Chapter 16 Analyzing Transfer Pricing issues

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

16.1 In General

Contents:

a. Introduction
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a. Introduction

With respect to water's-edge taxpayers, Revenue and Taxation Code (R&TC) §25114 provides that Franchise Tax Board (FTB):

- May audit tax returns filed for potential transfer pricing issues.
- Follow the rules, regulations, and procedures of the Internal Revenue Service (IRS) when conducting audits under Internal Revenue Code (IRC) §482.

This chapter provides a standard approach for evaluating intercompany transfer pricing issues that exist between members of the water's-edge combined group and excluded foreign affiliates, and determining whether or not to pursue an IRC §482 transfer pricing examination.

R&TC §25114 deals with intercompany transactions that occur between the water's-edge group members and affiliated entities, excluded from the water's-edge combined report. It evaluates whether profits or gains from these intercompany transactions have been reported at arm's length.

An intercompany transaction includes the transfer, sale, purchase, or license for use of tangible or intangible property from or by a water's-edge group member to or from an excluded foreign entity. Note the definition of "intercompany transaction" for purposes of California Code of Regulations (CCR) §25106.5-1(b)(1), the intercompany transaction regulation, is different and deals with intercompany transactions that remain within the combined group for which a gain or profit can be deferred.

For more information on IRC §482, refer to WEM 15, and the Treasury Regulations (Treas. Reg.) pursuant to IRC §482.

b. Analysis of Potential Transfer Pricing Issues

Perform an analysis of potential transfer pricing issues during the initial stages of the audit.

You may need to request information or documents from the taxpayer to complete your analysis. When making requests for information from the taxpayer at this preliminary stage, clearly explain to the taxpayer, in your Information Document Request (IDR), that the information is needed to conduct a preliminary analysis to determine whether or not an IRC §482 audit is warranted. Be careful to clearly advise the taxpayer that the FTB has NOT commenced an IRC §482 examination. This point is significant, as once the FTB proposes an IRC §482 adjustment with respect to a transaction, then the taxpayer has the right to raise IRC §482 in connection with any transaction between the same entities. (See "Offsetting Issues" in Section 16.5(a), Factors to Consider in Making a Recommendation.)

Transfer pricing audits are generally resource intensive. These audits may require the assistance of an economist, and possibly third party consultants (industry experts.) In deciding whether to pursue a transfer pricing audit, general audit procedures apply.

Therefore:

1. If your analysis reveals material, potential transfer pricing issues, and you recommend pursuing an examination, discuss your findings with your supervisor. If you and your supervisor agree, discuss the issue with your Program Manager and Bureau Director to obtain approval to pursue the issue.

2. If your analysis reveals material, potential transfer pricing issues, and you recommend not pursuing an examination, your findings should be approved by your supervisor. Document your audit work and conclusions in your Scope, Audit Issue Sheet (AIS), or Narrative.

3. If your case has no material, potential transfer pricing issues, or the IRS is conducting a transfer pricing audit, document your findings in your Scope, or Narrative. For example,

   a. Material potential pricing issues do not exist.
   b. An Advance Pricing Agreement (APA) addresses the material intercompany transactions.
   c. An IRS International Examiner (IE) is examining the same issue for the same tax year.

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A taxpayer may engage in multiple types of intercompany transactions with excluded related parties. If this occurs, each type of intercompany transaction would need analysis.

16.2 Related Party Intercompany Transactions

Contents:

a. Identify Intercompany Transactions Involving Excluded Entities
b. Classify Transactions

a. Identify Intercompany Transactions Involving Excluded Entities

The water's-edge election generally excludes foreign affiliates from the water's-edge combined report. The first step is to divide the unitary group of corporations between those that meet the inclusion criteria per R&TC §25110 and those that are properly excluded. A second step is to identify all excluded foreign affiliates that have intercompany transactions with a member of the water's-edge group.

A third step is to analyze the intercompany transactions. This will generally require you to obtain a detailed breakdown of intercompany transactions, and to determine the nature of the business activities of both parties to the intercompany transactions.

