

**The Controls for Examination Processes for
Industry Cases With International Transfer
Pricing Issues Can Be Improved**

September 2004

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 10, 2004

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS
DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Controls for Examination Processes for
Industry Cases With International Transfer Pricing Issues Can
Be Improved (Audit # 200330014)

This report presents the results of our review of international transfer pricing documentation. The overall objective of this review was to determine the impact of the contemporaneous transfer pricing documentation regulations on Industry Case (IC)¹ transfer pricing examinations.

In summary, international transfer pricing is a term commonly used to describe pricing arrangements for exchanging goods, services, and other property between related entities or affiliates of a Multinational Enterprise (MNE) group² with operations in the United States (U.S.) and other countries. The Congress and other stakeholders are concerned whether entities with cross-border transactions are reporting and paying the proper amount of taxes. There is a broad range of estimates regarding the loss of taxes due to transfer pricing noncompliance.³ For example, an Internal Revenue Service (IRS) study in 1999 estimated an annual loss of \$2.8 billion,⁴ while an independent

¹ An IC is one that is not a Coordinated Industry Case (CIC) in the Large and Mid-Size Business Division. CIC examinations are generally assigned to a team of examiners due to the size and complexity of the taxpayer's business, whereas an IC examination is usually assigned to a single revenue agent.

² An MNE group is a group of associated companies with business establishments in two or more countries. These companies may be any form of business entity including corporations, partnerships, and sole proprietorships.

³ Transfer pricing noncompliance occurs when prices are set above or below the "arm's length" price range for the purpose of shifting income to low tax or no tax jurisdictions and expenses to high tax jurisdictions.

⁴ U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482* (1999).

study estimated the annual loss at \$53 billion.⁵ If the actual noncompliance is closer to the \$53 billion range, it would be a substantial addition to the \$311 billion⁶ gross tax gap estimate.⁷ To ensure related party cross-border transactions are accurately reported, one of the operating priorities of the IRS Large and Mid-Size Business (LMSB) Division is to implement appropriate strategies to ensure compliance with the transfer pricing rules and documentation provision as enacted by the Congress.

As part of a comprehensive transfer pricing strategy coordinated with the Department of the Treasury Office of Tax Policy, the Commissioner, LMSB Division, issued a Transfer Pricing Compliance Directive on January 22, 2003. The memorandum directs LMSB Division executives, managers, and revenue agents to request transfer pricing documentation from MNE taxpayers at the beginning of an examination so it may be evaluated by an international examiner and/or economist. This should occur during the preplanning risk assessment phase of the examination, so a determination can be made as to whether material transfer pricing issues exist, and should be developed as part of the examination plan.

Our analysis identified that transfer pricing documentation was requested for only about 35 percent of the IC cases closed between Fiscal Years 1997 and 2002. After issuance of the Transfer Pricing Compliance Directive, transfer pricing documentation was requested about 55 percent of the time. However, this still fell short of the Directive's requirement to request the documentation in each case.

As an additional concern, we estimate that 470 (56 percent) of 846 returns with potential transfer pricing issues were not referred to an international examiner for evaluation because they were improperly surveyed⁸ by domestic revenue agents and team managers and were never opened for examination. Likewise, some returns with potential transfer pricing issues that are opened for examination are also not being referred for review by international examiners. The established examination procedures are intended to ensure cases with transfer pricing issues are identified, evaluated, and examined by specialists; however, these procedures are not always effective. We estimate that, by improving the controls that ensure returns with potential transfer pricing issues are referred to international examiners for consideration, Federal Government revenue could increase by approximately \$32.3 million annually in additional income taxes or reduction in tax attributes,⁹ provided the IRS has the additional international examiner resources to examine the returns.

⁵ *U.S. Trade with the World: An Estimate of 2001 Lost U.S. Federal Income Tax Revenue Due to Over-Invoiced Imports and Under-Invoiced Exports*, by Professors Simon J. Pak, Ph.D. of Penn State University – Great Valley and John S. Zdanowicz, Ph.D. of Florida International University (October 2002).

⁶ IRS Oversight Board *FY 2005 Budget/Special Report* (March 2004).

⁷ Tax gap is defined as the amount of tax that is imposed by law for a given year but is not paid voluntarily and timely.

⁸ A survey is defined as a decision not to examine a return that is made without contacting the taxpayer or inspecting any records after evaluating the examination potential and determining that an examination of the return will not result in a material change in the taxpayer's tax liability.

⁹ Tax attributes are carryforwards of net operating losses and tax credits that can be used to reduce future taxes.

To improve the use of transfer pricing documentation and transfer pricing examination results, we recommended the Commissioner, LMSB Division, reemphasize to all executives, managers, and revenue agents the requirements in the Transfer Pricing Compliance Directive. To improve the performance for the requirement to refer the transfer pricing cases to international examiners, the Commissioner, LMSB Division, should encourage Territory Managers¹⁰ to communicate through team meetings, memoranda, and operational reviews the importance of making appropriate specialist referrals and requesting transfer pricing documentation. To better ensure IC cases classified for transfer pricing issues are not improperly surveyed, the Commissioner, LMSB Division, should implement an automated control to prevent returns selected during classification for international examiners from being surveyed without the prior approval of the International District Program Manager. In the long term, to ensure referrals are made to international examiners, the Commissioner, LMSB Division, should have the Specialist Referral System (SRS)¹¹ modified to automatically generate referrals to international examiners for returns containing the criteria for referral when the returns are opened for examination.

Management's Response: The Commissioner, LMSB Division, agreed with three of our four recommendations. The Commissioner will reemphasize the Directive by issuing a memorandum suggesting that its requirements be communicated through team meetings, memoranda, and operational reviews, and agreed to incorporate the substance of the Directive into the Internal Revenue Manual. The Commissioner also agreed to issue a memorandum to the field addressing timely specialist referrals and will continue with efforts to modify the SRS to ensure required referrals to international examiners are made timely.

The Commissioner did not concur with our recommendation to implement an automated control that will prevent a return with international features from being improperly surveyed prior to approval of the International District Program Manager and to detect this occurrence. The Commissioner believes the preferred approach is to ensure returns are referred timely and will continue efforts to develop and test either an automated referral system or a system which will efficiently provide information regarding returns awaiting referral. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We agree with the Commissioner that the preferred approach is to ensure returns with international features are referred timely. As the report indicates, the intent of the recommendation is to implement an automated control that would ensure all required returns are referred to an international examiner within a short period of time. While we still believe our recommendation is worthwhile, we do not intend to elevate our disagreement concerning it to the Department of the Treasury for resolution.

¹⁰ A Territory Manager is a second-level manager who oversees groups in a geographic area. An operational review is a process used by the Territory Manager to evaluate performance and to identify opportunities for improvement.

¹¹ The SRS is an automated referral process that allows revenue agents to request the assistance of a field specialist.

In responding to our draft report, the Commissioner, LMSB Division, also included numerous comments regarding our work that we believe need to be clarified. First, the Commissioner expressed concern about references to the estimates on transfer pricing noncompliance developed by Doctors Pak and Zdanowicz. Our purpose for using these figures in the report was to illustrate the range of estimates of transfer pricing noncompliance in recent studies.

Second, the Commissioner indicated the IRS subsequently conducted an independent survey of International Territory Managers to determine the rate of request for transfer pricing documentation and determined it to be higher than the 55 percent described in our report. We are pleased it appears that examiners are requesting transfer pricing documentation more consistently, which indicates to us that our review activities had a positive impact. However, we cannot comment on the reliability of the LMSB Division survey results because they were provided subsequent to our audit work.

