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Prepared Remarks of
Michael Danilack
Deputy Commissioner (International) LB&I

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Thank you for the kind introduction. It's great to be here this afternoon.

Exactly a year ago, I stood here and said that I welcomed the opportunity to kick off an open and productive period on matters pertaining to international tax administration. But last year at this time, I'd only recently returned to government service, so when it came to providing specifics about what our international strategic priorities would be during the period we were kicking off, I necessarily had to resort to generalities. I said both the IRS and taxpayers should be able to focus resources on issues that pose the greatest compliance risk, and I mentioned a couple of basic ways that could be done. I also said we must make sure we're spending resources working together, as cooperatively as possible, to address issues that present compliance risks. I said I believed transfer pricing and withholding on U.S. FDAP require focus in that regard, and I shared some early thoughts on how I thought we'd achieve focus in those areas. Today, a year later, I'm happy to say I have more specifics to share with you.

Over the course of the past year, we've seen some very significant and sweeping changes in LB&I as a whole. Fundamentally, these changes are all designed to enhance our examination function's ability to (1) identify the highest compliance risks among our taxpayer base, (2) work cases more effectively and efficiently, and (3) find more appropriate ways to resolve cases as soon as possible. As an organization, LB&I has been working hard to find new ways to utilize its technical expertise, reform its examination process, and utilize a variety of new approaches to issue resolution.

These overarching changes in LB&I as a whole have created an environment in which we can maneuver well to reach our strategic goals in the international area, and these goals are what I'd like to outline for you today. I'd first like to touch on internal, U.S.-centric developments and then I'll spend the remainder of my time on more global concerns.

As many of you know, last summer we announced the realignment of our functions in LMSB to form a more robust international practice; and we renamed the organization the "Large Business & International" division to reflect a new focus on international issues and programs. Now that the realignment's been accomplished, we've moved on to the development of an integrated approach to organizing our international strategy, our international training, and the handling of our international data. Core to this integrated program is the development of a new international knowledge management network, which will allow all IRS employees engaged in international work to access the expertise, legal support, and tools they need to do their jobs. What all this

means at the bottom line is that, in the near future, taxpayers should find themselves dealing with IRS international personnel who are better trained, better supported, better informed on international developments, and better connected to one another.

With this in mind, I'd like to give you a quick update on our areas of strategic focus. First, I'll touch quickly on Chapter 3 withholding on U.S. source income, an area where I believe our efforts need to be greatly coordinated and enhanced. This is a complex area, with relatively new rules and very high stakes. Since withholding became a "Tier I issue" in 2008, we've made strong efforts to improve awareness of withholding compliance issues, particularly as they pertain to non-financial multinationals. But we believe much more can, and should, be done. It's critical to reinforce what has been done so far, but we intend soon to extend our focus to include U.S. financial withholding agents and foreign financial intermediaries. We're working an action plan and I'll be speaking more about this area in the near future.

A second key area for us, of course, is transfer pricing. Our plans to develop a new Transfer Pricing Practice have been known for more than a year now; and, as you know, we took those plans into a pilot phase last spring by identifying a handful of transfer pricing cases that we're now working on a concentrated basis. This means that we've been bringing in some of our best experts from among our IEs, economists, APA staff, and Counsel attorneys, including Senior Trial Attorneys, to work certain cases rigorously and thoroughly. We've picked cases involving transactions we think are of strategic importance, so we can ensure these cases are developed correctly and with an eye toward resolving issues in a way that will have broad impact. The cases are being worked on a team basis and within the confines of the normal examination process, and it's been a most enlightening experience. I think it's fair to say that we've learned quite a bit about ourselves, in that we've uncovered weaknesses in both our organizational dynamics and our strategic approach to working difficult transfer pricing cases. This learning from the transfer pricing pilot is going to make standing up the Transfer Pricing Practice, which should take place in the very near future, much easier.

