TAX FOUNDATION

BACKGROUND PAPER #10

Is the Transfer Pricing Penalty Counterproductive? A View Through the Commissioner's Study

September 1994

By J. Dwight Evans, Esq.
Special Tax Counsel
Tax Foundation

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Executive Summary

The IRS Commissioner's 1989 study of civil tax penalties examined the philosophy, purpose, goals, and design of tax penalties and concluded that their sole objective is to encourage voluntary compliance with tax laws. The study found that there are three processes through which a tax penalty encourages voluntary compliance:

- The setting and validation of standards of behavior, i.e., setting norms;
- Deterring departures from the norms; and
- Providing just deserts to taxpayers who depart from norms.

In measuring how well a penalty does the job of encouraging taxpayer compliance, the study asks:

- Is the penalty fair?
- Is the penalty effective?
- Do taxpayers understand?
- Can the IRS administer the penalty?

Specifically, the study concludes that the role of the accuracy penalty is to assure that taxpayers take reasonable care to file a reasonably accurate tax return.

At the same time that the IRS was conducting a comprehensive study of tax penalties it was also studying the problems which it encounters in enforcing the arm's length intercompany transfer pricing standard of the Section 482 regulations. Beginning with the 1988 Intercompany Pricing White Paper and continuing through Congress' deliberations in enacting OBRA'90 and93, the IRS has increasingly argued that the solution to the loss of revenue caused by alleged multinational taxpayer misvaluations in intercompany transfer pricing is the enactment of a new tax penalty designed to force the expedited production at audit of a taxpayer's documents and records demonstrating contemporaneous compliance with the arm's length pricing standard. In OBRA'93 Congress enacted just such a penalty in the form of the transfer pricing "net adjustment penalty".

The net adjustment penalty of 20%, or 40% in the case of gross valuation misstatements, requires taxpayers to contemporaneously document the correctness of their transfer prices when filing the tax return and produce that documentation within 30 days of an IRS request. The Section 482 net adjustment threshold is low; the lower of $5 million in adjustment or 10% of the taxpayer's gross receipts. To avoid the penalty, the temporary regulations prescribe extensive rules for determining whether a taxpayer has used a reasonable method in determining its transfer prices and requires detailed documentation in support of that methodology.

The new transfer pricing net adjustment penalty involves a fundamental shift in focus from ensuring a reasonable level of correctness in a tax return to ensuring a very high level of taxpayer conduct in documenting the intercompany transfer prices used in the tax return and in cooperating with the IRS on audit of those prices.

Examining the provisions of the net adjustment penalty in light of the Commissioner's study raises basic questions as to whether the net adjustment penalty is focused on correct norms of taxpayer conduct, will substantially enhance use of correct transfer prices, and will deter and punish the right parties. Also, based on criteria developed in the study to identify a "good penalty", the issue is presented whether Congress and the IRS have created a tax penalty which in actual practice will prove to be very difficult to administer and counterproductive in reaching the stated objective of increased use by taxpayers of correct transfer prices in related party transactions.

Advanced pricing agreements, audit agreements, and an IRS penalty screening committee are proposals which may solve or help to mitigate the serious compliance and administrative problems in the transfer pricing penalty scheme.

Introduction

Civil tax penalties have been a part of the income tax code from the beginning and are universally recognized as an essential tool for encouraging tax compliance. A 1989 study for the Commissioner of Internal Revenue examined the philosophy, purpose, goals, and design of civil tax penalties and concluded that the overriding objective was to encourage compliance, which, by definition, includes a reasonable level of correctness in the tax filing.

Few areas of the income tax law can match the complexity of the rules for determining income and expense of a taxpayer engaged in international commerce. Not only is the tax law and regulatory structure in this area exceptionally complicated, and often ill-defined, but the very multiplicity of transactions that a typical multinational corporation engages in each year makes any attempt at filing a correct return daunting. These problems are compounded by the very different accounting and business practices found around the world. Not surprisingly, the Internal Revenue Service ("IRS") sees in these complexities a multitude of opportunities for taxpayers to arrange their operations in noneconomic ways so as to minimize their U.S. tax liability in transactions with related parties. A simple example of such an arrangement is, say, a profitable U.S. parent corporation which has a loss operation in the U.K. and an excess foreign tax credit position in the U.S. Such a corporation can reduce its overall tax liability by shifting income from the U.S. to the U.K. by, for example, lowering the transfer price on goods sold by the parent to the U.K. subsidiary. In this way, the U.S. parent records less income and pays less U.S. tax, while the U.K. subsidiary is able to buy at a lower price and realize a higher profit which is not taxed or taxed at a relatively low rate.

The international standard for setting intercompany transfer prices is the arm's length standard, which simply says the price set on a transaction between related parties should be the same as that which would be charged between unrelated parties, i.e., the price that would be charged in an arm's length transaction. Clearly, if in related party transactions companies alter their transfer prices to shift the recorded location of income or expense, then it is highly likely that these prices vary from the arm's length standard. In the U.S., the governing law is Section 482 of the Internal Revenue Code ("Code") and supporting regulations.

The IRS and the Treasury are legitimately concerned about the potential loss of income from the misstatement of value in transfer pricing between related parties. IRS personnel have repeatedly testified before Congress as to the difficulties which they encounter in enforcing the arm's length pricing standard, including the alleged lack of taxpayer cooperation received in auditing this issue. Beginning with the Treasury Department's 1988 Intercompany Pricing White Paper,[1] and continuing through the deliberations by Congress in enacting both the 1990 and 1993 tax bills,[2] the IRS has increasingly argued that the solution to the loss of tax revenue caused by alleged multinational taxpayer misvaluations in intercompany transfer pricing is the development of a new penalty specifically designed to force the expedited production at audit of a taxpayer's documents and records demonstrating compliance with the arm's length standard.