Third, while the Commissioner expressed no specific disagreement with the outcome measure described in our report, concern was expressed over our assumptions and the fact that our projection is contingent on the premise that the LMSB Division has the international examiner resources to examine the additional returns that should be referred. Specifically, the Commissioner noted that transfer pricing examinations frequently lead to the dispute resolution processes where significant issues are resolved at amounts substantially less than those originally proposed. As we indicate in the report, we took these factors into consideration. Our assumption that additional international examiner resources may be required was based on the unstated assumption that current international examiner resources are already fully employed and therefore unavailable.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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International Transfer Pricing Issues Can Be Improved**

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Background

One of the Internal Revenue Service (IRS) Large and Mid-Size Business (LMSB) Division's top priorities since its standup in June 2000 has been to build a tax administration organization to deal effectively with globalization. The LMSB Division's Strategy and Program Plan Fiscal Year (FY) 2004 – 2005 describes this challenge:

As the business world continues to globalize, tax planning is increasingly focused on worldwide effective tax rate minimization. As a result, taxpayers often have an inherent incentive to adopt structures or arrangements that maximize U.S. [United States] expenses or shift income abroad. While many cross-border transactions are clearly contemplated and addressed under U.S. domestic law or treaty provisions, others involve emerging issues that may constitute unacceptable tax avoidance or evasion.

One of the operating priorities of the LMSB Division is to implement appropriate strategies to ensure compliance with the transfer pricing rules and documentation provision as enacted by the Congress.

International transfer pricing is a term commonly used to describe pricing arrangements for exchanging goods, services, and other property between related entities or affiliates of a Multinational Enterprise (MNE) group¹ with operations in the U.S. and other countries. The Congress and other stakeholders are concerned whether entities with cross-border transactions are reporting and paying the proper amount of taxes. There is a broad range of estimates regarding the loss of taxes due to transfer pricing noncompliance.² For example, an IRS study in 1999 estimated an annual loss of \$2.8 billion,³ while an

¹ An MNE group is a group of associated companies with business establishments in two or more countries. These companies may be any form of business entity including corporations, partnerships, and sole proprietorships.

² Transfer pricing noncompliance occurs when prices are set above or below the "arm's length" price range for the purpose of shifting income to low tax or no tax jurisdictions and expenses to high tax jurisdictions.

³ U.S. Department of the Treasury, IRS, *Report on the Application and Administration of Section 482* (1999).

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independent academic study estimated the annual loss at \$53 billion.⁴ If the actual noncompliance is closer to the \$53 billion range, it would be a substantial addition to the \$311 billion⁵ gross tax gap estimate.⁶

One factor that historically hindered the IRS' effective administration of Internal Revenue Code (I.R.C.) Section (§) 482⁷ and international transfer pricing was limited access to the information necessary to establish the proper transfer pricing methodology and transfer prices under the "arm's length" standard.⁸ As a result, international transfer pricing has historically been one of the most contentious issues leading to protracted disputes between the IRS and MNE taxpayers.

In response, the Congress in 1993 amended I.R.C. § 6662(e)⁹ to encourage MNE taxpayers to contemporaneously document their transfer pricing methodology and transfer prices when they file their returns and provide that documentation to the IRS within 30 days of a request. In exchange, the MNE taxpayers would not be assessed the substantial valuation or gross valuation penalties if a transfer pricing adjustment resulted from an examination.

As part of a comprehensive transfer pricing strategy coordinated with the Department of the Treasury Office of Tax Policy, the Commissioner, LMSB Division, issued a Transfer Pricing Compliance Directive on January 22, 2003. The memorandum directs LMSB Division executives,

⁴ *U.S. Trade with the World: An Estimate of 2001 Lost U.S. Federal Income Tax Revenue Due to Over-Invoiced Imports and Under-Invoiced Exports*, by Professors Simon J. Pak, Ph.D. of Penn State University – Great Valley and John S. Zdanowicz, Ph.D. of Florida International University (October 2002).

⁵ IRS Oversight Board *FY 2005 Budget/Special Report* (March 2004).

⁶ Tax gap is defined as the amount of tax that is imposed by law for a given year but is not paid voluntarily and timely.

⁷ I.R.C. § 482 (2004).

⁸ For additional information on the "arm's length" standard and current trends in the IRS' administration of transfer pricing, see our audit report *Current Trends in the Administration of International Transfer Pricing by the Internal Revenue Service* (Reference Number 2003-30-174, dated September 2003).

⁹ I.R.C. § 6662(e)(3)(B) (2004).

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managers, and revenue agents to request transfer pricing documentation from MNE taxpayers at the beginning of an examination so it may be evaluated by an international examiner and/or economist. This should occur during the preplanning risk assessment phase of the examination, so a determination can be made as to whether material transfer pricing issues exist, and should be developed as part of the examination plan.

If contemporaneous documentation is not available or is provided more than 30 days after the IRS' request, the taxpayer may be subject to the substantial valuation penalty of 20 percent or the gross valuation penalty of 40 percent of the portion of the tax deficiency arising from transfer pricing-related adjustments.

The audit was performed in accordance with *Government Auditing Standards* as part of our FY 2004 emphasis on the LMSB Division's strategic initiatives. The review was performed at the LMSB Division Headquarters in Washington, D.C., and in Examination function groups in the LMSB Division field offices in the Los Angeles, New York City, and Philadelphia metropolitan areas during the period May 2003 through March 2004. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Examiner Requests for Transfer Pricing Documentation Increased After the Compliance Directive, but Opportunities for Improvement Still Exist

Our analysis of sample cases with transfer pricing issues closed on the International Case Management System (ICMS)¹⁰ between FYs 1997 and 2002 (prior to issuance of the Transfer Pricing Compliance Directive) showed that in only 35 percent (20 of 57) of the cases did the revenue agent request transfer pricing documentation from the MNE taxpayer. After issuance of the Directive, transfer pricing documentation was requested for Industry Cases (IC)¹¹ about 55 percent of the time (12 of 22 open cases reviewed).

¹⁰ The ICMS is a computer system used to track cases referred and assigned to international examiner groups.

¹¹ An IC is one that is not a Coordinated Industry Case (CIC) in the LMSB Division. CIC examinations are generally assigned to a team of examiners due to the size and complexity of the taxpayer's business, whereas an IC examination is usually assigned to a single revenue agent.

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However, this still fell short of the Directive's requirement to request the documentation in each case.

In 8 (36 percent) of the 22 cases, the examiner or team manager indicated that the request was not issued because the transfer pricing issues were de minimis, the related party transactions were not material, or the transfer pricing issues had little potential. Thus, in these cases a decision was made regarding materiality without requesting the transfer pricing documentation, which negates one of the primary objectives contained in the Directive.

In 2 (9 percent) of the 22 cases, transfer pricing documentation was not warranted. In one case, the team manager indicated that the request was not made because the case was a limited-scope examination based on “continuing compliance issues” identified from the prior examination. In the other case, the team manager indicated that the request was not made because of the extremely remote possibility of a transfer pricing issue being present on interest transactions on loans between the U.S. branch office of a foreign bank and the bank’s home office.

In the 12 cases for which the documentation was requested, MNE taxpayers responded timely with transfer pricing documentation in 4 cases. In another 4 cases, MNE taxpayers provided transfer pricing documentation or studies more than 30 days after the initial requests. In the final 4 cases, the taxpayers did not provide the documentation. In summary, in only two-thirds (8 of 12) of the cases did the MNE taxpayers provide some form of study or documentation describing their transfer pricing methodologies.

One cause of the problem with requesting transfer pricing documentation was that the issue was not addressed by LMSB Division Territory Managers¹² during operational reviews of their teams. Our review of a judgmental sample of the documentation for 18 operational reviews conducted by 9 Territory Managers after issuance of the Transfer

¹² A Territory Manager is a second-level manager who oversees groups in a geographic area. The LMSB Division has 62 Territory Managers. An operational review is a process used by the Territory Manager to evaluate performance and to identify opportunities for improvement.

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Pricing Compliance Directive showed that the requirements of the Directive were not addressed in any of the operational reviews.

When transfer pricing documentation is available but not requested, the benefits that would be derived from its use are lost. To better understand the benefits of having the documentation early in the decision-making process, we surveyed the 11 International function team managers that controlled the international portion of the open examination cases to determine the effectiveness of the Transfer Pricing Compliance Directive and transfer pricing documentation when it is present. Ten of these International function team managers provided responses to the following issues.

