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In this installment of Practically Speaking: Tax Controversy, the authors examine the IRS's shift toward increasingly asserting penalties in transfer pricing disputes, and they explain mitigation and defense options for affected taxpayers.

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Historically, transfer pricing penalties have been something of a bogeyman: widely feared but seldom spotted. The relative dearth of penalty assertions did not reflect a fault in IRS enforcement. Instead, it showed that the penalty regime was working as it should by encouraging taxpayers to document their intercompany pricing: In the decades since the introduction of the penalty regime, transfer pricing documentation has become largely ubiquitous.

That has begun to change. Transfer pricing documentation is still ubiquitous, but it is no longer enough for some IRS examination teams. After laying the conceptual groundwork, this article discusses the IRS's shift toward increased penalty assertion and explores procedural considerations for taxpayers grappling with penalties.

I. Overview of Penalties

Under section 6662, accuracy-related penalties may be imposed for underpayment of tax required to be shown on a tax return. Penalties are either 20 or 40 percent of the relevant underpayment, depending on the penalty imposed. This means the penalty is not applied directly to the gross amount of the underlying transfer pricing adjustment. For taxpayers in a

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Table 1. Relevant Accuracy-Related Penalties

Penalty		Trigger	Amount
Net adjustment penalty	Substantial valuation misstatement	Net section 482 adjustment exceeds lesser of $5 million or 10% of gross receipts	20%
	Gross valuation misstatement	Net section 482 adjustment exceeds lesser of $20 million or 20% of gross receipts	40%
Transactional penalty	Substantial valuation misstatement	Transfer price is 200% or more, or 50% or less, of arm's-length amount	20%
	Gross valuation misstatement	Transfer price is 400% or more, or 25% or less, of arm's-length amount	40%
Substantial understatement (for corporations)		Understatement of tax exceeds the lesser of 10% of the tax required to be shown or $10 million	20%
Disregard of rules or regulations		Careless, reckless, or intentional disregard	20%
Economic substance		Transaction lacks economic substance and is disclosed	20%
		Transaction lacks economic substance and is not disclosed	40%

loss position, the transfer pricing penalty regulations provide a mechanism to apply the penalty in the year that a carryover creates an underpayment.[1]

In the transfer pricing context, penalties generally relate to valuation misstatements; however, accuracy-related penalties for understatement of income tax, disregard of rules or regulations, and economic substance could apply to some transfer pricing adjustments. There are three types of valuation misstatement penalties: net adjustment, transactional, and misstating the value of property for tax purposes (which is generally less applicable for transfer pricing purposes). Fortunately, accuracy-related penalties do not stack; the maximum accuracy-related penalty is 40 percent.

Table 1 summarizes the most relevant penalties, triggers, and amounts.

The net adjustment penalty is seen most often in practice. A net section 482 adjustment is calculated as the sum of all positive section 482 adjustments for the year (excluding adjustments to transactions between foreign entities that do not affect U.S. taxable income), less amounts for which adequate documentation exists, less collateral adjustments (for example, setoffs) as ratably applied to undocumented transactions. When taxpayers have sufficient documentation for all material transactions, taxpayers should weigh the costs and benefits of preparing documentation for de minimis transactions for which adjustments would almost certainly be below the threshold.

Transactional penalties are another form of valuation misstatement penalty that are not commonly applied in practice, likely in part because they are easier to defend against than the net adjustment penalty. The relative lack of transactional penalties may also be caused by IRS resource constraints, which means most transfer pricing enforcement is focused on large taxpayers and large transactions and thus involves cases that would qualify for the net adjustment penalty. In the case of transactional penalties, the results of the taxpayer's transactions are compared against what the IRS (or the final decision-maker in the case) regards as arm's-length amounts.

II. Mitigating Exposure

There are several ways in which a taxpayer can potentially mitigate or defend against penalties. Depending on the situation and penalty, a taxpayer should consider the viability of each approach.

[1] Reg. section 1.6662-6(e).

