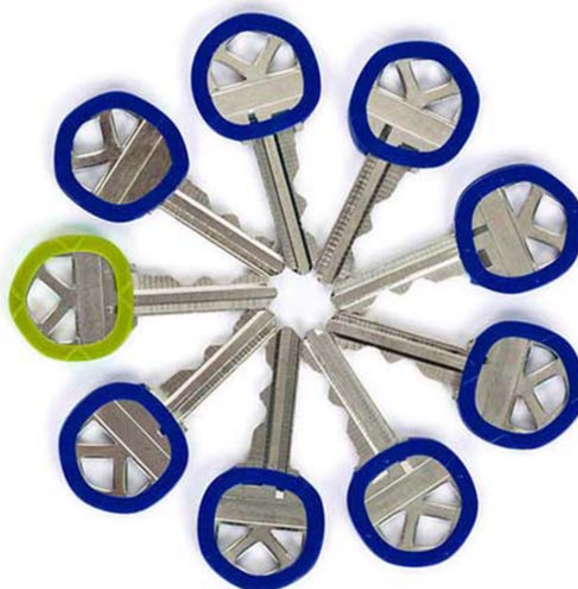

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## IRS Large Business & International Division Issues Transfer Pricing Guidance

During January 2018, the Commissioner of the Large Business & International ("LB&I") division of the Internal Revenue Service ("IRS") issued five directives (collectively "Transfer Pricing Directives") addressing various transfer pricing enforcement issues and mechanisms, such as Information Document Requests ("IDR") and the assertion of penalties in transfer pricing cases. These directives are designed to provide guidance on the issues to examiners, as well as other applicable IRS personnel.

The Transfer Pricing Directives are as follows:


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1. Interim Instructions on Issuance of Mandatory Transfer Pricing IDR in LB&I Examinations;[1]
2. Instructions for Examiners on Transfer Pricing Issue Examination Scope – Appropriate Application of I.R.C. § 6662(e) penalties;[2]
3. Instructions for Examiners on Transfer Pricing Selection – Reasonably Anticipated Benefits in Cost Sharing Arrangements;[3]
4. Instructions for Examiners on Transfer Pricing Selection – Cost-Sharing Arrangement Stock Based Compensation;[4]
5. Instructions for LB&I on Transfer Pricing Selection and Scope of Analysis – Best Method Selection.[5]

A short summary of each directive is set forth below. Taxpayers and practitioners with a LB&I examination involving these types of issues or with an Advanced Pricing Agreement submission, should be aware of these significant changes to LB&I procedures.

Since 2003, LB&I examiners have been required to issue a transfer pricing IDR, which specifically requests documentation under Section 6662(e), for any taxpayer with certain international information returns or cross-border transactions.[6] The first directive removes this requirement and instead provides that the mandatory transfer pricing IDR will only be issued in certain circumstances, such as pursuant to an IRS campaign or if initial indications of compliance risk are noted.[7] This directive expires on January 12, 2020.

The second directive addresses Section 6662(e) contemporaneous documentation and specifies that penalties are required to be assessed if the documentation is not adequate, reasonable, and timely. To this end, the directive instructs examiners that mere presence of documentation is not, by itself, necessarily sufficient to forestall penalties and must be evaluated "for adequacy and reasonableness" to ensure it is meets the requisite standards.

The last three directives apply to specific transfer pricing issues and the process for evaluation of a taxpayer's selection of a method under Section 482 and the regulations thereunder. Under the third and fourth directives, IRS examiners are instructed to stop developing issues or opening issues related to the following two items:

- Cost sharing arrangements based on changing a taxpayer's multiple reasonably anticipated benefit ("RAB") shares to a single RAB share when certain transactions are added to an existing cost-sharing arrangement; and
- Stock-based compensation included in cost-sharing arrangement intangible development costs.

The fourth directive states that it is necessary to stop stock-based compensation adjustments in this context, while the IRS appeals the decision in *Altera Corp. v. Comm'r.*, 145 T.C. 91 (2015). This directive provides that, if this issue has already been opened in an examination, the taxpayer may agree to extend the statute of limitations until *Altera* is decided, otherwise, the development of the issue by the IRS examiner or specialists will continue.