Use of documentation allows for more efficient examinations

Nine of 10 International function team managers believed documentation allowed international examiners to more quickly identify transfer pricing issues. In addition, the IRS reported in a study¹³ to the Congress that the transfer pricing documentation significantly reduced the time and effort necessary to obtain information to analyze transfer prices. The IRS report states:

In many examinations, documentation saved significant IRS resources. Documentation permitted the IRS to determine at an early stage of the examination process . . . whether to devote personnel and other resources to transfer pricing issues. In several cases, the examiner's initial review of the documentation enabled a reasoned judgment to be made to devote scarce examination resources to other issues. In contrast, in several other cases, the initial review revealed significant issues that required additional scrutiny. Under prior practice, in contrast, the IRS could not allocate appropriate resources to transfer pricing issues until it conducted preliminary inquiries, which often consumed lengthy periods of time.

¹³ *Fiscal Years 2000-2001 IRS Study: Effectiveness of Internal Revenue Code Section 6662(e)* (dated December 28, 2001), page 42.

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Use of documentation allows for more effective understanding of the taxpayer's point-of-view and facilitates more open communication

Seven of 10 managers see the documentation as beneficial because it defines the taxpayer's position and transfer pricing methodology. The IRS report also made this point:

. . . By placing the taxpayer's transfer pricing analysis in a clear framework and stating the taxpayer's position regarding the arm's length price for the controlled transactions, it provides a basis for the IRS examination of these issues. Examinations conducted with the benefit of documentation tend to be quicker and more focused than examinations conducted under the ad hoc approach to transfer pricing that many taxpayers used prior to the enactment of section 6662(e).

Use of documentation reduces the time and resources needed to resolve disagreed cases

Seven of 10 managers believe when transfer pricing issues are proposed to the taxpayer, access to transfer pricing documentation improved the quality of the transfer pricing issues developed. The improved quality in the development of transfer pricing issues should improve the IRS' ability to prevail on these issues in postexamination administrative appeals and court actions. This should eventually lead to more agreements on these issues at the examination level, thereby reducing the time and resources needed to resolve disagreed issues.

Recommendation

1. The Commissioner, LMSB Division, should reemphasize the Transfer Pricing Compliance Directive and incorporate it into the Internal Revenue Manual (IRM). Additionally, the Commissioner should encourage Territory Managers to communicate the requirements of the Directive through team meetings, memoranda, and operational reviews. This increased emphasis at the executive and manager level should communicate the importance of requesting the documentation at the onset of an examination.

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Management's Response: The Commissioner, LMSB Division, will issue a memorandum to the field reemphasizing the Transfer Pricing Compliance Directive and suggesting that requirements of the Directive be communicated through team meetings, memoranda, and operating reviews. The Commissioner also plans to incorporate the substance of the Transfer Pricing Compliance Directive into the IRM.

Office of Audit Comment: In the response to our draft report, the Commissioner, LMSB Division, also included numerous comments regarding our work that we believe need to be clarified. First, the Commissioner expressed concern about references to the estimates on transfer pricing noncompliance developed by Doctors Pak and Zdanowicz. Our purpose for using these figures in the report was to illustrate the range of estimates of transfer pricing noncompliance in recent studies.

Second, the Commissioner indicated the IRS subsequently conducted an independent survey of International Territory Managers to determine the rate of request for transfer pricing documentation and determined it to be higher than the 55 percent described in our report. We are pleased it appears that examiners are requesting transfer pricing documentation more consistently, which indicates to us that our review activities had a positive impact. However, we cannot comment on the reliability of the LMSB Division survey results because they were provided subsequent to our audit work.

Many Income Tax Returns With Potential Transfer Pricing Issues Never Received Consideration by International Examiners

Requests for transfer pricing documentation and the subsequent review of the information provided by the MNE taxpayers can occur only if the returns are opened for examination and the information, once obtained, is referred to an international examiner or economist with the proper technical training to evaluate it. However, tax returns with international features selected for examination are not always being opened, and the returns with international features that are opened are not always being referred to an International function group for evaluation and possible examination.

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We estimate that, in FY 2002, 470 (56 percent) of 846 returns with potential transfer pricing issues were not referred to an international examiner for evaluation because they were improperly surveyed¹⁴ by domestic revenue agents and team managers and were never opened for examination. The estimate was based on a case review of an attribute sample of 106 returns from a population of 2,489 Tax Years (TY) 1999 and 2000 returns containing potential transfer pricing issues that were surveyed. The sample had a 95 percent confidence level, ± 7.3 percent precision margin, and 18.9 percent expectation of finding returns that were surveyed without proper approval.

Likewise, some returns with potential transfer pricing issues that are opened for examination are also not being referred for review by international examiners. A computer analysis showed that 146 (27 percent) of 547 TYs 1999 and 2000 returns opened for examination with potential transfer pricing issues as of August 2003 were not referred to international examiners for evaluation as required.

The LMSB Division reported similar results concerning all returns surveyed in FY 2003 in an internal study released on March 4, 2004. The study of a statistical sample of 380 surveyed returns found that 126 (33 percent) of the returns reviewed contained material issues worthy of examination. We also reported this condition in our report on Foreign Controlled Corporations.¹⁵

The LMSB Division also reported in February 2004 that mandatory referrals to specialists, including international examiners, continue not to be made, declining another 14 percent between FYs 2001 and 2003. In FY 2001, the LMSB Division reported that referrals to specialists were made in only 64 percent of the cases for which guidelines

¹⁴ A survey is defined as a decision not to examine a return that is made without contacting the taxpayer or inspecting any records, after evaluating the examination potential and determining that an examination of the return will not result in a material change in the taxpayer's tax liability.

¹⁵ *Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement* (Reference Number 2001-30-119, dated July 2001).

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required a specialist referral to be made; this declined to 50 percent by FY 2003.

The IRM provides the procedural guidelines on the criteria for surveying cases with potential transfer pricing issues and for referring cases to international examiners once the cases are opened. The established examination procedures are intended to ensure cases with transfer pricing issues are identified, evaluated, and examined by specialists; however, these procedures are not always effective. Therefore, the control system to ensure compliance needs improvement.

The Government Accountability Office (formerly the General Accounting Office) *Standards for Internal Control in the Federal Government* specify that control activities are policies, procedures, techniques, and mechanisms that enforce management's directives. Control activities are an integral part of an entity's planning, implementing, reviewing, and accountability for stewardship of Federal Government resources and achieving effective results. When these control activities are ineffective to enforce management's directives, significant losses can occur because risks were not minimized.

There are at least two causes for not following the referral requirements. First, Territory Managers do not uniformly include an evaluation as to whether proper referrals to specialists were made during their operational reviews. Our review of a judgmental sample of 43 team operational reviews conducted by 12 LMSB Division Territory Managers in Dallas, Houston, Los Angeles, and New York between September 1, 2000, and November 24, 2003, showed that only 11 (26 percent) discussed and evaluated the manager and team on the need for making specialist referrals. The remaining 32 provided no evidence that the referrals to specialists were discussed or evaluated.

Second, the current procedures rely simply on the procedures themselves to achieve the control objective. However, there are no controls to prevent noncompliance or to detect when there has been no compliance. Therefore, the control system could be improved to minimize the risk that returns with potential transfer pricing issues miss being referred for evaluation.

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We estimate that, by improving the controls that ensure returns with potential transfer pricing issues are referred to international examiners for consideration, Federal Government revenue could increase by approximately \$32.3 million annually in additional income taxes or reduction in tax attributes.¹⁶ This projection is contingent on the premise that the LMSB Division has the international examiner resources to examine the additional returns that should be referred. The \$32.3 million is composed of estimates of \$24.7 million currently lost due to the improper surveying of cases with potential transfer pricing issues, and \$7.6 million currently lost due to open cases with potential transfer pricing issues not being referred to international examiners for consideration. Details of our analysis are included in Appendix IV.

Recommendations

2. In the short term, the Commissioner, LMSB Division, should strengthen controls by encouraging Territory Managers to communicate through team meetings, memoranda, and operational reviews the importance of making appropriate referrals.

Management's Response: The Commissioner, LMSB Division, agreed to issue a memorandum to the field addressing timely specialist referrals.

3. In the long term, the Commissioner, LMSB Division, should have the Specialist Referral System (SRS)¹⁷ modified to automatically generate referrals to international examiners for returns containing the criteria for referral that can currently be identified through the Business Return Transaction File (RTF)

¹⁶ Tax attributes are carryforwards of net operating losses and tax credits that can be used to reduce future taxes.

