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TAX DISPUTES IN THE US

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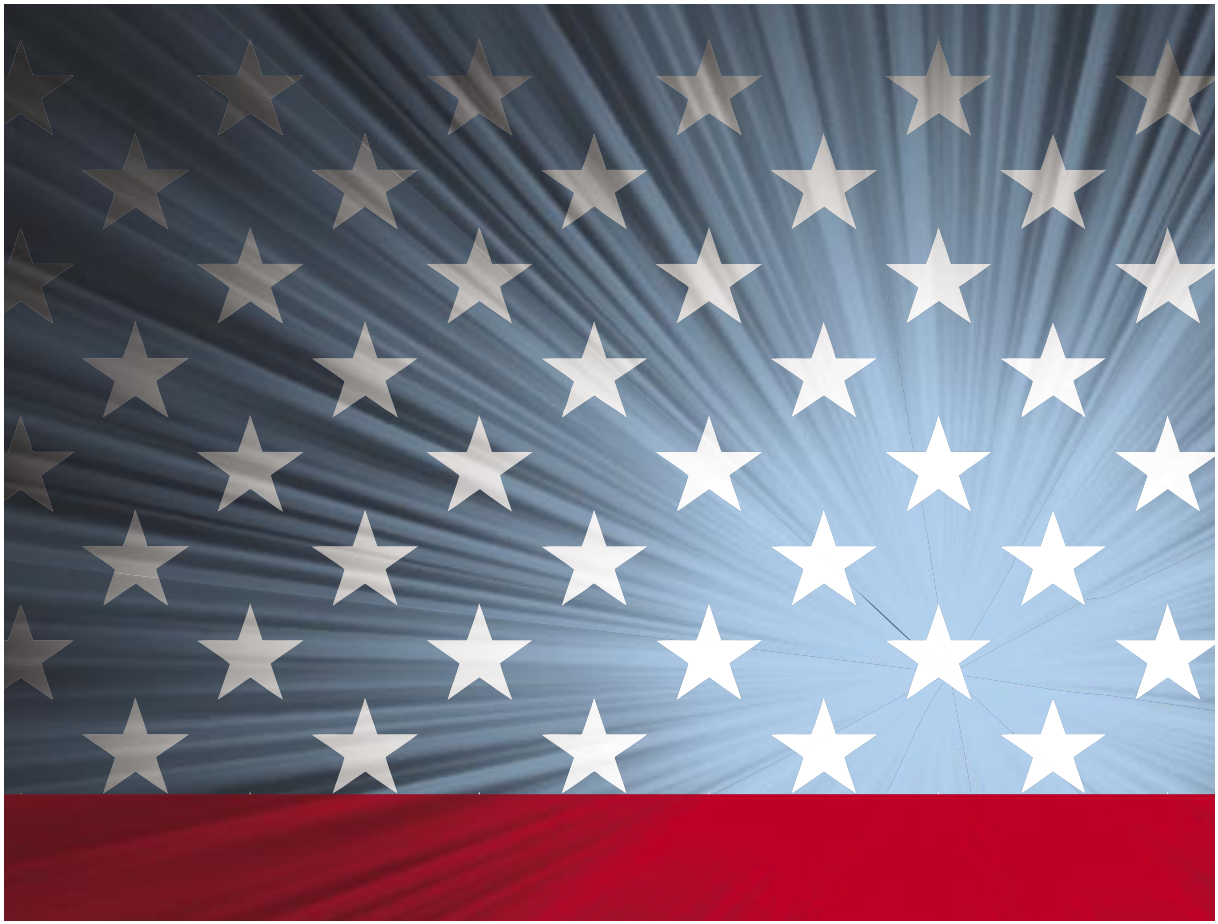
HOT TOPIC

TAX DISPUTES IN THE US



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CD: In your opinion, what important developments have emerged in the US tax regime over the past 12-18 months?