The intercompany pricing issue was highly publicized and politicized in the 1992 presidential campaign in which candidate Clinton argued, at least initially, that some $45 billion in tax revenue was lost each year because of the alleged noncompliance by U.S. and foreign multinational businesses with the Section 482 regulations. Adopting one of President Clinton's legislative proposals, and consistent with the promise by the IRS to increase dramatically the number of audits involving cross-border transfer pricing by U.S. and foreign multinationals, Congress has now given the IRS the transfer pricing penalty provisions which it has eagerly sought in order to force on audit a contemporaneous, documented, and explicit explanation of a taxpayer's transfer pricing.

Few tax issues have provoked more complaints from tax professionals representing international business or produced more counter arguments from the IRS than the Section 482 penalty scheme and its regulations, now issued as temporary regulations.[3] The new temporary regulations implement the transfer pricing penalty provisions of Code Sections 6662 and 6664, as amended by OBRA'93, and replace the previously proposed regulations issued under OBRA'90. The taxpayer complaints leveled against the transfer pricing penalty scheme and its regulations include charges that they are unrealistic and impractical, impose an excessive, if not impossible, compliance burden, and are unnecessarily severe to such an extent as to run the serious risk of failing to accomplish the Service's goal of enhanced compliance with the provisions of the Section 482 regulations.

The transfer pricing penalties (particularly the net adjustment penalty), as amended by OBRA'93, and the new temporary regulations thereunder involve a fundamental shift in focus, if not in the very purpose, of an accuracy penalty, namely, from ensuring a reasonable level of correctness in a tax return to ensuring a very high level of taxpayer conduct in documenting its tax return and in connection with the audit of the tax return. This paper examines the new transfer pricing penalty scheme and regulations in light of the findings and conclusions in the Commissioner's Tax Penalty Study. It also briefly reviews several proposed solutions to some of the alleged problems with the regulations.

I. The Commissioner's Study of Civil Tax Penalties

At the same time that the IRS was at first tentatively suggesting in the Transfer Pricing White Paper that new penalties might be necessary to provide taxpayers with a greater incentive to comply with Section 482 requirements, the IRS was also engaged in a comprehensive study of the role of civil tax penalties. That study was begun in 1987 at the request of the Commissioner and resulted in a detailed Report on Civil Tax Penalties ("Commissioner's Study") dated February 21, 1989. The Commissioner's Study was the subject of hearings both in 1988 and 1989 before the Subcommittee on Oversight of the House of Representatives' Committee on Ways and Means, at which time the study's findings and recommendations regarding the purpose of civil tax penalties and the IRS's philosophy of tax penalties were presented. As a result of the Commissioner's Study and the congressional hearings, the civil penalty provisions of the Code were revised in the 1989 tax bill.[4]

The impetus for the Commissioner's Study was the increase in the civil tax penalties in the Code from 13 penalty provisions in 1954 to some 150 in 1987 without a consistent rationale as to their purpose or role in the tax administrative process. As a decline in compliance was perceived (a rise in the number of abusive tax shelters and tax protesters and increasing participation in the audit lottery), Congress reacted by enacting new and more severe penalties and the IRS responded with more aggressive compliance efforts. "As a result, penalties have produced tensions that are counterproductive to the goals of tax administration".[5]

A. The Purpose of a Civil Tax Penalty

The Commissioner's Study concludes that civil penalties should exist for the purpose of encouraging voluntary compliance with tax laws and not for other purposes, such as raising revenue. The study states that there are three processes through which penalties encourage the noncompliant taxpayer to comply voluntarily and compliant taxpayers to continue to comply, namely:

(1) The setting and validation of standards of behavior, i.e., setting norms;

(2) Deterring departures from the norms; and

(3) Providing just deserts to taxpayers who depart from the norms.

B. Evaluating A Tax Penalty

Evaluating penalties requires measuring how well they do the job of encouraging taxpayer compliance. In this context, a "good penalty" is defined in the Commissioner's Study by answering four questions:[6]

- Is the penalty fair? Are similarly situated taxpayers treated similarly and is the amount of the penalty proportional to the culpability of the taxpayer and the harm caused by his behavior?
- Is the penalty effective? Is the penalty tough enough to deter noncompliance and encourage noncompliant taxpayers to comply?
- Do taxpayers understand? Do taxpayers understand what they are supposed to do and what will happen if they do not comply?
- Can the IRS administer the penalty? Will the penalty work well in practice as well as in theory? Some penalties do not work well in practice because they are hard for the IRS to administer. A penalty should leave room for IRS employees to handle each particular case to get the best compliance result. Penalties that are too high may be administered inconsistently. Theoretical perfection in a penalty must be reconciled with the reality that only a certain amount of resources can be devoted to administering it.

C. The Role Of The Accuracy Penalty.

The Commissioner's Study devotes considerable analysis to the problem of accuracy of taxpayer information and the role of the accuracy penalties (Chapter 8). Under the self-assessment system the goal of accuracy penalties is stated to be a correct return. In preparing the return, taxpayers are required to maintain their records, gather the facts needed, and apply the law to the facts in preparing the forms and making the computations that constitute the return. In these regards, the study finds that taxpayers should be required to use reasonable care and not act negligently. It is noted that the taxpayer is in the best position to determine accurately the tax due, since the taxpayer has the best knowledge of his own financial situation and has the best access to the needed facts.

In analyzing the accuracy penalties, the study notes that:

> ". . . an underlying issue is the government's need for accurate self-assessments, which might well be seen alone as an absolute, and a variety of factors that limit the extent to which absolute accuracy can (or

perhaps should) be achieved". (Commissioner's Study VIII-2)

These limiting factors include:

- Complexity of the tax system and the high degree of change;
- Human factors that limit the amount of efforts and expertise that can be brought to bear in the preparation of a return; and
- The many ambiguities in the application of the law to concrete factual situations that may result in more than one arguable position, one of which the taxpayer must choose.

