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

COMMISSIONER
LARGE AND MID-SIZE
BUSINESS DIVISION

January 22, 2003

MEMORANDUM FOR LMSB EXECUTIVES, MANAGERS, AND AGENTS

FROM: Larry R. Langdon
Commissioner, Large and Mid-Size Business Division

SUBJECT: Transfer Pricing Compliance Directive

I am writing to share details of an important transfer pricing compliance initiative now underway and to ask you to take the steps outlined in the attached directive to support it. This compliance initiative is a key component of a high-priority joint IRS/Treasury effort in the transfer pricing area. As Assistant Secretary Pamela Olson has stated, this effort is motivated by a concern that "where the arm's length standard is not properly applied or enforced, the inappropriate income shifting that results can significantly erode the U.S. tax base."

Both policy and compliance efforts are now underway in connection with this joint initiative. In the policy arena, for example, our current transfer pricing regulations on cost sharing arrangements, services, and related issues are being reviewed and will be revised. LMSB personnel are participating actively in each of these guidance projects to ensure that the resulting guidance addresses the issues we are encountering on examination in a clear and administrable manner.

The compliance initiative involves a review of current practices in the examination of transfer pricing issues and in the imposition of transfer pricing penalties. LMSB has identified transfer pricing as a top priority in its globalization strategic initiative. We have implemented quarterly measures for all of the industries to assess transfer pricing examination activity. Although these measures currently focus on Coordinated Industry Cases, our transfer pricing initiative applies equally to Industry Cases. Together with narrative, this information will be part of LMSB's Business Performance Review meetings with the Commissioner.

We also have initiated and are involved in several other administrative efforts concerning transfer pricing. For example, we are in the process of surveying the current transfer pricing compliance rules and practices of other countries, both as a means of identifying best practices, and to ensure that current U.S. practice is consistent with that of our trading partners to the greatest extent possible. We are continuing our dialogue with relevant treaty partners to address recurring

differences of approach that have surfaced in applying transfer pricing principles in practice. LMSB also is participating, together with Appeals and Counsel, in a study now being launched by TIGTA to evaluate how transfer pricing controversies are handled as they move through our tax administration system.

Critical to our compliance initiative is the comprehensive implementation of several processes relating to transfer pricing documentation and penalties. We recognize that many teams already follow these processes as a matter of good administrative practice, but we need to ensure national consistency. We are in the process of updating the Internal Revenue Manual to make these procedures clear. To ensure the effective use of the tools provided by current law to enhance transfer pricing compliance, please implement the processes outlined in the attached directive, effective immediately.

I would like to thank you in advance for your actions in support of this important compliance initiative. Please feel free to direct any questions or comments to Carol Dunahoo or Elvin Hedgpeth, our Director and Deputy Director, International.

cc: Joseph Kehoe, Commissioner, Small Business/Self-Employed Division

LMSB Commissioner Directive
Transfer Pricing Compliance Processes
January 22, 2003

Documentation

1. **At the joint opening conference for each audit cycle, issue a written information document request for a copy of any transfer pricing documentation prepared by the taxpayer pursuant to section 6662(e). The following language should be used to request the pricing documentation: "Please provide within 30 days of this request any principal documentation outlined in Treas. Reg. § 1.6662-6(d)(2)(iii)(B) that has been prepared."**

2. **Apply the 30-day time frame provided by statute for providing a copy of any documentation prepared pursuant to section 6662(e). The discretion authorized by the regulations to excuse minor or inadvertent failures to provide required documents is limited to those situations where the taxpayer has made a good faith effort to comply and promptly remedies the failure when it becomes known, and should be exercised sparingly. With the exception of the principal documentation items described in Treas. Reg. § 1.6662-6(d)(2)(iii)(B)*(9)* and *(10)*, any documentation prepared by taxpayers pursuant to section 6662(e) must be in existence when the return is filed in order to be used to meet the documentation requirement of Treas. Reg. § 1.6662-6(d)(2)(iii).**

3. **If, as the statute permits, the taxpayer has not prepared section 6662(e) documentation, issue a written information document request at the beginning of the audit for relevant information regarding the taxpayer's transfer pricing practices. An exception should be made only if recent experience with the taxpayer has indicated that examination of some or all transfer pricing issues is unnecessary, and there have been no major changes in the taxpayer's transfer pricing practices.**

4. **Follow similar processes where Industry Cases are selected for audit.**

Audit Planning Process

1. **As soon as the taxpayer's section 6662(e) documentation or other transfer pricing information is received, refer it to an international examiner and/or economist for risk assessment.**

2. **If the risk assessment indicates that transfer pricing issues should be examined, include those issues in the audit plan.**

3. **In accordance with current IRM procedures, refrain from pursuing *de minimis* transfer pricing adjustments. Where the Limited Issue Focused Examination (LIFE) process is being used, the materiality thresholds and other procedures specified in IR 2002-133 (December 4, 2002) should be followed for transfer pricing issues, as for others.**

<u>Section 6662(e) Penalty</u>

1. **Assert the penalties provided under section 6662(e) where warranted. Under the law, an otherwise applicable net section 482 transfer price adjustment penalty under section 6662(e)(3) may not be waived unless documentation is prepared and submitted in accordance with the requirements of the statute and regulations.**

2. **If the team decides to propose an adjustment that would trigger a section 6662(e) penalty, the Penalty Screening Committee must review the case before the 30- or 90-day letter is issued. (See Announcement 96-16, 1996-13 I.R.B. 22.)**

3. **If the penalty threshold is met but the team decides not to propose the penalty, the concurrence of the responsible International Territory Manager must be obtained. The International Territory Manager should forward a copy of relevant documentation that explains the decision to the International Penalty Technical Advisor.**