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A qualified amended return (QAR) — that is, an amended return filed before the taxpayer is contacted by the IRS in connection with an examination of their return — is one mitigation strategy. If the QAR corrects the issue that gave rise to the underpayment, it is a defense against all penalties. However, the taxpayer must pay all taxes associated with the amended return accordingly.

In the transfer pricing context, QARs typically have limited utility outside a limited number of binary issues (for example, regulatory validity challenges) and remediation of errors because it is not possible to predict in advance of an examination exactly where the IRS will land on valuation questions. For example, a taxpayer may initially price a transaction at $100*x*, later realize that the price ought to have been $120*x*, and file a QAR in the belief that it corrects the valuation misstatement — only for the IRS to take the position that $150*x* is the correct arm's-length price.

The QAR would benefit the taxpayer by reducing the extent of the net transfer pricing adjustment subject to penalties. On the other hand, filing a QAR that increases the taxpayer's U.S. income from transfer pricing would likely result in double tax because double tax relief under the mutual agreement procedure article of a bilateral tax treaty might not be practically available for a taxpayer-initiated adjustment, depending on the counterparty jurisdiction and factual context. For non-treaty countries, filing a QAR when the income has already been reflected in the counterparty country inherently results in double taxation. A QAR may be a good option in some situations when there is no risk of double taxation because of tax attributes or nontaxation in the counterparty jurisdiction, but pillar 2 may make those situations fewer than they were historically.

If QARs are potentially problematic, are there better or more effective penalty mitigation options? There is not a single answer for all types of penalties. For example, the penalty for disregard of rules or regulations requires not only that the taxpayer have reasonable basis for its position but also that the position be disclosed on Form 8275, "Disclosure Statement," Form 8275-R, "Regulation Disclosure Statement," or Schedule UTP. Then there is the economic substance penalty, which cannot be defended against absent a QAR curing the issue or a victory on the merits of the underlying economic substance issue.

For the other types of accuracy-related penalties most relevant to transfer pricing, there is a common defense: transfer pricing documentation. Complying with the documentation requirements is equivalent to establishing reasonable cause and good faith for the transfer pricing position, which is important because the normal reasonable cause and good-faith defense does not apply to the net adjustment penalty, and because transfer pricing documentation therefore provides a defense against other penalties (specifically, the understatement penalty) for which reasonable cause and good faith is available as a defense. Table 2 provides an overview of defenses against the relevant accuracy-related penalties.

Table 2. Penalty Defenses

Penalty	Defenses (Excluding QAR)
Net adjustment penalty	Satisfaction of transfer pricing documentation requirements
Transactional penalty	Reasonable cause and good faith; or satisfaction of transfer pricing documentation requirements
Substantial understatement (for corporations)	Reasonable cause and good faith (including via satisfaction of transfer pricing documentation requirements); substantial authority; or reasonable basis with disclosure
Disregard of rules or regulations	Reasonable basis with disclosure
Economic substance	No defense, absent victory on the merits of the underlying issue

III. Transfer Pricing Documentation

To be effective, transfer pricing documentation must be reasonable and satisfy the documentation requirements of reg. section 1.6662-6(d) and the other requirements under reg. section 1.482. If the requirements of reg. section 1.6662-6(d) are satisfied by a taxpayer's transfer pricing documentation, the amount will be

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excluded from a net section 482 adjustment. Separate requirements exist when a taxpayer applies a specified section 482 method versus an unspecified section 482 method.

A. Application of a Specified Section 482 Method

Under reg. section 1.6662-6(d)(2)(ii), the specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. The taxpayer's selection and application of a specified method is reasonable if, "given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result."[2] A taxpayer can reasonably conclude that a specified method provided the most reliable measure of an arm's-length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods in a manner consistent with the principles of the best method rule.

Seven factors are used to determine the reasonableness of the taxpayer's conclusion:

- the experience and knowledge of the taxpayer;
- the reliability of available data and reasonableness of the data analysis;
- the extent to which the method application followed the section 482 regulations;
- reliance on a study or analysis performed by a qualified professional;
- whether the taxpayer arbitrarily selected an extreme point in range;
- the extent to which the taxpayer relied on a prior advance pricing agreement or other IRS-approved approach; and
- the size of the adjustment in relation to the size of the relevant transaction.

