

***FISCAL YEARS 2000 – 2001 IRS STUDY***  
***EFFECTIVENESS OF INTERNAL REVENUE CODE***  
***SECTION 6662(e)***

***FINAL REPORT***

Response to:

The Request from the Senate Committee on Appropriations

106<sup>th</sup> Congress, 1<sup>st</sup> Session

**December 28, 2001**

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**Introduction**

This Final Report is submitted in response to a request from the Senate Committee on Appropriations (the “Committee”), attached to Report No. 106-87 on the Treasury and General Government Appropriation Bill, 2000 (S.1298, 106<sup>th</sup> Congress, 1<sup>st</sup> Sess.) (the “Committee Report”). Senate Bill 1298 was the predecessor of H.R. 2490, which was enacted as the Treasury and General Government Appropriations Act, 2000, Pub. L. No.106-58, 113 Stat. 430 (1999).

The Committee expressed the view that it is critical that the IRS improve its enforcement of section 482 of the Internal Revenue Code of 1986 (the Code). In particular, the Committee expressed concern about the effectiveness of legislative changes affecting administration of section 482, such as section 6662(e) of the Code.

For this reason, the Committee Report directed the IRS to study in fiscal years 2000 and 2001 the effectiveness of section 6662(e).

The Committee asked the IRS to provide information on three specific areas of interest:

1. whether taxpayers are preparing contemporaneous transfer pricing documentation as anticipated by section 6662(e),
2. the quality of the documentation, and
3. the utility of such documentation to the IRS in enforcing section 482.

The Committee directed the IRS to file an interim report by September 30, 2000, and a final report by December 31, 2001. An Interim Report was submitted on October 20, 2000, pursuant to an extension agreed to by the Committee Chairman’s office.

This Report contains the findings of the IRS from a two-phase study, which gathered information concerning transfer pricing documentation prepared by taxpayers.

## **Executive Summary**

Section 482 of the Code authorizes the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income. The regulations under section 482 generally provide that prices charged by one affiliate to another, in an intercompany transaction involving the transfer of goods, services, or intangibles, yield results that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. This standard of a taxpayer dealing at arm's length with a controlled affiliate, known as the arm's length standard, has been incorporated in regulations under section 482 or its predecessors for more than sixty years.

The IRS's goal in administering section 482 is to ensure that each controlled taxpayer reflects its "true taxable income" from intercompany transactions, as determined under the arm's length standard. The arm's length standard applies to foreign controlled corporations (FCCs) in the United States and to domestic corporations with controlled affiliates within and outside the United States.

To discourage taxpayers from using transfer pricing inappropriately to shift taxable income, Congress enacted legislation that imposes penalties on underpayment of tax related to transfer pricing transactions involving substantial and gross valuation misstatements (described below). Section 6662(e) (substantial valuation misstatement) and section 6662(h) (gross valuation misstatement) and the regulations thereunder prescribe circumstances under which the taxpayer is subject to these penalties.

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. The regulations set forth standards designed to ensure that the documentation evidences use of the transfer pricing method that provides the most reliable measure of an arm's length result based upon the facts and circumstances involved.

Sections 482 and 6662(e) are predicated on three fundamental principles:

- (1) The taxpayer should substantiate the appropriateness of its transfer pricing practices.
- (2) The taxpayer's transfer pricing methodology should be reasonable in light of the facts and circumstances, and should produce the most reliable measure of an arm's length result under section 482.

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**Executive Summary (Continued)**

- (3) To avoid imposition of any penalties that might otherwise apply under section 6662(e), the taxpayer must have contemporaneous documentation that supports the determination and reasonableness of its transfer prices, and these documents must be readily available to the IRS.

The Committee posed three questions to the IRS concerning transfer pricing documentation:

- (1) Are taxpayers preparing contemporaneous documentation as anticipated by section 6662(e)?
- (2) What is the quality of this documentation?
- (3) What is the utility of the documentation to the IRS in enforcing section 482?

The IRS performed a two-phase study to gather information to respond to the Committee's inquiry. In Phase 1, a sample of 696 corporate taxpayers responded to a questionnaire on an anonymous basis. This questionnaire was intended to determine the extent to which taxpayers prepare contemporaneous documentation. In Phase 2, teams of IRS personnel conducted on-site reviews of twenty-five selected multinational corporations, in order to assess the quality and utility of the section 6662(e) documentation provided by taxpayers subject to ongoing examinations.

The aggregate response data collected in Phase 1 indicate that a substantial percentage of taxpayers prepares contemporaneous documentation pursuant to section 6662(e). Most taxpayers report that they prepare documentation for a substantial proportion of controlled transactions. Taxpayers that prepare documentation for fewer than all transactions generally do so based on a cost-benefit analysis. These taxpayers generally attempt to prepare documentation for transactions that have the greatest potential to generate significant transfer pricing adjustments.

The taxpayer-specific reviews conducted in Phase 2 indicated that most taxpayers in the group made substantial efforts to prepare documentation in accordance with section 6662(e), particularly for the controlled transactions deemed to have the greatest potential for scrutiny under section 482. The range of the quality of documentation in individual cases varied widely. The review teams identified several specific areas in which the documentation provided by

### **Executive Summary (Continued)**

most corporations could have been improved, in order to increase the utility to the IRS.

The IRS examination teams surveyed in Phase 2 concluded that the documentation provided was very useful in the examination of transfer pricing issues. Documentation allowed early identification of key issues and in many cases yielded significant savings of resources. In addition, evidence suggests that the preparation of contemporaneous documentation leads taxpayers to perform more comprehensive up-front analysis of transfer prices, and thereby reduces the number of disputes in this area.

The extent to which taxpayers prepare contemporaneous documentation pursuant to section 6662(e), and the quality of that documentation, could be improved. However, this Report concludes, based on the information collected, that taxpayers prepare documentation in most cases, and that documentation often covers a significant percentage of the taxpayer's controlled transactions. Transfer pricing documentation has proven useful to the IRS's administration of section 482. Moreover, the data indicate that the quality and usefulness of the documentation are improving and will continue to improve as taxpayers and the IRS gain additional experience with section 6662(e).

This Report gives an overview of section 6662(e) and current section 6662(e) administration, and describes in detail the methodology and findings of Phase 1 and Phase 2 of the study. An independent evaluation of the Phase 1 survey results is also provided in Appendix A. Evaluations of the corporations examined in Phase 2, from which all taxpayer-identifying information has been deleted, are contained in Appendix B.

This Final Report consists of five sections:

- I. Section 6662(e) of the Code
- II. IRS Administration of Section 6662(e)
- III. Study Methodology
- IV. Findings
- V. Conclusion

## **I. SECTION 6662(e) OF THE INTERNAL REVENUE CODE**

Section 6662(e) of the Internal Revenue Code and the regulations under that provision establish a mechanism whereby taxpayers may perform contemporaneous analysis of the prices charged in controlled transactions and prepare documentation of that analysis, to be provided to the IRS upon request. Preparing such documentation and providing it in response to a request from the IRS may provide protection from penalties that might otherwise result from an IRS adjustment of the transfer prices pursuant to section 482. This section summarizes the statutory and regulatory provisions governing preparation of contemporaneous transfer pricing documentation.

### **A. Statutory Framework**

The following section discusses the statutory framework for valuation misstatement penalties, and the reasonable cause and good faith exception from their application provided that a taxpayer prepares contemporaneous documentation.

#### **1. Introduction**

The Omnibus Budget Reconciliation Act of 1990 (the “Act”) amended section 6662 to apply the accuracy penalty for substantial and gross valuation misstatements to IRS transfer pricing adjustments under section 482. Subsections (a) and (b)(3) impose a 20% penalty on underpayments of tax due to substantial valuation misstatements. Subsection (h) increases this penalty to 40% in the case of gross valuation misstatements. The statute provides for two categories of section 482-related valuation misstatement penalties:

- (1) A penalty triggered by a **variance of the transaction price** from the appropriate amount determined under section 482, in excess of a specified threshold (transactional penalty), and
- (2) A penalty triggered by a **net section 482 transfer price adjustment** in excess of a specified threshold (net adjustment penalty).

The Act established an exception from the penalties based on reasonable cause and good faith of the taxpayer. Importantly, 1993 amendments to the Act further made the net adjustment penalty applicable unless the taxpayer:

- Undertook an up-front effort to comply with the arm’s length standard;



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- Prepared contemporaneous documentation of its efforts to apply the arm's length standard; and
- Provided that documentation to the IRS within 30 days of request.

The regulations provide that the preparation of contemporaneous documentation also establishes the reasonable cause exception from the transactional penalty.

The Omnibus Budget Reconciliation Act of 1993 amended the penalty threshold provisions applicable to net section 482 adjustments. In such cases, the 1993 amendments reduced the net adjustment penalty threshold for a substantial valuation misstatement from \$10 million to the lesser of \$5 million or 10% of gross receipts, and for a gross valuation misstatement from \$20 million to the lesser of \$20 million or 20% of gross receipts. The transactional penalty thresholds (described below) were not changed.