Fisher: The most significant developments in 2013 and 2014 are on the international tax enforcement front. The US Department of Justice (DOJ) launched an unprecedented program in August 2013 for Swiss banking institutions to come forward and disclose activities that may have violated US tax law, to pay penalties and avoid criminal prosecution; 106 institutions applied to participate in the first phase of the program by year's end. In May 2014, in a highly coordinated effort with US bank regulators, the US indicted a prominent Swiss bank, rather than deferring prosecution of the institution, as had long been the practice in similar cases. The bank pled guilty and paid $2.6bn in fines in connection with assisting US clients to conceal assets from the Internal Revenue Service (IRS). US authorities continue to prosecute US persons who have failed to disclose secret overseas accounts and to investigate and indict foreign banks, bankers and other 'enablers'.

Gregor: The most important development that has emerged in the US tax regime over the past 12-18 months relates to reporting of offshore assets and income, as well as related enforcement efforts. The federal government and other state taxing authorities continue to pursue offshore tax evasion schemes. US taxpayers are subject to US income tax on worldwide income, and it is illegal to hide assets abroad, or to help US taxpayers hide assets abroad, in order to avoid or evade US tax. The DOJ is going after financial institutions that it alleges have helped US taxpayers hide assets abroad, such as Credit Suisse, UBS and Bank of Tokyo-Mitsubishi UFJ. The DOJ is continuing its efforts and expanding its reach to other banks: on 30 April 2014, the DOJ issued a press release stating that a federal court had entered an order authorising the IRS to serve a 'John Doe summons' to allow it to obtain names of US taxpayers who may have held offshore accounts at Canadian Imperial Bank of Commerce FirstCaribbean International Bank. We are expecting to see a significant uptick in IRS audits of individuals holding assets at these accounts in the upcoming months.

Curd: The tax code in the United States is very complex. While there are many different areas of tax that impact international taxation, transfer pricing is covered in Section 1.482 of the Internal Revenue Code; only one section of a very large code. Transfer pricing is my area of expertise, so I cannot speak to changes in other areas of tax. The United States has had transfer pricing regulations in place since the 1960s and the current version has largely been in place since 1994. There has been significant global discussions surrounding transfer pricing and global

taxation, but we continue to wait for any significant changes.

CD: To what extent is the Internal Revenue Service (IRS) increasingly aggressive with respect to its focus on investigations? What factors are driving this enhanced scrutiny and is it leading to a rise in tax disputes?

Gregor: The IRS continues to be strategic in the cases that it pursues. Given its limited resources, the IRS prioritises its targets. Presently, a significant focus of inquiry remains offshore tax evasion. This is made easier for the IRS because certain non-US banks are cooperating and providing names to IRS of US taxpayers that are account holders. This is fairly 'low hanging fruit' and an efficient use of IRS resources. This has led to a rise in tax disputes in that area.

Fisher: Since the IRS launched the Offshore Voluntary Disclosure Initiative in 2009, over 43,000 individuals have come forward to disclose secret offshore accounts, identify their banks, bankers and other professionals, and pay back taxes and significant penalties to get back into US tax compliance. The disclosures have resulted in a 'treasure trove' of leads identifying jurisdictions, banks and individuals around the globe who have facilitated US tax evasion. This has led to widespread financial industry investigations, with over 100 criminal indictments, targeted amnesty programs and increased intergovernmental cooperation to combat tax evasion, including the implementation worldwide of the Foreign Account Tax Compliance Act (FATCA). In addition, the IRS has reorganised its Large Business and International Division (LB&I) – its most sophisticated audit function, to focus on, and coordinate its activities with respect to, the examination of cross-border tax issues.

CD: Could you explain the Information Document Request process and how it has evolved in recent years? In your opinion, is the IDR process becoming too rigorous and overbearing?