¹⁷ The SRS is an automated referral process that allows revenue agents to request the assistance of a field specialist.

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when the returns are opened for examination.¹⁸

Additional automatic criteria for referral can be added to the SRS as the information becomes available with the electronic filing of corporation income tax returns.

Management's Response: The Commissioner, LMSB Division, agreed to continue the development and testing of modifications to the SRS to achieve automatic referral of returns meeting international mandatory referral requirements and to deploy the system developed, provided it is both efficient and cost-effective. The Commissioner will also continue the development and testing of information systems that will efficiently provide information with respect to returns with international features awaiting referral.

4. In the long term, the Commissioner, LMSB Division, should implement an automated control that, when a return is selected during classification for international examiners, prevents the return from being improperly surveyed without the prior approval of the International District Program Manager and detects this occurrence so the team's Territory Manager can take appropriate corrective action.

Management's Response: The Commissioner, LMSB Division, did not concur with this recommendation, stating that the suggested approach has been attempted in the past and has had mixed results. A primary weakness is that, if a return is not referred and sufficient time is allowed to elapse, the International function will not have the time necessary to identify and develop substantive issues, such as issues under I.R.C. § 482.

The Commissioner believes the preferred approach is to ensure returns are referred timely and will continue

¹⁸ The Business RTF currently has in place indicators for the following forms specified in the Referral Criteria and Procedures of the International Procedures Handbook, IRM 4.60.5: Foreign Tax Credits – Corporations (Form 1118), Information Return of U.S. Persons with Respect to Certain Foreign Corporations (Form 5471), Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472), Return by a U.S. Transferor of Property to a Foreign Corporation, (Form 926), and International Boycott Report (Form 5713).

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efforts to develop and test either an automated referral system or a system which will efficiently provide information regarding returns awaiting referral.

Office of Audit Comment: We agree with the Commissioner that the preferred approach is to ensure returns with international features are referred timely. As the report indicates, the intent of the recommendation is to implement an automated control that would ensure all required returns are referred to an international examiner within a short period of time.

The Commissioner, LMSB Division, also included numerous comments regarding our work that we believe need to be clarified. The Commissioner expressed no specific disagreement with the outcome measure described in our report, but did express concern with the assumptions and the fact that our projection is contingent on the premise that the LMSB Division has the international examiner resources to examine the additional returns that should be referred. Specifically, the Commissioner noted that transfer pricing examinations frequently lead to the dispute resolution processes where significant issues are resolved at amounts substantially less than those originally proposed. As we indicate in the report, we took these factors into consideration. Our assumption that additional international examiner resources may be required was based on the unstated assumption that current international examiner resources are already fully employed and therefore unavailable.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the impact of the contemporaneous transfer pricing documentation regulations on Industry Case (IC)¹ transfer pricing examinations. To achieve this objective, we extensively relied on internal management reports and computer-processed data contained in the Audit Information Management System (AIMS),² Examination Return Control System (ERCS),³ Foreign Information System (FIS),⁴ International Case Management System (ICMS),⁵ and Specialist Referral System (SRS).⁶ We did not establish the reliability of these data because extensive data validation was outside the scope of this audit.

The specific tests included the following:

- I. Determined the extent of use of the contemporaneous transfer pricing documentation described in Internal Revenue Code (I.R.C.) Section (§) 6662(e)⁷ and Treas. Reg. § 1.6662-6(d)(2)(iii).⁸
 - A. Through a closed case review, determined the number of cases requesting transfer pricing documentation prior to issuance of the January 22, 2003, Transfer Pricing Compliance Directive using a judgmental sample. We used a judgmental sample because location and travel factors associated with the selection of a random sample would have been cost-prohibitive. We identified a population of 2,782 post-Tax Year (TY) 1995 non-Coordinated Industry Case (non-CIC)⁹ tax returns with transfer pricing issues that were closed on the AIMS and ICMS between Fiscal Years (FY) 1997 and 2002 and reviewed 57 complete cases.

¹ An IC is one that is not a Coordinated Industry Case (CIC) in the Large and Mid-Size Business (LMSB) Division. CIC examinations are generally assigned to a team of examiners due to the size and complexity of the taxpayer's business, whereas an IC examination is usually assigned to a single revenue agent.

² The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the Internal Revenue Service database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

³ The ERCS is an automated inventory system used for controlling tax returns and technical time charges from the time returns arrive in the operating divisions until they are closed on the AIMS.

⁴ The FIS is a computer system containing information transcribed from the Information Return of U.S. Persons With Respect to Certain Foreign Corporations (Form 5471) and Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472).

⁵ The ICMS is a computer system used to track cases referred and assigned to international examiner groups.

⁶ The SRS is an automated referral process that allows revenue agents to request the assistance of a field specialist.

⁷ I.R.C. § 6662 (2004).

⁸ Treas. Reg. § 1.6662-6 (2003).

⁹ The non-CIC Program is a field examination program formerly known as the General Examination Program. It is operated by both the Small Business/Self-Employed and LMSB Divisions and involves examinations of income tax returns using a single revenue agent.

The Controls for Examination Processes for Industry Cases With International Transfer Pricing Issues Can Be Improved

- B. Through an open case review, determined the number of cases requesting transfer pricing documentation after issuance of the Transfer Pricing Compliance Directive. We identified a population of 109 cases (114 returns) with potential transfer pricing issues through matching Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons (Schedule M) of the Information Return of U.S. Persons With Respect to Certain Foreign Corporations (Form 5471) and Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472) information for TYs 1999 and 2000 from the FIS to referrals open on the ICMS as of October 15, 2003, that were started between October 1, 2002, and July 31, 2003. We selected a judgmental sample of 50 cases (54 returns) located in the metropolitan areas with the greatest concentration of cases open during this period – Los Angeles, New York, and Philadelphia. We selected a judgmental sample because a statistical sample was impractical due to cost, time, staffing, and travel considerations associated with such a sample. Forty-three open cases were available for review in November and December 2003. We determined that, in 22 of the cases, taxpayer contact took place subsequent to issuance of the Transfer Pricing Compliance Directive, based on the issuance date of the first information document request.
- C. Through computer analysis, determined the number of open cases with potential transfer pricing issues that were not being referred. We identified a population of 503 open cases (547 open returns) with potential transfer pricing issues by matching Form 5471 Schedule M and Form 5472 information for TYs 1999 and 2000 from the FIS to the open return examination information on the ERCS as of August 2003. We ran the ERCS and FIS match of 503 open cases against the ICMS and SRS databases and identified 366 cases (73 percent of open cases involving 401 open returns) that were referred and 137 cases (27 percent of open cases involving 146 open returns) that were not referred for consideration by international examiners.
- D. Determined the number of non-CIC surveyed returns with potential transfer pricing issues that were improperly closed without approval of the International District Program Manager. We identified a population (N) of 3,099 surveyed returns with potential transfer pricing issues through matching Form 5471 Schedule M and Form 5472 information for TYs 1999 and 2000 from the FIS to return information on the nonexamined AIMS database for FY 2002 with survey before assignment (Disposal Code 31) and survey after assignment (Disposal Code 32). We selected and requested from files a random attribute sample (n) of 132 returns. The sample, when selected, had a 95 percent confidence level (Z) with ± 5 percent tolerable sampling error (E). The expected percentage (p) of returns with the attribute of being selected for examination by the International function and being improperly surveyed was 10 percent, based on a pilot sample conducted in our audit of Foreign Controlled

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Corporations.¹⁰ Twenty-six (20 percent) of the 132 sample returns were unavailable for review, reducing the effective sample size (n') to 106 returns. Because no data were available on these 26 returns, we assumed these returns may behave differently from the returns reviewed, preventing projection of results to 610 (20 percent) of the 3,099 returns in the population. The effective sample of 106 returns allows projection to 2,489 (80 percent) of the 3,099 returns.

Because of changes in the effective sample size, from 132 to 106 returns, and the actual value of p exceeding the expected value of p (18.9 percent compared to an expected value of 10 percent), the tolerable sampling error was adjusted to ± 7.3 percent. Projecting these results into the population of surveyed returns with a 95 percent confidence level, we estimate that 846 returns $[(36/106) \times 2,489]$ were originally selected for examination (with a range between 572 and 1,119 returns) and that 470 returns $[(20/106) \times 2,489]$ were improperly surveyed (with a range between 244 and 695 returns).