Transfer pricing documentation consists of principal documents and background documents. The principal documents focus on the facts of the taxpayer's business, its intercompany transactions, the selection of the best method (including an explanation of alternative methods considered), the economic analysis, and other requirements (index of the principal documents, organizational chart, etc.).[3]

Besides the index requirement and a description or summary of relevant information obtained after the end of the tax year, all principal documents must be contemporaneous (that is, they must be in existence as of the filing of the taxpayer's return for the year in question).

Also, a taxpayer must maintain background documents that support the principal documents to establish that the taxpayer's method was selected and applied in the way that provided the most reliable measure of an arm's-length result. Both principal and background documents must be provided to the IRS within 30 days of a request; IRS requests for the principal documents (usually referred to colloquially as the taxpayer's transfer pricing documentation) are more common.

B. Application of an Unspecified Method

When the taxpayer selected a method other than a specified method, it must consider if a specified method was potentially applicable or if no specified method was applicable.

If the transaction is of a type for which no methods are specified in the regulations under section 482, the taxpayer will be considered to have met the unspecified method requirement if it selected and applied an unspecified method in a reasonable manner.

If the transaction is of a type for which methods are specified in the section 482 regulations, the taxpayer will be considered to have met the unspecified method requirement if it reasonably concludes, given the available data, that none of the specified methods was likely to provide a reliable measure of an arm's-length result, and that it selected and applied an unspecified method in a way that would likely provide a reliable measure of an arm's-length result. By looking to specified methods' reliability in absolute rather than in relative terms, the documentation rules effectively put a thumb on the scale in favor of specified methods. Otherwise, the documentation requirements are identical to

[2] Reg. section 1.6662-6(d)(2)(ii)(A).

[3] Reg. section 1.6662-6(d)(2)(iii)(B).

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the requirements regarding the application of a specified method.

IV. Historical Penalty Application

An early version of the transfer pricing penalties appeared in 1990,[4] but proved fruitless: As of 1993, the penalties had never been asserted.[5] That same year, Congress set out to modify them, decreasing the threshold for penalty application and replacing the reasonable cause and good-faith defense to the net adjustment penalty with a new defense: transfer pricing documentation.[6] Final regulations detailing the documentation requirements followed in 1996.[7]

That development was transformative. By eliminating the general reasonable cause and good-faith defense and instead conditioning avoidance of penalties on the preparation of documentation in advance of an audit, the revised penalties regime made transfer pricing compliance a crucial item for many taxpayers. Without these rules from the mid-1990s, the transfer pricing documentation landscape that exists today is inconceivable.

Yet for more than two decades, the transfer pricing penalties seemed to be primarily effective as a Damocles sword that very seldom fell: The threat of penalties had a profound effect on compliance, but penalties rarely made the leap from threat to reality. That is not entirely surprising. The IRS tends to exercise restraint with powerful new enforcement tools; after Congress authorized it to impose economic substance penalties under section 6662(b)(6) in 2010,[8] for example, the IRS limited the new penalty's application by requiring executive approval to assert it and did not lift this requirement until 2022.[9] While the transfer pricing penalty was not subject to a similar formal limitation, experience indicated that in practice, IRS examiners generally declined to assert the penalty if the taxpayer could produce any sort of documentation, even if not complete or contemporaneous.