Leading our Transfer Pricing Practice will be our new Transfer Pricing Director. For the first time, we'll have an executive-level position focused entirely on our work in this area. The new Director will be at the epicenter of transfer pricing for the IRS as a whole, and thus will be able to coordinate our strategy, our training, and our interaction with taxpayers on key transfer pricing matters, whether those matters arise in the context of field examination, Competent Authority, or APA. We are also in the process of recruiting economic talent to enhance our transfer pricing program. Our intent is to bring in experienced economic experts to assist the Director in developing our strategy and training, and to interact with taxpayers on economic analysis, again, whether that analysis pertains to examination, Competent Authority, or APA. Top on my list of to-dos is to bring an IRS Chief Economist for that purpose, and I believe we'll be able to do that shortly after the Transfer Pricing Director comes on board.

Our strategy in the transfer pricing area will have to be a thoughtful one. This means that we must start by recognizing that the United States will soon have the highest statutory corporate tax rate of any developed nation in the world. We must also take into

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account that U.S. companies report their earnings on a consolidated, world-wide basis and, subject to treating certain earnings as permanently reinvested, book tax expense at the U.S. rate. These facts mean several things.

First, our high statutory rate means that we must be looking carefully at inbound investment, and examination resources must be steered in that direction. We should be carefully evaluating the transactions of foreign-controlled U.S. corporations and we should also be focusing on the U.S. activities of foreign corporations in branch form. In this area, we'll be looking for situations where goods or services transferred to or from the U.S. are purposefully mispriced, but we'll also be looking for situations in which the U.S. base is being eroded through aggressive financing structures, misallocations of deductions, or transactions that avoid U.S. tax when earnings are repatriated to the enterprise's home jurisdiction.

We also need to focus more closely on the outbound activities of U.S.-controlled entities where those activities are designed to maximize the rate effect of permanent reinvestment. We completely understand that many of these structures are business-driven and have legitimate commercial purposes, and we will not be quarreling with that. But we all know that the drive to lower the global effective tax rate can push companies to the very aggressive end of the spectrum in pricing transactions involving these structures and that pricing must be scrutinized closely. Further, where one of these deferral structures is in place, while recognizing the company's legal rights to lower its effective tax rate, we must also carefully scrutinize (1) the company's position on subpart F, (2) its attempts to access foreign tax credits associated with the structure, and (3) its attempts to repatriate cash from them without incurring residual U.S. tax.

As I already mentioned, now that the international realignment's been accomplished, we're engaged in the development of an integrated approach to organizing our international strategy and training, on both the inbound and outbound side, and we're designing a better way for our international employees to access expertise and support they need to do their jobs. The strategy I just briefly outlined in broad terms will form the basis for the development of these various initiatives. I should also add that, as always, we very much welcome your input as we work to reshape our priorities for policing tax compliance in the international area.

I want to move now to what I call the global scene, because this is an equally important area for strategic thinking and planning. As we all know, during the past decade, tax administrations around the world have given heightened attention to international tax compliance in response to the increase in cross-border business activity and investment; and more recently, widespread budget crises seem to have raised the stakes even higher. Here too we must be very thoughtful in developing a strategy to carry out our responsibilities.

The dedication of new examination resources to international issues around the world has led to a steep rise in the number of proposed tax adjustments on U.S.-controlled multinational enterprises. Where such adjustments are made in a country with

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which the U.S. doesn't have a tax treaty, a foreign tax credit is the sole means for relieving double taxation, as you know. But, as I have said publicly before, the credit is conditioned on the payment not being a voluntary one, so we fully expect that taxpayers will exhaust their administrative remedies in the foreign country and challenge aggressive adjustments with comparable aggression. I've also suggested that, if a taxpayer isn't sure about whether or not we'll consider remedies to have been exhausted in particular circumstances, it should come to us and ask before making assumptions.

Now, where unprincipled or very large adjustments are made in a country with which the U.S. does have a treaty, the U.S. Competent Authority (USCA) is where taxpayers should go first. Yes, a foreign tax credit may also be available, but this should be viewed as a backstop, and exhaustion of remedies in this situation means that taxpayers must reach out to the USCA early in the process. It is the USCA's responsibility to work with its foreign counterpart to determine whether an adjustment is consistent with our treaty and the underlying principles, and the only way we can get involved is if the taxpayer brings us in. I have a number of points to make here.