- II. Reviewed the criteria associated with transfer pricing documentation and the identification, selection, and referral of returns with potential transfer pricing issues for evaluation and potential.
 - A. Reviewed I.R.C. § 482¹¹ and I.R.C. § 6662(e) along with the associated regulations, internal operating procedures in the Internal Revenue Manual (IRM), and the Transfer Pricing Compliance Directive of January 22, 2003.
 - B. Reviewed the IRM for the internal procedures concerning the identification, selection, and referral of returns with international features.
- III. Assessed the causes for not requesting transfer pricing documentation on IC cases and for not referring IC cases with potential transfer pricing issues to the International function for evaluation through surveys, reviews of operational reviews and official memoranda, and responses to case reviews. The review of the operational reviews was from a judgmental sample consisting of 12 Territory Managers selected from a population of 62 LMSB Territory Managers. These 12 Territory Managers conducted 43 operational reviews between September 1, 2000, and November 24, 2003. The population of operational reviews conducted during this period is not readily available. A judgmental sample was used because the population of operational reviews was not readily available and location and travel factors associated with the selection of a random sample of Territory Managers would have been cost-prohibitive. Eighteen of the 43 operational reviews were conducted by 9 Territory Managers after issuance of the Transfer Pricing Compliance Directive.

¹⁰ Based on the results of a pilot sample in which 6 (10 percent) of 60 returns were determined to be improperly surveyed in our report *Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement* (Reference Number 2001-30-119, dated July 2001).

¹¹ I.R.C. § 482 (2004).

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- IV. Determined the effects of transfer pricing documentation not being requested and returns with potential transfer pricing issues not being referred for evaluation and potential examination.
 - A. Determined the benefits lost when the Internal Revenue Service does not request transfer pricing documentation from the taxpayer and the taxpayer has prepared the documentation. We submitted questionnaires to the 11 International function team managers that controlled the international portion of the open examination cases and obtained and analyzed questionnaires from 10 International function team managers whose cases were included in the open case review to determine anecdotally the benefits received when transfer pricing documentation is provided by the taxpayer.
 - B. Estimated the approximate revenue lost as a result of returns with potential transfer pricing issues being improperly surveyed.
 - C. Estimated the approximate revenue lost as a result of returns with potential transfer pricing issues that were opened for examination but not referred to international examiners.

Major Contributors to This Report

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**The Controls for Examination Processes for Industry Cases With
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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Director, Field Specialists SE:LM:FS
Director, International SE:LM:I
Director, Strategy, Research, and Program Planning SE:LM:SR
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National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Large and Mid-Size Business Division SE:LM

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$24.7 million in additional recommended taxes or reduced tax attributes¹ annually; \$123.5 million over 5 years (see page 7).

Methodology Used to Measure the Reported Benefit:

To estimate the increased revenue that could result from examining returns with potential transfer pricing issues that are currently being improperly surveyed, we began by identifying the population of 3,099 returns with potential transfer pricing issues surveyed in Fiscal Year (FY) 2002.² We selected a random attribute statistical sample of 132 returns from the population with a 95 percent confidence level, ± 5 percent tolerable sampling error level, and 10 percent³ attribute of finding returns that were surveyed without proper approval. Because 26 of the 132 returns were unavailable, the effective sample size was reduced to 106 returns, allowing projection to 2,489 returns [$3,099 \times (106/132)$] in the population. We identified 20 of 106 sample returns (18.9 percent) with potential transfer pricing issues that were surveyed without evidence of approval by the International District Program Manager. The tolerable error level of the sample was adjusted from ± 5 percent to ± 7.3 percent because of changes in the effective sample size and because the actual percentage of returns surveyed without proper approval exceeded the expected percentage. Projecting the sample into the population of 2,489 returns, we estimate that 470 returns with potential transfer pricing issues [$2,489 \times (20/106)$] were improperly surveyed.

¹ Tax attributes are carryforwards of net operating losses and tax credits that can be used to reduce future taxes.

² The population of 3,099 survey returns with potential transfer pricing issues was identified through matching the closed FY 2002 nonexamined Audit Information Management System (AIMS) database for returns surveyed before assignment (Disposal Code 31) and returns surveyed after assignment (Disposal Code 32) to Tax Years (TY) 1999 and 2000 Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Parties (Schedule M) of the Information Return of U.S. Persons With Respect to Certain Foreign Corporations (Form 5471), Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472), or both from the Foreign Information System (FIS). The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the Internal Revenue Service database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data. The FIS is a computer system containing information transcribed from Forms 5471 and 5472.

³ Based on the results of a pilot sample in which 6 (10 percent) of 60 returns were determined to be improperly surveyed in our report *Controls Over the Identification and Selection of Foreign Controlled Corporations for Examination Need Improvement* (Reference Number 2001-30-119, dated July 2001).

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To determine the amount of additional recommended taxes or reduced tax attributes that could be generated from examination of the 470 improperly surveyed returns with potential transfer pricing issues in the future, we assumed that:

- Fifty international examiners would be available to evaluate and possibly examine these returns.
- The returns, when referred to International function groups, are rejected for examination at the FY 2002 historical rate of 32.56 percent because of workload considerations or indications that no significant tax adjustments exist.
- The remaining returns, when examined, would have the same profile of no changes and changes as returns examined and reported on the International Case Management System (ICMS)⁴ over the last 5 years with transfer pricing issues under Internal Revenue Code (I.R.C.) Section (§) 482⁵ (see Table 1).
- The returns resulting in changes when examined would yield the same average dollars per return as examined returns reported on the ICMS over the last 5 years with transfer pricing adjustments under I.R.C. § 482 (see Table 1).
- The recommended assessments would be sustained at the FY 2002 historical rate of 17.5 percent in postexamination appeals.

**Table 1: Analysis of Non-Coordinated Industry Case (CIC)⁶ Transfer Pricing Return Examinations
FYs 1999 - 2003**

Fiscal Year	Total Returns Examined	Return Examinations Resulting in No Change	Return Examinations Resulting in Adjustment	Total Transfer Pricing Adjustments
1999	1,012	499	513	\$ 562,148,003
2000	796	389	407	405,575,391
2001	639	290	349	1,203,537,437
2002	524	228	296	969,291,816
2003	479	233	246	1,264,033,712
Summation	3,450	1,639	1,811	\$4,404,586,359
Divisor	3,450	3,450	3,450	1,811
5-year average percentage	100%	47.51%	52.49%	
5-year average of transfer pricing adjustment per return				\$2,432,129

Source: Treasury Inspector General for Tax Administration analysis of the dispositions and adjustments on non-CIC transfer pricing return examinations on the ICMS for FYs 1999 - 2003.

⁴ The ICMS is a computer system used to track cases referred and assigned to international examiner groups.

⁵ I.R.C. § 482 (2004).

⁶ The non-CIC Program is a field examination program formerly known as the General Examination Program. It is operated by both the Small Business/Self-Employed and Large and Mid-Size Business Divisions and involves examinations of income tax returns using a single revenue agent.

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Based on these assumptions, we estimate the referral of 470 returns in the future would result in 153 (470×32.56 percent) returns being rejected because of indications of no significant adjustment or workload considerations. The remaining 317 returns would yield 151 (317×47.51 percent) no change return examinations and 166 (317×52.49 percent) return examinations with transfer pricing adjustments to taxable income averaging \$2.43 million per return, or \$403 million in total ($166 \times \2.43 million). This \$403 million in adjustments could increase recommended examination tax assessments or reduce tax attributes attributable to net operating loss carryforwards by about \$141 million ($\$403 \text{ million} \times 35$ percent marginal corporate tax rate⁷). The \$141 million in recommended tax assessments or reductions in tax attributes would be further subject to postexamination appeals, which would further reduce the amount of revenue. Therefore, taking into account the sustention rate on transfer pricing issues in the Office of Appeals for FY 2002, the potential increased revenue would be about \$24.7 million ($\$141 \text{ million} \times 17.5$ percent) per year.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$7.6 million in additional recommended taxes or reduced tax attributes annually; \$38 million over 5 years (see page 7).