(Refer to WEM 3, for a discussion of FTB's ability to obtain information.) To identify issues, review items such as:

- Federal:
  - Forms 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations
  - Forms 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
  - Form 851, Affiliation Schedule
  - Form 1118, Foreign Tax Credit–Corporations
  - Form 8275, Disclosure Statement
- Annual Reports and Financial Statements
- Securities and Exchange Commission (SEC) Form 10-K or Form 20-F
- A corporation's public website
- Mergent Online
- Lexis and other online news articles
- Consolidated financial statement workpapers with corresponding eliminations, detailed by company
- Corporate organization and ownership charts
- Chart of accounts

- Minutes to the Board of Directors meetings

Federal Forms 5471 and 5472 are information returns that sometimes contain errors or omissions. There can be instances where intercompany transactions exist, but are not reflected on the federal forms. For example, if the taxpayer does not charge its foreign affiliate for intercompany services or interest, a pricing issue may exist. However, no intercompany payments would appear on the federal Forms 5471 or 5472. If these related party transactions are material, you may find references to them in the footnotes to the financial statements, on the corporation's public website, in notations in the corporate minutes, or Lexis, or other online news articles.

Once you have identified intercompany transactions between an excluded affiliate and a member of the water's-edge group, consider whether or not there are any other affiliates doing the same or similar activities. Such information could be useful for purposes of comparison as part of your pricing analysis. Be mindful that multiple pricing issues may exist. If the intercompany transactions are immaterial, your analysis is done and you should briefly document your audit steps in your Scope or Narrative. If the intercompany transactions are material, continue your analysis.

b. Classify Transactions

An analysis of the pricing issues is needed if one of the following exceptions occurs:

1. Excluded foreign affiliates were engaged in material intercompany transactions with at least one member of the water's-edge group.
2. There is no applicable APA.
3. The IRS is not auditing the transfer pricing issues for the same years.

Determine whether the transactions involve tangible or intangible property, services, loans or advances, or some combination thereof. Be aware that a corporation may engage in multiple types of intercompany transactions with the related party, and each type of transaction should be analyzed. For example, a manufacturer that licenses a product (tangible asset) and a related trademark (intangible asset) to an excluded affiliate for manufacturing may also provide marketing support (services.) Each of these transaction types would need separate analysis.

16.3 Tangible and Intangible Property

Contents:

a. Transactions with Excluded Foreign Entities
b. Ratio Analysis
c. Outbound Transactions
d. Inbound Transactions
e. Taxpayer's Transfer Pricing Methodology

a. Transactions with Excluded Foreign Entities

The following steps should be performed for the entities with material (or potentially material) intercompany transactions involving tangible and/or intangible property.

1. Determine if there is an applicable APA or if the IRS is conducting a pricing audit with respect to transactions between the US entities and the excluded foreign affiliates. Get copies of the APA and the IE's IDRs addressing the transfer pricing issues. It may be beneficial to talk with the IE, who can provide specific information about the IRC §482 audit activity. The FTB has an Information Exchange Agreement with the IRS. (See MAP 2.5.)

2. For those entities that are not covered by an APA or part of an IRS pricing audit, the transactions with excluded foreign corporations need to be segregated into the following categories:

    - Outbound Transactions – Outbound transactions are transfers or use of tangible or intangible property from a water's-edge group member to an excluded foreign entity. Tangible property would include items such as inventory, goods, materials, and fixed assets. Intangible property is broadly defined to include items such as patents, trademarks, know-how, and secret processes.

    - Inbound Transactions – Inbound transactions are purchases of inventory or tangible property by a water's-edge group member from an excluded foreign entity; or the transfer or license for use of intangible property by an excluded foreign entity to a water's-edge group member.

Intercompany transactions can generally be identified through a review of the detailed consolidating financial statement workpapers and federal Forms 5471 and 5472. However, outbound transfers of intangible property may not be as readily identifiable from these sources of information. Unlike a license for use of intangible property that can be identified by intercompany royalty payments, a prior year outbound transfer of intangible property may not have associated royalty payments.

In addition, an inbound transfer of an intangible property may not be readily identifiable. However, since an inbound transfer results in royalty expense to the water's-edge group, the issue is whether the actual royalty payments made by the water's-edge group to an excluded foreign corporation are at arm's length. Whether a prior year transfer of an intangible asset generates current year royalty payments depends on the date of the transfer and the taxpayer's interpretation and application of the commensurate income provisions.

When there are intercompany transactions for numerous foreign affiliates, focus on the material intercompany pricing transactions. In some cases, there may be several foreign corporations that have material intercompany transactions, while the majority of the affiliated foreign corporations have no or minimal intercompany transactions.

b. Ratio Analysis

If there exist material inbound or outbound transactions, compute the financial ratios needed to evaluate those transactions.