## **2. Penalty Rates**

Section 6662 imposes distinct penalty rates, depending upon the degree of misstatement:

- **Section 6662(a) - Substantial valuation misstatement:** a penalty of 20% of the underpayment of tax attributable to transfer pricing adjustments when the adjustments exceed the transactional or net adjustment penalty thresholds provided by sections 6662(e)(1)(B)(i) and (ii)
- **Section 6662(h) - Gross valuation misstatement:** the penalty is increased from 20% to 40% where the underpayment of tax is attributable to a gross valuation misstatements

## **3. Penalty Thresholds**

Section 6662 applies distinct penalty thresholds to the transactional and net adjustment penalties:

- **Section 6662(e)(1)(B)(i) – transactional penalty threshold:** the price for any property or service (or for the use of property) claimed on the tax return in connection with any **transaction** between persons described in section 482 is 200% or more (or 50% or less) of the amount determined under section 482 to be the correct price.

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- **Section 6662(e)(1)(B)(ii) – net adjustment penalty threshold:** the net section 482 transfer price **adjustment** for the taxable year exceeds the lesser of \$5,000,000, or 10% of the taxpayer's gross receipts.

#### 4. Gross Valuation Misstatement

Section 6662(h)(2)(A) defines “gross valuation misstatement” to mean any substantial valuation misstatement as determined under section 6662(e), but substitutes the following amounts for the amounts in subsection (e):

- **Transactional Penalty threshold:**
  - substitute 400% for 200%, and
  - substitute 25% for 50%
- **Net Adjustment Penalty threshold:**
  - substitute \$20,000,000 for \$5,000,000, and
  - substitute 20% for 10%.

#### 5. Exceptions to Application of Penalties

Section 6664(c) of the Code excuses a taxpayer from the accuracy-related penalty for underpayment of tax if it is shown that the taxpayer had **reasonable cause** for any portion of the underpayment and that the taxpayer acted in **good faith** with respect to such portion.

In the case of the net adjustment penalty for additional tax arising from an adjustment under section 482, section 6662(e)(3)(D) makes the reasonable cause exception available only if the taxpayer prepared contemporaneous documentation for the transactions in question. The regulations also make such documentation a sufficient basis for the reasonable cause exception to the transactional penalty. See Treas. Reg. §§1.6662-6(b)(3) and 1.6662-6(c)(6).

A de minimis provision in section 6662(e)(2) states that no penalty applies to a substantial valuation misstatement unless the portion of underpayment of tax attributable to the misstatement exceeds \$5,000 (or \$10,000 in the case of a corporation other than an S corporation or a personal holding company).

## **B. Contemporaneous Documentation of Transfer Prices**

By preparing contemporaneous documentation of its transfer prices, a taxpayer may avoid the application of penalties that would otherwise result from a section 482 adjustment that exceeds the transactional or net-adjustment penalty thresholds. The IRS issued final regulations under section 6662(e) and (h) in 1996, which provide guidance to taxpayers on how to avoid section 482-related penalties by satisfying standards relating to analysis, documentation, and production. The analysis to be performed for this purpose differs to some extent depending on whether the taxpayer applies a specified or an unspecified transfer pricing method under the section 482 regulations. This section describes the best method rule under the 1994 section 482 regulations, as well as the documentation and document production provisions of the final regulations under section 6662(e).

### **1. Background: Best Method Rule**

Under the **best method rule** in the section 482 regulations, the arm's length result of a controlled transaction must be determined under a transfer pricing method that, under the facts and circumstances, provides the "most reliable measure of an arm's length result." Neither the IRS nor the taxpayer is held to the hierarchy of methods that applied under the pre-1994 section 482 regulations. If, however, another transfer pricing method is subsequently shown to produce a more reliable measure of an arm's length result, such other method prevails.

In selecting the best method, the two primary factors taken into account are the degree of comparability between the controlled and uncontrolled transactions and the quality of the data and assumptions used in the analysis. If these considerations do not clearly indicate which transfer pricing method should be selected, then an additional factor may be taken into account, i.e., whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method.

If a **specified transfer pricing method** is used, the section 6662(e) regulations require the taxpayer to select and apply that method in a reasonable manner. The regulations contemplate that the taxpayer will reasonably conclude that, under the facts and circumstances, the particular method and its application will provide the most reliable measure of an arm's length result under the best method rule. In conducting this analysis, the regulations intend that the taxpayer perform a reasonably thorough search for relevant data and consider the potential applicability of the other specified methods.

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If an **unspecified transfer pricing method** is used, the taxpayer must reasonably conclude that, under the facts and circumstances, none of the specified methods was likely to provide a reliable measure of an arm's length result, and that the method selected is applied in a way that would likely provide a reliable measure of an arm's length result. For purposes of this analysis, the taxpayer must evaluate the potential applicability of the specified methods in light of the best method rule. If the intercompany transaction being analyzed is a type for which no method is specified under the section 482 regulations, the taxpayer must conclude that the unspecified method and its application provide the most reliable measure of an arm's length result under the best method rule.

## **2. Preparation of Contemporaneous Documentation**

To avoid the imposition of penalties that would otherwise apply under section 6662(e), the taxpayer must prepare and maintain documentation as provided by section 6662(e) and the regulations thereunder, showing that the taxpayer reasonably concluded that the method (and its application) provided the most reliable measure of an arm's length result under the principles of the best method rule of Treas. Reg. § 1.482-1(c). See Treas. Reg. § 1.6662-6(d)(2)(iii)(A). The regulations divide the documentation into two categories, principal documents and background documents.

**Principal documents** are certain specified documents that bear directly on the taxpayer's choice of transfer pricing methodology. Such documents include explanations of the taxpayer's business operations, organizational structure, application of the section 482 regulations to the controlled transactions, and the like. These documents generally must include the following ten items:

- a. Overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of property or services.
- b. Description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States.
- c. Documentation explicitly required by the regulations under section 482.
- d. Description of the method selected and an explanation of why that method was selected.
- e. Description of the alternative methods that were considered and an explanation of why they were not selected.

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- f. Description of the controlled transactions (including terms of sale) and any internal data used to analyze those transactions.
- g. Description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made.
- h. Explanation of economic analysis and projections relied upon in developing the methodology.
- i. Description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing the tax return which would help determine if the taxpayer selected and applied a specific method in a reasonable manner.
- j. General index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

**Background documents** support the assumptions, conclusions, and positions contained in the principal documents. Such documents may include the documents listed in Treas. Reg. §1.6038A-3(c).

The regulations provide that all documents are to be in existence when the tax return for the year in question is filed, with the exception of the summary of post-year end relevant data and the general index and description of the recordkeeping system.

### 3. Production of Documents in Response to IRS Request

To avoid application of a section 6662(e) penalty, the taxpayer must provide the principal documents to the IRS within 30 days of a request. The IRS may excuse a minor or inadvertent failure to produce documentation if the taxpayer made a good faith effort to comply and promptly remedies the failure. Background documents need not be produced in response to an IRS request for principal documents, but must be provided within thirty days of a request for background documents. The IRS may extend the period for production of the background documents.

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**II. IRS ADMINISTRATION OF SECTION 6662(e)**

The IRS has taken steps to ensure that it administers the section 6662(e) penalties fairly and effectively, with minimal burden on the taxpayer's business activities. IRS initiatives in this area include the following:

**A. IRS Penalty Oversight Committee**

The IRS established a **Section 6662(e) Penalty Oversight Committee** on February 16, 1995. See Announcement 96-16, 1996-13 I.R.B. 22. The objective of this committee is to ensure uniform nationwide application of the reasonableness standard and the documentation provisions. The committee is composed of local and National Office personnel with international, examination, appeals and counsel experience.

The responsibilities of the committee include the following:

1. Monitor and gather information relating to the section 6662(e) transfer pricing penalty;
2. Review all proposed penalties under section 6662(e) and the associated case files, including the taxpayer's position, prior to imposition of the penalty;
3. Evaluate the appropriateness of applying the penalty;
4. Review a sample of closed transfer pricing cases where the section 6662(e) penalty threshold was met but no penalty was proposed, to determine whether the taxpayer satisfied the reasonable cause and good faith exception to the application of those penalties;
5. Provide national-level guidance and instruction on the application of the penalty; and
6. Ensure the accuracy of the international examiners' threshold computations under section 6662(e)(1)(B).

The Oversight Committee reviews all section 6662(e) penalty cases via a National Office notification procedure. No penalties may be finally imposed prior to the committee's review. The Oversight Committee has received seventy-seven (77) notifications to date. Of these, the Oversight Committee recommended against application of the penalty in several cases, and one case was returned to the Field for further development.

EFFECTIVENESS OF I.R.C. SECTION 6662(e)**B. Enhancing IRS Expertise**

Recognizing its responsibility to apply the section 6662(e) penalties fairly and effectively, the IRS has taken steps to enhance the expertise of its management and examination staff. The penalty procedures are an integral component of the IRS strategy to further improve the administration of section 482. This strategy is delineated in Chapter 8 of the IRS Report on the Application and Administration of Section 482, dated April 29, 1999, which states in relevant part:

*[T]he IRS plans a combination of section 482 guidance, promotion of upfront compliance with the arm's length standard, strengthening the international consensus on transfer pricing guidance and compliance, advanced resolution of transfer pricing issues in the APA Program, and strategic management of section 482 issues in litigation.*

The IRS includes the section 6662(e) penalties in its Phase 2 International Training Course, which all international examiners attend. The topic is covered in annual Continuing Professional Education (CPE) training courses, attended by international examiners, economists and their managers. In addition, contacts have been identified within the National Office to assist international examiners in applying the penalties where appropriate.