Methodology Used to Measure the Reported Benefit:

To estimate the increased revenue that could result from examining returns with potential transfer pricing issues that are currently open but not being referred, we began by identifying the population of 547 open return examinations with potential transfer pricing issues in FY 2003.⁸ We matched this population against the ICMS and the Specialist Referral System (SRS),⁹ identifying 401 open returns that were referred to international examiners for evaluation and possible examination while the remaining 146 open returns were not.

To determine the future amount of additional recommended taxes or reduced tax attributes that could be generated from examination of the 146 open returns with potential transfer pricing issues that were not referred, we assumed that:

- Sixteen international examiners would be available to evaluate and possibly examine these returns.
- The returns, when referred to International function groups, are rejected for examination at the FY 2002 historical rate of 32.56 percent because of workload considerations or indications that no significant tax adjustments exist.

⁷ I.R.C. § 11 (2004).

⁸ The population of 547 open returns with potential transfer pricing issues was identified by matching the Examination Return Control System (ERCS) database as of August 2003 for all return examinations started during FY 2003 to the Form 5471 Schedule M, Form 5472, or both for TYs 1999 and 2000 from the FIS. The ERCS is an automated inventory system used for controlling tax returns and technical time charges from the time returns arrive in the operating divisions until they are closed on the AIMS.

⁹ The SRS is an automated referral process that allows revenue agents to request the assistance of a field specialist.

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- The remaining returns, when examined, would have the same profile of no changes and changes as returns examined and reported on the ICMS over the last 5 years with transfer pricing issues under I.R.C. § 482 (see Table 1).
- The returns resulting in changes when examined would yield the same average dollars per return as examined returns reported on the ICMS over the last 5 years with transfer pricing adjustments under I.R.C. § 482 (see Table 1).
- The recommended assessments would be sustained at the FY 2002 historical rate of 17.5 percent in postexamination appeals.

Based on these assumptions, we estimate the referral of 146 returns in the future would result in 48 (146×32.56 percent) returns being rejected because of indications of no significant adjustment or workload considerations. The remaining 98 returns would yield 47 (98×47.51 percent) no change return examinations and 51 (98×52.49 percent) return examinations with transfer pricing adjustments to taxable income averaging \$2.43 million per return, or \$124 million in total ($51 \times \2.43 million). This \$124 million in adjustments could increase recommended examination tax assessments or reduce tax attributes attributable to net operating loss carryforwards by about \$43.4 million ($\$124 \text{ million} \times 35$ percent marginal corporate tax rate¹⁰). The \$43.4 million in recommended tax assessments or reductions in tax attributes would be further subject to postexamination appeals that would further reduce the amount of revenue. Therefore, taking into account the sustention rate on transfer pricing issues in the Office of Appeals for FY 2002, the potential increased revenue would be about \$7.6 million ($\$43.4 \text{ million} \times 17.5$ percent).

¹⁰ I.R.C. § 11 (2004).

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Appendix V

Management's Response to the Draft Report



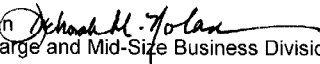
DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED

AUG 26 2004

AUG 19 2004

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Deborah M. Nolan 
Commissioner, Large and Mid-Size Business Division

SUBJECT: Comments on Draft Audit Report –The Controls for Examination Processes for Industry Cases with International Transfer Pricing Issues Can Be Improved (Audit # 2003-30-014)

One of the Large and Mid-Size Business (LMSB) Division strategic initiatives is to build a tax administration to deal effectively with the global economy. We consider transfer pricing a top priority in our globalization strategic initiative and work with the Department of Treasury, Chief Counsel, and Appeals to develop compliance initiatives to carry out our globalization strategy. As mentioned in your report, we coordinated a comprehensive transfer pricing strategy with the Office of Tax Policy from Treasury to issue a Transfer Pricing Compliance Directive (TPCD) in January 2003. The Directive provides guidance on the examination of transfer pricing cases to ensure effective application of the current tax law by our agents and taxpayer compliance with pricing rules and documentation provisions. We have also implemented measures for all of the LMSB industries to evaluate transfer pricing examination activities.

We appreciate the opportunity to comment on the subject draft audit report. We have reviewed the report and have the following comments:

**Summary, page 2, 1st paragraph
Report, page 2, 1st paragraph (continuing from page 1)**

We are concerned about the references to the estimates on transfer pricing noncompliance developed by Doctors Pak and Zdanowicz; although you acknowledged that other attempts to estimate the tax gap have produced much lower figures accompanied by significant caveats (e.g., Report on the Application and Administration of Section 482, IRS Publication 3218, 4 -1999). As you are aware, we are not able to comment on the professors' work at this time because we are participating in a Congressionally-mandated study to evaluate the application of their methodology. We further note, however, that the Washington Post¹ had done a long article on a report in which senior Treasury officials raised several concerns. GAO, Treasury, and IRS have

¹ *Phony Prices May Hide Import-Export Profits from IRS*, By Jonathan Weisman, Washington Post, Friday, November 1, 2002, E01

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also evaluated the professors' methodology in the past and found it to have a number of shortcomings.

**Summary, page 2, 2nd Paragraph
Report, page 3, 1st Paragraph**

The report comments that the TPCD directs managers and examiners to request transfer pricing documentation from Multinational Enterprise (MNE) examiners at the beginning of the examination, so that an international examiner and/or economist may evaluate it. The report states that this should occur during the pre-planning risk assessment phase of the examination to determine if material transfer pricing issues exist and should be developed as part of the examination audit plan. We concur with this observation and are in the process of amending the Internal Revenue Manual (IRM) to achieve the results noted in the report.

**Summary, page 2, Paragraph 3
Report, page 3, Paragraph 4; page 4, Paragraph 1-4
Appendix I, Paragraphs I A and I B.**

Your report states, based on your analysis, that transfer pricing documentation is being requested for Industry Cases (IC) only about 55 percent of the time since the issuance of the TPCD. In comparison, the report notes that only 35 percent of the closed cases had transfer pricing documentation requests prior to the issuance of the Directive. The 55 percent was based on a judgmental sample of 22 cases in which taxpayer contact took place subsequent to the issuance of the TPCD. The 22 cases were identified through the matching of Schedule M (Transactions Between Controlled Foreign Corporations and Shareholders or Other Related Persons), Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations), and Form 5472 (Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) for tax years 1999 and 2000 that were started between October 1, 2002 and July 31, 2003. You note that in 8 out of 22 cases (36 percent) the examiner or team manager indicated that the request was not issued because the transfer pricing issues were *de minimis*², the related party transactions were not material, or the transfer pricing issues had little potential. Your report comments that a decision was made regarding materiality without requesting the transfer pricing documentation, which negates one of the primary objectives contained in the Directive.

² Latin for "of minimum importance" or "trifling"

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As you know, the International groups are embedded within the five LMSB industries. Two international territory managers within each industry are responsible for ensuring that matters related to the administration of international tax law are addressed within the LMSB Division. International maintains ongoing communications with the international territory managers regarding international field operations. Subsequent to our receipt of this report, we asked the international territory managers to review the open inventory of IC cases within their areas of responsibility and determine what percentage of cases were identified as having transfer pricing transactions between related parties within the meaning of Section 482. We have received input from nine out of ten of the international territory managers. One international territory manager responded that, on the basis of the survey conducted, 100% of the IC cases identified as having international transfer pricing issues had documentation to support the fact that a request for transfer pricing had been made. A second international territory manager provided examples of communications sent to the field on the subject and concluded that the subject matter had adequately been addressed. For the remaining seven territory managers that provided statistical data, 163 cases were identified as being open and having transfer pricing issues; and out of these 163 cases, transfer pricing documentation was requested in 144 cases or 88.3%. We believe the data that we have been able to develop from the records of personnel directly involved in the examination of transfer pricing issues is indicative that we are undertaking a reasonable effort to secure transfer pricing documentation.