Curd: Between 2013 and 2014, the IRS issued three directives related to the Information Document Request (IDR) process. The primary changes relate to the form of the IDR, role of communication between the IRS and taxpayer, and added a defined punitive enforcement procedure for non-compliance. These changes were prompted by problems identified by both the IRS and taxpayers. Specifically, a large number of taxpayers found that the IDRs often contained laundry-list like requests and the taxpayer sometimes would not understand the pertinence of the items requested. This could lead to prolonged document recovery or providing items that were not of use for the IRS. Additionally, where the IDR had multiple items requested and all but one item

was provided to the IRS, the whole IDR would still then be treated as being non-compliant due to the one missing item. The IRS was similarly plagued with problems relating to things such as the timing of and lack of full responses to the IDRs. The new IDR directives set guidelines on the form of the IDR, specifically that each IDR can cover only a single issue. Additionally, the IRS is required to discuss the draft IDR with the taxpayer prior to issuing. The intention of this step is to ensure both parties understand how the requested data relates to the issue under audit. I believe this is an important step as a deeper level of understanding of what is wanted by the IRS may give the taxpayer the opportunity to propose alternative information or data that can better display what the IRS is looking for. The limitation of one issue per IDR will likely increase the number of IDRs received by a taxpayer, but should assist in understanding and compliance. I hope that the training that the examiners have received will give them the skills required to effectively communicate with taxpayers and work collaboratively to obtain the information and data they need. If this happens, then I believe the new IDR procedures are helpful for both the IRS and taxpayers.

Fisher: Information-gathering in a US tax examination is conducted by the IRS issuance of IDRs – written requests for information needed to examine a taxpayer. The IDR and taxpayer response process was traditionally conducted informally and was negotiated on a case-by-case basis. In March 2014, LB&I announced new formalised IDR procedures that require advance negotiation between the IRS and the taxpayer concerning the subject matter and scope of an IDR with fairly rigid deadlines for response. If a taxpayer fails to respond under the agreed deadlines, it is now mandatory that the process escalate with the issuance of an administrative summons, which can be enforced in a court of law. The advance dialogue component of the new process is a 'best practice' and should lead to better understanding and cooperation between taxpayers and the IRS. However, the strict deadlines and lack of discretion for examiners to avoid proceeding to summons enforcement may ultimately lead to unnecessary litigation and delays of the examination process in certain cases.

Gregor: The new IDR process is more streamlined, and taxpayers should be sure to take the process seriously. If the taxpayer is not responsive, or does not respond in a way that is satisfactory to the IRS, the IRS can issue a summons requesting the information. If the taxpayer does not comply with the summons, the IRS can seek to enforce it in court. Quashing a summons is an uphill battle. Courts typically, and often without oral argument, deny taxpayers motions to quash. Thus, taxpayers' best course is to cooperate with IDRs and any summons, unless the requests appear to be an abuse of

process. Beyond enforcement implications, ignoring IDRs is a bad strategy, and can be a lost opportunity. A taxpayer under examination and knows that there is a potential disputed issue can use the IDR process to frame in the best light possible. Responses need to be complete, and not misleading, but the taxpayer should use every opportunity to make his or her case.

CD: Have you seen an increase in cross-border tax disputes in recent years? Is this being fuelled by greater collaboration between tax authorities around the world?

Fisher: The rise in cross-border tax disputes is largely the result of an increasingly global economy and the temptation for businesses to engage in tax arbitrage to take advantage of varying tax rates in locales where they do business around the globe. The amounts at issue in these disputes are often staggering, and so the intense focus of tax authorities on issues such as transfer pricing, hybrid financial instruments, inversions and repatriation is not surprising. There is no question that there has been a marked increase in global intergovernmental cooperation in combating tax avoidance, which is fostering enhanced civil and criminal tax enforcement. For example, the OECD's ongoing Base Erosion and Profit-Shifting (BEPS) project targets the shifting of profits to low tax jurisdictions and aims to combat harmful tax practices worldwide. And, in addition to the variety of tax cooperation in agreements already in place and constantly evolving, new intergovernmental agreements (IGAs) with the US that require transparency and accountability in global banking and annual intergovernmental sharing of banking information are the cornerstone of FATCA. Similar multilateral financial reporting has been recommended by the OECD and adopted by the G-20, set for implementation by 2017. These initiatives will certainly enhance tax compliance and transparency, as they are meant to do, but are also so complex that their enforcement will inevitably lead to additional tax disputes.