Relevant ratios are computed for the "tested party" and compared with industry average ratios. With outbound transactions, the tested party will normally be the foreign purchaser or transferee. With inbound transactions, the tested party will normally be the US purchaser or transferee. The tested party will generally be the controlled entity that performs the simplest and, therefore, the easiest operations to compare.

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Common Ratios:

- Gross Margin—(Gross Income / Net Sales)

- Gross income is sales less cost of goods sold.
- Net sales are sales less returns and allowances.
- This ratio reflects control over the cost of sales and pricing policies.
- This ratio is also known as the Gross Profit Percentage or Gross Profit Margin.

- Operating Income to Sales—(Operating Income / Net Sales)

    - Operating income is gross income less operating expenses, excluding interest and taxes measured by income.
    - Net sales are sales less returns and allowances.
    - This indicates the company’s ability to control operating expenses.
    - This ratio is also known as the Operating Margin.

- Rate of Return on Assets—(Operating Income / Total Assets)

    - Operating income is gross income less operating expenses, excluding interest and taxes measured by income.
    - Total assets is the book value of total assets (measured by the average beginning and ending book values, without adjustment for liabilities).
    - This ratio reflects the earning power and effective use of company resources.

- Operating Expenses to Net Sales (Operating Expenses/Net Sales)

    - Operating expenses are all expenses excluding tax expense, interest expense and non-operating expenses.
    - Net sales are sales less returns and allowances.
    - This ratio reflects the organizations' ability to generate a profit.

- Gross Profit to Operating Expenses-Berry Ratio (Gross Profit/Operating Expenses

    - Gross profit is revenue less cost of goods sold.
    - Operating Expenses are all expenses excluding tax expense, interest expense and non-operating expenses.
    - The ratio reflects a company's profit in a given period of time.

Compare the ratios computed for the tested party to industry average ratios that may be obtained from the sources listed below. Any of these reference sources can be used. However, care should be taken to ensure that the ratios for the tested party are computed in the same manner as the reference source. Always ascertain and document the methodology used in the computation of the industry average ratios.

For example, for the Rate of Return on Assets above, neither the interest expense nor income taxes have been deducted from net income. However, note below that the Rate of Return on Assets, provided by Dun & Bradstreet, has both interest expense and income tax deducted from net income. If you are able to re-compute one of these ratios so that both ratios are consistently calculated, you should do so. Whenever possible, the tested party ratio and the industry average ratio should be consistently computed.

In general, public sources of industry averages use financial statement data. Therefore, where possible, use financial statement data when comparing taxpayer data to industry averages. In some instances, you may only have access to tax return data and not to the financial statement data for the tested party. Therefore, you may have to request financial statements from your taxpayer.

Depending on the tax year and the publication, the below sources will either be presented based on the North American Industry Classification System (NAICS) or the Standard Industrial Classification (SIC) system. NAICS replaced the SIC system.

Sources of Industry Averages:

- *Dun & Bradstreet Industry Norms & Key Business Ratios*

  - Ratios are provided based on either SIC codes or the NAICS.
  - These codes classify an entity based on its Principle Business Activity (PBA). (PBA codes are similar in format to SIC codes. The IRS uses PBA codes to classify enterprises by the type of activity in which they are engaged to facilitate administration of the IRC.)
  - Provides the Gross Margin ratio, shown as the Gross Profit Percentage.
  - Provides the Rate of Return on Assets ratio. (Note that operating income is net profit after taxes. Thus, interest

expense and taxes measured by income have been deducted.)
- Operating Income to Net Sales ratio is not provided. However, it can be computed from the information provided.
- Presented in a single-year format.

- *Robert Morris Associates Annual Statement Studies*

  - Ratios are provided based on either SIC codes or the NAICS.
  - These codes classify an entity based on its PBA.
  - Provides the Gross Margin ratio, shown as the Gross Profit Percentage.
  - Provides the Operating Income to Net Sales ratio, identified as the Operating Profit Percentage.
  - Rate of Return on Assets ratio is not provided.
  - Presented in a three-year format, which provides comparative historical data.

- *Almanac of Business and Industrial Financial Ratios by Leo Troy, PhD.*

  - Ratios are provided based on either SIC codes or the NAICS.
  - Provides the Rate of Return on Assets ratio.
  - Presented in a single-year format.

- *Standard & Poor's*

  - This platform quality provides information on both public and private capital markets, along with applications for research, screening, real-time market data, quantitative analysis, etc.