As noted in the final report prepared in response to the request from the Senate Committee on Appropriations, 106th Congress, 1st Session, entitled Effectiveness of Internal Revenue Code Section 6662(e), the primary objective of Section 6662(e) and the regulations thereunder is to promote taxpayer compliance with the arm's length standard by encouraging taxpayers to prepare contemporaneous documentation of their transfer pricing methodologies and to make the resulting documents available promptly to the IRS. Your report makes the same comment on page 2, Paragraph 3 of the report. A risk assessment is an integral part of the examination process and its application is the primary means by which examiners and their managers make the determination whether a return should be examined and, if so, what issues should be pursued. The risk assessments bring together varied sources of information for assessing materiality to evaluating examination potential. We recognize the importance of transfer pricing documentation in the risk assessment process and believe that in most instances transfer pricing documentation should be requested at the pre-examination conference.

However, the process needs to be balanced. Historically, the IRS has recognized that it is imprudent to raise *de minimis* transfer pricing issues. This concept is recognized in IRM 4.61.3.1 (2), Development of IRC Section 482 cases. The IRM provides:

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“International Examiners (IEs) should exercise care and good judgment when recommending IRC Section 482 adjustments. *De minimis* adjustments are not to be made. In this context, *de minimis* is not meant to be a specific dollar figure, rather, IEs should look to those situations where there have been substantial deviations from the arm’s length standard, resulting in a significant shifting of income.”

Ultimately, judgment is required in determining whether or not to request transfer pricing documentation in a particular case. Through the risk assessment process, it may become apparent that when working with existing examination thresholds, a potential Section 482 adjustment is not practicable. This is not to say that there is not a potential issue in the particular case, there may be, but that the adjustment potential does not meet an agreed upon adjustment threshold.

**Summary, page 2, Paragraph 4
Report, page 7, Paragraph 3 through page 8, Paragraph 4
Appendix I, page 12, Paragraph 1C**

The report states that it is estimated that 470 of 846 returns (56 percent) with potential transfer pricing issues were not referred to an international examiner for evaluation because domestic revenue agents and team managers improperly surveyed them and never opened them for examination. Similarly, the report notes that some returns with potential transfer pricing issues that are opened for examination are also not being referred for review by international examiners. The report also states that, based on a computer analysis, the percentage of cases opened, but not referred, is estimated to be 27 percent, and that established examination procedures intended to ensure that transfer pricing issues are identified, evaluated, and examined are not always effective.

In addition, the report states that an LMSB report released on March 4, 2004, found that in a sample of 380 surveyed returns, 33 percent of cases surveyed contained material issues worthy of audit, and that in February 2004, LMSB mandatory referrals to specialists, including international examiners, continue not to be made, commenting that the percentage of required referrals declined from 64 percent in FY 2001 to 50 percent in FY 2003. Finally, your report notes that the IRM provides procedural guidelines for surveying cases and referring cases, but that these procedures are not always effective, and that existing control systems need to be improved to ensure compliance.

We do not dispute these observations, but would like to share the following comments regarding steps we are taking to ensure that internationally featured returns meeting mandatory referral requirements are in fact being referred.

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- We are working on joint initiatives involving personnel assigned to International, Strategic Research and Program Planning (SRPP), Field Specialists (FS), Performance Management, Quality Assurance, and Audit Assistance (PQA), as well as international field personnel.
- Both SRPP and PQA have had an instrumental role in capturing and quantifying data related to the processing of internationally featured returns with potential transfer pricing issues. PQA has recently entered into an agreement with International to provide specific input regarding surveyed returns having large, unusual, or questionable items with international tax law implications. PQA has further agreed to specifically assess, through the review process, the extent to which the TPCD is adhered to and provide statistical feedback to International.
- International personnel over the last several years have been working with SRPP and field personnel to improve workload delivery. Part of this activity has been to ensure that the IRM adequately addresses mandatory referral requirements.
- The FS office has recently introduced the Specialist Referral System (SRS). Personnel representing the Field Specialists and International have had active involvement in the further development of this system. International personnel worked directly with FS personnel to ensure that mandatory international referral requirements are effectively incorporated into the SRS system. International is unique in that referral requirements can be linked to specific return filings. Proper data entry by domestic personnel (referral requestors) will automatically activate the mandatory international referral screens for further data entry.
- Even with the improved SRS application, which incorporates specific trigger thresholds for international referrals, there obviously have been referral omissions. SRPP personnel have worked to improve the International Case Management System enabling International personnel to identify unreferral internationally featured returns within domestic groups, thus enabling international territory managers to deal directly with their domestic counterparts.
- International is working with FS, SRPP, and PQA to continually improve the referral process. Consideration is being given to the development of a system, which would automatically refer an internationally featured return to international when the return (case) moves to status ten. International personnel would be

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required to timely determine whether to accept or reject the return. If the return is accepted, international personnel would communicate that information to the appropriate domestic manager, who would then make his or her assessment regarding the impact on the domestic group. If the domestic group manager were to determine that he or she did not want to take control of the case, the International Manager would then have opportunity to take control of the case. In those instances in which international personnel were to decide not to accept the automatic referral, the International Manager would be responsible for communicating the reason why the return was not accepted. This information would have significant value in assessing staffing needs as well as the criteria for mandatory referral.

International has had to address the fact that on certain IC cases the only issues of substance have been international issues. There has been reluctance by some domestic managers to assume responsibility for cases in which the domestic revenue agent's role is primarily administrative. To address this problem, International, working with the National Treasury Employees Union (NTEU), has made provision for international personnel to take control of cases whose issues are predominantly international.

Automated Referral System

In early November 2003, a committee headed by an SRPP representative presented a case for automatic international referrals to the leaders of the Specialist Referral System (SRS) committee. After analysis and discussion, the SRS committee determined the suggestion was plausible. After the idea is presented to and approved by the LMSB Operations Committee, a test will be conducted in a large metropolitan area. It will involve the uploading of a data stream extract created from the Automated Information Management System (AIMS) or Examination Returns Classification Systems (ERCS). The extract will include all status 10 returns in quantiles 1 and 2 with an international feature. After approval by the Operations Committee, the programming can be completed and the test initiated within a ninety-day period. If the test is successful, the program change will be implemented nationally.

As of the date of this report, the direct use of Business Returns Transaction File (BRTF) and e-file data to generate automatic international referrals utilizing SRS is not plausible. AIMS and ERCS are the current databases used to order and track returns in the audit cycle. SRS is a system that simply routes the referral to the proper resource and has limited tracking and reporting capabilities. Automatic referrals will require the input of various taxpayer information, most importantly the audit site

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address, to timely and properly route the referral. Since this vital information is not known in the extract, it will have to be extrapolated by comparing the domestic group information to a Post of Duty (POD) table. Based on data obtained through the extract and resulting extrapolation, the international referral will be routed via the SRS.

An alternative approach is being developed, which will access information from existing database systems and will enable the Office of the Director International, the international territory managers, and international team managers to identify international work within their geographical area of responsibility.

Monetary Benefits

Summary page 2, Paragraph 4; page 3, Paragraph 3

Report page 9, Paragraph 3

Appendix IV page 17

The report comments that by improving controls, which ensure returns with potential transfer pricing issues are referred to international examiners for consideration, revenue to the U.S. Treasury could potentially increase to approximately \$32.3 million annually in additional income taxes or reduction in tax attributes provided the IRS has the additional international examiner resources to examine the returns. The report states the projected benefit will be incorporated into the Semiannual Report to Congress. In Appendix IV on page 17 of the report a potential \$24.7 million is stated to be the annual benefit derived from auditing returns with potential transfer pricing issues that are currently being improperly surveyed. Projecting this adjustment over five years, the additional recommended taxes or reduced tax attributes (carry-forwards of net operating losses and tax credits) are expected to be \$123.5 million. In Appendix IV on page 19 of the report, a potential \$7.6 million is stated to be the annual benefit derived from auditing returns with potential transfer pricing issues that are currently open, but not referred. Projecting this adjustment over five years, the additional recommended taxes or reduced tax attributes (carry-forwards of net operating losses and tax credits) are estimated to be \$38 million. [References are made to page 6, which apparently is a clerical error.]