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> *Rebel A. Curd, CRA*

Curd: Transfer pricing audits are initiated by a single government against a taxpayer for profit reported in that country. Despite the information coming from the OECD on things like the BEPS and governments sharing information between countries, the fact of the matter is each government wants to maximise its own tax base, which by definition means minimising the tax base of another country. This dichotomy makes it difficult for multi-country collaboration. The increase in transfer pricing tax disputes stems from the complexity of the issue where the allocation of profit is often difficult to determine and contains ranges of acceptable profit. To maximise a tax base, a government will want to ensure that the taxpayer is assigning the highest point in the acceptable range to their country.

Gregor: Companies that operate on a global basis plan their affairs to optimise tax efficiency. That is, operations are often structured so that income can be sourced to the jurisdictions that would result in a lower overall effective tax rate. Countries and taxpayers participate in a multilateral Advance Pricing Agreement (APA) process to provide a single proceeding in which the taxpayer can submit the economic information to the various taxing authorities, and come up with a process by which the parties will analyse the relationships that would result in an agreement regarding allocations among countries. Mutual Agreement Procedure

(MAP) provides a dispute resolution process where the parties are unable to reach an agreement. Collaboration among countries relates to process, not outcomes. Each country has its tax revenue interests at the forefront of its positions. The point of the process is to set up a fair procedure whereby each country believes that its interests are fairly represented.

CD: What difficulties do US firms face with regard to transfer pricing? How can companies reduce the risk of entering a transfer pricing dispute?

Gregor: The key to navigating smoothly a transfer pricing dispute is to ensure that a firm has done its homework. A company that is undertaking a transfer pricing arrangement should realise that the upfront costs of obtaining a valuation report and substantiation work papers can result in significant costs savings in the event of a challenge. A taxpayer who comes to the table prepared with existing substantiation reports may find that a transfer pricing audit may be a simple negotiation. However, a company without substantiation instead may find itself at the mercy of an examiner's choice of pricing and valuation methods.

Curd: Despite the global scrutiny increase, there are still companies that are unprepared for a dispute. While annual documentation is a compliance issue in many countries, it can be very expensive and time consuming to prepare, so taxpayers are sometimes constrained to the point that they prepare only a minimal amount of support for their transfer pricing. When there is a lack of proactive full preparation of documentation, transactions can be overlooked and not addressed. Then when the audit comes around these items are uncovered and can surprise the taxpayer, leading to assessments and penalties. When transfer pricing is thoroughly reviewed proactively, there is less uncertainty. This makes the audit process go more smoothly as the tax authority will see that the taxpayer has thought through the issues and has written support for each transaction. In many countries that have penalties, having documentation done proactively eliminates the potential for a penalty.

Fisher: Transfer pricing remains a subject of significant IRS scrutiny, regulation and enforcement. The IRS has recently developed internal training materials for examiners that encourage a more issues-based approach. A company should review and consider the new IRS 'roadmap' to understand how a tax examination would be focused and to prepare for an efficient and complete presentation of relevant issues should it become the focus of a transfer pricing inquiry. Up-front presentation, transparency and narrowing of issues are the goals of the new audit process. Thus, a company will benefit not only from developing the required documentation

to support transfer pricing, but from being prepared at the outset to present a transfer pricing study and to explain to the IRS what drives the business, how the business is accounted for and how it is affected by the competitive landscape.

CD: No matter what precautions it takes, a company may become the target of an audit or investigation at any time. What should it do in such circumstances?

Curd: Taxpayers should be prepared for an audit. Having a multinational company makes you a prime target for audit. Having complete documentation done proactively saves a significant amount of time in an audit. It is very important, and now expected based on the LB&I Roadmap that came out in February 2014, that the taxpayer provides a presentation on the company and industry at the beginning of the audit. Educating the exam team gives them a deeper understanding of issues that may have impacted your company during the audit cycle. Starting the audit with good communication between the taxpayer and audit team helps set the stage for a collaborative effort throughout the process.