**C. Technical Advisor Program (formerly IFASP)**

The International Field Assistance Specialization Program (IFASP) began in October 1991. It was created to provide International Examiners (IEs) technical assistance on various complex international tax issues, including section 482 and the section 6662(e) penalty. After the reorganization of the IRS, IFASP experts were re-classified as International Technical Advisors under Prefiling and Technical Guidance, within the Large and Mid-Size Business (LMSB) Division. The benefits of the International Technical Advisor Program include uniform issue development and consistent treatment of taxpayers, better developed cases, increased working knowledge of IEs in complex areas, reduced time spent on cases through early identification of issues, and technical guidance and advice on examination techniques. The goal of the program is to provide technical assistance to the field in the simplest manner possible and to keep management streamlined.

The International Technical Advisors offer both case-related experience and tax law expertise. They provide the following services:

- Issue memoranda to provide guidance on specific issues.

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- Teach IE training classes.
- Participate in writing and reviewing training materials in areas of expertise, including audit guides and sections of the Internal Revenue Manual.
- Participate as instructors in yearly Continuing Professional Education courses and various seminars and workshops.
- Act as liaisons between the IEs and local, area, and national office Counsel.
- Present, write, and plan technical Interactive Video Teleconferences (IVTs). IVTs are shown nationwide to IEs, economists, appeals officers, and large case examiners. For example, one IVT discussed how to evaluate the economic studies submitted as part of section 6662(e) documentation.
- Assist the Office of the Associate Chief Counsel (International) (ACCI) in connection with regulation projects, field service advice memoranda, technical assistance memoranda, notices, revenue rulings and revenue procedures. The International Technical Advisors are in constant communication with their counterparts in ACCI. If they are assisting on an audit, they often call their counterpart for clarification of the law or to point out an area of ambiguity. The International Technical Advisors may arrange meetings along with examination team members to present issues to and obtain guidance from Counsel.
- Participate as presenters in outside seminars, such as the yearly IRS/George Washington University International Seminar. This seminar attracts more than 500 participants, and the audience includes IRS employees, corporate tax executives, and private practitioners.



### III. STUDY METHODOLOGY

The IRS conducted a two-phase study to gather information in response to the Committee's inquiry. Phase 1 of the study addressed whether taxpayers are preparing contemporaneous documentation as anticipated by section 6662(e). Phase 2 collected information regarding the quality of taxpayer documentation and its utility to the IRS in enforcing section 482.

#### A. Phase 1

In Phase 1, a survey (questionnaire) was sent to a sample of mid- and large-sized corporate taxpayers, to obtain information concerning the first question posed by the Committee:

***(1) whether taxpayers are preparing contemporaneous transfer pricing documentation as anticipated by section 6662(e)***

The survey also collected information concerning costs incurred by taxpayers in preparing documentation, taxpayer perceptions of the role of documentation in IRS examinations involving section 482, and other related issues.

In order to encourage candid responses from taxpayers, and to allay potential taxpayer concerns regarding use of the survey data by the IRS, an independent market research firm, Schulman, Ronca, & Bucuvalas, Inc. (SRBI), was hired to conduct the survey. SRBI conducted the survey, compiled the response data, and provided IRS access to the data only in aggregated form that prevents identification of particular respondents.

SRBI drafted the questionnaire based on input from IRS personnel. The IRS and SRBI also met with representatives from taxpayer and practitioner organizations such as the American Institute of Certified Public Accountants, American Bar Association, and Tax Executives Institute, to obtain comments on the proposed questionnaire. The questionnaire was then finalized and approved by the Office of Management and Budget, as to content and survey procedure.

The IRS provided SRBI with an initial database, consisting of 9,982 corporations that had net assets of \$50 million or more and were either: (1) domestic corporations that engaged in transactions with related foreign corporations, (2) foreign-owned U.S. corporations, or (3) claimants of foreign tax credits. Corporations that met these criteria were deemed most likely to have cross-border controlled transactions potentially subject to section 6662(e).

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Corporations were categorized by IRS Activity Codes, which correspond to the following net asset levels:

<u>Activity Code</u>	<u>Asset level</u>
221	\$50 - 100 million
223	\$100 - 250 million
225	\$250 million or more

IRS Activity Codes 221 and 223 denote corporate taxpayers in the small- and mid-size range. Activity Code 225 applies to large-size corporations, many of which are in the IRS Coordinated Industry Case (CIC) Program (formerly, the Coordinated Examination Program). In the CIC program, a team of specialists from various examination functions conducts an on-going examination that covers multiple issues and years.

Applying standard survey techniques, SRBI identified a total of 1,529 corporations that met the following criteria for participation in the survey: (1) gross receipts of more than \$10 million on the most recently filed federal income tax return, and (2) cross-border transactions with one or more related entities during that taxable year.

SRBI asked these corporations to complete the questionnaire and transmit the results to SRBI via a secure web site, by fax, or via U.S. mail. A total of 696 corporations submitted substantially complete responses to SRBI.<sup>1</sup> This number corresponds to a 46% response rate. SRBI believes that this is a statistically significant sample of corporate taxpayers, based on the response rate from the initial population of 1,529 corporations, and based on follow-up contacts directly by SRBI with non-responsive corporations. In considering the Phase 1 methodology, it should be recognized that corporations that responded to this voluntary survey did not constitute a random sample, and might not be representative of the population of corporate taxpayers with cross-border controlled transactions subject to section 6662(e).

The 696 corporations that provided substantially complete questionnaire responses to SRBI may be classified in the following annual gross receipts categories.

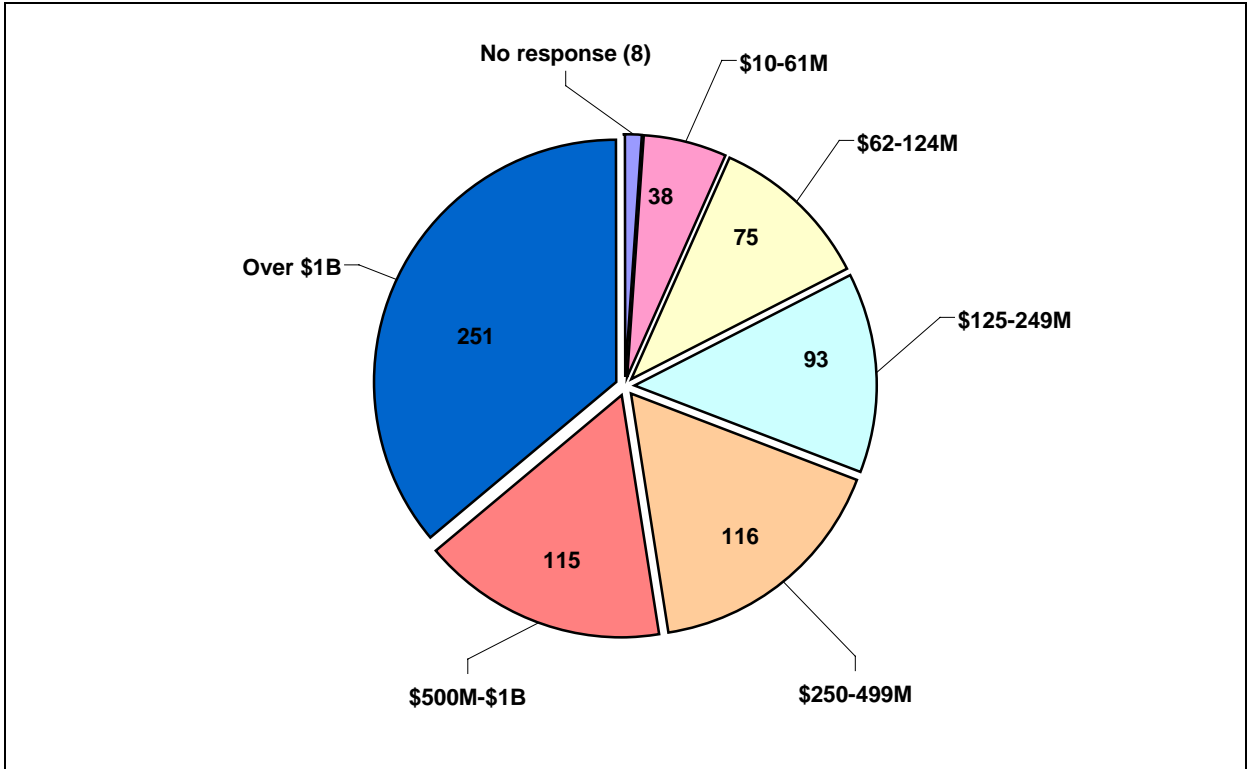
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<sup>1</sup> In addition to the final report (Appendix A), SRBI provided the IRS with aggregated data from the Phase 1 questionnaire responses. The IRS independently analyzed these aggregated data in reaching its findings regarding Phase 1. Minor differences between the IRS findings in section IV.A and the SRBI Report in Appendix A are attributable to rounding and other non-material differences in presentation of the underlying data.

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The distribution of respondents by annual gross receipts is shown in Chart 1 and Table 1, below.