V. Recent Enforcement Guidance

Signs of a change came in early 2018, when the IRS Large Business and International Division issued a directive titled "Instructions for Examiners on Transfer Pricing Issue Examination Scope — Appropriate Application of IRC Section 6662(e) Penalties."[10] The directive exhorted examiners to be more diligent in considering and asserting transfer pricing penalties, reminding them that penalties ought to apply if documentation is not contemporaneous, is not timely provided to the IRS, or is "unreasonable or inadequate." It instructs examiners to look beyond the four corners of the documentation to determine if the information provided is adequate. The directive also noted the importance of evaluating whether documentation includes an adequate best method analysis.[11]

Refocusing on penalty application and the sufficiency of transfer pricing documentation has likely been spurred on by the Treasury Inspector General for Tax Administration's finding that IRS administration of penalties was broadly deficient. In 2019 TIGTA released a report with a title that states its conclusion: "Few Accuracy-Related Penalties Are Proposed in Large Business Examinations, and They Are Generally Not Sustained on Appeal."[12] The TIGTA study looked at accuracy-related penalties (which include the transfer pricing penalties) and found that LB&I too seldom asserted penalties: Examiners "are not always considering penalties [and] not always supporting their decisions for nonproposal of accuracy-related civil penalties."[13]

One of TIGTA's recommendations that met with the agreement of LB&I was simple — and revolutionary: "Ensure that examiners and supervisors are trained to: 1) consider the

[4]Omnibus Budget Reconciliation Act of 1990, section 11312.

[5]H.R. Rep. No. 103-111 at 719 ("According to the Administration, the IRS has not attempted to apply the transfer pricing related penalties since their enactment in 1990.").

[6]Omnibus Budget Reconciliation Act of 1993, section 13236.

[7]T.D. 8656.

[8]Reconciliation Act of 2010.

[9]LB&I-04-0422-0014.

[10]LB&I-04-0118-003.

[11]This theme was echoed in a companion directive issued at the same time, LB&I-04-0118-002.

[12]TIGTA, "Few Accuracy-Related Penalties Are Proposed in Large Business Examinations, and They Are Generally Not Sustained on Appeal," Report No. 2019-30-036 (May 31, 2019).

[13]*Id.*

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accuracy-related penalty for *all* applicable examination cases [and] 2) follow the proper procedures to document all actions taken during penalty consideration and development, whether assessing or not assessing the penalty."[14] (Emphasis added.) Examiners are supposed to consider transfer pricing penalties in all cases that meet the (low) penalty thresholds and to provide an affirmative justification if they decline to assert the penalty.

Under the Internal Revenue Manual, therefore, "all examiners are required to document the procedures used, information obtained, and conclusions reached in deciding to recommend or not recommend applicable penalties during examinations."[15] And more than a de minimis amount of work is required to justify nonassertion of penalties: "Standard statements such as 'penalty deemed not to be applicable' are not sufficient" in underpayment cases.[16]

Indeed, in a reversal of the normal supervisory approval requirement, an examiner must actually receive written supervisory approval *not* to assert penalties when there is a substantial underpayment under section 6662(b)(2) (for example, when a corporate taxpayer has understated its tax liability for the year by more than $10 million).[17] By its terms, the requirement applies only to the substantial understatement penalty and not to the transfer pricing penalties — but in practice, many transfer pricing adjustments meet the substantial understatement threshold, and thus nonassertion of penalties in those cases would require supervisory input.

Picking up the 2018 directive's theme of increasing scrutiny of documentation, the IRS in 2020 issued a set of frequently asked questions on transfer pricing documentation.[18] The FAQs appear to have evolved out of recommendations made in a 2018 report from the IRS Advisory Council, which reflected concerns with the adequacy of documentation:

> During recent years, the IRS and some external practitioners have observed that the quality of some transfer pricing documentation has declined to levels possibly falling short of the requirements of the statute and regulations, but the IRS has not consistently asserted the penalty. Moreover, despite the requirement that documentation exist at the time of filing of tax returns, taxpayers frequently submit more than one version of analysis in support of their transfer pricing.[19]

The IRS FAQs lay out best practices and seek to make Damocles's sword into a carrot, suggesting that high-quality transfer pricing documentation could facilitate early deselection of transfer pricing issues during an audit. At the same time, the FAQs provide a stark reminder that just having documentation is not enough: "Having 6662(e) documentation does not automatically protect against penalties. . . . Unless a taxpayer's 6662(e) documentation is adequate and timely, the regulations require the net adjustment penalty to be assessed in every case where the penalty thresholds are met."[20]

Unfortunately, the IRS's best practices are often unrealistic — for instance, the IRS would like to see taxpayers document not only the search strategy used in the taxpayer's transfer pricing analysis but also the steps taken to search internal and external data when determining that other methods were not applicable. Producing documentation that meets these standards would significantly increase the costs of transfer pricing compliance, with no guarantee that the carrot of issue deselection would materialize. Thankfully, the best practices of the FAQs are just that — best practices, not regulatory requirements.

