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Surveying 2024 US Transfer Pricing Enforcement Trends

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As the IRS has seen more success in transfer pricing enforcement cases, taxpayers should re-evaluate their current transfer pricing documentation and defense strategy and determine whether a proactive approach through the APA or ICAP program could reduce its global transfer pricing exposure, says a Grant Thornton practitioner.

The Internal Revenue Service has meaningfully improved its transfer pricing enforcement outcomes in recent years. Largely due to an organizational change to examination oversight over a decade ago, the IRS has had recent success in some high-profile transfer pricing cases. Current IRS hiring and enforcement efforts are intended to expand and continue that trend. Further, the IRS has increased its assertion of 20% and 40% transfer pricing penalties. Due to these changes, and a general increase in the amounts in transfer pricing disputes, the financial reporting for transfer pricing as an uncertain tax position ("UTP") under Accounting Standards Codification (ASC) 740 has risen in importance.

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In response to this changed enforcement environment, taxpayers should re-evaluate their transfer pricing approach to update and upgrade their documentation (with particular attention to intangibles transactions), seriously consider the financial reporting for transfer pricing and proactive approaches to prevent disputes regarding valuable intangibles.

Changed IRS Approach to Transfer Pricing Enforcement

In 2012, the IRS established the Transfer Pricing Practice ("TPP") within its Large Business and International ("LB&I") division to facilitate national oversight of its transfer pricing enforcement efforts. In individual cases, TPP oversees case selection and issue development, and coordinates with the IRS counsel attorneys responsible for litigation. The national management and coordination of transfer pricing disputes has certainly contributed to the improved IRS track record discussed below.

The Inflation Reduction Act (P.L.117-169) increased the IRS budget substantially, and LB&I has been spending on additional personnel and technology to increase its coverage of transfer pricing issues. According to IRS officials, increased staff will focus on transfer pricing noncompliance using sophisticated data analytics; data will be used to identify noncompliant as well as compliant taxpayers.

The IRS kicked off its Large Foreign-Owned Corporations Transfer Pricing Initiative by sending "compliance alerts" ("Alerts") to approximately 180 distribution subsidiaries of large foreign corporations. The Alert (either Letter 6607 or 6608) points out that the taxpayer reported losses or low margins on its tax return for tax years 2017 through 2021, and those results might indicate that the taxpayer's transfer pricing did not comply with §482. The IRS does not expect distributors with limited function, asset, and/or risk profiles to report losses or low margins for multiple years. Letters 6607 and 6608 each state that the letter does not constitute an examination, but the IRS will be monitoring its results and encourages the taxpayer to evaluate its transfer pricing policy, intercompany agreements, financial results, and Form 1120 and consider whether self-correction is warranted. Each letter states that the taxpayer should evaluate its transfer pricing policy, intercompany agreements, financial results and Form 1120 for tax years 2017 to 2021 to confirm its compliance with §482.

It is helpful to view these Alerts as the IRS use of data analytics to identify perceived non-compliance and encourage taxpayers to self-correct, if necessary. The IRS shared that it had a very high response rate from taxpayers that received Alerts. Non-responders have been referred for possible examination. Similar data analytics-based approaches could be forthcoming.

Another area of transfer pricing concern for the IRS is intercompany indebtedness. On December 29, 2023, the IRS issued general legal advice memorandum (GLAM) AM 2023-008, "Effect of Group Membership on Financial Transactions under §482 and Treas. Reg. §1.482-2(a)." Based on principles in the §482 regulations, the GLAM concludes that the IRS can recognize group membership to determine an arm's length interest rate on intercompany loans based on implicit financial support expected from a group member. This GLAM may encourage companies to reconsider their intercompany debt agreements.