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[1] LB&I-04-0118-001, *Interim Instructions on Issuance of Mandatory Transfer Pricing Information Document Request (IDR) on LB&I Examinations*, located at: https://www.irs.gov/businesses/corporations/interim-instructions-on-issuance-of-mandatory-transfer-pricing-information-document-request-idr-in-lbi-examinations (January 12, 2018).
[2] LB&I-04-0118-003, *Instructions for Examiners on Transfer Pricing Issue Examination Scope – Appropriate Application of IRC § 6662(e) penalties*, located at: https://www.irs.gov/businesses/corporations/instructions-for-examiners-on-transfer-pricing-issue-examination-scope-appropriate-application-of-irc-ss6662e-penalties (January 12, 2018).
[3] LB&I-04-0118-004, *Instructions for Examiners on Transfer Pricing Selection – Reasonably Anticipated Benefits in Cost Sharing Arrangements*, located at: https://www.irs.gov/businesses/corporations/instructions-for-examiners-on-transfer-pricing-selection-reasonably-anticipated-benefits-in-cost-sharing-arrangements (January 12, 2018).
[4] LB&I-04-0118-005, *Instructions for Examiners on Transfer Pricing Selection – Cost-Sharing Arrangement Stock Based Compensation*, located at: https://www.irs.gov/businesses/corporations/instructions-for-examiners-on-transfer-pricing-selection-cost-sharing-arrangement-stock-based-compensation (January 12, 2018).
[5] LB&I-04-0118-006, *Instructions for LB&I on Transfer Pricing Selection and Scope of Analysis – Best Method Selection*, located at: https://www.irs.gov/businesses/corporations/instructions-for-lbi-on-transfer-pricing-selection-and-scope-of-analysis-best-method-selection (January 29, 2018).
[6] IRS Large and Mid-Size Business Division Commissioner Transfer Pricing Compliance Directive dated January 22, 2003. *See also* Internal Revenue Manual Exhibit 4.46.3-4 for procedures.
[7] In this instance, only a specialist will be allowed to issue the transfer pricing IDR requesting contemporaneous documentation.


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Lastly, the fifth directive provides that the IRS Treaties and Transfer Pricing Operations Transfer Pricing Review Panel ("TTPO Review Panel") must provide approval before an IRS examiner can change a taxpayer's selected method as the best method. Importantly, however, this directive provides that an IRS examiner is allowed to alter the application of the taxpayer's chosen method without obtaining the approval of the TTPO Review Panel. This directive applies to LB&I examinations and Advance Pricing Agreement submissions from October 1, 2017 on a going forward basis.

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## Organisation for Economic Co-operation and Development Launces ICAP

The Organisation for Economic Co-operation and Development (OECD) recently launched its International Compliance Assurance Programme (ICAP) pilot. The ICAP pilot is being led by the OECD Forum on Tax Administration (FTA), and focuses on the multilateral risk assessment and resulting tax assurance of large Multinational Enterprise (MNE) groups. There are eight FTA jurisdictions participating in the pilot: Australia, Canada, Italy, Japan, the Netherlands, Spain, the United Kingdom and the United States.

The ICAP pilot is a voluntary program that will use Country-by-Country reports and other information to facilitate multilateral engagements between MNE groups and tax administrations. By coordinating engagements between a MNE group and tax administrations in several jurisdictions simultaneously, ICAP is intended to make more effectively use of transfer pricing information, as well as resources for both the MNE groups and for tax administrations.

The international tax risks to be covered as part of the ICAP pilot (the covered risks) are transfer pricing risk and permanent establishment risk. Future ICAP risk assessments may also cover other relevant or material international tax risks, as agreed between a MNE group and covered tax administrations (including, for example, withholding taxes and the application of the relevant international tax treaty).

The ICAP pilot process begins with each participating MNE group providing a package of documentation to their lead tax administration, which then shares the package with other covered tax administrations. Approximately six weeks after the documentation package is provided, a kick-off meeting is held between the MNE group and all covered tax administrations, to discuss the documentation package and ensure a common understanding of its content and the process to be followed.

