

Tax-Efficient Business Practices in the Face of Unprecedented International Tax Enforcement

By Douglas E. Whitney, Gregory G. Palmer and Matthew C. Boch

The political winds are calling for greater and stricter international tax enforcement efforts.

A stream of commerce that becomes more global every day. A global economic downturn that has left governments all over the world desperately seeking to make up for historic revenue shortfalls. A new administration publicly committed to cracking down on tax havens and curtailing international tax evasion. A Congress outraged by undisclosed offshore bank accounts and committed to expanding international enforcement authority and resources. An Internal Revenue Service (IRS) wrapping up its largely successful war on domestic tax shelters. A shared commitment among all enforcement agencies to reduce the international "tax gap," estimated to be between \$40 and \$123 billion annually.¹

Any combination of these factors could be cause for concern among business entities relying on cross-border operations or revenues, as they portend a more aggressive approach to international tax enforcement. But the cross-border business community is not merely facing a combination of these factors—it is now facing all of them. At once. For businesses seeking to structure tax-efficient, cross-border transactions, the risks have never been greater, as it is more likely than ever that they will face lengthier and more intrusive IRS audits, a more aggressive and rigid approach to compliance and an increasingly rapid resort to civil and criminal tax penalties.

The IRS Goes Global

There are already plenty of signs that the IRS intends to export the aggressive techniques it employed

in its crackdown on domestic tax shelters to the international enforcement arena. The government has filed criminal charges against those involved in establishing undisclosed foreign bank accounts, it has collected \$780 million as part of a deferred prosecution agreement with UBS, and it is aggressively seeking to compel the bank to provide the names of roughly 50,000 additional individuals who established foreign accounts. Congress has also proposed legislation that would grant prosecutors substantial new powers to prosecute international tax evasion, including the ability to apply the international money laundering statute to tax evasion.² The government is also renegotiating tax information exchange agreements and qualified intermediary agreements with foreign banks to require greater reporting and access.

At the same time, IRS Commissioner Douglas Shulman recently pledged an "aggressive agenda" against offshore tax abuse, and President Barack Obama has proposed a significant increase in funding for international tax compliance initiatives. And while Commissioner Shulman has attempted to reassure business groups that the IRS understands the "difference between legitimate international

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business and tax planning and abuse,” companies engaged in cross-border business should expect a much more aggressive and resourceful IRS in the coming years.³ Thousands of revenue agents are in the process of being added this year, and this type of massive expansion is slated to take place next year as well.

The IRS official that led the IRS’s efforts to penalize investment banks, accounting firms and law firms for promoting tax shelters was recently made the deputy commissioner (international) for the Large and Mid-Size Business division (LMSB) of the IRS. And the IRS has already elevated numerous cross-border issues to Tier I status, which means that these transactions will receive significantly greater attention during audits; the resolution of these issues will be more protracted, expensive and inflexible; the IRS will be more likely to attack claims of privilege; and the IRS will be much more likely to seek to impose penalties. All of these factors counsel a careful and conservative approach when planning, implementing and defending cross-border transactions.

IRS International Enforcement Priorities

The upsurge in international tax enforcement extends well beyond the highly publicized efforts to crack down on accounts and businesses located in traditional tax haven jurisdictions, and it is already reflected in the Tier I issues identified by the LMSB division of the IRS. Numerous cross-border issues are among the Tier I issues that the IRS has designated for enhanced enforcement efforts, including the following:

- Foreign tax credits
- Hybrid instrument transactions
- Foreign earnings repatriation
- Cost-sharing agreements
- Withholding agents

Taxpayers should also expect continued attention to the long-running issues of transfer pricing and tax havens and should be aware of up-and-coming Tier II issues.