Recent and Current Transfer Pricing Disputes

The IRS is addressing transfer pricing for high value intangibles issues and proposing extremely large amounts of tax, penalties and interest. In a marked change from previous decades, the IRS has seen

dramatic improvement in transfer pricing case outcomes, achieving at least a partial win in the following transfer pricing cases, even if some of them are likely to be appealed:

- *Altera Corporation & Subsidiaries v. Commissioner,* Nos. 16-70497 and 16-70497 (9th Cir. 2019). On June 22, 2020, the US Supreme Court declined to review the 9th Circuit decision in favor of the IRS. The case focuses on the 2007-2009 impact of the 2003 cost-sharing regulations that required the inclusion of stock-based compensation in cost-sharing cost pools. The case involves a transfer pricing adjustment of approximately $81 million.
- *The Coca-Cola Company & Subsidiaries v. Commissioner*, 155 T.C. No. 10 (2020). On August 2, 2024, the US Tax Court entered a decision against The Coca-Cola company that reflects a tax underpayment of approximately $2.7 billion for tax years 2007-2009. With applicable interest, the total underpayment is expected to be approximately $6.0 billion.
- *3M Company & Subsidiaries v. Commissioner*, 160 T.C. No. 3 (2023). On February 9, 2023, the US Tax Court ruled in favor of the IRS in a “blocked income” case. The case resulted in a $27.3 million adjustment.
- *Medtronic, Inc. and Consolidated Subsidiaries v. Commissioner,* No. 17-1866, 900 F.3d 610 (8th Cir. 2018). Upon receiving the case for a second time in a re-trial, the Tax Court applied a three-step unspecified method that resulted in approximately $1.4 billion in adjustments for tax years 2005-2006.

Transfer pricing cases recently filed with the Tax Court include:

- *Amgen Inc. et al. v. Commissioner***,** T.C. Memo 2024-38, No. 16017-21 (Apr. 4, 2024)**.** The transfer pricing issue focuses on the allocation of income between the US parent and its Puerto Rican manufacturing subsidiary for tax years 2010–2015. The IRS alleges an underpayment of $10.7 billion of tax and penalties. *Newell Brands, Inc. v. Commissioner*, T.C. No. 11897-24 (petition filed July 19, 2024). The IRS alleged that Newell’s comparable uncontrolled services price method for intercompany procurement services was not the best method because Newell’s comparable transactions were not comparable. IRS alleged an underpayment of $90M of tax and $34M in related penalties.
- *Airbnb Inc. v. Commissioner*, T.C. No. 12423-24 (petition filed July 31, 2024). The IRS claimed that Airbnb Inc. understated its US taxable income based on resources and rights that it made available to its Irish affiliate under a platform contribution agreement. Airbnb Inc. determined the cost of the licenses using an “income method"; the IRS employed an unspecified method. The IRS alleged an underpayment of taxes by $1.33 billion for 2013, plus $573 million in penalties.
- Microsoft’s case, which would be the largest case of all, has not yet been filed.Microsoft is currently engaged in a long-standing transfer pricing dispute with the IRS over $28.9 billion of additional taxes, plus penalties and interest for tax years 2004-13 (Mimi Song, *Microsoft’s $29 Billion Tax Bill Offers Transfer Pricing Lessons*, Daily Tax Rpt. (Feb. 7, 2024)).
- The *Loper Bright Enters.v. Raimondo* case can greatly affect transfer pricing enforcement even though it is not even a tax case. In *Loper Bright*, 144 S. Ct. 2244, No. 22-451 (June 28, 2024), the Supreme Court overturned *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984) to hold that federal agency interpretations of law are not entitled to deference (e.g., the deference provided to the Department of Treasury and IRS in the promulgation of tax regulations). The Court’s opinion in *Loper Bright* may substantially change the administration of taxes. The Court limited the scope of its decision slightly by holding that prior decisions relying

on *Chevron* remain good law, and that courts may still rely on agency interpretations to the extent they are persuasive. By overturning *Chevron*, courts may no longer be bound to uphold IRS regulations as authoritative interpretations of ambiguous statutes. Because the transfer pricing rules contained in §482 are general and brief, the Treasury and IRS promulgated regulations to clarify and address certain perceived ambiguities within the statute. Due to §482's arguable lack of regulatory delegation on appropriate profit allocation methods, transfer pricing regulatory guidance could be exposed to litigation.