The covered tax administrations then conduct an assessment of the transfer pricing risks and permanent establishment risks (the covered risks) posed by the MNE group, based on the information contained in the documentation package and other information held by the covered tax administrations. The covered tax administrations will seek to gain assurance that the MNE group poses no or low risk for each of the covered risks, within agreed upon timeframes.

At the end of the risk assessment process, and subject to domestic requirements and processes, each covered tax administration will issue an outcome letter to the MNE group, which will set out each of the covered risks where the tax administration has been able to gain assurance, and any identified tax risks that remain.

If MNE group and tax administrations reach agreement, the process moves to providing tax assurance to the MNE group. ICAP does not provide an MNE group with legal certainty as may be achieved, for example, through an advance pricing agreement, but gives assurance where tax administrations participating in the program consider a risk to be low. Additionally, ICAP is designed to be forward looking, as such, the participating tax authorities will aim to provide tax assurance to an MNE group at the conclusion of the ICAP risk assessment for the covered risks for the next two succeeding tax filing periods, provided there are no material changes during this period.

For more information on the ICAP pilot see the International Compliance Assurance Programme Pilot Handbook.
**URL:** http://www.oecd.org/tax/forum-on-tax-administration/international-compliance-assurance-programme.htm

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## The Tax Court Vacates Opinion upon Consideration of Second Circuit's Decision, but Still Concludes that Taxpayers are Liable for Accuracy-Related Penalties

IRC § 6751 was enacted as part of the IRS Restructuring and Reform Act of 1998, which introduced additional procedures for determining and assessing penalties. Section 6751, in particular, was designed to curtail the improper imposition of penalties and prevent IRS agents from using the prospect of penalties as a bargaining chip against taxpayers.

In *Graev v. Comm'r*[8] ("*Graev II*"), the Tax Court concluded that Lawrence G. Graev and Lorna Graev (the "Graevs"), who claimed deductions for a conservation easement contribution that were disallowed by the Tax Court in 2013, were liable for 20-percent accuracy-related penalties. In *Graev II*, the Tax Court considered whether the IRS was barred from assessing accuracy-related penalties because the IRS could not demonstrate that the proper written approval for assessment of the penalties had been given, as required by IRC § 6751(b)(1).

The Graevs purchased property in a historic preservation district in New York, New York in 1999. In December of 2004, the Graevs contributed cash and a façade conservation easement to the National Architectural Trust ("NAT"), and claimed a charitable contribution deduction for the cash contribution and noncash (easement) donation on their 2004 Form 1040, *US Individual Income Tax Return*, and carried the deduction forward on their 2005 Form 1040. In September of 2004, the Graevs received a "side letter" from NAT, which provided that, in the event that the IRS were to disallow the charitable contribution deductions that the Graevs intended to claim on their individual tax returns, then NAT would refund their cash contribution and remove the façade conservation easement from the Graevs' property.

In the notice of deficiency, the IRS disallowed the Graevs' charitable contribution deductions taken in connection with the easement donation, asserted a 40-percent accuracy-related penalty and, in the alternative, a 20-percent accuracy-related penalty, under IRC § 6662, for both 2004 and 2005. The Graevs argued that there was no managerial approval for the alternative 20-percent accuracy-related penalties recorded in writing, as required by IRC § 6751(b). In a prior opinion, the Tax Court determined that the charitable contribution deductions were properly disallowed.[9] Thereafter, the IRS conceded that the IRC § 6662(h) valuation penalty was inapplicable; however, the IRS maintained that the accuracy-related penalties under IRC 6662(a) applied.

In contesting the IRS's penalty determinations, the Graevs argued that the IRS had failed to comply with the requirement of IRC § 6751(b)(1), which states that "[n]o penalty shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher office as the Secretary may designate." In *Graev II*, there was no evidence offered that the accuracy-related penalty determinations were approved by the immediate supervisor of the IRS agent who made the initial determinations.

After analyzing the Graevs' argument and the IRS's counterarguments, the Tax Court determined that it was premature for the Tax Court to consider whether the IRS had complied with the IRC § 6751(b)(1) requirement because the IRS had not yet assessed the IRC § 6662 penalties at issue. The Tax Court noted that an assessment is the formal recording of a taxpayer's liability on the IRS's records. The Tax Court then pointed to the statutory language and the legislative history to IRC § 6751, and concluded that there is no deadline for obtaining the requisite approval before assessment. The Tax Court ultimately concluded that the Graevs were liable for the 20% accuracy-related penalties, finding that none of the defenses to the penalties that they raised applied.

