



Performance audit of IRS concludes transfer pricing issues not being properly evaluated

Global Transfer Pricing Alert 2016-037

The Treasury Inspector General for Tax Administration (TIGTA) in a final report issued November 3 concluded that transfer pricing issues are not being properly evaluated by the Internal Revenue Service because of various procedural barriers at the agency.

TIGTA's report was written at the conclusion of a performance audit conducted for the 2012-2014 calendar years. As discussed below, TIGTA has made seven recommendations to improve the IRS's evaluation of transfer pricing issues. The IRS agrees with some but not all of the recommendations and will implement various changes accordingly.

TIGTA's Audit

TIGTA conducted a performance audit of the IRS because cross-border trade in goods and services has increased substantially over the past several decades. In addition, the IRS has designated transfer pricing as a key focus of its international compliance initiatives. Transfer pricing issues account for approximately 46 percent of the Large Business and International Division's (LB&I's) international issues inventory and 71 percent of the potential total dollar adjustment amounts of all international tax issues. TIGTA initiated this audit to identify and assess whether any barriers existed to the IRS efficiently evaluating transfer pricing issues.

Of particular note was the sustention rate of cases taken to IRS Appeals. In its survey, TIGTA analyzed 213 examinations that included at least one transfer pricing issue with appealed adjustments that was closed during calendar years 2012 through

2014. TIGTA determined that appealed cases were settled for amounts that were much smaller than what was proposed by LB&I's Examination function. Specifically:

- Of the 213 examinations, the total amount of proposed adjustments was approximately \$10.5 billion during the time period under review.¹ In contrast, the total final examination assessment amount was only \$2.0 billion. This shows that the originally proposed adjustment amounts were reduced by \$8.5 billion through the Appeals process.
- Actual assessment amounts showed that only \$321 million of the original proposed \$10.5 billion in proposed adjustments were ever posted to taxpayer accounts.

Examiners were not always aware that their proposed transfer pricing-related adjustments had been reduced by the Appeals function. One of TIGTA's survey questions to Transfer Pricing Practice (TPP) and the International Business Compliance (IBC) function employees asked if they were informed when their proposed transfer pricing adjustments were reduced by the Appeals function. Approximately 54 percent of the respondents said they were not informed. Another 14 percent said they were informed, but were unaware of the reason for the change.

TIGTA also made the following findings:

- The IRS has provided external stakeholders (including taxpayers and foreign governments) sufficient education and outreach related to the transfer pricing examination process. However, some IRS employees might not have been consistently following the Transfer Pricing Audit Roadmap, which was issued as a tool to help taxpayers and the IRS conduct transfer pricing audits.
- The IRS did not have a process to ensure that all transfer pricing issues were identified for specialized review. Only 20 percent of the transfer pricing inventory was received from the Specialist Referral System (SRS), an electronic, web-enabled referral routing system used to request international assistance on original filed returns. Further, employees of the TPP function did not have access to the SRS and needed to rely instead on management of another IRS function, the IBC function, to share any transfer pricing referrals with them. In addition, the rules of engagement between the TPP and the IBC function were not always followed.
- There were no separate performance measures related to quantifiable results to determine the success of the IRS's transfer pricing efforts. This included a lack of performance measures to evaluate IRS Appeals (Appeals) determination information, which could be used to refine the approach for identifying and working transfer pricing cases.

¹ Due to limitations on how the IRS captures the net assessment on each case, TIGTA was not able to differentiate whether the appealed adjustments related to transfer pricing or to the other adjustments in the examination assessment.

As a result of these findings, TIGTA recommended the following measures:

- The IRS should ensure that its employees follow the Transfer Pricing Roadmap and include this as an attribute of the quality review process.
- The IRS should ensure that TPP employees have full access to the SRS and that TPP and IBC function employees follow the rules of engagement between the two functions. This latter measure should be included as an attribute of the quality review process, too.
- The commissioner, LB&I Division, should develop a formal and comprehensive transfer pricing strategy, as well as implement a post-mortem review of examinations with transfer pricing issues that went through the Appeals process.

TIGTA organized these measures into seven recommendations. The IRS agreed or partially agreed with five of the recommendations, and disagreed with two of them.

For more details of TIGTA's performance audit, please see the link below:

<https://www.treasury.gov/tigta/auditreports/2016reports/201630090fr.pdf>

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