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**Key changes to
IRS audits in
transfer pricing:
are you in the know?**



BUREAU VAN DIJK



Since 2010 the **Internal Revenue Service (IRS)**, the US federal government's tax authority, has lost 30% of its enforcement staffing through budget cuts.

As reported recently in the **Wall Street Journal (WSJ)**, this dent in operational might has forced the agency to rethink its approach to auditing individual and corporate returns – something that, in the case of the latter, will significantly affect the way multinationals' **transfer pricing** arrangements are assessed. It will also shift attention on to some mid-market companies and their offshore tax payments.

The WSJ quotes Doug O'Donnell, commissioner for the IRS's large business and international division (LB&I), who describes the audit process as a "very expensive and time-intensive activity".

Clearly big changes were needed.

**By Alistair King,
content and communications
manager, Bureau van Dijk**

New audit “campaigns”

Addressing the tricky issue, O'Donnell's unit has introduced 13 audit “campaigns”, representing the initial rollout of a wider push in tax compliance. In this context, a campaign appears to be an initiative to pursue a particular tax issue and all the companies that are affected by it.

Outlined on a **summary page** on its website, the IRS says that the scheme represents a “significant milestone”, reached “through LB&I extensive data analysis, suggestions from IRS compliance employees and feedback from the tax community [which will] improve return selection, identify issues representing a risk of non-compliance, and make the greatest use of limited resources”.

To a large extent, these campaigns will replace old algorithmic flags, which had done nothing to reduce the need to dig through entire returns.

Of the 13 new campaigns already announced, the four most relevant to cross-border tax considerations for multinationals and large corporations are highlighted in these excerpts:

The “related party transactions” campaign, relating to the “enterprise activities” practice area

“This campaign focuses on transactions between commonly controlled entities that provide taxpayers a means to transfer funds from the corporation to related pass through entities or shareholders. LB&I is allocating resources to this issue to determine the level of compliance in related party transactions of taxpayers in the mid-market segment. The treatment stream for this campaign is issue-based examinations.”

The “repatriation” campaign, relating to the “cross-border activities” practice area

“LB&I is aware of different repatriation structures being used for purposes of tax free repatriation of funds into the US in the mid-market population. It has also been determined that many of the taxpayers do not properly report repatriations as taxable events on their filed returns. The goal of this campaign is to simultaneously improve issue selection filters while conducting examinations on identified, high risk repatriation issues and thereby increase taxpayer compliance.”

The “form 1120-F non-filer” campaign, also relating to the “cross-border activities” practice area

“Foreign companies doing business in the US are often required to file Form 1120-F. LB&I has data suggesting that many of these companies are not meeting their filing obligations. In this campaign, LB&I will use various external data sources to identify these foreign companies and encourage them to file their required returns. The treatment stream for this campaign will involve soft letter outreach. If the companies do not take appropriate action, LB&I will conduct examinations to determine the correct tax liability. The goal is to increase voluntary compliance by foreign corporations with a U.S. business nexus.”

The “inbound distributor” campaign, relating to the “treaty and transfer pricing operations” practice area

“US distributors of goods sourced from foreign-related parties have incurred losses or small profits on US returns, which are not commensurate with the functions performed and risks assumed. In many cases, the US taxpayer would be entitled to higher returns in arms-length transactions. LB&I has developed a comprehensive training strategy for this campaign that will aid revenue agents as they examine this IRC Section 482 issue. The treatment stream for this campaign will be issue-based examinations.”

And that might not be the end of the matter; according to the IRS, “More campaigns will continue to be identified, approved and launched in the coming months”. But it’s enough for now. So what does it mean for you?

What this means for tax specialists operating in this space



Luis Carrillo, director of tax and transfer pricing solutions at Bureau van Dijk, is quick to spell out that “the IRS’s focus on transfer pricing will very noticeably affect multinationals that operate in the US, including those headquartered in Europe and Asia”.

He added that the increased scrutiny on US-based distributors of foreign companies is significant, and that “because the agency will look at mid-tier firms and not just look at the large blue chip multinationals, more companies will be affected”.

As highlighted by the WSJ, other salient points include these:

- Auditors are now focusing on how middle-market companies bring offshore earnings home. While US companies owe the 35% tax on their worldwide income – minus foreign taxes – they can defer paying their US tax until they bring the money home. This practice is known as “repatriation”.
- According to its announcement on 31st January, the IRS “determined that many of the taxpayers do not properly report repatriations as taxable events on their filed returns”.
- The agency’s auditors are also examining whether foreign companies using US-based distribution subsidiaries are charging market rates. The agency is concerned that distributors avoid US tax by underpricing their services.

First and foremost this is a US tax concern. However, since most multinationals have operations in the US, this new initiative will have knock-on effects on many companies’ international tax regimes. To the extent that the IRS initiative results in tax adjustments and the reallocation of profits to the US, the risk of double taxation becomes greater for multinationals operating in the US. So, according to Carrillo, “multinationals may have to resort to dispute resolution procedures in order to mitigate the impact that any US-driven tax adjustments may have on double taxation”.

The good news is that companies with appropriate documentation, and with robust arm's-length analysis justifying their cross-border dealings with regard to the US, are likely to be less affected by these initiatives – though not necessarily exempt from being audited as part of these campaigns.

With regards to documentation strategies that multinationals can draw from, these are discussed in a **recent webinar** we hosted. But there are other ways we can help.

How Bureau van Dijk's transfer pricing solutions can help

In this complex area of tax and transfer pricing compliance, much of your work hinges on access to extensive and reliable company information for comparables research. In turn, this needs to be properly documented.

“The best way for companies to protect themselves is to have robust documentation for their TP policies and to have clear evidence of arm's-length pricing, i.e. a solid benchmarking analysis,” says Carrillo, who draws attention to two key areas with which we can help:

- **Documentation** “Documentation is a company's best defence,” says Carrillo. “Our **TP Catalyst Document Manager** can help multinationals identified by the IRS via these campaigns to manage, maintain and produce TP documentation to support their policies.”
- **Arm's-length pricing** “This is the best way to prevent tax adjustments. **TP Catalyst** benchmarking – with data from our **Orbis** database of more than 200 million companies – can help establish arm's-length TP policies for related party transactions, for inbound distributors, for foreign companies operating in the US (1120Fs) and to justify the amounts repatriated via transfers of property or related-party transactions.”

**Do get in touch to
discuss these solutions
or to request a trial**

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bvd@bvinfo.com

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