What all of these issues have in common is that they have historically been treated as legitimate tax-planning techniques—tax arbitrage—that take advantage of differences in the tax systems of coun-

tries to conduct international business in the most tax-efficient means possible. They are grounded in the time-honored principle that no corporation should pay more taxes than the laws require. But increasingly, the IRS is restricting the scope of what it respects as legitimate tax planning and even challenging outright entire categories of activities that have long been respected as appropriate international tax planning. The IRS has formed a special team of attorneys to review transactions involving the generation of foreign tax credits, and it is also aggressively reviewing and contesting transfer-pricing issues.

Even a relatively high-level review of the issues that the IRS has targeted for enhanced enforcement activity will indicate that they will appear on or will affect the returns of most sophisticated taxpayers. Accordingly, all such taxpayers should prepare for an arduous and increasingly contentious audit cycle.

Foreign Tax Credits

To avoid double taxation, the United States gives taxpayers a foreign tax credit for taxes paid in other jurisdictions, but as noted by the Treasury, “certain United States taxpayers are engaging in highly structured transactions with foreign counterparties in order to generate foreign tax credits,” which have the effect of “shift[ing] domestic earnings offshore while generating foreign tax credits that can be used to offset other income.”⁴ Generally, if the complex structure were simplified, then the foreign tax credit would be lost.

Foreign tax credit generators in some ways resemble the domestic tax shelters of a decade ago, as highly structured transactions with advantageous results. But rather than being based solely on technical inconsistencies of law, the foreign tax credit generators can be based on legitimate arbitrage between different countries’ tax systems. The government’s response to these transactions nevertheless follows the tax shelter playbook, with aggressive, strategic litigation of past transactions and with new regulations to prevent such transactions going forward. The regulations issued to shut down the foreign tax credit generator transactions have been criticized by taxpayers and practitioners for their complex and overly technical nature. Meanwhile, the government

has had some success in its litigation of some early tax credit generator cases, in part using economic substance arguments, and this success is further emboldening its aggressive enforcement efforts.

Hybrid Instrument Transactions

It seems that any attempts at tax arbitrage are now facing IRS challenge. Hybrid instruments that are treated as debt in the United States and equity by another country, or *vice versa*, are now facing IRS challenge despite their widely perceived legitimacy. Depending on the structure, such instruments can be used to increase interest expense deductions, reduce withholding rates on interest payments under a tax treaty, avoid recognition of interest income in the foreign jurisdiction and/or give rise to foreign tax credits in the foreign jurisdiction. Each case is determined based on its own facts and circumstances, and the taxpayer will often prevail. In fact, the IRS's own Office of Chief Counsel has released a memorandum analyzing a typical situation and concluding that hybrid treatment is appropriate.⁵ Still, these hybrid instruments have been designated as a Tier I issue by LMSB and, accordingly, will raise a red flag on any audit. As a result, a revenue agent is required to issue intrusive and costly requests for documents and is likely to challenge the claimed result if there is any basis to do so. Any further review of the issue is highly coordinated and centralized.

Foreign Earnings Repatriation

Foreign earnings repatriation has and continues to be a contentious issue, as U.S. multinationals seek to bring profits back into the United States while avoiding the 35-percent corporate-level tax. In 2004, Congress enacted Section ("Code Sec.") 965 of the Internal Revenue Code, which allowed U.S. companies a one-year chance in 2004 or 2005 to repatriate foreign earnings from controlled foreign corporations at a 5.25-percent rate instead of the standard 35 percent. The use of Code Sec. 965 in these years is now under audit, and companies that aggressively planned and structured in order to maximize use of the onetime opportunity may be challenged by the IRS. Code Sec. 965 enforcement has also drawn attention to other tax structures facilitating low- or no-tax repatriation. The so-called Killer B transac-

tion (so named for reorganizations under Code Sec. 368(a)(1)(B)), in which foreign earnings were used to buy back shares of the corporate parent, has been reined in by regulation and administrative pronouncement,⁶ but completed transactions over the past decade are the subject of much contention as cases work their way through audit, appeals and into the courts. Other innovative repatriation structures developed by taxpayers and practitioners will face similar challenges as the IRS becomes aware of them. To ferret out such strategies, the IRS may use specially crafted document requests to obtain information on repatriation strategies.

