The following comments relate to the IRS Large and Mid-Size Business Division Commissioner’s Transfer Pricing Compliance Directive issued January 22, 2003. The comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Transfer Pricing of the Section of Taxation. Principal responsibility was exercised by Sean Foley and Raphaele Chappe. Substantive contributions were made by Charles Triplett and Steven C. Wrappe. The Comments were reviewed by Nicholas S. Freud of the Section's Committee on Government Submissions and Elinore Richardson, Council Director for the Transfer Pricing Committee.

Although some members of the Section of Taxation who participated in preparing these comments may have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or firm or organization to which the member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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EXECUTIVE SUMMARY

We are requesting that the Internal Revenue Service consider granting taxpayers an opportunity to supplement the documentation on their transfer pricing methodology by March 1, 2004 (or six months from the date of the IRS announcement) for purposes of waiving penalties that might otherwise apply under Section 6662(e) with respect to a net Section 482 transfer price adjustment. Any such documentation prepared during this grace period and submitted to the Internal Revenue Service would be deemed to have been prepared contemporaneously with the tax return.

A grace period would further the objectives of enhanced compliance and simplified administration underlying Section 6662(e) and Treas. Reg. Section 1.6662-6 by allowing taxpayers to produce supporting documentation that would provide useful guidance in accurately reflecting arm’s length results for controlled transactions. We argue that in light of taxpayers’ reliance on the internal practice of the Service in the past, which was not routinely requesting documentation from all taxpayers, such measure would allow taxpayers to complete their Section 6662(e) documentation for prior taxable years to conform to the new IRS practice to routinely request such documents. This proposal would assist both taxpayers and the Service in determining proper allocations under Section 482.
Comments

I. Introduction.

Regulations under Section 6662(e)\(^1\) require that transfer pricing documentation supporting the taxpayer’s selection of the transfer pricing methodology under the principles of the Section 482 best method rule be prepared contemporaneously with the return. The regulations were issued in response to P.L. 103-66 (Omnibus Budget Reconciliation Act of 1993) and have been in effect since 1994.\(^2\)

On January 22, 2003, former Large and Mid-Size Business Division (LMSB) Commissioner Larry Langdon issued a Transfer Pricing Compliance Directive\(^3\) (“Langdon Directive”) reviewing current practices in the examination of transfer pricing issues and in the imposition of transfer pricing penalties. The Langdon Directive instructs examiners to request transfer pricing documentation prepared by the taxpayer pursuant to Section 6662(e) at the joint opening conference for each audit cycle and reaffirms that taxpayer transfer pricing documentation must be in existence when the return is filed to avoid misstatement penalties under Section 6662(e).

II. The Langdon Directive Represents a Shift In The IRS’ Administration of The Section 6662(e) Penalties.

1. Description of Past IRS Practice Leading to The Langdon Directive.

The genesis of the Langdon Directive was clarified in an interview with LMSB Director, International Carol Dunahoo.\(^4\) Ms. Dunahoo stated that the Langdon Directive was prompted by indications that examiners were not adequately auditing transfer pricing documentation. In particular, IRS management received complaints from taxpayers that while they were investing resources to prepare Section 6662(e) studies, agents were not requesting the studies on exam. The IRS “Report on Transfer Pricing Documentation” released in May 2002 “confirmed that these were not isolated incidents,” Ms. Dunahoo said.\(^5\) IRS statistical information also indicated that transfer pricing enforcement had fallen off.

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\(^1\) Treas. Reg. § 1.6662-6(d)(2)(iii).
\(^2\) The regulations were first issued as temporary regulations in the Federal Register (T.D. 8519) (58 F.R. 5263) on February 2, 1994 and were subsequently finalized on February 9, 1996 (T.D. 8656) (61 F.R. 4876-4885).
\(^3\) Memorandum for LMSB Executives, Managers, and Agents; From: Larry R. Langdon Commissioner Large and Mid-Size Division; Subject: Transfer Pricing Compliance Directive; Issued January 22, 2003.
\(^5\) This report was prepared at the request of Congress. See request from the Senate Committee on Appropriations, attached to Report No. 106-87 on the Treasury and General Government Appropriation Bill, 2000 (S. 1298, 106th Congress, 1 Sess.). 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).
Ms. Dunahoo’s comments regarding past IRS practice not to request Section 6662(e) documentation routinely is consistent with our experience. Since the Section 6662(e) documentation requirement regulations were promulgated in 1994, we are aware that taxpayers have prepared numerous documentation studies. In many cases, we understand that these studies were never requested by the IRS auditors.