Transfer Pricing Disputes are Getting Larger

Transfer pricing is the largest tax issue for some of the world's largest multinationals. According to US Census Bureau statistics, imports and exports of goods between related parties accounted for 41.6% of all imports and exports in 2022; all of these transactions involve transfer pricing. Further, unlike many tax disputes, transfer pricing disputes generally are not limited to a single transaction for a single year, but instead could address all cross-border transactions with related parties over many years. Due to the factual development necessary to analyze transfer pricing issues and the time needed to analyze that information for multiple transactions, multiple years are generally included in the transfer pricing dispute, further adding to the amount of deficiency asserted.

Probably the major reason for the continuing increase in transfer pricing amounts in issue is the focus of transfer pricing examinations on intangibles transactions and the enormous increase in the value of those intangibles in the global operations of multinationals (*See* Steven C. Wrappe, *Tranfer Pricing Disputes: Big, Getting Bigger* , Tax Mgmt. Int'l J. (Sept. 23, 2024)). In recent years, more transfer pricing disputes have focused on intangibles transactions that have a large impact on company profits; intangibles are inherently difficult to value due to the lack of closely comparable transactions for unique intangibles. These problems are amplified by the increasing financial importance of intangibles in a modern business. In a study of the value of intangibles relative to the overall value of S&P 500 companies, the percentage in 1975 was 17%, increasing to 90% in 2020 (*Intangible Asset Market Value Study* , Ocean Tomo). To the extent more transfer pricing disputes focus on intangibles, it is not surprising that amounts in dispute have risen substantially. Further, the changed IRS stance on penalties and rising interest rates associated with tax underpayments has contributed to increased amounts in transfer pricing disputes.

Trends Regarding §6662 Penalties

Congress enacted the §6662 penalty provisions in 1989 to encourage taxpayers to make reasonable efforts to determine and document arm's length transfer prices. These penalties may be asserted on both a transactional and net adjustment basis and may produce a 20% or 40% penalty. The regulations provide for a reasonable cause and good faith exception to avoid penalties if valid contemporaneous transfer pricing documentation that demonstrates the reasonableness of the taxpayer's choice of pricing methods is provided within 30 days of an IRS request. It is important to note that transfer pricing tax deficiencies involving over $20 million of proposed tax adjustments can carry a 40% penalty in the United States.

Until recently, the IRS did not apply the §6662 penalty provisions as assertively as the statute and regulations would allow. However, in 2018 the IRS Advisory Council observed that the quality of some

transfer pricing documentation possibly fell short of the §6662 requirements, but the IRS had not consistently asserted the penalty. In the years subsequent to the IRS Advisory Council report, IRS executives repeatedly messaged an intention to apply these penalties more frequently than in the past, specifically stating that documentation must be of a sufficient quality to prevent imposition of the penalty.

Consistent with the changed IRS position regarding penalty assertion, the IRS has asserted §6662 penalties in four recent cases— *Amgen* ($10.7 billion of tax, penalties and interest) and Microsoft ($28.9 billion of taxes, plus penalties and interest). The IRS treatment of transfer pricing issues in *Newell* and *Airbnb* is also consistent with the trend of more assertive application of transfer pricing penalties.

Financial Reporting Trends

The financial reporting rules under ASC 740 control how companies identify, measure, and report UTPs on their US Generally Accepted Accounting Principles (GAAP) financial statements. Tax "positions", which include transfer pricing issues, are evaluated using a two-step process. First, a tax position is only recognized at all if, based on the technical merits, that position is expected to be sustained upon examination (FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109 (June, 2006)). If the position is recognized, the second step is measurement of the tax benefit. The tax benefit from the tax position, "…shall initially and subsequently be measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information." (*Id*.). Given the size of transfer pricing issues and the IRS scrutiny of transfer pricing transactions, transfer pricing has become one of the most significant UTPs.

Two developments in the US transfer pricing enforcement could change how entities evaluate their transfer pricing-related tax positions and the company's intentions related to defending these positions. First, the increase in IRS transfer pricing litigation success makes it more difficult to assign a low probability to IRS success. Second, the IRS has asserted transfer pricing penalties in more cases, including in situations where transfer pricing documentation exists, if that documentation is found to be insufficient. As long as opportunity to resolve or appeal a transfer pricing case a transfer pricing case is not foreclosed, the taxpayer can take the position in its financial statements that it will ultimately prevail over the IRS and low or no tax reserve is necessary.

