases before the IRS's approach has received the sanction of a court in a test case. At the same time, the directive's insistence that Exam teams obtain

[12] *Altera Corp. v. Commissioner*, Nos. 16-70496 and 16-704976 (9th Cir. 2018).

[13] *Altera*, 898 F.3d 1266 (9th Cir. 2018) (order withdrawing prior opinion).

[14] *Altera*, 926 F.3d 1061 (9th Cir. 2019), *rev'g* 145 T.C. 91 (2015).

[15] The opinion became final with the issuance of the Ninth Circuit's mandate on November 20, 2019, although a petition for a writ of certiorari was filed February 10, 2020.

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statute extensions in exchange for declining to explore SBC issues in open cases helped ensure that the IRS delay potential action rather than forgo it entirely. LB&I-04-0118-005 may signal that the IRS is willing to shift focus away from a string of potentially unproductive fact patterns to more fruitful areas of controversy and litigation. Importantly, the withdrawal of the directive, like its initial promulgation, was grounded in principles of efficient resource management.[16]

Limits on Method Selection Challenges

LB&I-04-0118-006, titled "Instructions for LB&I on Transfer Pricing Selection and Scope of Analysis — Best Method Selection," requires Exam and advance pricing agreement teams to follow new approval processes before challenging a taxpayer's selection of a transfer pricing method, but only in some circumstances. If there is an adequate best method analysis and selection in the taxpayer's contemporaneous transfer pricing documentation or APA submissions, Exam and APA teams must obtain treaty and transfer pricing operations (TTPO) Transfer Pricing Review Panel approval before challenging the taxpayer's selected transfer pricing method.

Transfer pricing method selection under section 482 is governed by the best method rule of reg. section 1.482-1(c), which requires that the taxpayer apply the method that "provides the most reliable measure of an arm's length result." Because method selection under the section 482 regulations comes down to a judgment call about what, given the circumstances of the taxpayer's case, most accurately reflects an arm's-length price, there is substantial space for disagreement. Even the flawless application of a selected transfer pricing method will not shield a taxpayer from controversy if the IRS determines that the method applied was not the best method. The directive does not change that basic principle, but it does make it harder for the IRS to make the determination that the taxpayer's selected method is not the best one.

The procedures prescribed by LB&I-04-0118-006 apply to two sets of taxpayers: those that are "LB&I taxpayers" (assets of at least $10 million) and are required to file Form 5471 or 5472 with their annual tax returns,[17] and all taxpayers in the APA program. The examinations to which the directive applies are TPP examinations, examinations involving CBA personnel, and those by geographic practice area agents without TPP participation.

For the new approval requirement to apply, the directive states that the taxpayer under examination must timely provide with its section 6662(e) documentation or APA submission a report that clearly identifies the selection of a method, concludes that the method selected is the best method, and provides an analysis supporting that conclusion. Of course, transfer pricing documentation will suffice for this purpose only if it is contemporaneous, timely provided to the IRS upon request, and adequate, as explained earlier regarding the new transfer pricing penalty directive.

When the taxpayer falls into one of the specified categories and has provided adequate supporting documentation, LB&I-04-0118-006 requires an IRS Exam team to consult with and obtain TTPO approval before contesting the selection of a transfer pricing method. Although the directive notes that the use of unspecified methods may be subject to increased scrutiny at the exam stage, TTPO approval is still required before an unspecified method can be changed. The choice to remove the best method determination from the sole discretion of the examination team is not grounded in any notion of deference to taxpayers' analysis. Rather, it is motivated by LB&I's recognition that it has "limited transfer pricing resources," which are "divert[ed]" by ignoring the taxpayer's analysis and "start[ing] the best method selection analysis from scratch."

Thus, Exam teams are directed to start with the taxpayer's selection of the best method rather than make their own best method determinations *de novo*. LB&I-04-0118-006 instructs them to thoroughly analyze the taxpayer's method application and develop and document any

[16] Ryan Finley, "Ninth Circuit's *Altera* Decision Didn't Cause a Circuit Split," *Tax Notes Federal*, Nov. 11, 2019, p. 1051 (reporting remarks of TPP Director of Field Operations John Hinman).

