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Increasing IRS enforcement of TP penalties

Mark Martin and Thomas Bettge of KPMG in the US discuss the US TP penalty regime and a recent shift towards more aggressive penalty enforcement by the IRS.

The early 1990s marked a watershed moment in the evolution of the US TP regime. New regulations were introduced, following Congress' 1986 amendment to the TP statute and US Treasury's 1988 study of how to modify the prior regulations, which had been in place since the 1960s. In parallel with these substantive developments, TP-specific penalties were introduced for the first time.

The penalty amounts are significant: 20% of any underpayment of tax resulting from a net TP adjustment in excess of $5 million, or 40% if the adjustment exceeds $20 million. Given IRS resource constraints and a stated policy of using risk assessments to direct TP examinations, TP enforcement activity in recent years has almost exclusively centered around potential adjustments that exceed the penalty thresholds, often at the heightened 40% level. The possibility of large penalties provides a powerful incentive for taxpayers to get their TP right – but experience shows, time and again, that a taxpayer's view (even when based on ample evidence and thorough analysis) of what constitutes an arm's length price will not necessarily accord with the IRS's view.

Fortunately, taxpayers need not rely on the caprices of an IRS exam team to avoid penalties – at least, that is how the system is designed to work. When the regulations took their final form in 1993, the TP penalty rules provided what should be a surefire way of avoiding penalty imposition: preparing contemporaneous documentation containing certain enumerated items of information that establish the taxpayer's reasonable selection and application of a TP method, and providing that documentation to the IRS within 30 days of a request. The documentation-based defence replaced, in this context, the general reasonable cause and good faith defence that can be used as a shield against other accuracy-related penalties.

By allowing for a documentation-based penalty defence and making it the sole defence against TP penalties, Congress created a powerful incentive for taxpayers to think through and explain their TP on a contemporaneous basis. This reduces the information asymmetry between the taxpayer and the IRS, as well as reliance on post hoc rationalisations developed in response to IRS exam positions. To achieve these policy aims, and to satisfy the regulatory requirements to avoid penalties, TP documentation need not be correct; it need only be reasonable. This allows the IRS to review the documentation in an exam (generally as the first TP information request) and reach its own view as to how the taxpayer's intercompany transactions should be priced.

Indeed, it would be nonsensical to require TP documentation to be correct in the IRS's view. This would eliminate the defence, bring the taxpayer back into a world where penalties can apply whenever the IRS disagrees with its TP, and discourage taxpayers from preparing contemporaneous TP documentation, which would thwart the purpose of the US TP penalty regime. It is sensible, therefore, that the IRS historically seldom asserted penalties if the taxpayer could provide documentation. The TP penalties were serving their intended purpose.

That has begun to change. A 2018 directive instructed IRS examiners to scrutinise documentation for adequacy, and a 2020 set of FAQs continued in the same vein. Fuel was no doubt added by the Treasury Inspector General for Tax Administration's 2019 finding that the IRS seldom asserted accuracy-related penalties, and that what penalties they did assert were seldom sustained on appeal. The report suggested – and the IRS agreed – that penalties should be considered in every case, and decisions not to assert penalties should be documented.

The pendulum is swinging – and far. Practitioners are now encountering cases where IRS exam teams impose penalties despite high-quality contemporaneous documentation that is timely provided to the IRS. A review of recent and ongoing TP litigation shows the same pattern, whereas penalty application even in litigated cases was uncommon just a few years ago.

In this environment, taxpayers should take particular care that their documentation accurately reflects the underlying facts and contains all requisite items, including a robust best method analysis. While some IRS exam teams are less likely to respect documentation, no matter how good, the quality of documentation will matter more than ever for taxpayers that proceed beyond the examination phase.

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