Chart 1 and Table 1  
 Distribution of Respondents, by Annual Gross Receipts  
 (Total = 696)



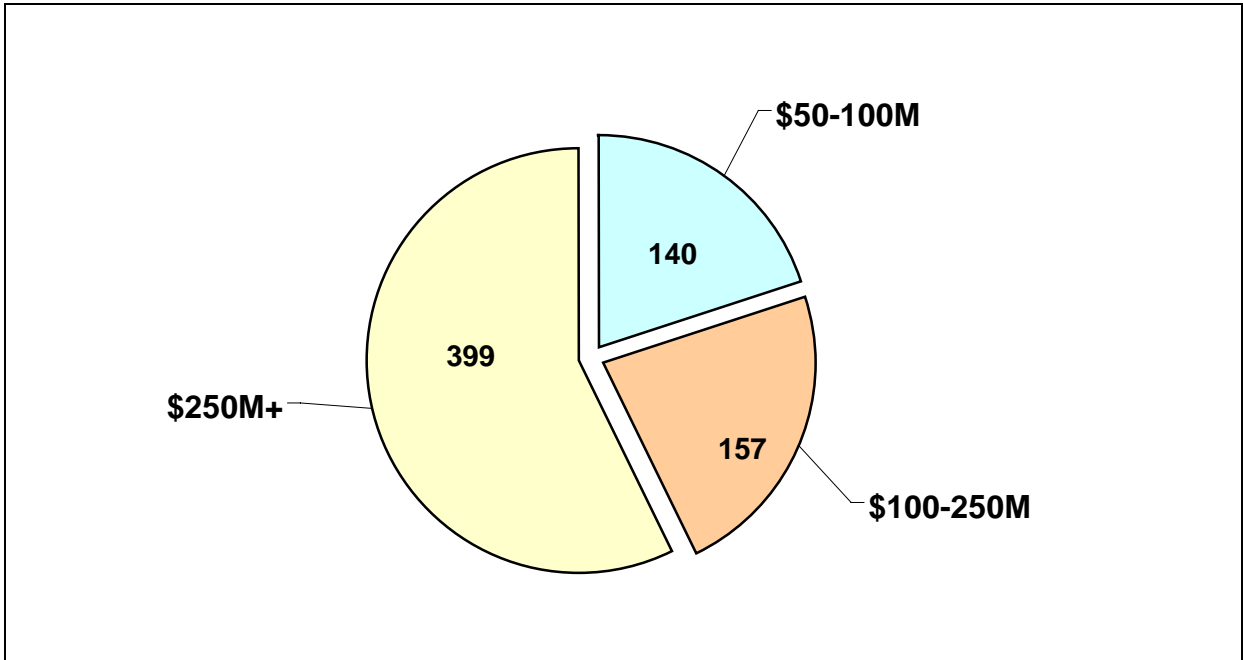
	GROSS RECEIPTS							TOTAL
	No response	\$10-61M	\$62-124M	\$125-249M	\$250-499M	\$500M-\$1B	Over \$1B	
Number of respondents	8	38	75	93	116	115	251	<b>696</b>
Percent of total	1%	5%	11%	13%	17%	17%	36%	<b>100%</b>

Source: SRBI Data, Question 2.

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Alternatively, the respondents may be classified based on the net assets reported on the most recently filed income tax return, corresponding to the IRS activity codes that were provided to SRBI with the initial database. The distribution according to net assets is shown in Chart 2 and Table 2, below.

**Chart 2 and Table 2**  
**Distribution of Respondents, by Net Asset Categories**  
 (Total = 696)



	NET ASSETS			TOTAL
	\$50-100M	\$100-250M	\$250M+	
Number of respondents	140	157	399	696
Percent of total	20%	23%	57%	100%

Source: SRBI Data, correlated by IRS Activity Code Classification of Potential Respondents, as provided by SRBI with aggregated response data.

Thus, 80% of the respondents are medium- and large-size corporate taxpayers.

Respondents were asked whether they filed Forms 5471 or 5472 with their most recent income tax return. SRBI Question 3. The answers permit observations about the composition of the respondent database, without compromising the

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anonymity of the respondents. The composition of the group of respondents is summarized in Table 3, below.

Table 3  
Composition of Phase 1 Respondent Database, by Ownership Type

<u>Status</u>	<u>Number of Respondents</u>
U.S. corporation with foreign subsidiaries	434
Foreign controlled U.S. corporation	107
Foreign controlled U.S. corporation with foreign subsidiaries	130
Other	14
No response	<u>11</u>
TOTAL	696

Source: SRBI Data, Question 3.

Respondents comprise a cross-section of U.S. corporations with foreign subsidiaries, foreign controlled corporations (FCCs), some of which have foreign subsidiaries, and a limited number of other entities whose status could not be determined. Additional details concerning composition of the respondent database are contained the SRBI report, provided as Appendix A.

The Phase 1 questionnaire, which contained thirty-one questions, focused on the following areas:

1. Percentage of intercompany transactions for which documentation was prepared pursuant to section 6662(e) and the regulations under that provision
2. Costs of preparing documentation pursuant to section 6662(e)
3. Reasons why taxpayers elect not to prepare contemporaneous documentation, if applicable

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4. Impact of contemporaneous documentation on the IRS examination of the taxpayer's section 482 issues (as evaluated by the taxpayer)

The responses provided a substantial amount of information with respect to each of these areas. The aggregated results of the survey are presented in detail in the independent report prepared by SRBI and provided as Appendix A. The key findings are analyzed in Section IV.A of this Report.

**B. Phase 2**

In Phase 2, the IRS analyzed transfer pricing documentation prepared by selected corporate taxpayers currently under IRS examination. The goal of Phase 2 was to collect information regarding the following concerns:

***(2) the quality of taxpayer documentation, and (3) the utility of such documentation to the IRS in enforcing section 482.***

In Phase 2, review teams, which generally consisted of two or three IRS transfer pricing experts, conducted in-depth analysis of the transfer pricing documentation prepared by twenty-five corporate taxpayers.

Corporations were selected to participate in Phase 2 based on the following criteria:

1. Large-size corporate taxpayer currently under examination by the IRS.
2. Audit cycle generally included 1997 or later tax year.
3. Prepared transfer pricing documentation.
4. No Advance Pricing Agreement (APA) in effect or being negotiated.

The corporations identified included both foreign controlled corporations and U.S.-controlled groups.

The IRS examination team assisted the review team in analyzing the information provided. All principal and background documents provided pursuant to section 6662(e) were made available to the review team.

The goal of the Phase 2 reviews was to evaluate the overall quality and utility of the documentation prepared by each taxpayer. To that end, the review teams evaluated the ten principal documents specified in the section 6662(e) regulations, and any background documents. To ensure that its conclusions reflected a broad perspective, the review team drew on the prior examination experience of the International Examiner and the IRS Economist.

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Importantly, the review teams analyzed overall quality and utility of the documentation at the development stage of the transfer pricing examination. Prior to completion of the examination, it is generally not possible to ascertain definitively whether the documentation provided reasonably supports a conclusion regarding the best method under the best method rule in the view of the IRS. Despite these limitations, the review teams were able to make observations concerning overall quality of the documentation and its utility to the IRS in the examination process.

Summary reports were prepared to describe the findings for the corporate taxpayers reviewed in Phase 2. These reports, from which all taxpayer-identifying information has been eliminated, are provided in Appendix B. The findings, which reflect the reviews of all twenty-five companies, are contained in Section IV.A of this Report.

## IV. FINDINGS

This section of the report presents the findings of the IRS in the Phase 1 and Phase 2 studies. Additional detail on these findings is contained in Appendix A (SRBI Report) and Appendix B (IRS Summaries of Phase 2 reviews).

### A. Phase 1: Anonymous Survey of Corporate Taxpayers

This section analyzes data obtained by SRBI to determine the extent to which taxpayers prepare contemporaneous transfer pricing documentation. In addition, the section discusses survey data concerning taxpayers' perceptions of the role of documentation in the examination process.

The key data in Phase 1, regarding preparation of contemporaneous documentation, were obtained from a database of 696 corporate taxpayers that provided usable responses to the survey. Additional data were obtained in Phase 1 from a smaller group (144 respondents) that provided documentation to the IRS in examinations that specifically addressed transfer pricing issues. This group was comprised primarily of mid- and large-size taxpayers.

#### 1. Preparation of Contemporaneous Documentation

The Committee asked the IRS to determine whether “taxpayers are preparing contemporaneous transfer pricing documentation as anticipated by section 6662(e).”