In further analyzing the correct standard of behavior in preparing a tax return and exploring the practical human limits on the probable correctness of returns, the Commissioner's Study observes that:

> "While not in and of themselves determinative of the correct standard of behavior, a variety of factors limit the ability of taxpayers to report positions disclosing a liability that is probably correct. Perhaps the most significant limitation is the ambiguity inherent in applying a complex and changing set of tax rules to an infinite variety of factual situations, which may themselves be of ambiguous import. These complexities may result in failure to recognize issues, incorrect conclusions as to the probability that a particular position will prevail, and differences of opinion regarding probability that are not resolvable short of the courthouse. The complexity of modern financial affairs, when coupled with the legal requirement to file a return by a statutory deadline and the costs of making the best possible assessment of each individual issue may also provide practical limits on the pursuit of a theoretically perfect return.
>
> "A second limiting factor is the effort that, given competing resource needs, a taxpayer is likely to exert in the analysis of issues and the preparation of a return regardless of behavioral standards. Generally, the Task Force accepts the proposition that, whatever standard of behavior exists or is adopted, taxpayers are likely to exert only that level of effort or care in preparing their returns that is reasonable under the circumstances. For the most part, the existing level of care is based on a negligence concept .... While such a "reasonable care" standard has much to recommend it, acceptance of such a limitation as the touchstone of penalties in the area fails to consider the fact that the expectations established by a penalty themselves help determine what level of effort is likely to be exerted in an attempt to determine the probable correctness of a position." (Commissioner's Study, VIII-11)

Specifically, in connection with valuation penalties the Commissioner's Study concludes that:

> "Nevertheless, mindful of problems that the IRS faced dealing with valuation errors, the Task Force believes that it is appropriate to retain the concept that certain large valuation errors should be penalized. This is consistent with the standard of care since it could be expected that a large valuation error would generally not occur if the taxpayer exercised reasonable care. The most simple manner of incorporating this concept is to make certain objective tests a presumption of a failure of the test in the primary penalties. Thus, if the valuation error is such that the value claimed exceeds 150 percent of the correct valuation, a presumption

arises that the position lacked a substantial basis .... Where the valuation error becomes more egregious, for example, an overvaluation in excess of 250 percent of the correct value, a presumption of gross negligence would arise." (Commissioner's Study, VIII-41)

The study also includes a recommendation that the taxpayer be entitled to rebut the presumption supporting the penalty in connection with large valuation errors.

Thus, the Commissioner's Study concludes that the goal of an accuracy penalty is a correct tax return. Further, the study recognizes that the tax return results from sifting a very wide range of activities and transactions through an extraordinarily complex set of tax rules and regulations, and that there are reasonable limits as to how much time and effort a taxpayer can be expected to spend filing a return. In the final analysis, the accuracy tax penalties are intended to assure that the taxpayer will take reasonable care to file a reasonably accurate tax return.

II. The Transfer Pricing Penalty Scheme And Temporary Regulations.

To understand the OBRA'93 transfer pricing penalties and the new temporary regulations, a review of the OBRA'90 penalty provisions and the proposed regulations under that statute may be helpful.

A. The OBRA'90 Transfer Pricing Penalty Scheme

OBRA'90 added a specific transfer pricing valuation misstatement penalty to the existing penalty provisions in Section 6662 of the Code. There were two parts to this penalty—a "transactional" penalty and a "net adjustment " penalty.

The Transactional Penalty.

A so-called transactional penalty was added to impose a 20 percent penalty if the transfer price for "property or services (or for the use of property)" is 200 percent or more or 50 percent or less of what is determined to be the correct arm's length price for the transaction. A 40 percent gross valuation misstatement penalty is imposed if the transfer price is 400 percent or more or 25 percent or less of the correct price.

The Net Adjustment Penalty.

In addition, Congress added a so-called net adjustment penalty. The 20 percent penalty applied if the taxpayer's net Section 482 transfer price adjustments for the year exceeded $10 million, and the 40 percent penalty applied if the net adjustment was $20 million or more. A net Section 482 transfer price adjustment is the net increase in taxable income for a year resulting from allocations under Section 482 (the allocation of income and expenses between related parties) as finally determined.

The Reasonable Cause/Good Faith Exception.

Under OBRA'90, the transactional and net adjustment penalties were both subject to the reasonable cause and good faith standard in Section 6664(c) of the Code. This section provides that penalties are not imposed on any portion of an underpayment of tax where "there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion", i.e., a facts and circumstances test.

B. The OBRA'90 Proposed Transfer Pricing Penalty Regulations.

On January 21, 1993, the IRS published proposed Section 482 valuation misstatement penalty regulations for the OBRA'90 transfer pricing penalty provisions. Instead of adopting the same reasonable cause and good faith standard for both the transactional and net adjustment penalties, as provided in the statute, the proposed regulations imposed significantly different requirements for avoiding the net adjustment penalty.

The Transactional Penalty Compared To The Net Adjustment Penalty.

The proposed regulations provided that the transactional penalty would be subject to the general rules for reasonable cause and good faith contained in Treasury Regulation Section 1.6664-4(b). However, in the case of the net adjustment penalty, the proposed regulations provided that any transaction that failed to satisfy the requirements for exclusion from the net adjustment penalty could not come under the reasonable cause/good faith exception and would be included in the computation of the net adjustment penalty. A transaction could only be excluded from the net adjustment penalty's $10/$20 million threshold computation if the taxpayer demonstrated that (1) it had made "a reasonable effort to determine its proper tax liability" and (2) it "reasonably believed that its transfer pricing methodology produced an arm's length result."

The Reasonable Effort Test.

Under the reasonable effort test, the taxpayer was required to document contemporaneously its efforts to determine the proper tax liability under Section 482 prior to the date of its tax return, including an analysis supporting the arm's length character of the transfer price. If these documents were not made available within 30 days of an IRS request, it was presumed that the taxpayer had not made a reasonable effort to determine its tax liability accurately.

The Reasonable Belief Test.

The reasonable belief test required that the taxpayer have a basis for reasonably believing that more likely than not it would prevail against the IRS in any dispute over its transfer price. The taxpayer's level of experience and knowledge, the use of one of the specified pricing methods in the Section 482 regulations, and well-founded reliance on professional advice were all factors to be considered.