[17] Reg. section 1.6046-1 lays out the requirements for who must file Form 5471, and reg. section 1.6038A-2 gives the requirements for Form 5472.

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changes to that application at an early date. It suggests that when Exam teams do consider recommending a method change, they consult the examples of best method selection in reg. section 1.482-8.

In the APA context, LB&I-04-0118-006 indicates that the APA team must follow the same approval process to change the appropriately documented selection of a method as the best method (or, in a bilateral APA request, the "most appropriate method" under the OECD transfer pricing guidelines[18]). However, the directive provides that when formal competent authority negotiations concerning a bilateral APA are underway, the competent authorities may change the method selection without consulting with or securing approval from TTPO.

The specific procedure for securing TTPO approval requires elevating the recommendation for a method change through the applicable management chain until it reaches a director of field operations, who is responsible for referring it to the national TTPO Transfer Pricing Review Panel. The panel consists of the TPP director or, if the issue arises in the context of an APA, the APMA program director; a senior adviser to the TTPO director; and the income-shifting practice network manager. The panel will look at "(1) Why the taxpayer's method is unreliable, (2) Whether the taxpayer's method can be adjusted to make it more reliable, and (3) If not, what method is more reliable, and why." To facilitate this process, the initial recommendation from the Exam or APA team must address these questions and be accompanied by an analysis supporting the alternative method selection.

The restraints that this directive imposes on Exam and APA teams' ability to dispute method selection clearly benefit taxpayers. LB&I's reluctance to continue expending scarce resources in difficult-to-win fights over the best method determination should mean that more taxpayers will survive examination or APA negotiations with their desired transfer pricing method intact.

Yet the directive does not mean that LB&I is not still interested in method selection issues. In early 2019 APMA released a functional cost diagnostic model, which applies a cost-based, residual profit-split analysis for use in some APA cases, and IRS personnel have indicated that the model may also be appropriate for use by Exam.[19] Although the functional cost diagnostic model is not intended to suggest that the profit-split analysis is the best method, it is conceived of as a method selection diagnostic and, when requested from a taxpayer, indicates that APMA is at least considering challenging the proposed method.

Moreover, taxpayers must take care under the new regime. Section 6662(e) documentation has become even more critical to reducing controversy exposure, because taxpayers with documentation that lacks a clearly identifiable analysis and conclusion on method selection will find themselves open to challenge without the need for TTPO approval. Further, LB&I-04-0118-006 may result not so much in a decrease in transfer pricing controversy as in a shift in focus: While fewer method selection challenges are to be expected, the directive's guidance may lead to more disputes over method application.

Then, too, there always remains the possibility of changes to a taxpayer's best method determination with TTPO approval, and in theory, those changes should be well substantiated and thus potentially harder for taxpayers to overcome than past method selection disputes. Moreover, because LB&I-04-0118-006 "is not an official pronouncement of law and cannot be used, cited or relied upon as such," a taxpayer would be unable to make any formal challenge if an Exam or APA team deviated from the directive and made an unapproved method change, although involving IRS management personnel could be helpful in those situations.

The directive should generally limit "one size fits all" comparable profits method approaches from IRS Exam teams. It is common for IRS Exam teams and economists to test the taxpayer's transfer pricing on a CPM basis, regardless of the taxpayer's selected method. Likewise, IRS Exam teams frequently ignore related-party contractual

[18] *See* OECD, "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017," at para. 2.2 ("The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case.").

[19] *See* Finley, "IRS Examiners May Use APMA Diagnostic Tool in Some Cases," *Tax Notes Int'l*, Apr. 8, 2019, p. 198.

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arrangements and key facts in order to support their CPM-based approaches. IRS management is clearly focused on curtailing this widespread reliance on the CPM and moving IRS Exam teams to consider pricing in a more open and efficient manner. Similarly, the functional cost diagnostic model indicates a developing awareness that the IRS should consider profit-split methods rather than one-sided CPM testing in appropriate cases.