Cost-Sharing Agreements

The use of cost-sharing agreements to move ownership of developing intellectual property outside of the United States is a problem of particular concern. In a cost-sharing agreement, commonly controlled domestic and foreign taxpayers agree to jointly develop intellectual property. The agreement maximizes future earnings of the foreign taxpayer, reducing the domestic tax base over the long term. The IRS and the Treasury have to challenge each agreement on a case-by-case basis, proving that the terms were not arm's length under applicable transfer-pricing regulations, and taxpayers have had some success defending aggressive cost-sharing agreements. Given taxpayer successes under the old 1995 regulations, the Treasury and the IRS responded by tightening the governing regulations, a new temporary version of which was released this January.⁷ While only applicable going forward, these regulations are much more restrictive, and the additional compliance will raise the cost of running a cost-sharing agreement.

Transfer Pricing

More broadly, transfer pricing—the determination of arm's-length pricing in transactions between related parties (of which cost-sharing agreements are just one type)—continues to be a headache for the IRS, specifically (1) "the appropriate transfer pricing of transactions between domestic and off-shore related corporations," (2) "the appropriate royalty structure between domestic and off-shore related entities" and (3) the transfer of property out of the

United States.⁸ In response, the United States has become very aggressive in fighting perceived erosion of its tax base, especially as companies move intellectual property offshore. Billions of dollars can be at stake in a single dispute, and so the IRS is hiring economists and financial specialists to handle the anticipated increased volume of disputes.⁹ Further, the voluminous transfer-pricing regulations are slowly being updated. But at least there is one trend working for taxpayers: The United States is inserting binding arbitration clauses in its tax treaties. These provisions should ensure that double taxation will not happen if the IRS and the foreign tax collector fail to agree on appropriate transfer pricing.

Withholding Agents

The recent offshore account scandals have brought the issue of withholding agents to the fore of tax policy, as financial institutions face an enraged public and the wrath of Congress. Generally, payments out of the United States are subject to 30-percent withholding tax that the U.S. payer is required to collect (or verify an exemption). But an exception is made for payments to qualified intermediaries, financial institutions that agree with the IRS to collect U.S. tax. The rationale is that such institutions, properly audited, are in a better position to verify the recipient's identity and determine appropriate taxation. The qualified intermediary program, almost a decade old now, is thought to have been a success, but the recent revelations of noncompliance make it highly likely that the IRS and the Treasury will more closely scrutinize claims of compliance by qualified intermediaries and other withholding agents. The situation is particularly irksome to the government because complex financial instruments were promoted by financial institutions as a way for their clients to avoid withholding tax, when the same institutions had a duty as qualified intermediaries to ensure proper withholding. Given the heightening political pressure, in-depth audits of qualified intermediaries and any other withholding agents should be expected. These reviews will closely examine the institution's internal controls and practices to confirm that proper tax collection is occurring. This issue is still very much in devel-

opment, but the political pressure should cause the government's approach to come into focus relatively quickly.

Tax Havens

The furor over withholding agents is closely linked to the well-publicized efforts to combat tax havens. While tax havens are not identified as a Tier I enforcement issue, concern that companies are shielding income in such jurisdictions motivates or at least touches on many of the Tier I international issues. The use of tax havens by U.S. corporations and individuals has come under increasing scrutiny, including hearings before Congress, and a Government Accountability Office (GAO) report that found that 83 of the 100 largest U.S. companies have subsidiaries in tax havens.¹⁰ The Stop Tax Haven Abuse Act is intended to shut down some of the benefits that tax havens provide to U.S. taxpayers.¹¹ Proposed by Senator Carol Levin, this bill is not yet law but has wide support. The bill would, among other provisions, treat entities organized in a tax haven as being located in their place of operation or management, causing offshore companies to be treated as located in the United States. The Fraud Enforcement and Recovery Act of 2009, proposed by Senators Patrick Leahy (D-VT) and Charles Grassley (R-IA), takes an even more aggressive approach by making tax evasion a criminal offense subject to the international money laundering statute. If either of these statutes is enacted, the IRS will have a whole new arsenal of tools to go after taxpayers using tax havens. But even if proposed legislation does not become law, taxpayers can be certain that the strong political pressure to combat the perceived unfairness relating to tax haven jurisdictions will undoubtedly alter IRS enforcement priorities in the coming years.