C. The OBRA'93 Transfer Pricing Penalty Scheme.

The OBRA'90 proposed regulations were criticized extensively by international business. The IRS response was to persuade Congress to amend Sections 6662 and 6664 in OBRA'93 by essentially codifying the IRS's proposed rules under OBRA'90. Under OBRA'93, the transactional penalty, including threshold amount and reasonable cause/good faith exception, was unchanged. However, the rules for excluding transfer pricing misvaluations from the computation of the threshold for the net adjustment penalty were materially changed, expressly differentiating the net adjustment penalty from the transactional penalty.

Changes In The Net Adjustment Penalty.

First, OBRA'93 lowered the threshold for the 20 and 40 percent net adjustment valuation misstatement penalties, respectively, to the lesser of $5 million in net Section 482 transfer price adjustments or 10 percent of the taxpayer's gross receipts, or the lesser of $20 million in net adjustments or 20 percent of the taxpayer's gross receipts.

Second, and most important, the standard for excluding transfer pricing misvaluations from the computation of the net adjustment threshold was changed significantly. The earlier reference to the reasonable cause/good faith exception was replaced by what is described in the legislative history as a more "objective" exception. The exception is now based on the pricing methods described in the Section 482 regulations, referred to as "specified" and "unspecified" methods.

The Specified Method Test.

The specified method test applies if the taxpayer chooses as its pricing methodology one of the "specified" methods provided for in the Section 482 regulations and if the use of such method is "reasonable", i.e., reasonably provides the most reliable measure of an arm's length result. The specified methods prescribed for transfers of tangible property are presently the "comparable uncontrolled price", the "resale price", the "cost plus", the "comparable profits" and "profit split" methods. The specified methods prescribed for transfers of intangible property are presently the "comparable uncontrolled transaction" the "comparable profits" and "profit split" methods. These various methods are described in detail in the final Section 482 regulations.

The Unspecified Method Test.

An alternative "unspecified method" test applies if a method other than one of the specified methods is chosen. In this case, the taxpayer must establish that the unspecified method chosen is "likely to result in a price that would clearly reflect income" and that none of the specified methods would likely result in a clear reflection of income. For example, service transactions do not presently come within one of the specified methods in the Section 482 regulations and thus are eligible for the unspecified method test.

The Documentation And Production Requirements.

Under both the specified and unspecified method tests, the taxpayer is required to have contemporaneous documentation in existence at the time that the tax return is filed which demonstrates that it has satisfied the test for exclusion from the net adjustment penalty threshold computation. Further, the statute now requires that this documentation be produced to the IRS within 30 days of a request. This is a stricter requirement than was found in the earlier proposed regulations under OBRA'90, which provided that failure to produce documents within 30 days merely created a presumption that the taxpayer had not acted reasonably.

D. The OBRA'93 Temporary Transfer Pricing Penalty Regulations.

The provisions of the new temporary regulations applying the 1993 Act changes to the net adjustment penalty provide detailed requirements for the use of the specified and the unspecified method exclusions. As stated in the preamble to the regulations, the comprehensive self compliance regime is:

> ". . . designed to encourage taxpayers to make a serious effort to comply with the arm's length standard, report an arm's length result on their income tax return, document their transfer pricing analyses, and provide that documentation to the IRS upon request."

The Documentation Rules.

At the heart of the new regulatory scheme are the transfer pricing documentation rules. Under the temporary regulations, taxpayers are now required to have available and produce at audit within 30 days of an IRS request two new categories of documents applicable under both the specified and unspecified methods—"principal" documents and "background" documents.

Principal documents are those necessary to establish that the taxpayer has met the relevant test. For example, under the specified method exclusion, the documents must "accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer". Similarly, a taxpayer using the unspecified method must have principal documents that establish that it reasonably concluded that no specified method was likely to provide a reliable measure of an arm's length result, and that it selected and applied an unspecified method that was likely to do so.

The degree of detailed information required is illustrated by the fact that by regulation the principal documents must include the following:

(1) An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;

(2) A 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;

(3) Any documentation explicitly required by the regulations under section 482;

(4) A description of the method selected and an explanation of why that method was selected;

(5) A description of the alternative methods that were considered and an explanation of why they were not selected;

(6) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions;

(7) A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;

(8) An explanation of the economic analysis and projections relied upon in developing the method; and

(9) A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

The background documents required are not described in detail in the temporary regulations. They are stated to be the documents that support the assumptions, conclusions, and positions in the principal documents.

This battery of records, reports, and analyses must be prepared on or before the date on which the tax return is filed and be made available to the IRS for each type of transaction between related parties which a multinational taxpayer engages in each year. Typically, this is a very large number involving hundreds or even thousands of separate transactions.

III. Is the Transfer Pricing Penalty a "Good Penalty" Under the Principles Established in the Commissioner's Study?

The net adjustment provisions of the transfer pricing penalty and new temporary regulations represent an important and possibly wide-ranging change in the use of the accuracy related penalty provisions. The new penalty and regulations do not relate directly to the accuracy of the tax return. Rather, they relate to the taxpayer's documentation justifying the transfer prices used in preparing the tax return and the taxpayer's conduct in connection with the audit of the transfer pricing issue in the tax return. A very a high level of taxpayer self compliance is required in both cases.

In the legislative history of OBRA'93, Congress clearly indicated its concern about the alleged loss of large amounts of tax revenue due to the IRS's difficulties in auditing transfer prices. Congress also indicated concern with the IRS's failure to implement the more liberal transfer pricing penalty provisions in the 1990 Act. The IRS's solution, which Congress has accepted (at least for the time being), is an even stricter penalty forcing contemporaneous, documented, and explicit explanation by taxpayers of their transfer pricing with the stated objective of improving audit compliance and transparency in the area of international transfer pricing.

A. An Examination of the IRS Solution To The Transfer Pricing Problem Using The Three Part Analysis In The Commissioner's Study.