Fisher: Maintaining good contemporaneous documentation will serve a company well when the inevitable examination occurs. Audits and investigations can take years to develop, and responsible personnel at the company may change. Thus, it is important to develop and preserve in an organised fashion not only the key documentation supporting and substantiating a tax position, but any analysis, rationales, advice, opinions or expert review that may be conducted. Care should also be taken to preserve applicable privileges where appropriate. Overall, the company should seek to foster a constructive relationship with the exam team, to be cooperative and to keep the focus of the inquiry as narrow as possible. A company should be prepared to devote adequate staffing and resources to an exam. It is often advisable to engage outside professionals to oversee the smooth functioning of the exam procedurally and logistically and to interface as needed with the tax authorities. Certainly, in any sensitive tax matter that could lead to litigation, criminal or fraud allegations, outside counsel should have a significant role.

Gregor: First, a company that is a target of an audit or investigation should not panic. No one likes to be the target of a taxing authority's inquiry. But it is important to understand the issues the government is looking at, and to identify if there really is any issue of concern. If there is a key issue, the company needs to understand the process, the possible outcomes, and the possible exposure. In addition, there are financial reporting obligations that apply that the company will need to consider. Second, it is good to

get counsel involved early to help with the analysis, but it is not always necessary to have counsel appear before the IRS at the earliest proceedings. It is often the case that getting an accountant out front in the exam – and have the lawyers behind the scenes – may be the right approach in more fact-driven inquiries. In contrast, if the major issue before the IRS is purely legal, rather than computational, getting a lawyer in early may be the right approach. In addition, if there is any risk of criminal exposure, getting legal counsel early is critical.

CD: In what ways do tax disputes differ from more traditional business-to-business disputes? What advice can you offer to firms engaged in a dispute with US tax authorities, in terms of reaching a resolution?

Fisher: In addition to the substantive tax expertise required to interface meaningfully with the IRS, US tax disputes are conducted in a highly regulated administrative setting, so it is important for a company to have advisers who understand not only the law but the procedures, along with opportunities and obstacles that may arise in the process. There are a variety of dispute resolution alternatives available at each administrative stage, and the standards the IRS applies in evaluating settlement at each stage differ. Thus, it is important to understand the level of discretion the IRS has in attempting to negotiate the resolution of a dispute. Also, a selection of judicial forums is available in the event administrative resolution cannot be achieved and litigation is necessary, and the choice of the optimal forum involves strategic analysis. Finally, with the full resources of the US government behind it, the IRS is not generally motivated by the types of business considerations that often drive dispute resolution in a commercial setting, so it is critical to frame tax dispute resolution with an understanding of the IRS policy objectives that may be implicated.

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>
> *Miriam L. Fisher, Latham & Watkins*

Gregor: Traditional business disputes generally involve the resolution of economic interests between

the parties. Either the plaintiff wants money, or wants the other party to do, or cease doing, something. In most cases, the matters can be resolved based on a dollar value that the parties will agree on. Where parties cannot agree, and a lawsuit is filed, the plaintiff files a complaint and has the burden of proof, by a preponderance of the evidence, but there may be a myriad of contractually-agreed alternative dispute resolution alternatives. There is a more structured dispute resolution mechanism in tax disputes. The IRS examines a return, and then issues a report. The examiner does not have the right to take into account risks of litigation. The taxpayer has a right to file an appeal of the examiner's report with the IRS Office of Appeals, pursue very limited alternative dispute resolution options or seek redress in one of three federal courts. Understanding the administrative law aspects to tax litigation is key to resolving a dispute quickly.

Curd: There are similarities and differences in tax disputes as compared to business-to-business disputes. The similarities arise from the fact that the two parties will have a long-term relationship so it is important that they try to keep the negotiation process from becoming too adversarial. However, tax disputes are rooted in an argument over law and in transfer pricing, the application of the law to economics. In this sense, the dispute is more like a legal dispute and can become quite intense, particularly if elevated to the tax court level.