Warning Clouds on the Horizon—Tier II Issues

The IRS has also identified other international issues that, while not yet justifying the enhanced enforcement measures associated with Tier I, have been identified as "areas of potential high non-

compliance and/or significant compliance risk.”¹² While enforcement pressure may be slightly less intense for these Tier II issues, such preliminary designation by the IRS often serves as a laboratory for future Tier I enforcement priorities. One such issue of particular concern for international taxpayers is cost-sharing stock-based compensation. The proper transfer pricing of stock-based compensation used to develop property for a cost-sharing arrangement is the subject of much debate between taxpayers, which want the cost to remain solely in the United States, and the IRS, which wants foreign participants to share in the costs. This area is the subject of an ongoing regulatory project, and the Ninth Circuit’s decision in the *Xilinx* case is the subject of much anticipation.¹³

A Proactive Approach to IRS Enforcement Efforts

There can be no doubt that the political winds are calling for greater and stricter international enforcement efforts. Almost all corporations engaging in significant cross-border operations will feel the effect in coming audit cycles, if they have not already. While there is no way to completely insulate a company’s tax-planning and -preparing functions from these enforcement efforts, there are numerous steps taxpayers can and should take to better their chances of successfully surviving them.

Staying Current

In recent years, the IRS has become increasingly more public about where it will be allocating its enforcement resources. Presumably, this is to be both more transparent and to create a chilling effect with respect to taxpayer behavior that is of concern to the IRS. These developments should be routinely monitored and treated as a frame of reference for evaluating the potential tax exposures within the taxpayer’s business operations. To varying degrees, other countries also provide this type of information and, for multinational taxpayers, it is important to have a coordinated organizational effort to monitor these developments and evaluate their impact.

Many taxpayers have found it to be a very worthwhile investment of time and resources to participate in organizations such as the Tax Executives Institute, the International Fiscal Association (IFA) and the tax sections of the American Institute of Certified Public Accountants and American Bar Association, as well as the international counterparts of these organizations. Subcommittees of the aforementioned groups that are specifically devoted to the taxpayer’s industry, or industry groups with their own tax section, provide important networking opportunities to identify and monitor important developments. However, care should be taken when communicating in such situations with respect to any sensitive or confidential information.

Multinational Approach

As mentioned previously, international tax enforcement efforts are becoming increasingly coordinated. The IRS and its counterparts are working to collectively target areas such as secret bank accounts, operations in tax havens and offshore hedge funds. These tax authorities are engaging in frequent personnel exchanges in order to share ideas and enforcement strategies. The authors have also noted an escalation of requests for assistance under information-sharing provisions of tax treaties. These trends will not only continue; they will accelerate.

Large multinational taxpayers consistently rank transfer pricing as one of their top areas of concern. The dollars at stake can be enormous, particularly when coupled with interest and potential penalties. The risk of double taxation is also of great concern. These risks can be mitigated through careful economic analysis and documentation of transfer-pricing policies.¹⁴ When the two countries involved in a transfer-pricing question are parties to an applicable tax treaty, this can afford very important protections to a taxpayer. A taxpayer may be able to take a proactive approach and request an advance pricing agreement with the countries. Alternatively, if an issue arises on examination, the taxpayer may request competent authority consideration, where the two countries meet in an effort to negotiate consistent treatment in order to avoid double taxation. In such circumstances it may be critical for the

taxpayer to act promptly to preserve its right to competent authority. Historically, competent authority proceedings have had a high rate of success, and, as mentioned previously, some tax treaties have been recently amended to provide for binding arbitration when the countries involved are unable to resolve the issue on their own.¹⁵