VI. Audits and Litigation

Regardless of the intentions that drove the enforcement guidance described above, IRS exam teams conducting transfer pricing examinations

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[14] *Id.*

[15] IRM 20.1.5.4(2)(a) (Aug. 31, 2021).

[16] IRM 20.1.5.4(2)(b) (Aug. 31, 2021).

[17] IRM 20.1.5.9.2(3) (Aug. 31, 2021) ("Written Supervisory approval is required when the understatement is substantial whether or not the penalty is asserted.").

[18] IRS, "Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs)" (last updated Nov. 28, 2023).

[19] IRS Advisory Council public report, Publication 5316 (Nov. 2018).

[20] IRS, *supra* note 18.

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appear to have heard a clear message — assert penalties more frequently — and they have responded. The effect on taxpayers was almost immediate. A few years prior, penalties were rare outside situations in which there was no documentation or documentation was missing numerous regulatory requirements. However, following the release of the guidance, taxpayers and practitioners have been seeing penalties asserted despite complete and well-supported documentation — a practice that goes well beyond the enforcement guidance's purpose.

Instead of encouraging fulsome documentation and facilitating early de-escalation of transfer pricing issues at exam, the IRS's new penalty approach has had the opposite effect. Examinations have generally become more contentious and can conclude with IRS Exam imposing penalties when the taxpayer and the exam team simply disagreed on issues, such as the best method selection. Troublingly, that can occur even when there has been no discussion of penalties during the exam, blindsiding the taxpayer at the eleventh hour.

Because transfer pricing, especially the pricing of nonroutine contributions, often involves issues on which reasonable minds can easily differ, two or more analyses can be reasonable but yield different results. The ability of both the IRS and the taxpayer to choose one-sided methods and tested parties, which are concepts enshrined in the section 482 regulations, exacerbates this issue. In practice, exam teams increasingly assert penalties when nothing is wrong with the taxpayer's documentation or analysis, except that the exam team disagrees with taxpayer's position and therefore concludes that the taxpayer's documentation was unreasonable (that is, no longer provides penalty protection). Disagreement alone should not be — and under the regulations, cannot be — a basis to impose penalties. Further, resolutions in Tax Court and other public filings have illustrated that the IRS's examination conclusions are frequently wrong.

Penalty issues have been absent in most large transfer pricing cases that have yielded judicial opinions in recent years,[21] but that is shifting. Public filings show that penalties are at issue — despite the existence of transfer pricing documentation — in several cases now working their way through the courts: *Amgen Inc.*,[22] *Eaton Corp.*,[23] *Microsemi Corp.*,[24] *Perrigo Co.*,[25] and *Sysco Corp.*,[26] to list some notable examples.

The watershed shift in the IRS's approach to transfer pricing penalties is best illustrated by the ongoing litigation in *Amgen*. The case involves two petitions, for tax years 2010 to 2012 and 2013 to 2015, dealing with materially identical transfer pricing issues that were covered by transfer pricing documentation. For 2010 to 2012, the IRS asserted deficiencies exceeding $3.5 billion; for 2013 to 2015, the claimed deficiencies total over $5 billion. No transfer pricing penalties were asserted for the 2010 to 2012 period; yet for 2013 to 2015, the IRS asserted almost $2 billion in penalties. From the limited publicly available information on this case, it appears that the sole fact explaining this $2 billion change of position is the shift in the IRS's attitude toward transfer pricing penalty enforcement.

