Chapter 1

Early Preparation and Documentation for Audit and Controversy

§ 1:1 Introduction
Taxpayers should prepare for an audit or other tax controversy at the earliest stages of planning a transaction. The record that a taxpayer creates of the motivations for the transaction, the steps taken to carry out the transaction, the prices charged, contemporaneous market conditions, and other crucial facts will be of critical importance in a controversy. Taxpayers that do not focus on what they will need in an audit at the time of a transaction may find themselves lacking the fundamental support necessary to preserve the positions they adopt on
their return. This chapter describes basic best practices to follow to help ensure that transactions are well-supported for defense during an audit and any subsequent proceedings.

The Internal Revenue Code (Code) imposes generally applicable recordkeeping requirements.\(^1\) In addition, as discussed below, the Code imposes specific recordkeeping and information reporting requirements for various cross-border transactions\(^2\) as well as documentation requirements specifically focused on transfer pricing.\(^3\) Companies engaging in cross-border transactions should be proactive, go beyond these requirements, and document their transactions robustly.

This type of pre-audit preparation can be challenging. With pressure to close a transaction, it is easy to ignore laying the groundwork necessary for success in a subsequent audit. But, if a taxpayer is attentive to these details at the time of the transaction, the probability of future success will likely increase.

\section*{§ 1:2 Sensitizing the Business}

Certain fundamental principles of tax law are well known to tax practitioners. For example: a transaction must have economic substance;\(^4\) economic substance cannot be proven by establishing that the transaction generated a federal tax advantage;\(^5\) substance generally governs over form,\(^6\) although taxpayers may not be able to disavow the form chosen;\(^7\) and meaningless steps in a series of transactions can be ignored.\(^8\) While those concepts are part of the everyday lexicon of an in-house tax department, they may be unknown or impenetrable

1. I.R.C. § 6001.
2. For example, I.R.C. §§ 6038 and 6038B impose recordkeeping and reporting requirements for U.S.-based multinational companies, while I.R.C. §§ 6038A and 6038C impose recordkeeping and reporting requirements for foreign-based multinational companies.
3. See Treas. Reg. § 1.6662-6(c)(6) and Treas. Reg. § 1.6662-6(d) (providing exceptions from transfer pricing penalties if the taxpayer has satisfied certain documentation requirements).
4. See I.R.C. § 7701(o).
7. See, e.g., Comm’r v. Danielson, 378 F.2d 771 [3d Cir. 1967].
to non-tax professionals. Indeed, some are actually counter-intuitive to business people. For example, it is not uncommon for business unit leaders to write lengthy memos to management justifying transactions by sole reference to the tax benefits to be achieved, or otherwise to make statements that strike them as perfectly reasonable but that in fact can undermine the defense of a transaction.  

Therefore, tax staff should sensitize non-tax business leaders to the key tax concepts before those concepts become relevant in planning a particular transaction. For example, justifying a transaction solely by tax benefits while ignoring important non-tax business justifications could defeat the desired tax treatment of the transaction. Such instruction is best done as part of a regular educational dialogue regarding tax planning between tax personnel and their non-tax colleagues.

It is especially important to sensitize all staff, tax and non-tax alike, to the importance of email communications and other electronically stored information (ESI). Email lends itself to quick communications made without careful consideration. Moreover, while perceived as transient, ESI can be both permanent and discoverable on audit and in litigation. In a recent case, a major financial services company developed a complex transaction involving the transfer of securities and unprofitable leases to a wholly owned subsidiary. The company drafted a lengthy document articulating three separate non-tax business purposes for entering into the transaction. All three of these documented purposes were undermined by the existence of an internal email, drafted prior to the document describing the

9. See, e.g., WFC Holdings Corp. v. United States, 108 A.F.T.R.2d 2011-6531 [D. Minn. 2011] (holding that subsidiary was a straw entity, citing to various internal memoranda and contractual agreements that disregarded the entity); Klamath Strategic Inv. Fund LLC v. United States, 472 F. Supp. 2d 885 [E.D. Tex. 2007] (holding that loan agreements lacked economic substance based on internal memoranda that revealed taxpayer’s plan to exit the investment on a schedule).