The number of returns on which the computation is based is a statistical projection based on a sample. Four assumptions are made. The first assumption addresses the number of IEs available to the examination of the issue. The second assumption is that the returns, when referred to international groups, are rejected for examination at the historical rate for FY 2002 of 32.56 percent because of workload considerations or indications that no significant tax adjustments exist. The third assumption is that the returns examined would have the same profile of no-change and changes as returns examined and reported on the International Case Management System (ICMS) over the

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last five years with transfer pricing issues under Section 482. The fourth assumption is that the returns resulting in changes when examined would yield the same average dollars per return as examined returns reported on the ICMS over the last five years with transfer pricing adjustments under Section 482.

As reflected in Appendix IV, Outcome Measures, projecting potential revenue based on a sample of returns either surveyed or not referred is subject to significant limitations. Further, transfer pricing examinations frequently lead to dispute resolution processes such as Appeals, Competent Authority, and litigation. Within these processes, a significant number of issues are resolved at amounts that frequently are substantially less than the amounts originally proposed. The resolution of such issues involves a number of considerations, which require the exercise of judgment, in particular, the choice and application of pricing methodology. As additional facts are presented, or the issue is brought into sharper focus, the original choice and application of pricing methodology may be modified to reflect additional facts and circumstances.

We are further concerned by the comment on page 8, fourth paragraph that states:

“This projection is contingent on the premise that the LMSB Division has the international resources to examine the additional returns that should be referred.”

Staffing is a significant consideration within the LMSB Division as well as within the other divisions within the IRS. SRPP has a major role in assessing staffing requirements as well as LMSB Finance and the various operating divisions and International. Dramatic changes have taken place within our economy over the last several years, including corporate reorganizations and relocations. We are on a continuing basis attempting to address apparent staffing imbalances. In fact, we have brought on new international examiners over the last several years and will continue to do so the in next fiscal year; however, staffing is a complex process that involves a number of significant variables including location as well as the time to develop the skills of an experienced international examiner. We recognize the need to align our workforce with workload demand and are continually attempting to take those steps necessary to ensure that alignment is as it should be.

The attached plan provides the specific actions the LMSB Division will take to implement your audit recommendations. If you have any questions, please contact Robert H. Green, International at (202) 435-5000.

Attachment

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Attachment

RECOMMENDATION 1:

The Commissioner, LMSB Division, should reemphasize the Transfer Pricing Compliance Directive (TPCD) and incorporate it into the Internal Revenue Manual (IRM). Additionally, the Commissioner should encourage territory managers to communicate the requirements of the Directive through team meetings, memorandums and operational reviews. This increased emphasis at the executive and manager level should communicate the importance of requesting the documentation at the onset of an examination.

Comments

We concur with Recommendation 1. We are incorporating the requirements of the TPCD in the IRM. The proposed change to the IRM will require that a request for transfer pricing documentation be made at the preplanning conference. We recognize the need to give continued emphasis to the TPCD by both domestic and International managers and their employees. Our international territory managers and team managers have addressed the Directive in their territory meetings, as well at team meetings, and through operational reviews.

As we have noted previously, the International office has asked PQA to specifically address the TPCD in their reviews, including the utilization of reason codes when an auditing standard is not met. This action will provide valuable information to the international and domestic management teams regarding compliance with this Directive over time and would become the basis for initiating follow up activity.

In addition, the TPCD has been incorporated into our globalization strategic initiatives. On the penalty side, we are tracking the percentage of cases referred to the Penalty Steering Committee in which the threshold for application of the penalty has apparently been met. Over the last year, we have initiated follow up activity with the field.

CORRECTIVE ACTION:

We will issue a memorandum to the field reemphasizing the TPCD, suggesting that requirements of the Directive be communicated through team meetings, memoranda, and operational reviews.

We are incorporating the substance of the TPCD into the IRM.

IMPLEMENTATION DATE:

We will issue a memorandum to the field on or before 10/31/2004

We will issue the revised IRM on or before 3/31/05.

RESPONSIBLE OFFICIAL:

Director, International

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CORRECTIVE ACTION(S) MONITORING PLAN

PQA is modifying review procedures to specifically address the requirements of the TPCD. We will review PQA reports on a quarterly basis to determine if follow up action is necessary.

RECOMMENDATION 2:

In the short term, the Commissioner, LMSB Division, should strengthen controls by encouraging territory managers to communicate through team meetings, memorandums and operational reviews the importance of making appropriate referrals.

Comments

We agree management has the responsibility to ensure that team managers and their teams are making appropriate referrals. As we have mentioned previously, we are undertaking two initiatives which will either result in automatic referral of international cases or will provide the field and the Office of the Director, International information regarding returns identified as returns meeting mandatory referral criteria, but not referred. We believe the adoption of either these approaches will significantly improve the referral process and may also assist in assessing staffing requirements. We also noted that the SRS has been significantly enhanced since its inception. If utilized properly, it will help to ensure that returns are timely referred.

CORRECTIVE ACTION:

We will issue a memorandum to the field addressing timely specialist referrals.

IMPLEMENTATION DATE:

We will issue a memorandum to the field on or before 10/31/04.

RESPONSIBLE OFFICIAL:

Director, International

Director, Field Specialists

CORRECTIVE ACTION(S) MONITORING PLAN

International will review and assess information derived from reports prepared by PQA addressing the non-referral of returns identified as meeting mandatory international referral criteria, and undertake follow up activity where appropriate.

RECOMMENDATION 3:

In the long term, the Commissioner, LMSB Division should have the Specialist Referral System (SRS) modified to automatically generate referrals to international examiners for returns containing the criteria for referral that can currently be identified through the

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Business Return Transaction File (BRTF) when the returns are opened for examination. Additional automatic criteria for referral can be added to the SRS as the information becomes available with the electronic filing of corporation income tax returns.

Comments

We concur with the intent of the recommendation and are considering several options. As we have noted previously, we are actively pursuing several computer applications which would ensure that international returns are timely referred. We are coordinating our activity with FS, and SRPP regarding the feasibility of having SRS automatically generate referrals. We will test this capability in a large metropolitan area after approval by the Operations Committee. If the test is successful, we will implement the program change nationally. The implementation of this program would also provide valuable information regarding existing staffing structure. We are also developing an information system, which will identify to the Director, International, and International field managers returns under examination meeting international referral requirements, but not referred.

CORRECTIVE ACTIONS:

We will continue the development and testing of modifications to the SRS to achieve automatic referral of returns meeting International mandatory referral requirements. If we develop a system, which is both efficient and cost effective, we will implement such system.

We will continue with the development and testing of information systems, which will efficiently provide information with respect to International featured returns waiting referral.

IMPLEMENTATION DATE:

Upon approval by the LMSB Operations Committee of an automated referral system, the programming can be completed and the test initiated within a ninety-day period. We expect to have a Committee decision on the proposed system by October 15, 2004.

A second system (prototype) which will provide information regarding international featured returns waiting referral to international, will be completed by September 30, 2004. We will decide whether to fully implement the system by November 30, 2004. This system is an alternative system to the automatic referral system.

RESPONSIBLE OFFICIALS:

Director, International

Director, Field Specialists

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CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor development of the tracking systems on a monthly basis.

RECOMMENDATION 4:

In the long term, the Commissioner, LMSB Division should implement an automated control when returns are selected during classification for international examiners that prevents the returns from being improperly surveyed without the prior approval of the International District Program Manager, and detects its occurrence so the team's Territory Manager can take appropriate corrective action.

Comments:

We believe that the preferred approach is to ensure that returns are timely referred. The suggested approach has been attempted in the past and has had mixed results. A primary weakness is that if the return is not referred and sufficient time is allowed to elapse, International will not have the necessary time to identify and develop substantive issues such as issues under Section 482. Managers' resistance to bringing international examiners into the examination process has added strength to their argument when statute of limitations considerations come into play. To do their work effectively, international examiners, economists, engineers, and financial product examiners must be brought onto the examination early in the examination process.

We do not concur with recommendation 4. We will continue efforts to develop and test either an automated referral system or a system which will efficiently provide information regarding returns waiting referral. Because of the time sensitivity of identifying and initiating examination activity, we believe the preferred approach is ensuring the prompt referral of international work.

IMPLEMENTATION DATE: N/A