On March 13, 2023, the Roofers Local No. 149 Pension Fund (the plaintiff) sued Amgen Inc. and others based on Amgen's failure to adequately disclose information about transfer pricing disputes with the IRS regarding the allocation of profits between Amgen affiliates in the United States and Puerto Rico. Most of Amgen's products are manufactured in Puerto Rico, and the IRS issue regarding allocation of profits centers on the transfer pricing with respect to these transactions. According to the Plaintiff, although Amgen had specific information in its possession about IRS proposed adjustment for years 2010-2012 and 2013-2015 before the July 29, 2020 filing of its quarterly report on Form 10-Q, Amgen did not share that information in its 10-Q. Amgen did disclose the transfer pricing dispute with the IRS regarding the Puerto Rico transactions and take the position that the IRS positions were "without merit", but omitted the fact that the amount at issue for 2010-2012 was over $3 billion and the amount at issue for 2013-2015 was over $7 billion—$10.7 billion in total. Further, the same issue is under examination in 2016-2018, and the issue continues in subsequent years.

Proactive Alternatives

Despite its recent success in transfer pricing enforcement, the IRS is firmly committed to proactively working with taxpayers to prevent transfer pricing disputes. In order to avoid costly transfer pricing disputes, taxpayers may wish to consider whether to proactively manage their transfer pricing exposure through an APA or an international compliance procedure ("ICAP").

An APA is a voluntary procedure whereby a taxpayer files a request that sets out relevant facts, background materials and economic analyses for the proposed covered transactions.Following the request, the involved tax authorities generally issue information requests to supplement the submitted materials, followed by meetings and negotiations with the taxpayer.The process can be long and labor-intensive, with the due diligence and negotiation process often lasting over two years for a unilateral APA, with an additional two years required for bilateral or multilateral negotiations between the IRS and foreign tax administrations. The process can also be expensive. The user fee for an original APA is currently $121,600, with advisor fees incurred to prepare the submission, respond to information requests, and attend meetings. At the end of the process, the taxpayer and the involved government or governments execute a binding agreement setting out the covered transactions, transfer pricing method, agreement duration, and other relevant terms. As long as the taxpayer adheres to the terms, the covered transactions cannot be adjusted if audited. An APA frees the taxpayer from the need to prepare documentation studies on the covered transactions, reduces Customs exposure, and, in the case of a bilateral or multilateral APA, eliminates the possibility of double tax on the covered transactions.

An ICAP is a voluntary process that differs from an APA in several respects. An ICAP submission is generally limited to information an MNE should already possess, such as transfer pricing studies, recent country-by-country reports, and financial data, among others.The process is expected to last between 24 and 28 weeks following receipt by the tax administrations of requested information; the completion timeframe likely varies depending on the complexity of the transactions and the number of countries involved. ICAP can cover several transactions and countries at once, provided those countries are among the 22 currently participating in the program.

Most APAs are bilateral and cover only two countries. ICAP does not require a user fee, so the costs are limited to the time spent internally and by external advisors preparing the documents for submission and meeting with tax administrations. Unlike an APA, which can cover several years prospectively and can be rolled back to filed years, ICAP generally covers only two filed years, and, under certain conditions, can be rolled forward an additional two years.Further, ICAP does not provide the same level of certainty provided by an APA. ICAP can provide an MNE with "assurance" that participating tax administrations do not anticipate further review of the covered risks for a defined period.Where a tax administration is not able to reach such a conclusion, it may make recommendations on how to resolve the issue, including pursuit of an APA.

Recommendation

In this changed enforcement environment, taxpayers should re-evaluate their US transfer pricing compliance. Further, taxpayers should update their documentation for any changes to operations and any changed expectations as a result of the recent IRS wins. Finally, taxpayers should use any information developed through the re-evaluation to determine whether a proactive approach through

the APA or ICAP program could reduce its global transfer pricing exposure.
In light of this changed enforcement environment, taxpayers should self-assess their current transfer pricing documentation and defense strategy and determine whether any change is needed.

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