The Commissioner's Study raises serious questions as to whether the IRS solution to the transfer pricing problem is correctly focused and uses valid norms. The three part analysis of a tax penalty utilized by the study requires one to ask (1) what underlying standard or norm should be set by a transfer price accuracy penalty, (2) what conduct does such a penalty deter, and (3) which taxpayers does it punish? Following this analysis, the first question posed is whether the norms established by the Section 6662 (e) and (h) net adjustment penalty are correct.

Does The Net Adjustment Penalty Use Correct Norms?

In developing the OBRA'93 net adjustment penalty, the IRS solution substituted the taxpayer's contemporaneous documentation of transfer prices and audit cooperation in place of the taxpayer's reasonable effort/reasonable belief tests used in the OBRA'90 proposed regulations to define the reasonable cause/good faith exception to the net adjustment penalty. The IRS explanation is that the reasonable efforts and belief tests, and in particular the "more likely than not to prevail" part of the reasonable belief test, are too subjective in application. While this may be true, the IRS solution makes a taxpayer's contemporaneous documentation of transfer pricing and audit conduct the norms for the imposition of the net adjustment penalty rather than the taxpayer's reasonable effort to use correct transfer prices. Assuming that the ultimate objective of the net adjustment penalty is to encourage taxpayers to use correct transfer prices in filing their tax return, the Commissioner's Study leads one to ask what connection might there be between a taxpayer's documentation of transfer prices or its audit conduct and the taxpayer's use of correct transfer prices in filing the return? The IRS answer in the preamble to the temporary regulation is that the penalty's contemporaneous documentation and audit requirements will "encourage taxpayers to make a serious effort to comply with the arm's length standard." As pointed out hereafter, this conclusion is not necessarily correct and may well be wrong.

Along the same line of inquiry regarding norms, the Commissioner's Study also leads to the question whether the net adjustment penalty threshold of the lesser of $5 million in transfer pricing net deficiency or 10 percent of gross receipts establishes a fair norm for determining taxpayer compliance with correct transfer pricing? This threshold does not take into account the size of the taxpayer, i.e., its volume of controlled transactions. The $5 million/10 percent threshold sets up *de facto* automatic exposure to the net adjustment penalty for large companies with a large dollar volume of transactions subject to Section 482. On the other hand, the threshold will let small taxpayers with flagrant misvaluations of transfer prices, but a small dollar volume of Section 482 transactions, escape exposure to the penalty entirely. While an argument can be made for economies of scale in tax enforcement, it nevertheless is questionable tax policy to let flagrant transfer price cheaters off the penalty hook entirely solely because they are small.

The low threshold of the net adjustment penalty, coupled with the possibility that in practice the net adjustment penalty could be imposed using a strict liability standard, i.e., if you are wrong, you incur a penalty, also raises the question whether the penalty will turn out to be a significant revenue raiser—an objective which the Commissioner's Study rejects for tax penalties. The possibility of a strict liability standard follows from a strict reading of the requirement in the temporary regulations that a transfer pricing adjustment is excluded from the net adjustment penalty threshold only if the taxpayer reasonably concluded that it chose and correctly applied the best transfer pricing method.[7] For example, if *a fortiori* a taxpayer's transfer pricing documentation does not qualify it for exclusion from the net adjustment penalty if the final net transfer pricing adjustment exceeds the $5 million or 10% of gross receipts threshold, many, if not most, large and middle sized multinationals will pay a net adjustment penalty and very large amounts of revenue will be raised.

What Conduct Does the Net Adjustment Penalty Deter?

The IRS solution to the transfer pricing problem is designed to deter a taxpayer's failure to document its transfer prices contemporaneously and to force the production of that documentation on audit with the objective of improving audit compliance in the area of international transfer pricing. However, the Commissioner's Study raises the question whether, for the purpose of imposing an accuracy penalty, such a failure is rationally related to the extent that a taxpayer misstates value in its transfer pricing?

Does The Net Adjustment Penalty Deter The Right Parties?

Finally, the Commissioner's Study poses the question whether the net adjustment penalty is punishing the right parties. The IRS solution will clearly punish taxpayers who fail to keep good contemporaneous transfer pricing documentation or fail to cooperate with the IRS on audit. However, these persons may not necessarily be the taxpayers who substantially misstate value in their transfer pricing. Taxpayers who take extremely aggressive positions on transfer prices may also have extremely detailed and sophisticated transfer pricing documentation which they are quite willing to produce on audit.

In summary, the three part analysis of a tax penalty utilized in the Commissioner's Study raises the basic policy question presented by the new net adjustment penalty, namely, whether a taxpayer's transfer pricing documentation and audit conduct is closely enough related to the amount of its transfer pricing net deficiency so as to justify fairly using documentation and audit conduct as a norm for an accuracy penalty of 20 or 40 percent of the net transfer price adjustment? As stated by IRS Commissioner Lawrence B. Gibbs in 1989 in his congressional testimony, tax penalties that are too severe and are perceived to be unfair can sometimes have unintended results and produce "tensions that are counterproductive to the goals of tax administration".

B. The Four Questions Identifying A "Good Penalty"

The net adjustment provisions have already created tensions between multinational taxpayers and the IRS, and these tensions are likely to increase substantially as the penalty provisions are applied in audits. A further examination of the net adjustment provisions in the light of the four questions utilized in the Commissioner's Study to identify "a good penalty" is useful in determining both whether the Congress and IRS have taken a wrong turn and adapted a counterproductive rule, and in evaluating proposed solutions.

Is The Penalty Fair?

In the Commissioner's Study, similar treatment of similarly situated taxpayers, the proportionality of the penalty to taxpayer culpability, and the harm caused by his behavior are key factors in determining fairness. Using the analysis in the Commissioner's Study, a penalty is proportional and taxpayer's are treated similarly if the penalty is based on the taxpayer's deviation from a valid norm, and taxpayer's who have similarly deviated from the norm receive similar penalties. This, however, is not necessarily the case under the new net adjustment penalty.