10. WFC Holdings Corp. v. United States, 108 A.F.T.R.2d 2011-6531 [D. Minn. 2011]; see also Stobie Creek Invs., LLC v. United States, 608 F.3d 1366 [Ct. Cl. 2010] [discussing a series of emails and faxes regarding backdating of documents in order to achieve beneficial tax treatment]; Winn Dixie v. Comm’r, 113 T.C. 254, 287 [1999] [in holding that taxpayer’s COLI program lacked economic substance, the court highlighted that in petitioner’s internal records the transaction was labeled as an “Expense Reduction Opportunity” and the only “expense” being reduced was petitioner’s income tax liability].
non-tax business purposes, in which the Vice President of Tax gave the transaction a “99.9% chance of losing” a tax audit unless its business purpose was bolstered.\footnote{WFC Holdings Corp., 108 A.F.T.R.2d at 2011-6536.} That one email undermined all of the company’s efforts to document the non-tax business purposes for the transaction.

In responses to information requests and during the course of discovery, counsel is often confronted with improvident emails, like the one described above, that make the job of defending a transaction more challenging. The company’s best defense to this is to sensitize employees against such ill-advised communications from the outset of their employment, and to reinforce the message at regular intervals. Companies should establish a general rule that email communications must be treated in the same fashion as formal memoranda that are intended as a permanent record. The rule should be that if one would not put the particular message on paper and circulate it through inter-office mail, it should not be put in an email. Employees also must understand that emails and other ESI do not just disappear—they are placed in folders, backed up, and stored. Unlike the spoken word, the content of email is permanent. Companies are well-advised to remind employees of these basic principles.

§ 1:3 Documenting the Business Purpose Narrative

From the moment that a transaction with significant tax implications is considered, it is important to develop and document the non-tax business reasons for the transaction and its structure. This process begins with discussions of the possibility of undertaking the transaction. Lengthy planning meetings, analyses, and discussions by tax professionals, without the involvement of the business functions that supposedly will benefit from the proposed deal, can undermine efforts to establish that the transaction was motivated in material part by non-tax business concerns. Hence, it is important to involve the non-tax business units that will reap the benefits of a transaction as early in the process as possible.

Ideally, a business should document non-tax business benefits for a transaction at the outset of the planning process. While no one can or should ignore the tax benefits of a transaction, it can be crucial to preserving the desired tax benefits to understand, analyze, and fully explore the non-tax benefits to be derived. For example, consider

\footnotetext{WFC Holdings Corp., 108 A.F.T.R.2d at 2011-6536.}
a transaction where a U.S.-based parcel shipping corporation creates a Bermuda subsidiary, Y, to receive its stream of insurance fees. This provides the obvious tax benefit of moving profit offshore. However, the structure also serves the genuine need of customers to obtain parcel insurance and allows X to lower its liability exposure. These non-tax benefits should be thoroughly documented by the taxpayer. If a non-tax benefit is not discussed and documented at the time the transaction is under consideration, with strong analytical support, it is much more likely to be viewed as a post hoc rationalization that was not a motivating factor in the decision to undertake the transaction.

Indeed, taxpayers have lost many cases because they could not produce contemporaneous documentation to support their alleged non-tax business purposes. There are numerous cases in which the court disregarded as self-serving testimony from corporate leaders that was offered to establish the business justifications for a transaction, where it was unsupported by contemporaneous written evidence. Stated simply, post hoc claims of a business purpose may be viewed as less credible, even if completely true.

Moreover, the Internal Revenue Service (IRS) will look behind superficial, cursory justifications and critically analyze whether the structure in question was truly likely to yield the projected advantages. The IRS, by itself or with expert assistance, is unlikely

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13. See, e.g., Palm Canyon X Invs., LLC v. Comm’t, T.C. Memo 2009-288 (“Although Mr. Hamel testified that he wanted to expand the Hamel companies’ foreign business operations, petitioner introduced no evidence, aside from self-serving memoranda prepared on the eve of the transaction, of any definite plans to expand operations overseas.”); Saba P’ship v. Comm’t, T.C. Memo 2003-31 (The court held that two partnerships between a domestic corporation and a foreign bank were disregarded for federal income tax purposes because they did not have a non-tax business purpose. Petitioner offered testimony by the domestic corporation’s CEO contending that the partnerships had been organized and operated to achieve the non-tax business purpose of reducing his company’s susceptibility to hostile takeover. The court commented that there was no documentary evidence to corroborate the testimony and states “we have simply rejected their testimony as being both self-serving and unsupported by the records as a whole.”).
to accept broad assertions of a benefit without a deep analytical underpinning.\textsuperscript{15}