The above publications are available in the business or financial reference sections of most large public libraries, university libraries or law libraries.

c. Outbound Transactions

1. Transfer of Tangible Property to Excluded Foreign Entity

When a water's-edge group member sells tangible property (usually inventory, goods, or materials) to foreign affiliates excluded from the combined report, the following steps can be performed to assist in identifying the existence of a potential pricing issue:

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E. Determine the tested party's PBA code. (PBA codes are similar in format to SIC codes. The IRS uses PBA codes to classify enterprises by the type of activity in which they are engaged to facilitate administration of the IRC.) This code is used to determine the appropriate SIC codes or NAICS for the analysis in item (c), 1., F., below. For foreign corporation ratio analysis, the PBA code should be listed on the federal Forms 5471 and 5472. For domestic corporation ratio analysis, the PBA code should be listed on the FTB Form 100W and on Schedule K of the federal Form 1120. However, the PBA listed on the tax return is the PBA code for the combined/consolidated group. Be aware that the tested party's business PBA code may not be the same as the PBA code for the entire group.

F. Obtain SIC or NAICS industry average ratios from the reference sources listed above and compare to the ratios computed in item (c), 1., B., above.

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2. Transfer (License for Use) of Intangible Property to an Excluded Foreign Entity

Potential pricing issues arising from the transfer of intangible property are most likely to exist in cases involving a highly profitable foreign manufacturing subsidiary, especially if the subsidiary is located in a tax haven country. The issue typically arises in situations where the US group has devoted significant resources (and deducted significant research and development expenses) to create a potentially high-profit intangible asset. This property could then be transferred to a foreign subsidiary in a "tax-free" transaction, such as an IRC §351 transfer, and the income generated from the intangible asset would be excluded from the US group. However, the IRC §482 commensurate with income standard requires that the income earned by the transferor or licensor of an intangible asset must be commensurate with the income attributable to the intangible asset.

If the taxpayer is engaged in a type of business that utilizes significant intangible assets, and the federal Form 5471 indicates material profits being reported by an excluded foreign manufacturing subsidiary, it is possible that the US group has transferred intangible assets to a foreign subsidiary excluded from the combined report. In this type of situation, you should consider performing the following analysis. The analysis would be conducted separately for each foreign manufacturing subsidiary with material intercompany transactions.

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d. Inbound Transactions

1. Transfer of Tangible Property to Water's-Edge Group Member

When a water's-edge group member purchases tangible goods (usually inventory) from excluded foreign affiliates, the following steps should be performed to assist in identifying the existence of a potential pricing issue.

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2. Transfer (License for Use) of Intangible Property to a Water's-Edge Group Member

When water's-edge group members make royalty or licensing payments to an excluded foreign affiliate, the following steps should be performed to assist in identifying the existence of a potential pricing issue.

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e. Taxpayer’s Transfer Pricing Methodology

If you have identified material intercompany transactions between a member of the water’s-edge group and excluded foreign entities; and the taxpayer does not have an APA covering these transactions; and the IRS is not conducting a pricing audit on these issues; then you may want to obtain additional information from the taxpayer to assist you in your preliminary analysis of these potential pricing issues.

You may want to request the taxpayer’s Transfer Pricing Studies regarding the material intercompany transactions you have identified to assist you in identifying the transfer pricing method used by the taxpayer and other relevant pricing information. Request the Transfer Pricing Studies only relevant to the specific material issues, and avoid making blanket requests for all Transfer Pricing Studies. You can always issue another request if you need additional information. In your IDR, be sure to notate that this request is made for preliminary analysis of a potential issue and that you have not commenced a pricing examination. The Transfer Pricing Studies and pricing documentation are not public information. If you wish to review them, you will need to request them directly from the taxpayer.

In addition, if the taxpayer had an APA covering prior years, you may want to request a copy of that APA from the taxpayer. The APA could contain very useful information.

16.4 Intercompany Services, Loans and Advances

Contents:

a. In General
b. Intercompany Services
c. Intercompany Loans and Advances

a. In General

IRC §482 issues may exist with regard to intercompany services, loans, and advances. The examination of these issues will generally not require the assistance of an economist or a third party consultant (industry expert). These issues can be pursued with your supervisor's approval, without the approval of your Bureau Director. (Note that if you also have a material issue regarding the transfer or use of tangible or intangible property for which you are recommending that a transfer pricing examination be conducted, then you will need your supervisor, Program Manager and Bureau Director approval before going forward with the pricing examination.)