2. **Retroactive Effect of The Langdon Directive By Virtue of Taxpayers’ Reliance on Past IRS Practice.**

As a result of the IRS practice not to request Section 6662(e) studies routinely, some taxpayers scaled back their initial efforts to address their transfer pricing documentation. For example, we are aware of taxpayers who annually had prepared complete Section 6662(e) documentation beginning in 1994. After one or more audit cycles in which the audit team did not request the documentation, these taxpayers determined to update their studies only every other year, or in some cases on a longer cycle. In some cases, in the year in which the documentation was not updated, the comparables used in the prior study were “refreshed,” i.e., the business results for the most recent available year for the comparable companies were compiled and added to the prior documentation. In other cases, the prior year documentation was left unamended.

In another common fact pattern, taxpayers prepared some of the principal documents listed in Treas. Reg. Section 1.6662-6(d)(2)(iii)(B) by the return filing date, while other principal documents were completed after that date. In still other cases, taxpayers completed draft documentation by the return filing date, and then finalized this draft after that date. We understand that IRS examiners who received Section 6662(e) documentation within 30 days of a request did not distinguish between documentation that was entirely complete on the filing date, and documentation that was finalized or supplemented after that date.

As a result of nine years of IRS practice and taxpayer experience since the Section 6662(e) regulations were first promulgated, the Langdon Directive represents a significant change in the administration of the Section 6662(e) penalty. In the particular circumstances of the Section 6662(e) penalty, taxpayers who became complacent and did not strictly comply with the filing date requirement of the Section 6662(e) regulations, now have little opportunity to make amends. If they don’t have documentation that was prepared by the return filing date, no subsequent effort by the taxpayer to document its transfer pricing policies can change that fact. The Langdon Directive, unfortunately, operates with a retroactive effect.

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6 As Ms. Dunahoo stated in the previously referenced interview, in some circumstances this might be a legitimate and appropriate course to follow.
III. Recommendation: Grace Period For Taxpayers To Prepare Their Transfer Pricing Documentation.

As the stricter compliance efforts established in the Langdon Directive are a departure from the Service’s past internal practice, we suggest that taxpayers be given the opportunity to assemble and complete the documentation required by Treas. Reg. Section 1.6662-6 during a grace period.

1. The Proposed Penalty Waiver Is Consistent With The IRS’ Recent Amnesty Initiatives.

When the IRS and Treasury make significant changes to administrative practice, the government has often provided some form of relief for taxpayers caught by the change. For example, in Rev. Proc. 2003-11, the IRS announced its offshore compliance initiative and offered certain relief to taxpayers who have underreported their United States income tax liability through financial arrangements that in any manner rely on the use of offshore payment cards issued by banks in foreign jurisdictions or on offshore financial arrangements. Similarly in Announcement 2002-2, the IRS waived certain penalties for taxpayers who disclosed listed tax shelter transactions. Commissioner Langdon stated that one reason for the leniency shown in Announcement 2002-2 was that the IRS felt it had changed the rules midstream. Most recently, in Notice 2003-38 the IRS waived certain filing deadlines and penalties for nonresident aliens and foreign corporations that have not filed U.S. federal income tax returns. We request that the IRS and Treasury provide similar relief with respect to the Langdon Directive. Taxpayers affected by the Langdon Directive are at least as worthy of relief as taxpayers involved in offshore credit card schemes, and in our view present an eminently more sympathetic case.

In particular, we request that taxpayers be allowed to complete their section 6662(e) documentation for prior years by March 1, 2004 (or six months from the date of the IRS announcement). Taxpayers who subsequently provide this documentation within this time frame will be considered to have completed their documentation as of the return filing date. The adequacy of the documentation would continue to be determined under the standards described in Reg. Section 1.6662-6.