"Understanding the administrative law aspects to tax litigation is key to resolving a dispute quickly."

Kathleen Saunders Gregor, Ropes & Gray LLP

CD: Tax controversies appear regularly in the media and 'offshore regions' have become a major issue of late. What steps can companies take to ensure ongoing tax compliance in the US? Do you expect to see further governance and regulation in this area?

Gregor: Multinational companies that are US companies or do business in the United States should have access to professionals, either internal or external, that can advise on how the US tax rules will affect their tax return positions and

filing obligations. It is often advisable to develop relationships with controversy experts in advance, or at least at the onset, of an examination. Incorporating a longer-term appeals and litigation strategy can be crucial at all stages of an examination process. Beyond that, because of the reporting obligations that apply to tax return preparers, tax professionals – whether internal or external – should know and understand the strengths and weaknesses of reporting positions. Where a reporting position depends on the establishment of facts, maintaining contemporaneous records that contain those facts in a way that can be accessed and reviewed by tax professionals in a controversy context is crucial. In many cases, legal costs are driven up by time spent reconstructing facts that support a return position. For example, the deductibility of a fee depends on whether it was paid in connection with an acquisition – and therefore capitalised – or as part of ordinary and necessary business expenses – and therefore deductible – may depend on whether the expenses were incurred prior to the date on which a letter of intent was signed. It will be important to maintain contemporaneous documentation regarding the nature of the expenditure, the identities of the service provider and the timing of the services. Tax professionals will need to keep up with material changes in law, which can be obtained through their tax advisers or publications.

Curd: The US has very explicit transfer pricing documentation requirements so I would not expect dramatic change in this area. Annual documentation is required to comply with the penalty provision exclusion under Section 6662 of the Internal Revenue Code. To potentially reduce the number of IDRs your company receives in an IRS audit, and to avoid being assessed for penalties if the IRS proposes an adjustment, make sure the transfer pricing documentation is clear by laying out the intercompany relationships in both words and pictures, explain why market or industry issues impact your business and the setting of prices, and comply with the 10 required elements as detailed in the regulations.

Fisher: The globalisation of US tax compliance and enforcement is undeniable and fast-moving. Companies must stay abreast of these developments, understand how their businesses are affected and develop appropriate compliance measures or risk severe sanction for non-compliance. Over the last five years, the US government has achieved unprecedented success in combating foreign banking practices that facilitated US tax evasion and has precipitated a previously unimaginable reduction in banking secrecy practices around the world. The implementation of FATCA, the coming multilateral financial reporting regime and the BEPS project exemplify a new global commitment to financial

transparency and cooperation that is specifically directed at reducing tax avoidance around the globe. The US has also shown a willingness to use a variety of both traditional and innovative enforcement measures in achieving these goals. These include, to date, wide ranging investigations and development of leads, extra-territorial summons enforcement, institutional and individual criminal prosecutions, deferred prosecution agreements, imposition of significant civil penalties, creative amnesty programs, increased sophistication of cross-border examination focus and techniques, use and negotiation of treaties and other intergovernmental cooperation agreements, as well as ground-breaking legislation and regulation affecting international financial practices. To stay in compliance and avoid serious complications, it is more critical than ever for businesses to have professional advisers who understand the policy and enforcement goals, as well as the tools and techniques, of the US tax authorities. CD

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Founded in 1965, **Charles River Associates** is a leading global consulting firm that offers economic, financial, and business management expertise to major law firms, corporations, accounting firms, and governments around the world. CRA has extensive experience in international arbitration, including both commercial and investment treaty claims, and has been engaged in some of the most complex and high-profile disputes of recent years. The firm provides expert testimony and analytical expertise in a variety of industries, including life sciences, metals and mining, financial services (including banking, finance, and insurance), energy, and telecommunication and other media.

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