\section*{§ 1:4 Developing Documentation Supporting the Tax Treatment of the Transaction}

As a transaction is being developed and implemented, taxpayers should consider the testimonial support that would be required to establish each element of the tax case and be certain that ample documentation exists providing contemporaneous support for that testimony. For example, a best practice would be for a business to identify the tax issues involved and the required elements of proof, and then craft a contemporaneous memo that demonstrates in detail the satisfaction of the requirements that are necessary to prevail.

Documentation generally is more persuasive if made at the time of planning the transaction, rather than created after the fact. \textit{Post hoc} documentation created when an audit appears likely will be viewed as self-serving. In addition, not only is it far preferable to create relevant documentation before it is requested by the IRS, but it is also easier to develop close to the time of the transaction, when records are readily available.

It is important to research carefully what the IRS and the courts will ask for or expect to see to justify the tax treatment sought for a transaction. The taxpayer should make certain it can meet the relevant requirements and document how those requirements are met. First, and most importantly, one should review the relevant requirements contained in the Code and Treasury regulations and document how those requirements are satisfied. Second, one should

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  \item analyses and internal memoranda stating otherwise, the taxpayer “could not have achieved a non-negative net present value under any reasonable forecast of future interest rates” in a contingent sale transaction].
\item See Pritired 1, LLC v. United States, 108 A.F.T.R.2d 2011-6605, 2011-4439 (S.D. Iowa 2011) [holding that the taxpayers had no realistic opportunity to earn a profit independent of foreign tax credits and stating “that the economic realities indicated that the Pritired transaction was not ‘an exercise of good business judgment,’ but was an investment designed to appear like something that it was not”]; see also ACM P’ship, T.C. Memo 1997-115 [noting that in order for that taxpayer to achieve a pre-tax profit the interest rates on certain notes acquired in the contingent sales transaction would have had to rise to the unrealistic level of 13\% and remain at that level for the five-year life of the notes].
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read the decisions, rulings, and other advice that have evaluated facts of particular cases, discern which facts have been important or determinative, and ensure that the taxpayer will have adequate documentation to establish similar facts with respect to its own transaction. Third, the taxpayer should review all of the materials the IRS has published to guide agents in examining a particular type of transaction and similarly determine the most important facts and documents on which those materials focus. That information can be found in some or all of the following:

- The Internal Revenue Manual;\(^\text{16}\)
- The Internal Revenue Manual Handbooks;\(^\text{17}\)

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16. See, e.g., I.R.M. § 4.61.2 [describing LB&I’s guidelines for development of section 482 cases]. The Internal Revenue Manual serves as the official compilation of policies, delegated authorities, procedures, instructions and guidelines relating to the organization, functions, administration and operations of the IRS. I.R.M. § 1.4.1.7. Nevertheless, the Internal Revenue Manual “does not confer any substantive rights on taxpayers but is instead only an internal statement of penalty policy and philosophy.” United States v. Crawford, 80 A.F.T.R.2d 97-6171, 97-6173 [4th Cir. 1997]; see also United States v. Caceres, 440 U.S. 741 [1979] [distinguishing internal rules of agency procedure from regulations mandated by the Constitution or federal law for a taxpayer’s benefit, holding that a taxpayer’s rights were not violated by agent’s failure to follow guidelines of the Internal Revenue Manual]; Urban v. Comm’r, 69 A.F.T.R.2d 92-1304, 92-1305 [9th Cir. 1992] (“[Commissioner]’s compliance with the [Internal Revenue Manual]’s requirements is not mandatory.”); United States v. Horne, 52 A.F.T.R.2d 83-5912, 83-5192 [1st Cir. 1983] (“The provisions in the [Internal Revenue] Manual are not codified in the Code of Federal Regulations. Even if they were codified, the provisions would not be ‘mandatory.’”). Thus, a taxpayer will not benefit where the IRS fails to adhere to the guidelines of the manual. See, e.g., Carlson v. Comm’r, 78 A.F.T.R.2d 96-6039, 96-6043 [N.D. Ill. 1996] (“[Internal Revenue Manual] requirements are merely directory, not mandatory, and noncompliance does not render an action of the IRS invalid...Courts have generally held [that] the [Internal Revenue Manual]...is not for the protection of taxpayers.”); United States v. Hallee, Inc., 51 A.F.T.R.2d 83-859, 83-861 [D. Conn. 1982] [rejecting the relevance of the taxpayer’s argument that the IRS had violated Internal Revenue Manual guidelines; holding that “the [Internal Revenue Manual] guidelines do not confer any rights upon the taxpayer; they were adopted solely for the IRS’ internal administration, rather than for the protection of the taxpayer”].