The existence or production of transfer pricing records has little to do with whether the transfer price used is correct and the amount of the net adjustment on which the penalty is based. Under the net adjustment penalty, taxpayer's are not penalized based solely on deviation from the correct transfer price. Rather, they may or may not be penalized based on how well they have supported and justified the transfer prices used in their tax returns. Consequently, a taxpayer with a large deviation from correct transfer prices can possibly escape the net adjustment penalty based on its documentation while a taxpayer with a much smaller deviation from correct transfer prices which are not well supported with documentation may have to pay the penalty. Because of the sweeping nature of the transfer pricing penalty in its attempt to force taxpayers to accept a new and heavy compliance burden, and the extensive use of judgmental words and terms in the temporary regulations, there is great potential for the net adjustment penalty to produce uneven and unfair results in actual application.

As pointed out above, the thresholds for the net adjustment penalty are low and will potentially ensnare all large multinationals with large resources as well as some small and many mid-sized multinational groups with much fewer resources. While the temporary regulations take into consideration the experience and knowledge of the taxpayer, the extent to which it has relied on qualified professional advice, and the cost of gathering required data in relation to the dollar amount of the intercompany transaction in question, the fact remains that the temporary regulations impose an extraordinarily heavy compliance burden on all international business which will be particularly difficult for small and mid-sized companies to undertake. In the Paperwork Reduction Act provisions of the regulations it is stated that:

> "The estimated annual burden per recordkeeper varies from 5 hours to 15 hours, depending on individual circumstances, with an estimated average of 10 hours".

These estimates, it has been suggested, are off by a factor of at least 100.

The onerous additional compliance burden—both in internal resources and external fees—which will be required to avoid the harsh transfer pricing penalty comes at a time when U.S. companies are trying to be leaner and more efficient to compete in the world market. This downsizing includes many corporate accounting and tax departments. These facts of life may cause many small and mid-sized companies to ignore, at their peril, the regulations' requirements and take their chances on audit. As a result, the net adjustment penalty could fall heavily on those taxpayers who can least afford it and be out of proportion to the total harm they cause.

The temporary regulations purport to adopt objective standards in determining the reasonableness of the taxpayer's effort to comply with their extensive requirements. However, in attempting to adopt objective standards, there is an extensive use of judgmental words and terms such as:[8]

- "in a reasonable manner,"
- "reasonably concluded,"
- "most reliable measure,"
- "more reliable measure,"
- "reasonably thorough search,"
- "reasonably relied on," and
- "relevant facts and circumstances."

This extensive use of judgmental terms in applying the regulations leaves much uncertainty and considerable room for disagreement between the taxpayer and the IRS auditor. This, in turn, can lead to different interpretations and conflicting results in different audits, thus violating the "similarly situated" rule for a good tax penalty.

Similarly, the limited discretion given a district director to excuse a taxpayer's failure to produce documentation within 30 days is hedged by subjective terms, such as:[9]

- "a minor or inadvertent failure,"
- "a good faith effort to comply," and
- "promptly remedies the failure."

What is minor or inadvertent, or what constitutes a good faith effort and a prompt remedy, are all subjective concepts which can lead to inconsistent results in different audits within the same IRS district and, more probably, between districts. The extensive use of subjective terminology and probable inconsistency in the application of the net adjustment penalty may well lead to increased resort to the courts to settle disputes at an increased cost to taxpayers and the IRS alike.

Is The Penalty Effective?

In determining whether a penalty is effective, the Commissioner's Study asks whether the penalty is tough enough to deter noncompliance and encourage noncompliant taxpayer's to comply. The transfer pricing penalty is certainly tough. However, by focusing on transfer pricing documentation and taxpayer cooperation on audit, instead of deviation from the correct transfer price, the net adjustment penalty may be ineffective in practice. For example, if the focus on documentation of transfer prices gives very aggressive taxpayers an out from the net adjustment penalty based on their ability to produce sophisticated, self-serving transfer pricing documentation, the penalty will end up encouraging self-serving documentation, not correct transfer pricing. Thus, unless the net adjustment penalty is administered on a strict liability basis, i.e., the penalty is imposed whenever the net transfer pricing adjustment exceeds the penalty threshold—which in turn raises the question whether the penalty is being administered as a revenue raiser—there is a distinct danger that by focusing the penalty on transfer pricing documentation it will not deter sophisticated taxpayers from taking aggressive positions on transfer pricing. Rather, the penalty may end up deterring only unsophisticated taxpayers who may also be less aggressive in connection with transfer pricing valuation.

Beginning in 1988 with the Intercompany Pricing White Paper, and continuing through the enactment of OBRA'90 and 93, it has increasingly been the IRS's objective to enact a tough tax penalty which will force contemporaneous, documented, and explicit taxpayer explanations of their intercompany transfer pricing for the purpose of improving audit compliance. Congress, at least for the time being, is in agreement and has given the IRS the tools it has asked for. Congress, however, is also expecting the IRS to produce a significant increase in tax revenue from the transfer pricing area.

The danger is that the transfer pricing penalty will not prove to be an effective deterrent against incorrect transfer pricing, and will prove very difficult for both taxpayers to comply with and the IRS to administer. This could result in the enhanced compliance and tax revenue goals not being realized. If this occurs, Congress may turn to other alternatives. The conference report passed by both chambers of Congress accompanying the fiscal 1995 budget resolution contains non-binding language supporting use of a formulary approach under Section 482 if regulations based on an arm's length standard do not work.[10] Such an approach could possibly result in an allocation of income and expense between related parties using worldwide apportionment factors, i.e., a method of worldwide formulary apportionment similar to that previously used in California and recently approved by the U.S. Supreme Court in the *Barclays* and *Colgate* cases.

Do Taxpayers Understand?