VII. Procedural Options

The imposition of penalties by the IRS in transfer pricing cases raises thorny procedural issues, primarily for cases in which effective MAP relief is available. That is, in cases in which effective MAP relief is not available, either from the lack of a tax treaty or an effective working competent authority relationship, the procedural pathway for U.S.-initiated adjustments will generally be limited to domestic options, which are fairly clear.

[21] A notable exception is the taxpayer victory in *Eaton Corp. v. Commissioner*, 47 F.4th 434 (6th Cir. 2022).

[22] *Amgen Inc. v. Commissioner*, T.C. No. 16017-21 (2021). *See* Alexander F. Peter, "Amgen Battles IRS Over New Transfer Pricing Penalties," *Tax Notes Federal*, Aug. 8, 2022, p. 1032.

[23] *Eaton Corp. v. Commissioner*, T.C. No. 2607-23 (2023).

[24] *Microsemi Corp. v. Commissioner*, T.C. No. 36721-21 (2023). *See* Alexander F. Peter, "Microsemi Seeks to Quash Transfer Pricing Penalties in Tax Court," *Tax Notes Federal*, May 22, 2023, p. 1437.

[25] *Perrigo Co. v. United States*, No. 1:17-cv-00737 (W.D. Mich. 2017).

[26] *Sysco Corp. v. Commissioner*, T.C. No. 5728-23 (2023).

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On the other hand, when MAP is a real option for avoiding double taxation and potentially reducing an IRS-initiated transfer pricing adjustment, there could be difficult choices ahead. The first step is to check the tax treaty language regarding penalties. Many U.S. tax treaties do not contain explicit references to penalties. For some of these, the technical explanation clarifies that, at least in Treasury's view, penalties can be discussed — although the foreign competent authority may take a different stance.[27] For those that do discuss penalties, the language often resembles that found in article 25(3)(e) of the U.S. model convention, which allows the competent authorities to agree "to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of this Convention."

Assuming that penalties are not referenced in the MAP article of the treaty at issue, penalties may not explicitly be discussed or addressed in MAP. However, the MAP process has significant implications for domestic penalty procedures (appeals or litigation). For example, if the competent authorities negotiate the case based on a method consistent with the taxpayer's selected method, this could be used in a domestic U.S. proceeding as evidence that the taxpayer's best method selection was reasonable (and thus no penalties should apply). On the other hand, if the foreign competent authority agrees with the method selected by the IRS, which is contrary to the taxpayer's selected method, this could reinforce an IRS argument that the taxpayer's best method selection was unreasonable.

Also, while formally the competent authority resolution is a different process, it would seem unlikely that U.S. transfer pricing penalties would not be proportionally reduced based on the resolution of the underlying adjustment by the competent authority. For example, if the underlying adjustment was reduced by 50 percent, with the foreign competent authority providing correlative relief for the other 50 percent of the adjustment, the penalties should be reduced by at least 50 percent as a practical matter. It would be difficult for the IRS to argue in Appeals and litigation that the MAP resolution was unprincipled and incorrect, especially because MAP resolutions are documented via a resolution letter sent to the taxpayer.

For cases in which U.S. transfer pricing penalties can (in theory) be negotiated under a treaty, there is a difficult decision to be made: Go to MAP, go to IRS Appeals, or go to simultaneous Appeals procedure (SAP), which allows for Appeals consideration of an issue under competent authority jurisdiction. The advantages of either MAP or SAP are clear: The penalties could be negotiated or eliminated in MAP, although in practice, competent authorities may decline to negotiate penalties even if explicitly permitted under the treaty. Even if penalties are not directly negotiated, the MAP or SAP process would likely ensure that penalties would be proportionally reduced. If the penalties could ultimately not be negotiated in MAP — either because the competent authorities agreed not to negotiate penalties or because no resolution could be negotiated — the penalties issue could then be taken to IRS Appeals to resolve.

