

AN ALERT FROM THE BDO TRANSFER PRICING PRACTICE

BDO KNOWS: TRANSFER PRICING



► SUBJECT

INTERNAL REVENUE SERVICE RELEASES GUIDANCE REGARDING THE STAGES OF THE TRANSFER PRICING EXAMINATION PROCESS, AND PROVIDES RECOMMENDED AUDIT PROCEDURES AS WELL AS SOURCES OF REFERENCE MATERIAL.

► INTRODUCTION

On February 14, 2014, the Internal Revenue Service released the *Transfer Pricing Audit Roadmap* (the "Roadmap"), which provides an outline for the stages of a transfer pricing audit. The Roadmap is intended for use by international examiners involved in 24-month audits, and states that transfer pricing specialists should be involved prior to the audit's commencement. The Roadmap is a useful tool for taxpayers, as it indicates the type of information and documents that a taxpayer will be asked to provide in order to support their intercompany transactions, as well as the timeline for which the taxpayer will be expected to do so. The Roadmap emphasizes that fact development is the focus and strength of the Service's examination teams and even a strong transfer pricing position may not be sustained upon review if the supporting facts are insufficient. The current version of the Roadmap is a work in progress, and the Service encourages users to submit suggestions for improvement.

► DISCUSSION

The Roadmap asserts that the ultimate goal of a transfer pricing audit is to determine whether a taxpayer's financial results are reasonable given its value chain and competitive position within its industry. The Roadmap organizes the progression of a transfer pricing audit into three phases: planning, execution, and resolution.

The Planning Phase should span roughly the first six months of an audit, during which the audit team should ascertain facts regarding the taxpayer's history,

CONTACT:

ROBERT PEDERSEN, New York
212-885-8398 / rpedersen@bdo.com

WILLIAM F. ROTH III, Grand Rapids
616-776-3761 / wfroth@bdo.com

VEENA PARRIKAR, San Jose
408-352-3534 / vparrikar@bdo.com

KIRK HESSER, Chicago
312-233-1802 / khesser@bdo.com

MICHIKO HAMADA HANEY, New York
212-885-8577 / mhamada@bdo.com

SEAN KIM, New York
212-885-7237 / skim@bdo.com

HOLLY CARMICHAEL, San Jose
408-352-1985 / hcarmichael@bdo.com

BRAD RODE, Chicago
312-233-1869 / brode@bdo.com

JERRY SEADE, Houston
713-986-3108 / jseade@bdo.com

SCOTT HENDON, Dallas
214) 665-0750 / shendon@bdo.com

CHIP MORGAN, Los Angeles
310-557-7517 / cmorgan@bdo.com

core business operations, global value chain, and competitive position within its industry. The section 6662(e) mandatory Information Documentation Request (“IDR”) should be sent to the taxpayer along with a request for a transfer pricing orientation meeting. Facts learned during the early months of the planning phase should assist the audit team to create an initial hypothesis to focus the risk assessment and guide the audit plan. At the conclusion of the planning phase, the audit team should have an understanding of the taxpayer’s legal organizational structure as well as the facts regarding the functional and risk profiles of the entities involved in the material intercompany transactions. These facts can either provide a clear rationale for entering into certain intercompany transactions, or signal to the audit team that a transaction warrants further substantiation and development, especially if the intercompany transaction is associated with the transfer of an income stream.

The Execution Phase, which includes fact finding and issue development, should overlap with the end of the planning phase, and span months three to 18 of the audit. During the execution phase the audit team will issue additional IDRs, conduct interviews with the taxpayer’s key employees, and perform a functional analysis. The purpose of the functional analysis is to identify the activities that are economically significant to the taxpayer’s intercompany transactions. Economically significant activities are those that have a material impact on the price charged in a transaction and the profits earned as a result of a transaction. Following the completion of the functional analysis, the audit team should be able to draft a review of the taxpayer’s transfer pricing methodology including the selected method, comparables, and assumptions.

The final phase or the Resolution Phase should include a discussion of the government’s findings with the taxpayer, and come to an agreement to resolve the transfer pricing issues. If the resolution is agreed upon, the implications under Rev. Proc. 99-32 should be discussed with the taxpayer, as well as the future implications of the agreement. If an agreement is not reached, the Roadmap lists the additional documents that should be prepared, as well as the initial steps of the appeals process.

The *Transfer Pricing Audit Roadmap* may be accessed on the IRS Web site at www.irs.gov/pub/irs-utl/FinalTrfPrcRoadMap.pdf. The Roadmap includes many links to other documents and audit tools used by the audit team.

RECOMMENDATION

All United States corporations with intercompany transactions with foreign related parties should examine their transfer pricing policies, and support for these policies in light of the Roadmap. This Roadmap should also be referenced when documenting the arm’s-length nature of intercompany transactions.

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