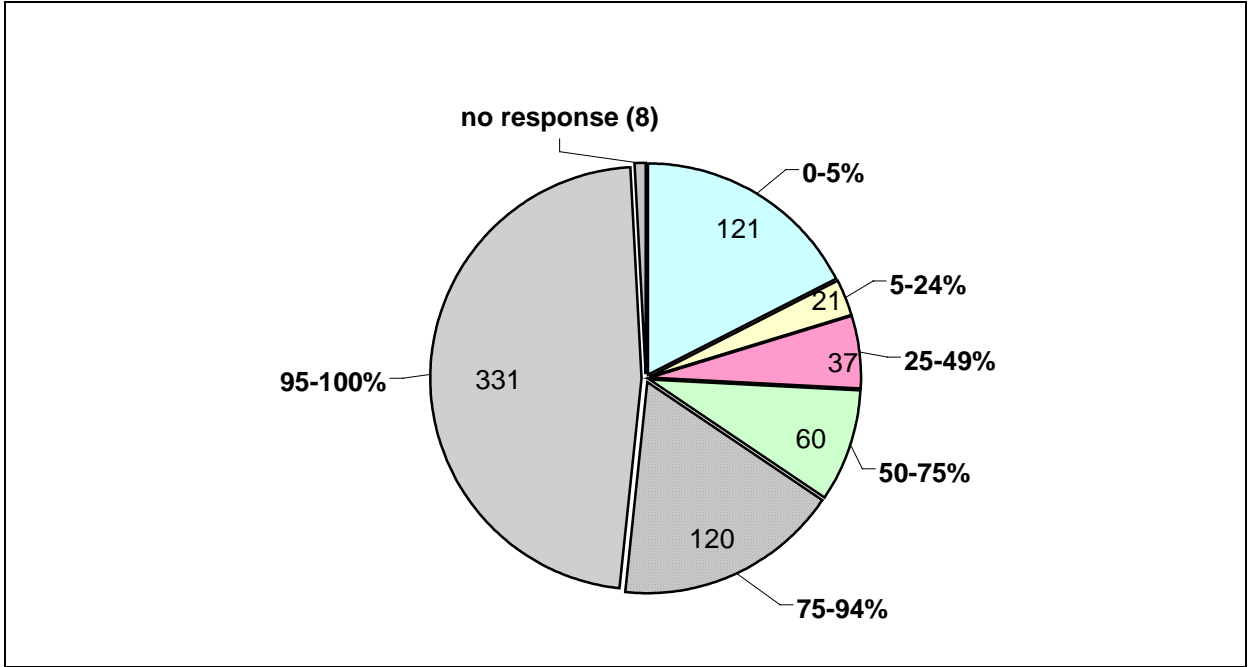
SRBI, with a confidence level of 95%, concludes that most respondents (82%, +/- 3%) prepare contemporaneous documentation for some cross-border transactions with related entities. For these purposes, documentation was defined as documentation for 5% or more of all controlled transactions, by dollar value.

The responses also indicate that nearly half of all respondents (48%, +/- 3%) prepared contemporaneous documentation for substantially all controlled transactions (95% or more). If affirmative responses at the 50% of controlled transactions level are cumulated, and the six non-responsive corporations are excluded, **approximately 74% of respondents prepared contemporaneous documentation for 50% or more of their controlled transactions, by dollar value.** These results are depicted in Chart 3, below.



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**Chart 3**  
 Distribution by Percentage of Controlled Transactions  
 (Dollar Value) for which Documentation Prepared  
 (Total=696)



Source: SRBI Data, Question 8.

Table 4 depicts the survey results based on respondents' annual gross receipts.

**Table 4**  
 Percentage of Controlled Transactions for  
 Which Documentation Prepared  
 (by Respondents' Gross Receipts Categories)

	GROSS RECEIPTS						TOTAL (N=696)
	\$10- 61M (N=38)	\$62- 24M (N=75)	\$125- 249M (N=93)	\$250- 499M (N=116)	\$500M- \$1B (N=115)	Over \$1B (N=251)	
% of controlled transactions							
95% or more	50%	48%	47%	49%	40%	49%	<b>48%</b>
75% - 94%	16%	19%	10%	17%	10%	23%	<b>17%</b>
50% - 74%	5%	1%	9%	10%	9%	10%	<b>9%</b>
25% - 49%	0%	4%	5%	6%	4%	7%	<b>5%</b>
5% - 24%	0%	4%	1%	3%	5%	3%	<b>3%</b>
Less than 5%	29%	23%	27%	13%	30%	7%	<b>17%</b>

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Source: SRBI Data, Questions 2 and 8 (total of 696 includes six corporations that did not respond to Question 8, plus two additional corporations that did not respond to Question 2).

Table 5 presents the survey results based on respondents' net asset levels.

**Table 5**  
Percentage of Controlled Transactions for  
Which Documentation Prepared  
(by Respondents' Net Assets Categories)

	NET ASSETS			<b>TOTAL (N=696)</b>
	\$50-100M (N=140)	\$101-250M (N=157)	\$250M+ (N=399)	
% of controlled transactions				
95% or more	53%	41%	48%	<b>48%</b>
75% - 94%	13%	15%	20%	<b>17%</b>
50% - 74%	5%	11%	9%	<b>9%</b>
25% - 49%	3%	5%	6%	<b>5%</b>
5% - 24%	4%	3%	3%	<b>3%</b>
Less than 5%	22%	24%	13%	<b>17%</b>
No response	1%	2%	1%	<b>1%</b>

Source: SRBI Data, Question 8, correlated to IRS Activity Code Classification of Potential Respondents, as provided by SRBI with aggregated response data.

The data do not show a strong correlation between corporate size (on either a gross receipts or net asset basis) and the percentage of controlled transactions for which contemporaneous documentation was prepared. Among respondents with annual gross receipts of less than \$62 million, 50% prepared documentation for substantially all (95% or more) controlled transactions. Among corporations with annual gross receipts of more than \$1 billion, 49% prepared documentation for substantially all (95% or more) of their controlled transactions. The percentage of corporations that prepared documentation for substantially all controlled transactions was also relatively consistent across the intermediate gross receipts categories.

The data suggest that small corporations are somewhat more likely to prepare documentation for less than 5% of their controlled transactions (this category also included respondents that prepared no documentation). Thus, 27% of respondents with annual gross receipts between \$125 and \$249 million prepared documentation for less than 5% of their controlled transactions. Similarly, 22% of respondents with net assets between \$50-100 million prepared documentation for less than 5% of controlled transactions. In contrast, only 7% of respondents

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with annual gross receipts of over \$1 billion, and 13% of respondents with net assets over \$250 million, prepared documentation for less than 5% of controlled transactions.

The data indicate that although most taxpayers prepared contemporaneous documentation for at least some controlled transactions, the percentage of transactions for which particular respondents prepared documentation varied widely. Importantly, a majority of taxpayers in all gross receipts and net asset categories prepared documentation for more than 50% of the total dollar value of their respective controlled transactions. In addition, small-, medium-, and large-size corporations prepared documentation at a fairly consistent rate. Because preparation of documentation is voluntary, this degree of preparation of documentation is a positive finding.

In considering the Phase 1 results, it should be recognized that, because responses to the survey were voluntary, respondents did not constitute a random sample of corporations with cross-border transactions subject to section 6662(e). In addition, because responses were provided on an anonymous basis, it was not possible to verify the reliability of the responses. Consequently, the Phase 1 results may over-state the degree to which taxpayers prepare documentation pursuant to section 6662(e).

EFFECTIVENESS OF I.R.C. SECTION 6662(e)**2. Resources Devoted to Transfer Pricing Compliance and Documentation**

The survey also collected information concerning taxpayers' expenditures on transfer pricing and related documentation and compliance issues. In particular, questions were asked concerning the percentage of respondents' total tax compliance budget devoted to transfer pricing issues, and changes in that percentage between pre-1994 years and the most recent year. SRBI Question 16. The survey defined "transfer pricing issues" as "transfer pricing documentation, audit related costs, litigation, etc."

Corporations that responded to this question spent a relatively consistent percentage of their total annual tax compliance budgets on transfer pricing issues, including contemporaneous documentation. The mean percentage spent on transfer pricing issues was 18.3%, and the median was 13.9%. Only small-size corporations (corporations with gross receipts of \$10-61 million) spent a significantly smaller percentage of their total annual tax compliance budgets (mean of 6.9%, median of 2.6%) on transfer pricing issues. SRBI Data, Question 16.

The survey also asked respondents whether they changed the percentage of the tax compliance budget devoted to transfer pricing issues, from pre-1994 years to the present. SRBI Question 17. The responses to this question are summarized in Table 6, below.

Table 6  
Percent of Tax Compliance Budget  
Spent on Transfer Pricing Issues:  
Pre-1994 versus Most Recent Year  
(by Respondents' Gross Receipts Categories)

	GROSS RECEIPTS						<b>TOTAL (N=567)</b>
	\$10- 61M (N=27)	\$62- 124M (N=58)	\$125- 249M (N=68)	\$250- 499M (N=101)	\$500M- \$1B (N=80)	Over \$1B (N=233)	
Percent of budget							
Increased	22%	50%	57%	63%	75%	74%	<b>65%</b>
Decreased	0%	2%	0%	2%	1%	0%	<b>1%</b>
Stayed about same	48%	21%	22%	14%	10%	14%	<b>17%</b>
Not applicable	7%	9%	7%	11%	5%	5%	<b>7%</b>
No response	22%	19%	13%	10%	9%	6%	<b>11%</b>

Source: SRBI data, Question 17.

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The data indicate that 48% of corporations in the smallest gross receipts category (\$10–61 million) spent about the same percentage of tax compliance budget on transfer pricing in pre- and post-1994 years. However, corporations in most other categories reported increases over this period. Fully 74% of respondents in the largest gross receipts category reported increases. Such increases are particularly significant, given that respondents in this category generally spent some amount on transfer pricing issues prior to 1994. Prior to 1994, 54% of corporations in the over \$1 billion gross receipts category spent between \$1 and \$100,000 annually, and 7% spent between \$100,000 and \$200,000. SRBI Data, Question 18.