Planning for the Audit

Before an audit even commences, there are important decisions to be made. For example, taxpayers could request to be included in the IRS's Compliance Assurance Program (CAP) or Limited Issue Focused Examination (LIFE) program if they meet the criteria established by the IRS. The goal of the CAP program is for the IRS to work together with large business taxpayers to address transactions as they take place, instead of years later during audit and examination. The LIFE program was developed in response to large business taxpayers' complaints concerning the protracted nature of the examination process. To make the process more timely and efficient for the taxpayer and the IRS, the LIFE process employs risk-based analysis and materiality thresholds to provide an improved focus of resources. For specific issues there is also the opportunity to request a prefiling agreement from the IRS. Under the prefiling agreement program, the taxpayer and the IRS endeavor to address an issue and reach a conclusion reflected in an agreement entered into before the tax return is actually filed. In all of these programs, the taxpayer is viewed as seeking to address issues in an aboveboard and proactive manner, so the IRS makes a special effort to research resolutions that are mutually agreeable with the taxpayer.

Another important internal matter to address before examinations start is the measures the taxpayer undertakes with respect to information for which it intends to claim protection under the practitioner privilege, the attorney-client privilege or the attorney work product doctrine. This should come to mind not only in the context of formal written tax opinions but also with respect to electronic communications and tax accrual work papers. The IRS and the Department of Justice have become increasingly aggressive in

their efforts to obtain this type of information. Although these efforts have been most common with regard to tax shelter controversies and listed transactions, the authors are seeing this extend into other contexts. As a result, well-thought-out policies and practices are crucial for protecting sensitive communications.

Conducting the Audit

Once an audit has commenced, the INTERNAL REVENUE MANUAL provides that the IRS should prepare an audit plan and share it with the taxpayer. This is an opportunity to understand the substantive areas in which the IRS intends to focus its audit resources as well as to address procedures for the audit. For example, the IRS and the taxpayer should establish realistic timetables for responding to information document requests. The IRS should commit to promptly review the taxpayer's responses and request any clarifications or additional information within a fairly short period of time. The authors frequently encounter circumstances where the IRS insists upon the taxpayer responding within 30 days but then will wait many months before reviewing information and asking any follow-up questions. The long time that has elapsed will often make the effort more time-consuming and inefficient for the taxpayer. The IRS should also be preparing any Notices of Proposed Adjustment and delivering them to the taxpayer during the course of the audit. All too frequently, those adjustments are delivered in a flood at the end of the audit, making it difficult for the taxpayer and the IRS to have a meaningful opportunity to discuss and resolve the issues.

If an issue becomes sufficiently crystallized during the course of an examination, the taxpayer should consider whether it is appropriate to request an early referral to the IRS appeals office. Under appropriate circumstances, an appeals officer can be assigned while an examination is ongoing in an effort to resolve an issue. Alternatively, as an examination nears its close, if there are a limited number of well-defined audit issues, the taxpayer may request consideration for fast-track settlement by the appeals office. In a fast-track settlement, one or more appeals officers may be assigned to act more in the nature of mediators

between the taxpayer and the examination team. This may be particularly attractive if the taxpayer has a good relationship with the examination team and there are issues that remain unresolved because the IRS believes they were of a nature that requires some type of compromise beyond the authority of the examination team. If the IRS and the taxpayer do not seek fast-track settlement consideration, or if issues remain unresolved after the fast-track settlement process, the IRS prepares a report of its adjustments, and the taxpayer then responds in the form of a protest letter.

Appeals and Litigation

After the taxpayer files its protest, the case is transferred to the IRS appeals office for normal consideration. Because the examination team has limited authority to resolve certain types of issues on a compromise basis, and because the IRS recognizes the burdens of litigation upon its own resources, as well as on the resources of the taxpayers and the courts, the appeals process offers an important opportunity to resolve issues outside of a courtroom. Consequently, it is an important goal of the appeals process to settle cases. If the normal appeals process is initially unsuccessful, the IRS appeals office endorses alternative dispute resolution mechanisms such as mediation and arbitration. Although postappeals mediation is becoming more common, taxpayers should understand that postappeals arbitration cases are extremely rare.