Further, many taxpayers test their related-party arrangements on a CPM basis, at least in documentation, because of the ease and cost-effectiveness of that approach. LB&I-04-0118-006 and the functional cost diagnostic model — especially coupled with the penalty directive's focus on best method analysis and its heightened standards for avoiding penalties — suggest that taxpayers should reevaluate their transfer pricing methods, both on a transactional basis and, above all, in their documentation. Although putting in more effort and thought upfront regarding a transfer pricing method has always been the best practice, these directives mean that this approach could now pay off even more.

In short, LB&I-04-0118-006 should limit the number of IRS challenges to taxpayers' method selection, but taxpayers must take care that their method application is proper and that their documentation sufficiently addresses method selection. Taxpayers should not rely on the directive to shield against challenges to aggressive stances on method selection, but they may benefit from the procedures it requires, which should reduce controversy regarding defensible method selections that are properly applied and documented.

TPEP Retools Exam Procedures

The 2014 transfer pricing audit roadmap was replaced in August 2018 by the TPEP, which is similarly intended to assist IRS employees and practitioners in the planning, execution, and resolution of transfer pricing examinations, and takes a generally similar approach. The TPEP, like the prior roadmap, offers audit techniques, case development tools, and general best practice reference material. While the TPEP is an attempt to address the key issues faced in a transfer pricing audit, it is not a general template. In that regard, the TPEP notes that each case presents unique facts and circumstances, and the planned timeline should be specific to the facts of each case. However, by establishing a general timeline and framework, the IRS seeks to provide guidance on key issues of case management, fact development, and issue presentation.

One change is that while the roadmap was structured around a suggested 24-month audit timeline, the TPEP recognizes that many transfer pricing examinations in fact take substantially longer than two years to complete. Therefore, the TPEP includes separate timelines for 24-month and 36-month examinations (depending on the complexity of the issues and the fact-finding necessary) and also recognizes that actual timelines may vary based on the facts of each case. By offering a more guided examination approach, the IRS hopes to increase efficiency and address taxpayer concerns about fishing expeditions (that is, theories in search of fact) while offering "a good foundation for organizing and formulating a complete analysis at the end of the examination process." The suggested audit timelines are organized around three key periods: a planning phase, an execution phase, and a resolution phase.

Another key evolution of the TPEP is that it places risk even more at the center of transfer pricing examinations, requiring both an initial risk assessment and a subsequent reassessment. Interestingly, the initial risk assessment must involve consultation with IRS APMA when the taxpayer's intercompany transactions involve a U.S. treaty partner.[20] As discussed in more detail in the next section, the objective appears to be to increase the quality of IRS transfer pricing adjustments and reduce the number of aggressive adjustments referred to APMA, which have often been reduced or eliminated in competent authority proceedings.

The planning phase and initial risk assessment include a review of materials available to the IRS from prior audits, as well as an analysis of the taxpayer's income tax returns, which will focus on subpart F and permanent establishment issues as well as transfer pricing. The Exam team will also analyze the taxpayer's country-by-country report, compute key financial ratios, and

[20] *See* TPEP para. 11.10.

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benchmark them against industry norms. Forms 10-K, taxpayer websites, and other publicly available information on a taxpayer's operations are also included in this initial review, which will conclude with the development of a preliminary working hypothesis.

Upon moving into the execution phase, the TPEP contemplates that examiners will engage in further risk assessment, which will involve a review of the taxpayer's section 6662(e) transfer pricing documentation. The IRS will request meetings for financial statement and transfer pricing/supply chain orientation, which will further inform its risk assessment, and it will continue to reassess risk throughout the execution phase of the audit. Although the TPEP intends that risk assessment be a continuous process, it suggests that examiners prepare a formal midcycle risk analysis to reflect changes in the risk assessment, and discuss this analysis with the taxpayer.

Like the roadmap before it, the TPEP requires the development and use of a working hypothesis throughout the examination. The working hypothesis then operates as a key element of the iterative process of risk reassessment, which should occur during the exam. As part of risk reassessment, the working hypothesis is reviewed, revised, and when necessary, discarded based on the development and documentation of new factual information. For example, the TPEP encourages Exam teams to keep an open mind about the case and practice strategic abandonment, which means that when information comes along that is inconsistent with the Exam team's theory, the team should either adjust its theory or conclude that the theory should not be pursued.