Increases in the percentage of budget devoted to transfer pricing issues (including analysis and documentation) indicate that this area has assumed heightened importance in the tax compliance activities of multinational corporations. The fact that, regardless of size, respondents devote relatively consistent percentages of total tax compliance their budgets to transfer pricing suggests that the costs of compliance (including preparation of documentation) do not fall disproportionately on corporations of any particular size.

### **3. Decision to Prepare Contemporaneous Documentation**

The survey also asked respondents what factors they considered in deciding whether to prepare contemporaneous documentation pursuant to section 6662(e).

Corporations that prepared contemporaneous documentation for less than 95% of cross-border controlled transactions (sample size of 365) were asked to state the primary reason why they did not prepare documentation for all transactions. SRBI Question 8a. The reason most often cited (by 52% of respondents) was that the company's transfer prices were correct and would not be subject to a section 482 adjustment. The next most commonly cited reason (by 42% of respondents) was that the company's tax department lacked the resources, personnel, or budget to prepare the documentation.

The major reasons why respondents prepared documentation for fewer than all transactions are summarized in Table 7, below.

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**Table 7**  
Reasons Why Respondent Prepared Documentation  
For Fewer than All Controlled Transactions

<u>Reason</u>	<u>Rank</u>
Transfer prices were correct and would not give rise to a section 482 adjustment	1
Tax department lacked the resources to prepare documentation	2
Transactions were based on market prices and were easily verified	3
Documentation effort too complicated and burdensome	4
Information contained in normal accounting reports is sufficient	5
Cost of preparing documentation was too great	6
Potential audit adjustment would not meet penalty threshold	7
Cost of preparing documentation was greater than potential penalties	8

Source: SRBI Data, Question 8a.

Corporations with annual gross receipts of more than \$500 million tended to cite cost as a basis for not preparing documentation more frequently than did other corporations. Thus, for example, a large-size corporation with a substantial volume of controlled transactions might determine that it need not prepare documentation for certain transactions, based on its evaluation of the relative magnitude of penalties that might apply to those transactions in the event of adjustments under section 482.

The survey also asked respondents whether they estimated the “cost of compliance” in deciding whether to prepare documentation. SRBI Question 11. Among 506 corporations that provided either a “yes” or a “no” response to this question, 53% indicated that cost of compliance was part of the decision-making process, and 47% stated that it was not. SRBI Data, Question 11. Corporations in the smallest gross receipts category were less likely (15% of total) than corporations in the largest gross receipts category (49% of total) to consider cost of compliance in the decision-making process.

The survey also asked whether respondents performed a cost/benefit analysis, based on “tax exposure risk.” SRBI Question 12. Overall, 29% of respondents

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that provided a “yes” or “no” answer to this question performed such an analysis. Corporations in the smallest net asset category were somewhat less likely (22% of yes/no respondents) to undertake a cost/benefit analysis based on tax exposure than were corporations in the highest net asset category (29% of same group). SRBI Data, Question 12. This is consistent with the responses to SRBI Question 8a. As noted above, large-size corporations that responded to Question 8a cited cost considerations as relevant more frequently than did small- or mid-size corporations.

The above data indicate that taxpayers take into account a range of factors in deciding whether to prepare documentation, and in determining which controlled transactions that documentation should cover. The primary considerations appear to be the cost of preparing documentation, the likelihood of IRS scrutiny of transfer prices, and the potential size of a transfer pricing adjustment and resultant penalties. It also appears that corporations tend not to prepare documentation for controlled transactions for which transfer prices may be readily determined without in-depth analysis (e.g., by reference to quotation media or spot-market prices). SRBI Data, Question 8a. The fact that taxpayers weigh the cost of preparing documentation against the likelihood of section 482 adjustments and penalties is consistent with the voluntary approach of section 6662(e) and the regulations under that section.

#### 4. Means Used to Prepare Contemporaneous Documentation

Because analysis of transfer prices may require specialized legal and economic expertise, taxpayers may use outside resources, such as law firms or accounting firms, to prepare documentation. The section 6662(e) regulations state that the relationship of the professional preparer to the taxpayer is not considered in evaluating the quality of the documentation.<sup>2</sup> The questionnaire asked what means were used to perform transfer pricing analysis and to prepare related documentation. SRBI Questions 10, 13, 14.

Approximately 28% of respondents used only internal resources, as compared to 51% that used both internal and external resources. Twelve percent (12%) of respondents used only external resources. SRBI Data, Question 10.

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<sup>2</sup> One factor used to evaluate the reasonableness of the taxpayer’s application of a specified or unspecified method is whether the taxpayer relied on “a study or other analysis performed by a professional qualified to conduct such a study or analysis, including an attorney, accountant, or economist.” Whether the professional is an employee of or related to the taxpayer is not determinative in evaluating the reliability of the study or analysis, provided that the study or analysis is “objective, thorough, and well-reasoned.” Treas. Reg. § 1.6662-6(d)(2)(ii)(D).

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The questionnaire also asked whether an external person or entity was consulted regarding transfer pricing documentation. SRBI Question 13. Of the 528 corporations that responded “yes” or “no” to this question, 465 (88% of those respondents) indicated that they sought external advice regarding transfer pricing analysis and documentation. SRBI Data, Question 13. Small corporations (annual gross receipts of \$10-61 million) were somewhat less likely to consult an outside professional.

**5. Impact of Contemporaneous Documentation on IRS Examination of Transfer Pricing Issues, as Evaluated by Taxpayers**

The survey also sought taxpayers’ views concerning the effect of transfer pricing documentation on the IRS examination process, including the adequacy of the IRS’ consideration of documentation and the impact of documentation on the amount of time and cost spent resolving transfer pricing issues in current and future examinations.

The IRS does not examine every corporate tax return, and it does not review transfer pricing in every examination. Consequently, only a subset of the respondents was asked questions concerning the impact of documentation in examinations. Among the total of 696 respondents, 235 stated that they participated in one or more IRS examinations that addressed transfer pricing (72 declined to comment). SRBI Data, Question 19. Among this group, the IRS examinations of 194 respondents addressed controlled transactions for which contemporaneous documentation was prepared. SRBI Data, Question 20. Five corporations were eliminated, because the examination in question took place prior to 1994. SRBI Data, Question 21. Of the 188 remaining respondents, a total of 144 stated that they were asked to provide contemporaneous documentation with respect to their most recent tax return. SRBI Data, Question 23. These 144 corporations were asked their impressions of the role of documentation in the IRS examination process.

The 144 respondents in this group are predominantly large-size corporations. Based on their size, many are likely in the in the CIC program and thus are subject to continuous examination, which would generally encompass transfer pricing issues. The composition of this group by annual gross-receipts categories is shown in Table 8, below.



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**Table 8**  
**Group of Respondents to SRBI Questions 24-31**  
**(by Respondents' Gross Receipts Categories)**

	GROSS RECEIPTS						TOTAL
	\$10-61M	\$62-124M	\$125-249M	\$250-99M	\$500M-\$1B	Over \$1B	
Number of respondents	3	6	11	21	21	82	144
Percent of total	2%	4%	8%	15%	15%	57%	n/a

Source: SRBI Data, Questions 2, 19a, 20, 21, 23 (percentages total more than 100 due to rounding).

A majority of these respondents (72%) provided documentation to the IRS within the time limit specified in the regulations (thirty days after the initial IRS request, subject to extension). SRBI Data, Question 25. Only 7% of these respondents took longer than sixty days to produce documentation in response to an IRS request.

These respondents were also asked whether the IRS proposed a transfer pricing adjustment in the most recent examination. Overall, 57% of respondents (82 corporations) were not subject to a proposed section 482 adjustment, 17% (25 corporations) were subject to such an adjustment, and others (total of 34) were uncertain or declined to comment. SRBI Data, Question 29. Three corporations did not respond to the question.

Most respondents believed that the IRS accorded adequate consideration to the documentation that was submitted. Overall, 73% of respondents believed that IRS consideration was adequate, compared to 17% that found it inadequate. SRBI Data, Question 27. Ten percent (10%) declined to respond to this question.

Thirty-six percent (36%) of these respondents believed that documentation significantly reduced the amount of time and cost spent resolving transfer pricing issues in the IRS examination of the most recent return. SRBI Data, Question 30. Forty-six percent (46%) believed that documentation had little or no impact in this regard. Among corporations that were subject to a proposed transfer pricing adjustment, 24% believed that documentation significantly reduced the time and cost spent resolving transfer pricing issues, but 64% believed that documentation had little or no impact in this regard. SRBI Data, Questions 29 and 30.

Questions were also posed concerning the anticipated effect of documentation in future examinations of transfer pricing issues. Forty-three percent (43%) of

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respondents believed that documentation would likely reduce the time and cost necessary to resolve transfer pricing issues in future examinations, either significantly or somewhat. SRBI Data, Question 31. On the other hand, 23% of respondents believed that documentation would increase the time or costs in future examinations. Twenty-nine percent (29%) believed that documentation would have little or no effect in this regard.