However, there is one potential negative, and therefore a reason to potentially choose to go to IRS Appeals instead of MAP for a transfer pricing penalty issue. This arises when the taxpayer and its advisers think that the transfer pricing penalty was clearly incorrectly asserted and should be easy to eliminate at IRS Appeals (or worst case, in litigation). In those situations, there may not be much downside to forgoing the chance of competent authority assistance with the penalties, and there can be a benefit.

This benefit primarily arises because MAP cases are by nature negotiated settlements, in which the party that initiates the adjustments often gets some portion of the adjustment sustained, regardless of the strength of its position. Consequently, conventional wisdom is that a larger initial adjustment or the addition of other adjustments or issues will very likely result in a larger sustained adjustment. If we consider the effect of including IRS-asserted penalties in the MAP case, simply including them in negotiations will most likely shift the negotiating leverage toward the U.S. competent authority.

[27] For instance, the 1983 technical explanation to article 24(2) of the Australia-U.S. treaty states that the competent authorities "may also discuss the application of the provisions of domestic law regarding penalties, fines and interest in a manner consistent with the purposes of the Convention."

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Taking the penalties separately to IRS Appeals reduces the effect of the penalties. Therefore, the decision to go to MAP or SAP versus traditional IRS Appeals is not automatic.

To add to the complexity, there is also a timing consideration. Because the penalties are likely dependent on the method selection, as discussed above, the fact that there is a related IRS Appeals case may influence the arguments and timeline of the MAP case. That is, the U.S. competent authority may not want to undercut the IRS Exam position in IRS Appeals by agreeing with the counterparty country on a method consistent with the taxpayer's as-filed transfer pricing method. There could therefore be a benefit to addressing the penalties issue as early as possible (via early referral to Appeals, for example).

On the flip side, there is a risk that a loss at IRS Appeals on penalties might result in full penalties being sustained, which might not be modified to take into account a proportional reduction in the underlying adjustment after the MAP resolution. While this would be unprincipled, we have seen arguments before that MAP resolutions do not affect "domestic" proceedings such as IRS Appeals, because they are merely "treaty settlements." Therefore, taxpayers should be mindful of converting an IRS Appeals case to an SAP case within the prescribed time limits (in applicable cases). Clearly, these timing issues complicate an already difficult decision regarding the procedural approach.

Finally, for all cases, a question arises regarding the use of APAs and rollback to earlier years. For those not familiar with rollback, it refers to coverage of past years as part of an APA. It is available for U.S. APAs, and most other countries can apply rollback or similar concepts to cover additional past years within the APA process. For all practical purposes, penalties will not apply to transfer pricing adjustments resulting from an APA for the primary APA years, and therefore requesting an APA limits not only the risk and inefficiency of successive audits and adjustments but also the potential application of penalties.

For rollback years in U.S. APAs, the impact is more complicated. Because IRS Exam has to accede to the application of APA rollback to years under its jurisdiction, it could reject APA rollback and simply issue a proposed adjustment for transfer pricing, plus apply penalties. Moreover, because IRS Exam has initial jurisdiction over rollback years, even if it acceded to rollback, in theory it could still have jurisdiction to apply penalties, although this is less clear and, as a practical matter, would likely not occur.

Because transfer pricing penalties could apply to rollback years, the normal calculus of maximizing APA coverage may be flipped on its head. Absent penalty considerations, taxpayers generally want to maximize the number of years covered by an APA by maximizing the number of rollback years. If penalties are on the table, however, it may be less risky to apply for an APA whose first non-rollback year is as early as possible, minimizing the rollback years. For bilateral APAs with some jurisdictions, of course, this flexibility is not possible, but fortunately the U.S. deadlines for APA filing are quite flexible.

VIII. Conclusion

Transfer pricing penalties are shifting from a theoretical risk to a real and significant concern that taxpayers must now consider. No longer are they a mere motivator for the transfer pricing documentation regime — and no longer does the mere existence of documentation suffice to ward them off. The evolving enforcement landscape increases not only the importance of carefully preparing documentation but also the complexity of the procedural roadmap for taxpayers faced with penalty enforcement.[28] ■

[28] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

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