If, ultimately, a taxpayer must resort to litigation to resolve U.S. federal income tax issues, it should give careful consideration to its choice of forum for litigation. At the trial level, the taxpayer can choose among the U.S. Tax Court, the Court of Federal Claims or Federal District Court. Although the considerations associated with such decisions are beyond the scope of this article, one important factor to address well in advance of the litigation is that in order to proceed in the Court of Federal Claims or Federal District Court, the taxpayer must pay the tax and interest and claim a refund. Particularly in trying financial times like the present, the practical consideration of not having the required cash available could force the taxpayer to litigate its issues in the Tax Court.

Tax Transparency in a Hostile World

Tax stories are on the front page of the news seemingly every day now, as journalists seek to publicize the next example of supposed corporate wrongdoing.¹⁶ The scrutiny is particularly intense on recipients of Troubled Asset Relief Program (TARP) funds, who many claim accepted both a moral and financial liability in receiving the funds. However, managers of any corporate entity have a responsibility to control all costs, including taxes, in order to compete effectively in a global arena. The reality is many multinational companies are organized in countries with more favorable tax environments, giving them an enormous advantage over those located in the United States. Yet, few in Washington, D.C., care to acknowledge that there is only one major industrialized nation with a corporate tax rate higher than that of the United States.

Unfortunately, there is no bright-line test as to when tax planning becomes too aggressive and turns abusive. Nor is there any surefire way to defend legitimate tax planning from an aggressive IRS assault. Nevertheless, with anticipation and proper preparation, the IRS audit can go much more smoothly, resolving matters at lower cost and without publicity, thereby preserving a company's bottom line and good reputation.

Endnotes

- ¹ Third-party estimates of the tax gap reported in Nicole Duarte, *IRS Lacks Estimate for International Tax Gap, TIGTA Says*, TAX NOTES 847 (Feb. 16, 2009).
- ² The Fraud Enforcement and Recovery Act of 2009, S. 386 (2009).
- ³ Michael Joe, *Shulman Promises "Aggressive Agenda" in Curbing International Tax Abuse*, 2009 TNT 36-1.
- ⁴ Internal Revenue Bulletin 2007-17 (Apr. 23, 2007); Senate Committee on Homeland Security and Government Affairs' Permanent Subcommittee on Investigations, written testimony of IRS Commissioner Mark Everson (Aug. 1, 2006).
- ⁵ Generic Legal Advice Memorandum 2006-001 (Sept. 26, 2006).
- ⁶ See IRS Notices 2006-85 and 2007-48.
- ⁷ T.D. 9441, 74 *Federal Register* 340 (2009).

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⁸ LMSB, Tier I Quick Reference Guide: Section 936 Exit Strategies (Transfer Pricing) (Dec. 2008). The 2006 sunset of the Section 936 Puerto Rico tax credit has especially encouraged such action in the pharmaceutical industry.

⁹ Lee Sheppard, *IRS Promises Better Transfer Pricing Enforcement*, 2008 TNT 210-1.

¹⁰ GAO-09-157 (Dec. 18, 2008).

¹¹ S. 506 (2009).

¹² Internal Revenue Manual 4.51.1.3.

¹³ *Xilinx Inc. & Subsidiaries*, Docket No. 06-74246, appealing 125 TC 37 (2005).

¹⁴ *See, e.g.*, Code Sec. 6662(e).

¹⁵ Mandatory arbitration provisions have been added to the U.S.-Belgium, U.S.-Canada and U.S.-Germany tax treaties.

¹⁶ *See, e.g.*, Jesse Drucker and Carrick Mollenkamp, *AIG's Bonus Unit Now in IRS's Sights*, WALL ST. J., Mar. 24, 2009.

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