b. Intercompany Services

IRC §482 applies when one related entity performs integral services for the benefit of another related party at a fee that is not an arm's length price. Management fees, commissions, consulting fees, or other fees paid or received may appear on the tax return. For example, assume a subsidiary operating in California performed marketing services for its foreign parent. The subsidiary was only reimbursed for its costs. As a result, no net profit was reported. In an uncontrolled environment, this corporation would not have performed these marketing services without receiving compensation that includes a profit component. Applying IRC §482 theories, you would reconstruct what the appropriate payment for these services would have been by using data from industry averages for similar services (if possible in the same location.)
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c. Intercompany Loans and Advances

IRC §482 applies when there are intercompany loans or advances with no stated interest or interest rate that is at a less than arm's length rate. For example, a US corporation loans money to a foreign affiliate at a rate below the prevailing interest rate. Prevailing interest rates for the same type of bank loan, in that same geographical area, can be determined. For example, the US charges the foreign affiliate 2 percent, while the prevailing interest rate is 5.25 percent. An adjustment can then be made to reflect the interest income that should have been reported.

Often, the existence of this issue may not be easily determined because there may be multiple intercompany loans/receivables with no breakdown of interest expense/income readily available. However, you should be alert that this issue may exist. For example, if the federal Form 5471 reflected a large loan from the US parent to the foreign subsidiary, but the federal Form 5471 reflected no interest expense. The question should arise as to the arm's length amount of interest that the US parent should have reported as income.

To identify intercompany loans or advances, review the balance sheet of the federal Form 1120, US Income Tax Return, and the federal Forms 5471 or 5472. Look at related party accounts receivable, accounts payable, and loans to shareholders and other related parties. Review the interest income/interest expense reported on the federal Form 1120, US Income Tax Return, and the federal Forms 5471 or 5472. Look in the financial statement footnotes for potential intercompany loans and advances.

To estimate the tax potential of a possible IRC §482 adjustment for loans and advances, you can use prevailing market interest rates for similar types of loans, in the same geographical area, for the applicable time period or apply the Applicable Federal Rate (AFR). AFRs are published in the Internal Revenue Bulletin (IRB). Federal tax services, e.g., Research Institute of America (RIA), Commerce Clearing House (CCH) and Prentice-Hall, also publish tables containing the AFRs.

Treas. Reg. §1.482-2(a) applies in determining the appropriate interest rate to charge on the principal amount of bona fide indebtedness between members of a controlled group. (See WEM 15, for a detailed discussion of intercompany loans and advances.)

16.5 Auditor Recommendation

Contents:

a. Factors to Consider in Making a Recommendation
b. Components of a Written Recommendation
c. Exceptions to Conducting a Transfer Pricing Analysis

a. Factors to Consider in Making a Recommendation

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Offsetting Issues—Transfer pricing adjustments cannot be applied to isolated transactions without considering the overall relationship between the parties. For example, if we propose IRC §482 adjustments with respect to a taxpayer's purchases of raw materials from its foreign parent, then the taxpayer has the right to bring up IRC §482 in connection with any other transaction between the same entities. These are called "setoffs" or "offsets." A setoff may occur, for example, if the taxpayer is paying below-market interest on loans from its foreign parent, or less than arm's length consideration for integral services provided by the foreign parent. Consequently, before you can evaluate the overall materiality of an IRC §482 issue, it is important to analyze the entirety of the transactions between the entities. Setoff transactions must be between the taxpayer and the same controlled party involved in the proposed IRC §482 adjustment and be in the same tax year and follow certain procedural requirements.

See WEM 15, and Treas. Reg. §1.482-1(g)(4) for more information about setoffs.

Dividend Recharacterization—Consider how dividend recharacterization would affect the tax potential. When an IRC §482 transfer pricing adjustment is proposed, the taxpayer's revised income no longer corresponds to the actual flow of cash that occurred between the taxpayer and its related party. If the taxpayer received a dividend payment from its related party in the year (or sometimes after) for which an agreed IRC §482 adjustment is made, the IRS will sometimes allow the taxpayer to exclude all or part of that dividend payment from income. (See Revenue Procedure (RP) 65-17, 1965-1 Cumulative Bulletin 833, or RP 99-32, IRB 1999-34, 296, August 2, 1999, which applies to years after August 23, 1999.) Essentially, the dividend is recharacterized as a return of the excess transfer price or a payment when there has been an understated transfer price.