17. See, e.g., Pass-Through Entity Handbook, I.R.M. § 4.31.1 [explaining the procedures for conducting an examination of a pass-through entity].
International Practice Units;\(^\text{18}\)
- IRS Industry Guides;\(^\text{19}\)
- Notices;\(^\text{20}\)
- Directives;\(^\text{21}\)
- Technical Advice Memoranda;\(^\text{22}\)
- Field Service Advice;\(^\text{23}\)
- General Legal Advice Memoranda;\(^\text{24}\)
- Chief Counsel Advice;\(^\text{25}\)
- Coordinated Issue Papers; and\(^\text{26}\)
- Tiered issued guidance.\(^\text{27}\)


19. Industry Guides provide examiners with industry-specific information for the biotech, food, hotel, motor vehicle, petroleum, pharmaceutical, railroad and trucking industries.

20. See, e.g., Notice 2010-34, 2010-17 I.R.B. 612 [providing guidance on reporting requirements for passive foreign investment corporations].

21. See, e.g., LB&I Directive 4-0211-0002 (Mar. 11, 2011) [providing guidelines to examiners for the efficient use of audit time and resources in the examination of sales-based royalty payments and sales-based vendor allowances].

22. See, e.g., TAM 200444022 (July 12, 2004) [requiring that foreign subsidiary make buy-in payments to U.S. corporation for intangible property under qualified cost-sharing arrangement].

23. See, e.g., FSA 200031015 [Aug. 4, 2000] [providing guidance regarding qualification as a passive foreign investment company].

24. See, e.g., AM 2011-003 [Aug. 19, 2011] [addressing the tax consequences when an insolvent foreign subsidiary of a domestic corporation makes a check-the-box election to be classified as a partnership].

25. See, e.g., CCA 200620022 [May 19, 2006] [denying foreign tax credits arising from a transaction in which the taxpayer had transitory ownership of shares in a foreign corporation].

26. See, e.g., Coordinated Issue Paper—Sec. 482 CSA Buy-In Adjustments, LMSB-04-0907-76 (Sept. 27, 2007) [providing guidance to examination teams on appropriate economic valuation methodologies of cost-sharing arrangement buy-ins].

27. While this program is no longer in existence, the information provided relating to tiered issues remains useful and provides meaningful insight.
§ 1:5 Avoiding the Creation of Contradictory Documents

Great care should be taken to avoid the creation of documents that contradict the business purpose narrative. In the case of large companies, it is critical that the lines of communication are open and functioning between the tax department and the business units. The business units should be involved in and aware of the tax planning for each transaction. All of the documents must characterize the transaction in a consistent and accurate manner. The taxpayer should avoid creating in-house analyses that focus exclusively on the tax benefits of the transaction or that describe large tax benefits in relation to small non-tax benefits. These types of documents would tend to suggest that the tax benefits were the primary motivator behind the transaction. The taxpayer should be particularly cautious of internal memoranda and emails created by non-tax professionals that may focus on the limitations of the transaction from a business perspective without also discussing the countervailing positives.