In dissent, Judge Gustafson and four other judges concluded that, in light of IRC § 7491(c), consideration of IRC § 6751(b)(1) was not premature in a deficiency case ("*Graev II* dissent"). The *Graev II* dissent observed that the majority's construction of the statute would undermine the congressional goal in creating a supervisory approval requirement, expressed in the legislative history to IRC § 6751, for penalties to only be imposed where appropriate and not as a bargaining chip. The five dissenting members would have held that written approval must be obtained prior to the initiation of Tax Court proceedings regarding penalties and that the failure to obtain the supervisory approval required by IRC § 6751(b)(1) bars the assessment of an accuracy-related penalty.

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[8] 147 T.C. No. 16 (Nov. 30, 2016).
[9] *Graev v. Comm'r*, 140 T.C. 377 (2013).


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In *Chai v. Comm'r*[10] ("*Chai*"), Mr. Chai did not pay self-employment tax on a $2 million payment he received in 2003. The IRS issued a notice of deficiency, asserting that Mr. Chai owed the additional amount of self-employment tax, as well as a 20-percent accuracy-related penalty under IRC § 6662. Mr. Chai petitioned the Tax Court for redetermination of the deficiency.

Mr. Chai argued, in his post-trial briefing, that the IRS failed to meet the burden of production under IRC § 7491(c) because the IRS had not provided evidence of compliance with the IRC § 6751(b)(1) written-approval requirement. The Tax Court sustained the self-employment tax deficiency and the associated accuracy-related penalty. However, the Tax Court declined to consider Mr. Chai's IRC § 6751(b)(1) argument because it was raised for the first time in a post-trial briefing.

On appeal to the Second Circuit, the IRS argued that the circuit court should adopt the reasoning of the majority in *Graev II* and find that the issue of compliance with the written-approval requirement was not ripe for review in a deficiency proceeding. The appellate court framed its task in *Chai* as: "to decide which side in *Graev* [*II*] got it right"[11] (*i.e.*, the majority or the dissent).

After reviewing the statutory language and the legislative history to IRC § 6751, the Second Circuit found the *Graev II* dissent more persuasive than the majority opinion. The Second Circuit endorsed the *Graev II* dissent's view that the IRS was required to obtain written approval of the penalty pre-assessment, and the court concluded that compliance with the written-approval requirement is an element of the IRS's penalty claim. Consequently, in *Chai*, the appellate court held that compliance with IRC § 6751(b) is part of the IRS's burden of production and proof in a deficiency case in which a penalty is asserted. The Second Circuit also determined that the Tax Court abused its discretion by declining to consider Mr. Chai's post-trial claim that the IRS had not complied with the written-approval requirement under IRC § 6751(b)(1), where compliance with IRC § 6751(b)(1) is required before the penalty proceedings begin. Because the IRS failed to show that it complied with the written-approval requirement, the Second Circuit concluded that assessment of the penalty was improper in this case.

Because *Graev II* is appealable to the Second Circuit, after *Chai*, the Tax Court vacated its decision in *Graev II*. In *Graev v Comm'r*[12] ("*Graev III*"), after considering the Second Circuit's decision in *Chai*, the Tax Court determined that IRC § 6751(b) does not bar assessment of the accuracy-related penalties under IRC § 6662(a) against the Graevs.

Upon reconsideration after *Chai*, the Tax Court reversed the portions of *Graev II* in which it concluded that it was premature to consider IRC § 6751(b) issues in a deficiency proceeding. Consequently, in *Graev III*, the Tax Court considered the merits of the Graevs' IRC § 6751(b) argument.