2. The Proposed Grace Period Does Not Undermine The Policies Underlying Section 6662(e) And Encourages Compliance Efforts.

We fully appreciate the importance of the contemporaneous documentation requirement. Section 6662(e) documentation has sometimes been referred to as a “road map” for the IRS to understand and analyze a taxpayer’s transfer pricing policies. As such, the completeness and timely production of the documentation is critical. These

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8 Announcement 2002-2, 2002-1 C.B. 304.
9 Commissioner Langdon’s speech to the AICPA’s Tax Division, an account of which is found in Tax Analyst, 2001 TNT 212-2.
policies underlying the regulation would be well served by a grace period that will provide an additional incentive for taxpayers to improve the quality and utility of their documentation. Taxpayers would know that after the grace period expires, the Service could be expected strictly to enforce the filing date cut-off for contemporaneous documentation. Thus such measure would not encourage non-compliance, but rather would provide an incentive for taxpayers to bring their documentation up to date.

It is important to note that this modest penalty waiver proposal is consistent with the Section 6662(e) as interpreted by the IRS and Treasury. Section 6662(e) describes the documentation necessary to avoid the accuracy related penalty as “documentation (which was in existence as of the time of the filing the return) . . .” Despite this seemingly inviolable command that documentation be in existence as of the filing date, the Section 6662(e) regulations state that two categories of documentation, i.e., post year-end data and the all important index, do not have to be in existence when the return is filed. Similarly, Section 6662(e) provides that taxpayers must provide their documentation “within 30 days of a request . . .” Again, despite this seemingly clear language, the regulations excuse certain “minor or inadvertent failures” that are promptly corrected from the hard and fast 30 day time limit. Evidently, and reasonably, Treasury and the IRS read Section 6662(e) as not overriding the Secretary’s authority to administer the tax laws under Section 7801 sensibly. Presumably similar rationales have been applied to other penalty relief initiatives.\footnote{Some commentators have argued that the requirement that contemporaneous documentation be in existence at the time that the return is filed does not necessarily require that all relevant information actually “exist” within the taxpayer’s documentation as of the return filing date. Under this interpretation, a taxpayer may supplement its contemporaneous documentation with information located after the filing of the return, provided that such information (e.g. additional comparables, economic study) was in existence at the time that the return was filed. While the IRS presumably does not agree with this reading of the regulations, \textit{(see “Report on Transfer Pricing Documentation” released by the IRS on December 28, 2001 in which taxpayer documentation prepared after the filing date is determined to be non-contemporaneous),} a grace period would remove potentially sympathetic fact patterns as a source of challenge.}

The proposed initiative would serve the Service’s proper administration of Section 482 and would not deter compliance efforts to meet the contemporaneous requirement. As a time-limited proposal, taxpayers would know that future documentation studies would have to be completed by the tax return filing date. Granting taxpayers an opportunity to supplement their transfer pricing documentation by a given date (e.g. March 1, 2004) for penalty waiving purposes would encourage them to prepare better researched, more accurate and updated data in situations where they would otherwise have no incentive to do so, much to the Service’s disadvantage.

Finally, the proposed grace period is fair. After years of apparent lax enforcement by the IRS, taxpayers were surprised by the Langdon Directive, and many taxpayers were caught unprepared for a strict enforcement of the return filing deadline of the Section 6662(e) regulations. Taxpayers who wish to demonstrate the arm’s length nature of their related party transactions should be given the opportunity to do so and to avoid penalties.
where the IRS and the taxpayer ultimately disagree on the proper transfer pricing methodology.

IV. Conclusion.

The Langdon Directive encourages compliance with the arm’s length standard under Section 482 through the strict enforcement of the documentation rules of Section 6662(e). Taxpayers, however, that have not strictly adhered to the contemporaneous requirement of Section 6662(e) because of the Service’s past administration of the Section 6662(e) provision find themselves in no position to react to the change in the Service’s administration of those penalties. Our grace period proposal is an equitable response to the new stricter enforcement of the Section 6662(e) documentation rules and will encourage taxpayers to take the necessary steps to be able to provide the IRS examiners with the documentation required to efficiently audit compliance with Section 482.