§ 1:6 Transactions Likely to Be Scrutinized

Although it is important to follow the procedures outlined above with respect to all transactions with tax ramifications, it becomes particularly important when the transaction is one that the IRS has

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28. See, e.g., Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966) (finding that the taxpayer’s sole purpose in entering the transaction was to obtain tax benefits based on contemporaneous analysis showing that no economic profit was anticipated); Transcapital Leasing Assocs. 1990-II v. United States, 97 A.F.T.R.2d 2006-1916 (W.D. Tex. 2006) (noting that transaction forecasts presented no possibility of profit).

29. See, e.g., H.J. Heinz Co. v. United States, 76 Fed. Cl. 570 (2007) (rejecting plaintiff’s argument that the transaction was intended to increase the subsidiary’s stature as a Delaware holding company, the court noted that Heinz’s primary tax manager stated “[n]othing can be done about the lack of substance in prior years . . . [we] must simply hope that our luck holds”); United States v. Davison, 105 A.F.T.R.2d 2010-2278, 2010-2285 (W.D. Mo. 2010) (disregarding a sham entity based in part on an email that described the entity as “responsible for window dress [ing]”).
identified for higher scrutiny. In 2006, the IRS adopted an Issue Tiering Process to identify and prioritize high-risk compliance issues. That system assisted taxpayers in identifying transactions that the IRS routinely reviewed. Transactions designated as Tier I, or of the highest risk, included alleged “foreign tax credit generator” transactions, research credit claims, and foreign earnings repatriation. In August 2012, the IRS announced that the Tiered Issue Process was being replaced by a knowledge management network consisting of Issue Practice Groups (IPGs) for domestic issues and International Practice Networks (IPNs) for international issues. This approach is intended to deploy subject matter experts, technical advisors and IRS counsel personnel in a collaborative manner to develop various issues. The method is intended to maintain the consistent standards created by the Tiered Issue Process while at the same time providing the flexibility to utilize expert advice based on the particular facts of each individual case.

§ 1:7 Case Studies

§ 1:7.1 International Hybrid Instrument Transactions

One of the issues on which the IRS focused in the Tiered Issue Program was “International Hybrid Transactions,” that is, cross-border related-party financing transactions that are treated inconsistently as debt or equity for U.S and foreign tax purposes. Before the Tiered Issue Program, these transactions received significant IRS scrutiny. The IRS then identified these types of transactions as a Tier 1 issue that required mandatory examination. It is likely that cross-border financings using hybrid instruments will continue to be carefully reviewed by the IRS.

30. See I.R.M. § 4.51.1. Tier 1 transactions are those that “pose the highest compliance risk across multiple LB&I Industries and generally include large numbers of taxpayers, significant dollar risk, substantial compliance risk or are high visibility.”

31. Although the Tiered Issue Process is no longer in place, prior tiered issues guidance may still be accessible on the IRS website and/or tax research databases and can be a useful tool in identifying potential IRS inquiries during audits of those issues. For example, the IRS identified in a directive that the core issue in hybrid instrument examinations is whether the particular financing should be treated as debt or equity under U.S. tax law. LMSB 04-0407-035, Directive 1 (June 15, 2007).
Prior guidance and case law demonstrate that the analysis of debt versus equity is very fact-specific and requires careful examination of the documents involved in the transaction. Taxpayers should seek to develop and have available key documents that address the various factors identified and relied on by courts to determine the existence of debt for tax purposes, including:

- The intent of the parties;
- The identity between creditors and shareholders;
- The extent of participation in management by the holder of the instrument;
- The ability of the corporation to obtain funds from outside sources;
- The “thinness” of the capital structure in relation to debt;
- The risk involved;
- The formal indicia of the arrangement;
- The relative position of the obligees as to other creditors regarding the payment of interest and principal;
- The voting power of the holder of the instrument;
- The provision of a fixed rate of interest;
- A contingency on the obligation to repay;
- The sources of the interest payment;
- The presence or absence of a fixed maturity date;
- A provision for redemption by the corporation;
- A provision for redemption at the option of the holder; and

32. Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968); see also Anchor Nat’l Life v. Comm’r, 93 T.C. 382, 400 (1989) (eleven factors); Roth Steel Tube Co. v. Comm’r, 800 F.2d 921 (6th Cir. 1986) (eleven factors), cert. denied, 481 U.S. 1014 (1987); Stinnett’s Pontiac Serv., Inc. v. Comm’r, 730 F.2d 634, 638 (11th Cir. 1984) (thirteen factors); Estate of Mixon v. United States, 464 F.3d 394, 402 (5th Cir. 1972) (thirteen factors); A.R. Lantz Co. v. United States, 424 F.2d 1330, 1333 (9th Cir. 1970) (eleven factors).
• The timing of the advance with reference to the organization of the corporation.