The Commissioner's Study found that for a penalty to accomplish its purpose of encouraging voluntary compliance, taxpayers must understand what they are supposed to do and what will happen if they do not comply. The point here is that taxpayers should understand how to regulate their behavior in order to bring that behavior closer to the norm which the penalty protects. Using the analysis in the Commissioner's Study, the question is: What norm should the net adjustment provisions of the transfer pricing penalty protect? If all they are intended to accomplish is to make taxpayers understand that they must document their transfer prices in great detail and produce that documentation at audit on IRS request, the provisions of the temporary regulations are instructive and the scope of the penalty is clear. On the other hand, if the net adjustment penalty's norm is to encourage taxpayers to use a correct transfer price, the provisions of the penalty are not instructive. The transfer pricing penalty is part of the accuracy penalties. As such, the net adjustment penalty would be more instructive to taxpayers and create a greater incentive to use a correct transfer price if its provisions were based directly on the degree to which a taxpayer has used a correct transfer price, not the degree of sophistication with which it has documented the transfer price used in its tax return and its cooperation on audit.

It should be noted that there has been an extraordinary amount of taxpayer criticism as to the unrealistic nature of, and difficulty of compliance with, the net adjustment provisions in the temporary regulations. On the other hand, IRS personnel responsible for the regulations contend just as strongly that the critics are exaggerating the difficulties. The transfer pricing penalty is clearly controversial and a large amount of criticism—some exaggerated—is to be expected. However, the extent of the taxpayer protests does not auger well for ease of administration of the penalty.

Can the IRS Administer the Penalty?

The final, and most inclusive question posed in the Commissioner's Study as a criteria of a "good penalty" is the practical question—can the IRS administer the penalty? The study points out that some penalties that look good in theory do not work well in practice because they are too hard for the IRS to administer. Also, the provisions of the penalty should permit leeway to the IRS auditor in handling a particular case in order to get the best compliance result. Penalties that are too high may be administered inconsistently. And, in reality, only a certain amount of limited taxpayer and IRS resources can be devoted to complying with and administering a penalty.

The issues discussed in connection with the first three questions are all relevant in answering the final question and raise, at the very least, the possibility, if not probability, that the IRS will have considerable difficulty in actually administering the transfer pricing penalty and regulations—in particular the net adjustment penalty. As pointed out in the introduction to this paper, the transfer pricing penalties and temporary regulations significantly change the focus of the accuracy penalty from ensuring an acceptable level of accuracy in a tax return to ensuring, as determined by the IRS, what is an acceptable level of taxpayer conduct in the audit of what often is an extraordinarily complex factual and legal issue—arm's length transfer pricing between related parties. By focusing on the taxpayer's conduct in filing its return and at the audit of that return, the net adjustment penalty emphasizes conduct that the IRS auditor is likely to feel strongly about, i.e., how the taxpayer treats the auditor. IRS auditors are in a particularly poor position to evaluate this sensitive issue.

One of the objections which can be made against the transfer pricing penalties and regulations is that in practical application they will be used to force the taxpayer to adopt the IRS answer as to what is the correct transfer price, from a tax revenue standpoint, rather than the right economic answer. Audits are contentious affairs and can produce hard feelings. Unless IRS auditors are well trained and, even more important, well supervised, there is the danger that the harsh transfer pricing penalties will be used to coerce taxpayers, particularly those with limited resources, to accept the IRS's transfer price even if that price is economically not a true arm's length price.

There is also a distinct danger that the severity of the penalties may force taxpayers to defend their transfer prices with greater determination and less willingness to negotiate compromises. If so, this will likely further slow the audit process, create a more hostile audit environment, and force taxpayers to challenge the IRS more frequently. Thus, the more aggressive penalty system may well cause some taxpayers with relatively few resources to acquiesce to the IRS agent's position but cause others with large resources to go to court and fight to the bitter end.

The transfer pricing penalty regulations do not directly give IRS personnel much leeway in administering the net adjustment penalty. The IRS auditor can exercise discretion in determining whether the transfer pricing methodology which the taxpayer used is reasonable but, once a determination is made that the methodology used is unreasonable, the auditor has no discretion and the penalty must be assessed if the threshold amount of tax adjustment is reached. Indirectly and possibly in actual practice, the large amount of subjective language used in the regulations leaves room for the IRS to handle a particular case in such a way as to obtain the best compliance result. What is not at all clear is whether this is the best way to vest discretion? As pointed out above, the subjective language and terms used in the regulation may result in undesirable inconsistency in administration.

The transfer pricing penalty regulations, while clearly setting a high standard for a taxpayer's conduct in preparing its return and on audit of that return, arguably have overestimated the resources which taxpayers can realistically bring to the preparation of the tax return and which the IRS can bring to the audit of the transfer pricing issue in the return. The Commissioner's Study clearly recognizes that the time constraints in preparing a tax return, the resources which can be brought to that task, and the legal and factual ambiguities of the issue involved all have to be taken into consideration in determining the correct standard of taxpayer behavior. Congress and the IRS, in their zeal to solve what they perceive to be a procedural audit problem and to capture what they believe is a very large amount of revenue escaping U.S. income tax, have arguably underestimated these facts of taxpayer life and have overestimated the benefits which the IRS will obtain from the transfer pricing penalty. In so doing, Congress and the IRS may well have created a penalty which, based on criteria established in the Commissioner's Study, stands a good chance of not accomplishing its intended goals because the penalty is incorrectly focused on a procedural issue, i.e., taxpayer documentation of transfer prices and audit cooperation, rather than directly on the substantive issue of whether the taxpayer has used correct transfer prices.

IV. Some Proposed Solutions To The Compliance And Administrative Problems Created By The Transfer Pricing Penalty.

A number of proposals to solve or mitigate the compliance and administrative problems perceived in the transfer pricing penalty scheme and its regulations have been advanced. These include the use of advance pricing agreements, audit agreements, and an IRS penalty screening committee.

The Advance Pricing Agreement.