Generally, under RP 65-17, this recharacterization treatment is only allowed for dividends occurring between the specific parties engaged in the transactions for which the IRC §482 adjustments were made. However, in situations where a dividend is paid through tiered Controlled Foreign Corporations (CFCs), and the IRS has allowed recharacterization of the dividends at multiple levels pursuant to a federal closing agreement, then the FTB will also follow the federal treatment. Therefore, this dividend recharacterization will be permitted. This is true even though the transfer pricing adjustment may be made directly between a lower-tier CFC and the US parent, while the actual cash dividend was paid first from the lower-tier CFC to a higher-tier CFC, and then to the

US parent. The amount of the dividend that may be excluded from income cannot exceed the amount by which the taxpayer's income was increased as a result of the IRC §482 adjustment. If the requirements stated in RP 65-17 or RP 99-32 have been met, then California may allow this same treatment. Therefore, the tax effect of a potential IRC §482 adjustment may be reduced by the potential dividend recharacterization.

Consider dividends received from the related party may have already been substantially eliminated or deducted under R&TC §§25106 or 24411. Hence, the actual tax impact of a dividend recharacterization will not always be material.

b. Components of a Written Recommendation

If your analysis reveals material, potential transfer pricing issues, and you recommend pursuing an examination, your findings should be discussed with your supervisor.

Your written recommendation should include the following items:

1. *Your Recommendation*—At the beginning of your recommendation, clearly state you recommend pursuing the issue.

2. *Economist Involvement*—Request assistance of an economist to proceed with the functional analysis when the issue involves intercompany transactions of tangible or intangible property.

3. *Issue Description*—Describe the business activities of the entities involved in the material intercompany transactions.

4. *Ratio Analysis*—Discuss your ratio analysis and the results.

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6. *Other*—Any transfer pricing analysis is based on the specific taxpayer facts and circumstances. Discuss any known factors that would impact the issue.

Note in the PASS file the conclusions made by your supervisor, Program Manager, and Bureau Director, and the approvals to proceed.

c. Exceptions to Conducting a Transfer Pricing Analysis

Transfer pricing issues for water's-edge audits should be evaluated by conducting a preliminary analysis and making a recommendation to obtain your supervisor, Program Manager, and Bureau Director approval to proceed, unless one of these four exceptions occurs:

1. Material potential pricing issues do not exist.
2. An applicable APA addresses the material intercompany transactions.
3. An IRS IE is examining the same issue for the same tax year.
4. The issue only involves intercompany services, loans or advances.

APA. Taxpayers can apply for and obtain an APA with respect to intercompany transactions. The taxpayer works with the IRS National Office to obtain an accepted APA. An APA provides the intercompany policies the taxpayer will apply to account for the applicable transactions on tax returns for the specified tax years. As long as the APA is followed, the IRS will accept the profits or gains as reported with respect to those intercompany transactions. The taxpayer may enter into more than one APA. The APA process applies theories pursuant to IRC §482. Hence, if the taxpayer applies the agreed APA, the IRS and the FTB would accept the applicable transactions on the tax returns.

IRS IE is Involved. This chapter applies to potential pricing issues if an IRS IE is not auditing the taxpayer for the same issues, the same tax years. We conform to IRC §482. Hence, if an IRS IE is addressing the transfer pricing issues pursuant to IRC §482, you should not do a detailed analysis. You should instead briefly document this fact in your Scope or Narrative. To verify that an IRS IE is addressing the IRC §482 issues, as evidence you can obtain copies of the IRS IE's IDRs. Realize that IEs issue their own IDRs. Reviewing copies of the IE's IDRs will indicate whether or not the IE is addressing any transfer pricing issues. Although an IE may be assigned to a case, the IE may not necessarily examine the IRC §482 issues. Copies of an IE's IDRs pertaining to the IRC §482 issues would be documentary evidence that the IRS is addressing the issue.

In addition, it may be beneficial to talk with the IE, who can provide specific information about the IRC §482 audit activity. The FTB has an Information Exchange Agreement with the IRS. Many of the California audit supervisors are on the list of Authorized Designees, and are authorized to contact the IRS. For out-of-state offices, the National Business Audit Bureau Director must make any request for IRS information that originates in an out-of-state office to verify that an IRS IE is addressing the IRC §482 issues.

Intercompany Services, Loans and Advances. If the transfer pricing issues involve services, loans or advances, these issues can be addressed following our general audit procedures. Generally, such issues will not require the assistance of an economist or third party consultant (industry expert.) As such, these issues must still be evaluated. However, these issues can be pursued with your supervisor's approval, without the specific approval of your Program Manager or Bureau Director. (See Section 16.4, Intercompany Services, Loans and Advances.)