Knowing that these factors will likely be considered by courts, the following should support characterization of an instrument as debt:

• The instrument itself;

• Documentation clearly showing that it was the intention of the parties to create a debtor-creditor relationship;\(^\text{33}\)

• Quotes from third-party lenders to demonstrate the ability of the corporation to obtain loans from outside lending institutions and/or analyses by investment banks of the market for the borrower’s paper;\(^\text{34}\)

• Detailed financial statements demonstrating that the borrower was adequately capitalized;\(^\text{35}\)

• Projections demonstrating the financial health of the company, for example sales projections that supported profitability, reasonably anticipated cash-flow or the existence of liquid assets;\(^\text{36}\) and

• Internal analyses of the terms available in the market demonstrating that a reasonable rate of interest was obtained.\(^\text{37}\)

Additional IRS materials provide guidance for specific hybrid instrument transactions. For example, Generic Legal Advice Memorandum (GLAM) 2006-001 discusses a transaction involving a U.S.

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33. See Estate of Carr v. Van Anda, 12 T.C. 1158, 1162 [1949] (“It must be clearly shown that it was the intention for the parties to create a debtor-creditor status”); Laidlaw v. Comm’r, T.C. Memo 1998-232 [concluding that the lender’s willingness to postpone repayment of interest and principal suggested that the lender never intended to require repayment and stating that “[t]he fixed maturity dates in the documents appear to be window dressing to make the form of the transaction look like debt”].

34. See, e.g., Nestle Holdings, Inc. v. Comm’r, T.C. Memo 1995-441, 29 [commenting that “we seek to determine whether the terms of the advances were a ‘patent distortion of what normally have been available’ to petitioner”]; Laidlaw Transp. Inc., T.C. Memo 1998-232.

35. CMA Consol., Inc., T.C. Memo 2005-16, 117-118.


corporation that wholly owned both a disregarded entity and a controlled foreign corporation. The disregarded entity borrowed funds from an unrelated party and then loaned the funds to the controlled foreign corporation (CFC) in exchange for a promissory note. The promissory note was treated as debt for foreign purposes. In GLAM 2006-001, the IRS determined that the note, when combined with a forward purchase agreement between the U.S. corporation and the CFC, should be treated as debt. The GLAM relied on the following factors in its analysis:

- The parties’ intention to create a debtor-creditor relationship;
- The creation of an unconditional obligation to repay;
- A reasonable expectation of repayment; and
- The existence of offsetting obligations.

In response to this guidance, taxpayers should be prepared to provide documentation to address each of these four factors. Documentation may include:

- Internal memoranda discussing the parties’ intention prior to engaging in the transaction;
- Specific language creating the unconditional obligation to repay;
- Financial reports of the debtor entity justifying an expectation of repayment; and
- Detailed descriptions of each party’s obligations to demonstrate that there were no circular payment requirements.

Additionally, taxpayers should survey case law, regulations, private letter rulings and additional guidance to assess how fact patterns similar to their own were addressed and resolved.

§ 1:7.2 Transfer Pricing Issues

Transfer pricing issues arise in transactions between related parties. The section 482 regulations describe various pricing methods, require use of the “best” pricing method, mandate analysis of the comparability of controlled transactions to uncontrolled transactions, provide for use of an “arm’s length range,” and establish other detailed rules and procedures for performing the required pricing analyses.
As taxpayers establish transfer prices in accordance with the section 482 regulations, care must be taken to document the process. Thorough documentation of transfer pricing strategies and practices is critical to sustaining transfer pricing policies and to avoiding transfer pricing penalties. Each decision made in applying the regulations (for example, which is the best method, what transactions are comparable, what adjustments are proper) should be justified and documented.\textsuperscript{38}

To avoid certain penalties in transfer pricing disputes, the Code requires that the documentation be in existence no later than “as of the time of filing of the [tax] return.”\textsuperscript{39} The Code and Treasury regulations specify what documents are required to satisfy the documentation exception to the transfer pricing penalty. In this regard, transfer pricing adjustments increasing taxable income may be excluded from penalty computations if the taxpayer:\textsuperscript{40}

- Reasonably determined the transfer price in accordance with a pricing method specified in the regulations or properly used another reasonable pricing method;
- Prepared documentation (which was in existence when the tax return was filed) showing the determination of the transfer price in accordance with the chosen method; and
- Provided that documentation to the IRS within thirty days of a request.