In our experience, adherence to the generally helpful principles and recommendations of the TPEP (and the roadmap before it) is inconsistent among IRS Exam teams.

APMA-Exam Consultations

On February 19, 2019, LB&I released a directive (LB&I-04-0219-001) announcing mandatory consultations for IRS Exam issue teams with APMA personnel. The new procedure, which is motivated by concerns of efficiency and effective use of specialized resources, applies to exams of LB&I taxpayers in which a potential transfer pricing adjustment would involve a U.S. treaty partner, regardless of whether APMA has an effective mutual agreement procedure relationship with the country in question. The requirement for APMA consultation during risk assessment and execution of an examination has also been reflected in the TPEP.

Consultations with APMA personnel will cover both procedural and substantive issues and will enable APMA to form an opinion on whether contemplated adjustments are justifiable under the applicable treaty. Although issue teams, rather than APMA, have the final say on whether to pursue issues, the consultation procedure should facilitate effective coordination and reduce the waste of IRS and taxpayer resources that results when Exam adjustments are eliminated in a MAP proceeding. Presumably, the objective is to reduce the amount of poorly developed IRS transfer pricing adjustments that APMA must deal with in competent authority, which has led to a high level of unilateral elimination or reduction of adjustments by APMA.[21]

Improving the Administration of Penalties

The message of the penalties directive (LB&I-04-0118-003) is echoed in a TIGTA report from May 31, 2019.[22] The title of the report aptly summarizes its message: "Few Accuracy-Related Penalties Are Proposed in Large Business Examinations, and They Are Generally Not Sustained on Appeal." Accuracy-related penalties are governed by section 6662. In addition to the transfer pricing penalties, they include penalties for negligence, substantial understatement of tax, non-transfer-pricing valuation misstatements, and transactions lacking economic substance.[23]

TIGTA found that out of 4,600 LB&I exams resulting in additional assessments exceeding $10,000 between 2015 and 2017, only 295 cases, or 6 percent, included accuracy-related penalties

[21] *See* Government Accountability Office, "Opportunities Exist to Improve IRS's Management of International Tax Dispute Resolution," GAO-19-81 (Mar. 2019) (indicating that a large number of MAP cases are conceded by APMA).

[22] TIGTA penalties report, *supra* note 3.

[23] *See* section 6662(a).

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under section 6662. In total, TIGTA identified 519 LB&I cases (out of 6,709 reviewed returns) in which section 6662 penalties were proposed during those years. The total penalties proposed in these 519 cases were $1.5 billion. Of those 519 cases, 308 were appealed, and as of December 2018, 195 had been resolved in Appeals, resulting in the elimination or reduction of penalties in 183 cases, or 94 percent, for a total reduction of $765 million. In 153 of these Appeals cases, the penalty was eliminated entirely; for the remaining 30, aggregate penalties of $26.7 million were reduced to $2.5 million following Appeals. TIGTA also reviewed the differences in these LB&I results, which pertain only to large corporate taxpayers, and penalty assessment by the IRS Small Business/Self-Employed Division, and found that SB/SE assessed section 6662 penalties in 25 percent of cases, as opposed to LB&I's 6 percent rate.

These numbers suggest a clear narrative: LB&I is proposing too few penalties, and too many are being discarded in Appeals. Yet this is not necessarily the correct narrative. The report has drawn criticism for "viewing penalties as a revenue raising tool rather than a compliance tool" and for suggesting that LB&I and SB/SE should impose penalties with comparable frequency.[24] Indeed, based on the rate at which proposed penalties are abandoned or significantly reduced on appeal, it would be possible to argue that LB&I Exam is proposing too many accuracy-related penalties.

Nonetheless, the TIGTA report on penalties sends an important message, and its procedural discoveries are probably more important than its statistical findings. TIGTA found that, in contravention of IRS policy, LB&I examiners "are not always considering penalties, not always supporting their decisions for nonproposal of accuracy-related civil penalties, and not always involving supervisors in penalty development and approval as required."[25] Under section 6751(b)(1), penalties may not be assessed without written supervisory approval of the initial penalty determination, and if the IRS fails to prove compliance with that requirement, a penalty assessment may be reversed.[26] TIGTA also found shortcomings in internal quality review processes and case file retention.