In *Graev III*, the Tax Court further developed the facts, and reviewed the specific steps that led to the assertion of the 20-percent accuracy-related penalties. Upon examination of the Graevs' 2004 and 2005 income tax returns, a Revenue Agent ("Revenue Agent") proposed disallowance of the cash and noncash charitable contribution deductions that the Graevs had claimed related to the façade easement given to NAT. The Revenue Agent proposed accuracy-related penalties under IRC § 6662(a), as increased to 40-percent under IRC § 6662(h), be asserted; these penalties were applied to the underpayments attributable to disallowance of the Graevs' noncash charitable contribution deduction. The Revenue Agent did not propose 20-percent accuracy-related penalties for 2004 and 2005. The Revenue Agent's penalty proposal was approved in writing by his Group Manager ("Group Manager").

Following receipt of the Group Manager's written approval of the 40-percent penalty, the Revenue Agent sent the administrative file to the IRS Technical Services Unit for review and for preparation of the notice of deficiency. After reviewing the case file, the Technical Services Unit employee prepared a proposed notice of deficiency and sent it to the office of the Manhattan Area Counsel, in the Office of Chief Counsel, for further review. A General Attorney ("General Attorney") reviewed and approved the proposed notice of deficiency and instructed that an alternative penalty position (asserting the 20-percent accuracy-related penalties under IRC § 6662(a), with respect to the noncash charitable contribution deduction and carryover deduction) be added to the notice of deficiency in a memorandum. An Associate Area Counsel ("AAC I"), General Attorney's immediate supervisor, approved General Attorney's memo in writing by initialing the memo.

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[10] 851 F.3d 190 (2d Cir. 2017).
[11] *Id.* at 216.
[12] 149 T.C. No. 23 (Dec. 20, 2017).


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After the memo, including the alternative penalty position, was approved by AAC I, the memo was sent to Manhattan Technical Services, where an employee made the requested changes to the notice of deficiency, consistent with the IRS's procedures, as set forth in the Internal Revenue Manual. Subsequently, the updated notice of deficiency was signed by the Technical Services Territory Manager ("Technical Services Territory Manager") and sent to the Graevs. The notice of deficiency included the penalties proposed by Revenue Agent and the alternative 20-percent penalties added by General Attorney.

As part of the Tax Court proceedings, an IRS attorney ("IRS Attorney") filed an Amendment to Answer, reasserting the 20-percent noncash contribution penalties and asserting the IRC § 6662(a) penalties, computed at the 20-percent rate, with respect to the cash charitable contribution and carryover deduction for the first time. In the Amendment to Answer, the IRS asserted 20-percent accuracy-related penalties on the grounds that the underpayments were due to negligence or disregard of rules and regulations under IRC § 6662(b)(1) and (c), and to substantial understatements of income tax under IRC § 6662(b)(2) and (d). The initial determination with respect to these cash contribution penalties was made by IRS Attorney, and the amendment to answer was then approved in writing by IRS Attorney's immediate supervisor, an Associate Area Counsel ("AAC II").

In *Graev III*, the IRS conceded that the Graevs were not liable for the 40-percent gross valuation misstatement penalties under IRC § 6662(h); however, it maintained that, based on the disallowance of the noncash and cash charitable contribution deductions, they were liable for the 20-percent accuracy-related penalty under IRC § 6662(a). Once again, the Graevs argued that the IRS was barred from assessing these accuracy-related penalties because the IRS did not comply with the supervisory approval requirements set forth in IRC § 6751(b).

The Tax Court, in *Graev III*, noted that the IRS has the burden of production with respect to the liability of a taxpayer for any penalty, in accordance with IRC § 7491(c). With respect to the 20-percent alternative noncash contribution penalties, the Tax Court concluded that the IRC § 6751(b) requirement was satisfied where General Attorney made the initial determination and AAC I, General Attorney's immediate supervisor, approved the determination in writing. With respect to the 20-percent cash contribution penalties, the Tax Court found that the initial determination was made by IRS Attorney and this determination was approved in writing by AAC II, IRS Attorney's immediate supervisor. Consequently, the Tax Court concluded that the IRS also met its burden of production with respect to the cash contribution penalties.

Because the IRS met its burden by demonstrating compliance with the IRC § 6751(b) requirements for the 20-percent accuracy-related penalties asserted in the notice of deficiency and the amendment to answer, the Tax Court held that the Graevs were liable for accuracy-related penalties under IRC § 6662(a) for 2004 and 2005.

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