Among the twenty-five respondents that were subject to a proposed IRS section 482 adjustment, less than one-third (seven respondents) believed that documentation would reduce the time and cost spent resolving transfer pricing issues in future examinations, and only one respondent in this group believed that the reduction would be significant. SRBI Data, Questions 29, 31. Eleven of the twenty-five corporations believed that documentation would have little or no effect (positive or negative) on future examinations.

A majority of the respondents that were not subject to a proposed section 482 adjustment (52%) believed that documentation would reduce the cost and time spent in future examinations, as compared to 22% that stated no impact was likely, and 20% that predicted an increase in costs or time spent to resolve transfer pricing issues. SRBI Data, Questions 29, 31.

EFFECTIVENESS OF I.R.C. SECTION 6662(e)**B. Phase 2: Analysis of Selected Taxpayers**

Phase 2 consisted of reviews of transfer pricing documentation prepared by medium- to large-size corporate taxpayers under current IRS examination. Individuals from the Office of Prefiling and Technical Guidance, LMSB, conducted these reviews, with assistance from the Office of Associate Chief Counsel (International). This section presents the Phase 2 findings.

**1. Scope (Transactional Coverage)**

The primary goal of Phase 2 was to obtain information concerning the overall quality and utility of the documentation provided by specific taxpayers. However, the Phase 2 reviews also provided an opportunity for general observations concerning the scope of the documentation.

Section 6662(e) does not mandate preparation of transfer pricing documentation. Rather, taxpayers have discretion whether to prepare documentation for all, some, or none of their controlled transactions. Many taxpayers prepare documentation for controlled transactions that in their view are most likely to generate a section 482 adjustment, assessment of additional tax, and associated interest and penalties.

The transactional coverage of the documentation prepared by the twenty-five corporations in Phase 2 varied widely. Some documentation covered all or substantially all of the taxpayer's controlled transactions. Thus, a few taxpayers prepared documentation for substantially all controlled transactions (other than de minimis or immaterial transactions). In most cases, however, the documentation covered only selected categories of controlled transactions.

A minority of the Phase 2 corporations appeared to prepare documentation only for controlled transactions for which the transfer pricing analysis was relatively straightforward. For example, in one case where indirect evidence of comparable uncontrolled prices (CUPs) was available from public-quotation media, the taxpayer prepared documentation for all controlled transactions for which such data were available, but not for any other controlled transactions. Several other taxpayers prepared documentation for transfers of tangible property, but did not address intangible property transactions that were both more complex and more significant from a transfer pricing perspective. These cases were the exception to the evidence otherwise suggesting that taxpayers tend to prepare documentation for controlled transactions most likely to be scrutinized in a section 482 examination.

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The review teams also observed that most taxpayers in Phase 2 prepared documentation for controlled transactions that the IRS had scrutinized in previous examinations, or that were viewed as controversial in the pending examination. In several cases, the examination team observed that, although the documentation addressed a relatively small proportion of the taxpayer's total controlled transactions, the controlled transactions addressed were those of greatest interest in the transfer pricing examination. This suggests that taxpayers identify and prepare documentation for controlled transactions that are most likely to be scrutinized under section 482.

The scope of transactional coverage observed in Phase 2 appeared less extensive than suggested by the survey data in Phase 1.<sup>3</sup> This may reflect the fact that the respondents to the voluntary Phase 1 survey were not necessarily representative of corporations with cross-border controlled transactions subject to section 6662(e). Consistent with the evidence in Phase 1, a majority of the taxpayers in Phase 2 prepared documentation in a targeted manner. Thus, the documentation prepared in a particular case might cover a relatively small percentage of the taxpayer's controlled transactions, but those were generally the most significant transactions in a potential transfer pricing examination.

## **2. Overall Quality of Documentation**

As noted in the methodology section (above), the review teams analyzed overall quality and utility of the documentation at the development stage of the transfer pricing examination. Prior to completion of the examination, it is generally not possible to ascertain definitively whether documentation reasonably supports a conclusion regarding the best method under the best method rule in the view of the IRS. Accordingly, the reviewers were generally not in a position, and did not attempt to consider whether the documentation provided would be likely to prevent application of penalties under section 6662(e), in the event of an adjustment pursuant to section 482. Despite these limitations, the review teams were able to make observations concerning overall quality of the documentation and its utility to the IRS in the examination process.

In order to give appropriate focus to evaluations of overall quality, the review teams considered whether the documentation provided an understanding of the controlled transactions, explained the transfer pricing method selected, and indicated that the taxpayer's choice and application of that method was reasonable under the circumstances.

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<sup>3</sup> In the Phase 1 survey, 50% of the respondents in the largest gross-receipts category (more than \$1 billion annually) stated that they prepared documentation for 95% or more of their controlled transactions, by value.

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**a. Quality and completeness**

In order to provide the information requested by the Committee, the review teams first rated the overall quality of the documentation provided by each taxpayer using a standardized format with ratings of excellent, good, moderate, or poor. These findings are presented in the Table 9, below. Company-specific descriptions of the findings are contained in the reports in Appendix B.

Table 9  
Phase 2: Overall Quality of Documentation  
Per IRS Review Teams

	<u>Excellent</u>	<u>Good</u>	<u>Moderate</u>	<u>Poor</u>
Participant number	7, 10, 19, 21	1, 4, 8, 15, 20, 22	2, 6, 9, 11, 13, 17, 18, 23, 24	3, 5, 12, 14, 16, 25
Number of participants	4	6	9	6
Percent of total	16%	24%	36%	24%

Source: IRS Summaries, Appendix B.

Overall, the review teams rated the documentation prepared by 76% of the corporations in the moderate to excellent range.

A substantial proportion of the documentation reviewed in Phase 2 met all the criteria in the section 6662(e) regulations and, based on the information available to the review team, appeared to reflect a reasonable application of the selected transfer pricing method. In many cases, the documentation described in detail the transfer pricing method, including the assumptions relied upon in applying that method. Such documentation generally permitted the examination team to proceed to detailed consideration of specific, substantive issues, such as selection of the best method or selection of comparables. Complete factual information concerning the company’s organization and the precise nature of the controlled transactions allowed the examiners to devote their time to substantive analysis, as opposed to development of basic facts.

In a few cases, the documentation provided by a particular company was deficient. For example, in a limited number of cases, the documentation did not include potentially significant facts about the controlled transactions or the taxpayer’s organizational structure. Only three such instances were noted among the twenty-five corporations reviewed in Phase 2. In most cases, the

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examination team was aware of the other information from alternative sources, such as SEC filings, news accounts, or the results of previous examinations.

Some documentation reviewed in Phase 2 contained all the principal documents specified in the section 6662(e) regulations, but nonetheless failed to reflect a reasonable application of a transfer pricing method. In such cases, the documentation appeared to have been prepared to support a particular transfer price or income figure, rather than to analyze the most reliable measure of an arm's length result. Again, the number of such instances was small.

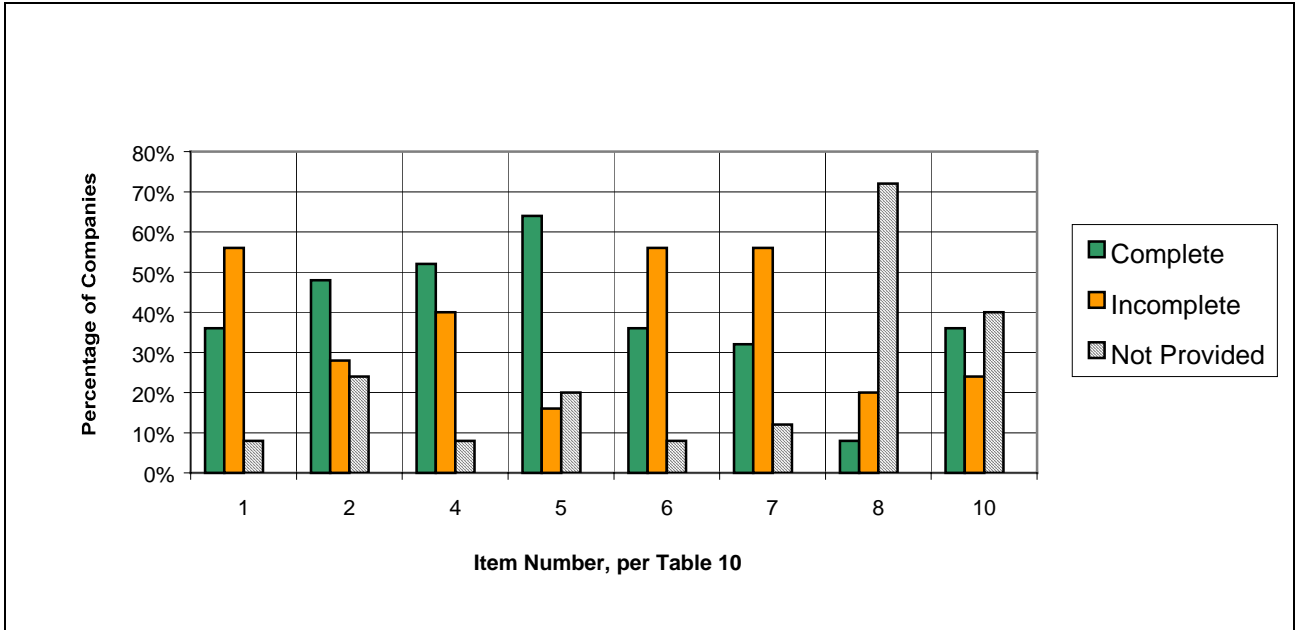
In order to provide another measure of overall quality, the review teams also considered whether the documentation contained complete versions of the documents specified in the section 6662(e) regulations.