The applicable regulations require taxpayers to provide “required documentation” that consists of both “principal documents” and “background documents.”\textsuperscript{41} Principal documents, which must

\textsuperscript{38} Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(6) states that “For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity. Similarly, if a cost-based method [such as the cost plus method, the services cost method for certain services, or a comparable profits method with a cost-based profit level indicator] is applied, the documentation must include a description of the manner in which relevant costs are determined and are allocated and apportioned to the relevant controlled transaction.”

\textsuperscript{39} I.R.C. § 6662(e)(3)(B)(ii).

\textsuperscript{40} I.R.C. § 6662(e)(3)(B).

\textsuperscript{41} Treas. Reg. § 1.6662-6(d)(2)(iii)(A); see also I.R.M. § 4.61.3.4.4.
accurately and completely describe the transfer pricing analysis conducted,” include the following:

- An overview of the taxpayer’s business, including an analysis of economic and legal factors affecting pricing;

- A description of the taxpayer’s organizational structure covering all related parties engaged in controlled transactions, including foreign affiliates;

- All documentation explicitly required by the regulations under section 482;

- A description of the transfer pricing method selected, including an explanation of why it was selected and an evaluation of whether regulatory conditions and requirements for application of that method were met;

- A description of the other transfer pricing methods considered, including an explanation of why they were not selected;

- A description of the controlled transactions and any internal data used to analyze those transactions;

- A description of the comparables used, including an explanation of how comparability was evaluated and what adjustments were made;

- An explanation of the economic analysis and projections relied upon in developing the pricing method;

- A description of any relevant data obtained between the end of the tax year and the filing of the tax return; and

- A general index of the principal and background documents.

Background documents are defined as documents that provide and support the “assumptions, conclusions, and positions contained in [the] principal documents.” These background documents may include those listed in Treasury Regulations section 1.6038A-3(c), which mentions original entry books and transaction records, profit and loss statements, foreign country and third party filings, ownership and capital structure records, and records of transaction documents.

42. Treas. Reg. § 1.6662-6(d)(2)(iii)(C).
In addition, taxpayers should consult IRS guidance and publications containing relevant documentation guidelines. For example, the Internal Revenue Manual provides that, in examining a controlled transfer of an intangible, an IRS examiner should obtain the following documents:43

- License agreements with all amendments;
- Sublicense agreements with all amendments;
- Any correspondence relevant to the substance of the license agreements;
- Any correspondence relevant to the substance of the sublicense agreements;
- License agreements with unrelated third parties involving the same or similar intangibles;
- Any U.S. and foreign patent applications, recorded assignments of patents, prosecution files, and litigation history;
- Any U.S. and foreign trademark registrations, assignments and licenses recorded at the Patent & Trademark Office, and litigation history;
- Any state registrations of franchises or business opportunities, and taxpayer’s disclosures to state governments; and
- Any U.S. and foreign copyright registrations.

Other portions of the Internal Revenue Manual further detail what documents IRS examiners are likely to request and review during the course of an audit.44

§ 1:8 Conclusion

Taxpayers may reap significant benefits from diligent pre-audit planning. Resources are available to understand what issues the IRS chooses to audit and how it goes about examining those issues. Taking the time to consider those issues from the outset, although

43. I.R.M. § 4.61.3.4.6[9].
44. I.R.M. §§ 4.61.3.4.2, 4.61.3.4.4 (requesting “transfer pricing documentation”), and Exhibits 4.61.3-1 and 4.61.3-2.
time-consuming, may help avoid difficult controversy in the future. After steps have been taken to develop and document the positive narrative, the next step will be to ensure that documentation is preserved, as discussed in chapter 2.