An advance pricing agreement ("APA") is an available alternative which has been suggested as a solution to the difficult problems which taxpayers and the IRS respectively face in connection with transfer pricing and thus, by extension, in compliance with, and the enforcement of, the transfer pricing penalty—particularly the provisions of the net adjustment penalty. An APA is a written agreement with the IRS confirming the arm's length nature of the taxpayer's transfer pricing in controlled transactions. It can provide both U.S. and foreign-based multinational taxpayers with a double benefit—certainty with respect to the correctness of transfer prices plus the avoidance of exposure to the transfer pricing penalty. The preamble to the temporary regulations state that if a transfer pricing methodology is developed and approved in an APA for any tax year, that methodology may be relied on in a later year if the relevant facts and circumstance have not changed, or if the methodology has been appropriately modified to reflect any change in facts and circumstances.

The APA procedure is entering its fourth year and is still being developed. The documentation required to obtain an APA is considerable, but may not be much, if any, more than will be required to comply with the temporary regulations. The IRS is reportedly developing a simplified APA that would be available to relatively small businesses or to taxpayers with relatively simple transfer pricing situations. The IRS is also looking at the development of industry-wide APA's under which several participants in the same industry could use a basic, generic agreement.

At present, the IRS is reported to have some 70 taxpayers involved in various stages of the APA process. If the APA becomes an attractive means of avoiding the perils raised by the transfer pricing penalties, the number of applications for APA's will increase substantially. In order to keep the APA program as a viable alternative, the IRS will need to expand the program and increase significantly the number of persons dedicated to it, as well as the expertise of those persons as international transfer pricing examiners. This will require the IRS to make a serious additional commitment to training.

Audit Agreements.

While APA's may be a practical and attractive alternative for numerous taxpayers, there will be many taxpayers who, for various reasons, will not want to go that route. In order to avoid being overwhelmed with a costly and repetitive process of data searches to qualify for the penalty exceptions in each tax year, it has been suggested that taxpayers negotiate agreements with their district director which would limit document requests in future audit cycles. In such agreements, the IRS could develop checkoff lists to give guidance to taxpayers as to the specific documentation required in future audits based on the taxpayer's particular facts. At the same time, such agreements would help IRS auditors objectively determine whether the documentation requirements have been met in the particular case for the taxpayer to qualify for the penalty exemption.

The IRS Penalty Screening Committee.

The IRS has reportedly established a transfer pricing penalty screening committee at the National Office level to assure taxpayers that the Section 6662(e) and (h) transfer pricing penalties are applied consistently.[11] As pointed out in the Commissioner's Study, similar treatment of similarly situated taxpayers is essential if a penalty is to be perceived as being fairly applied. Transfer pricing penalty review by the IRS in each district and between districts is essential to ensure consistency in the application of transfer pricing penalties. The transfer pricing penalty committee, if properly operated, could be an important step toward obtaining consistency within the IRS.

Based on the published report, it appears that there will be a single National Office committee. While this is desirable from the standpoint of obtaining over-all consistency in the application of the transfer pricing penalty, there is a danger that the committee could become either a bottleneck or a rubber stamp. Transfer pricing is very factual in nature. With the anticipated increase in IRS audits of transfer pricing, the committee's work load will be very heavy and involve many factual issues. This will be particularly true if the committee accepts, as it should, legal and factual submissions from taxpayers on a proposed transfer pricing penalty. In order to avoid becoming a bottleneck, the committee may be pressured to defer to the IRS agent's findings of fact and conclusions of law and leave it to the lawyers to contest the penalty issue in court. This would only exacerbate the administrative problems inherent in the transfer pricing penalty.

Conclusion

The new transfer pricing penalty scheme, intended by Congress and the IRS to enhance taxpayer compliance with the arm's length pricing requirements of the Section 482 regulations, requires a very high level of taxpayer documentation of its transfer prices and conduct on audit under threat of severe tax penalties. Under any objective measure, the new compliance burden imposed on most, if not all, multinational taxpayers by the scheme is extraordinarily heavy and comes at a time when U.S. multinational companies are trying to reduce administrative expense so as to be more competitive in the world marketplace. When examined in the light of the Commissioner's Tax Penalty Study, a serious question is raised as to whether the norm established by the net adjustment penalty—a very high level of transfer price documentation and taxpayer cooperation at audit—is the best way to encourage taxpayer compliance with what should be the ultimate objective—a correct transfer price. Furthermore, using the criteria which the Commissioner's study establishes for a "good penalty", there is a serious question whether the transfer pricing penalty scheme can be fairly and effectively administered. If the IRS auditors enforcing the penalty provisions are not well trained and closely supervised so as to obtain as consistent and as reasonable an application of the transfer pricing penalties as is possible, and if alternatives, such as APA's or individually tailored audit agreements limiting the compliance burden in future audits are not available as practical alternatives to the penalty scheme, there is real danger that the transfer pricing penalties will end up being counterproductive and the goal set by Congress and the IRS of enhanced compliance with Section 482 will not be obtained.

Endnotes

[1] Notice 88-123, 1988-2 C.B. 458.

[2] Omnibus Budget Reconciliation Act of 1990 ("OBRA '90") and 1993 ("OBRA '93").

[3] Temporary Regulations Sections 1.6662-5T, 1.6662-6T and 1.6664-4T issued January 27, 1994 and revised July 5, 1994 to conform with the best method rule in the new final Section 482 regulations.

[4] Omnibus Budget Reconciliation Act of 1989.

[5] Statement of Lawrence B. Gibbs, Commissioner of Internal Revenue, before the House Ways and Means Subcommittee on Oversight, February 21, 1989.

[6] Statement of Lawrence B. Gibbs, Commissioner of Internal Revenue, February 21, 1989; Commissioner's Study - Executive Summary - A Philosophy of Penalties.

[7] Temp. Treas. Reg. Sec. 1.6662-6T(d)(2)(ii).

[8] Temp. Treas. Reg. Sec. 1.6662-6T(d)(2).

[9] Temp. Treas. Reg. Sec. 1.6662-6T(d)(2) and (3).

[10] Tax Management, Transfer Pricing Report, Vol.3, No.2, p.73, May 25, 1994.

[11] Tax Management, Transfer Pricing Report, Vol.3, No.3, p. 83, June 8, 1994.