TIGTA recommended that LB&I:

> Ensure that examiners and supervisors are trained to: 1) consider the accuracy-related penalty for all applicable examination cases; 2) follow the proper procedures to document all actions taken during penalty consideration and development, whether proposing or not proposing the penalty; and 3) follow the requirements for supervisory involvement and timely, written approval of all penalty decisions.[27]

LB&I agreed with this recommendation and stated that "the Penalty Practice Network will provide materials for all LB&I employees on procedures to document penalty considerations and development and the requirements for supervisory involvement and timely written approval of penalty decisions. The Penalty Practice Network will also consider revising the penalty lead sheet to address this recommendation."[28]

TIGTA further recommended that the Internal Revenue Manual be revised to provide additional clarity on penalty procedures, ensure that quality review systems can accurately determine who is responsible for various steps related to penalty assessment, and evaluate and improve record retention practices. LB&I agreed with those recommendations as well. Lastly, TIGTA recommended that LB&I conduct a study to determine why Appeals was rejecting so many proposed penalties and to evaluate whether examiners were properly taking all the facts into account when proposing penalties. LB&I partially agreed with this recommendation, but it noted that the different missions of LB&I and Appeals, as well as the fact that many penalties will be removed in Appeals as a result of underlying issues, would make it difficult to determine the reasons Appeals eliminated or reduced penalties.

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[24] Eric Yauch, "Practitioners Poke Holes in TIGTA Report's Penalty Theories," *Tax Notes*, June 10, 2019, p. 1723.

[25] TIGTA penalties report, *supra* note 3, at 9-10.

[26] *See, e.g.*, *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017).

[27] TIGTA penalties report, *supra* note 3, at 14-15.

[28] *Id.* at 15.

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Whatever methodological flaws it may have, the TIGTA penalties report indicates that key stakeholders in the IRS and Treasury believe penalties should be considered and asserted with greater regularity, and that LB&I plans to implement that approach. Taxpayers should expect increased consideration and better documentation of accuracy-related penalties, and they will likely encounter fewer cases in which proposed penalties will be hamstrung by procedural deficiencies, such as a failure to obtain section 6751(b)(1) approval. Together with the directive on transfer pricing penalties, this indicates a move toward a world in which section 6662 penalties are no longer reserved for egregious cases, but rather may be routinely applied in all audits with adjustments that technically satisfy the section 6662 criteria for penalty application. While procedural improvements may also help proposed penalties fare better in Appeals, it remains to be seen whether any increase in penalty activity at the LB&I Exam level will survive Appeals review. Nonetheless, taxpayers should take note of the renewed attention to penalty application at the Exam level that is evinced by the LB&I directives on method selection challenges and penalties enforcement.

Conclusion: LB&I's New Approach

Much in these developments is poised to ease the burden for taxpayers in the short term. Transfer pricing inquiries, in the absence of the mandatory IDR, will no longer be a routine feature of all examinations for taxpayers with cross-border related-party transactions. Exam and APA teams should launch fewer method selection challenges, and Exam should dedicate less time to issues that APMA will be unlikely to prevail on in MAP. Still, as discussed earlier, optimism must be tempered by an appreciation of the context of these developments, both individually and as a whole.

LB&I's new approach is grounded in principles of resource conservation and risk-tiering, and represents a reshuffling, not a retreat from transfer pricing controversy. Other countries have experienced considerable success with a risk-tiering approach to transfer pricing examinations, one prominent example being the Australian Taxation Office. Experience has shown that risk-tiering and risk-based examinations can be tough and effective.

Yet issues in implementation may undermine the effectiveness of these developments. For example, as discussed earlier, while the penalties directive instructs examiners to consider and assess penalties consistently and methodically, LB&I practice has generally fallen short of that standard. It is too early to tell whether LB&I's reformulated approach will in fact be effective, or whether it will fall short because of implementation issues. But LB&I's risk-based approach has significant potential and should not be underestimated by taxpayers.[29] ■

[29] The information in this article is not intended to be "written advice concerning one or more federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

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