Not all of the principal documents identified in the section 6662(e) regulations are relevant in every case. Documents explicitly required by the section 482 regulations, such as cost sharing arrangements or market-share strategies, may not be applicable to a particular taxpayer. Similarly, information obtained after the end of the tax year in question, but before the tax return for that year is filed, may not apply, depending on the taxpayer's particular circumstances. Because these documents may not be relevant to evaluation of the overall completeness of the documentation, they are not included in the summary of findings.

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Chart 4 below summarizes the review teams’ findings with respect to the remaining eight of the ten principal documents in the section 6662(e) regulations. The information is keyed to the document categories in Table 10.

**Chart 4**  
**Status of Principal Documents**  
**Under the Section 6662(e) Regulations**  
**Per IRS Review Teams**



**Table 10**  
**Principal Documents under the Section 6662(e) Regulations**

<u>Item Number</u>	<u>Description</u>
1	Overview of the Business
2	Description of Organizational Structure
3	Documentation Required by Section 482 Regulations
4	Description of Transfer Pricing Method Selected and Why
5	Description of Other Methods Not Selected
6	Description of Controlled Transactions
7	Description of Comparables Used
8	Explanation of Economic Analysis
9	Data Obtained After Year End
10	Index of Principal and Background Documents

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In general, the corporations in Phase 2 provided each of the principal documents specified in the section 6662(e) regulations. The documents that the IRS review teams most frequently classified as complete were the description of the transfer pricing method selected (item 4) and the description of alternative methods that were not selected (item 5). On the other hand, the organization chart (included in item 2), description of controlled transactions (item 6) and description of the comparables (item 7) were incomplete or missing in a majority of the cases. In addition, less than 30% of corporations provided a description of the economic analysis (item 8). In most of those cases, the review teams classified the document that was provided as incomplete. In addition, a significant number of taxpayers provided no index of documents (item 10), or an index that was incomplete.

Several specific areas in which deficiencies were found to be relatively common are discussed below.

- Selection of comparables. Relatively few explanations contained sufficient detail to allow the examination team to test the taxpayer's selection of the comparables or the adjustments (if any) between the comparables and the controlled transactions to improve reliability of the results. Yet, the reliability of the transfer pricing analysis may depend to a large extent on the selection of comparables and the application of the comparable data to the controlled transactions.
- Functional and risk analysis. Few taxpayers performed a functional or risk analysis of the tested party or the comparables. Such analysis is used to evaluate comparability between controlled and uncontrolled transactions, and to perform adjustments to improve the reliability of the results. See Treas. Reg. § 1.482-1(d)(3). Functional and risk analyses, to the extent they were included in the documentation, generally consisted of short narrative descriptions or checklists.
- Economic analysis. One of the principal documents in the section 6662(e) regulations is "economic analysis relied upon in developing the transfer pricing method." The regulations also refer to "analysis of the economic and legal factors that affect pricing of [the taxpayer's] property or services." Many taxpayers provided no documents corresponding to either category.
- Organization chart. Less than half of the corporations in Phase 2 provided a complete organization chart in response to the IRS request for documentation. In some cases, the taxpayer provided an organization chart later in the examination, sometimes after multiple requests by the IRS. A complete organization chart permits the IRS to evaluate corporate relationships that may affect the controlled transactions, functional and



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risk analysis, etc. An organization chart is especially important when the examination deals with a large-size corporation.

**b. Contemporaneous preparation**

The reasonable cause and good faith exception to section 6662(e) penalties may be available if a taxpayer prepares documentation that is contemporaneous with the controlled transactions in question. For these purposes, “contemporaneous” refers to documentation that is in existence on the date of timely filing (including extensions) of the income tax return for the taxable year in question. Analysis of transfer prices and comparables on a contemporaneous basis facilitates taxpayers’ reporting of the correct amount of income on the income tax return for each year.

A majority of the taxpayers in Phase 2 prepared documentation that appeared to be in accordance with the contemporaneous preparation provisions of the section 6662(e) regulations. In a minority of cases, documentation that otherwise conformed to the regulations did not appear to have been prepared contemporaneously with the controlled transactions at issue. This concern arose in two scenarios: (1) documentation was not in existence when the tax return was filed (*i.e.*, documentation was prepared substantially after the taxable year at issue); or (2) documentation prepared for a prior year was submitted for a subsequent year, and that documentation did not reflect material changes in the facts and circumstances in the subsequent year (or intervening years).

One example of the first scenario was documentation prepared for the taxable year ended December 31, 1995. Because the documentation was prepared in 1998, well after the tax return for 1995 was filed, it could not be considered contemporaneous documentation for items reported on the 1995 tax return.

An example of the second scenario was a study dated 1995 that was provided for taxable years ending in 1996, 1997, and 1998. The taxpayer did not update the documentation for material changes in items such business structure, more recent data regarding comparables, or other information relevant to the years in question. Thus, the documentation did not address the reasonableness of the transfer prices that were charged during the years in question.

Some taxpayers in Phase 2 prepared comprehensive documentation for one taxable year, but no documentation for any subsequent years, despite material changes in business conditions, of which the examination team was aware by other means. In one case, the documentation submitted for the subsequent year consisted of a statement that, “transfer pricing was reviewed in a previous year and determined to be arm’s length.” In another case, five years passed between the initial documentation and the first update. In several cases, the update

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referenced a more detailed study that had been prepared for a previous taxable year, but failed to provide a copy of that study to the examination team, or failed to provide information on events that occurred since the initial study was prepared.

**3. Utility of Documentation to IRS in Administering Section 482**

The examination teams in Phase 2 were virtually unanimous in the opinion that documentation significantly reduced the time and effort necessary to obtain information needed to analyze transfer prices. Before the documentation provisions were enacted, examiners generally initiated an examination of transfer pricing issues by issuing a series of information document requests (IDRs). Because transfer pricing analysis is highly fact-intensive, multiple IDRs were often necessary to develop a basic understanding of the taxpayer's business and the controlled transactions. Section 6662(e) documentation -- even when it is of less than optimum quality -- eliminates these steps and places essential information in the examiner's hands, often within thirty days of the IRS request. Consistent with the findings in Phase 1, most corporations in Phase 2 provided documentation within the thirty-day period specified in the regulations.

In many examinations, documentation saved significant IRS resources. Documentation permitted the IRS to determine at an early stage of the examination process, for example by reviewing the documentation regarding taxpayer's selection of comparables, 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.

Documentation identifies the taxpayer's transfer pricing method and the comparables that it selected. 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).

In general, documentation proved useful even if the examination team found it necessary to request additional information or documents not included in the

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initial submission. In a limited number of cases, however, missing or substantially incomplete documents reduced the usefulness of documentation. Because each of the principal documents is generally important, a single document that is incomplete may delay the examination.

A primary goal of section 6662(e) was to expedite IRS examiners' access to information needed to analyze transfer prices. See Treas. Reg. § 1.6662-6(d)(2)(iii)(A) (a minor or inadvertent failure to provide documents may be excused, "if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known."). On the one hand, documentation that is incomplete or partial places the IRS examination team in a better position than it was prior to enactment of section 6662(e). On the other hand, if the examination team must make multiple requests to obtain the principal documents, the improvements under section 6662(e) are minimized.

A number of the examination teams in Phase 2 observed that the quality and utility of the documentation submitted improved from one taxable year (or one examination cycle) to the next, as the taxpayer became familiar with the section 6662(e) regulations and the appropriate level of detail to include in each document. This development is consistent with the view that most taxpayers make substantial efforts to respond to section 6662(e). It also suggests that the quality and utility of documentation are likely to improve, as taxpayers and the IRS gain additional experience from the use of the principal and background documents in the context of specific examinations.

## V. CONCLUSION

Effective IRS administration of section 482 of the Internal Revenue Code is facilitated by timely access to relevant documentation regarding the taxpayer's reasonable efforts to comply with the arm's length standard. Section 6662(e) and the regulations under that provision encourage taxpayers to prepare contemporaneous documentation of their transfer pricing methodology to avoid the imposition of accuracy-related penalties on underpayment of tax arising from section 482 adjustments.

The responses to the Phase 1 survey indicate that taxpayers prepare documentation for a substantial percentage of controlled transactions, and that they devote substantial effort to analysis of transfer prices and preparation of documentation.

The Phase 2 reviews indicate that, although the quality of documentation prepared by specific taxpayers varies, documentation benefits both IRS examiners and taxpayers. Contemporaneous documentation has alleviated many of the problems that examiners experienced in the past. Examiners can

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begin their analysis based on the analysis contemporaneously prepared by the taxpayer. More focused and efficient transfer pricing examinations, and increases in the quality of the analysis and documentation from one year to the next, also benefit taxpayers by reducing the time and expense spent resolving transfer pricing issues.