First, as a threshold matter, an examiner in a country with which we have a treaty should not take steps to dissuade a taxpayer from seeking competent authority involvement. It is completely unacceptable for an examiner to threaten a higher adjustment, or some type of correlative action, if the taxpayer chooses to seek competent authority assistance. If this happens, we must know about it. Simply paying the tax in circumstances like this, without informing the USCA, seriously risks treatment of the tax payment as voluntary. No country's examination function, whether in the United States or abroad, should view competent authority as a process to be avoided by finding a way to coerce a taxpayer into accepting an adjustment. Again, the foreign tax credit should be viewed as a post-CA backstop in these situations, not as an elixir to make a harsh and unprincipled adjustment go down more easily.

Second, I'll note that there will be times when a taxpayer reaches out to USCA to inform us of a potential for double taxation and finds that we suggest further pursuing the issue locally, either administratively or perhaps through litigation, before we take up the issue in USCA. We'll do this when we believe the proposed adjustment is not justified, either in principle or in amount, and if, in our judgment, it's important for the taxpayer to utilize further the dispute resolution options it has in the local jurisdiction before presenting the case to the competent authorities. Establishing the right principles by which international tax matters can be resolved is always critical, and sometimes it will be better to attempt to establish those principles broadly, under local law, than it will be to rely solely on the competent authorities to do so.

Now, as some of you may have read recently, when I speak about the competent authority process, I like to emphasize the importance of the proposition, the principles, the posture, and the process involved in reaching bilateral mutual agreements. I won't again today go through a full explanation of what I mean by each of these "four Ps." Rather, I'll refer briefly to a few of them, for context, to make some additional points.

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First, in terms of principle, I'd like to turn back to transfer pricing for a few moments. With the increase in adjustments to transfer prices and expense allocations that we're seeing in countries with which we have treaties, it's important to pause and focus on the governing treaty provisions for a few moments.

As most of you probably know, the Associated Enterprises provision of our treaties, which is found in Article 9 of the OECD Model Tax Convention, can apply whenever an enterprise in one contracting state owns or controls an enterprise in the other contracting state. Under the Article, such common ownership or control is necessary before the two treaty partners are permitted under the treaty to make adjustments to reallocate profits between the associated enterprises in question. But I want to note that there's more to Article 9 than just that. A second prerequisite before reallocation is permitted seems to be often overlooked. Not only do two enterprises need to be under common ownership or control, there must also be present conditions made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises.

Now, this second prerequisite is often read to mean that the two enterprises may be able to avoid reallocation under the treaty by showing that they engaged in "hard bargaining" in setting their prices, and that should certainly be the case. But I suggest that it can, and should, be read more broadly than that. I suggest that it also be read to mean that, if the taxpayer has, in good faith, completed a sound analysis to establish an arm's length result under accepted transfer pricing principles and fully documented that effort in both countries, and if it's apparent from the situation, and from all the evidence, that the taxpayer has not misused transfer pricing to reduce its overall tax burden, then the treaty should limit the ability of either contracting state to make an adjustment.

I put forward this proposition because, as we all know, it's relatively easy to challenge any transfer price or expense allocation simply by invoking a different comparable set, applying a different methodology, or pointing to extraneous factual considerations. If reallocation were permissible in any case in which two enterprises are related or controlled, then virtually every cross-border reporting position would be subject to proposed reallocation and presentation to CA for resolution. In other words, just because a decent examiner or economist can dive into a case and come up with a different set of numbers in a country's favor shouldn't mean that the adjustment is permitted under the treaty and should be presented to the other country for correlative adjustment. To prevent this from happening, I think it's important for the adjusting country to show that, in fact, there <u>are</u> conditions made or imposed between the enterprises differing from those which would be made between independent enterprises and that those conditions involved mispricing to gain a tax advantage.

Further, I'll point out that, in the competent authority process, the adjusting country has the burden of proof in this regard. First, paragraph 2 of Article 9 makes clear that the specific conditions supporting the reallocation must distinguish the case from a situation in which those conditions don't exist. In addition, the OECD commentary on paragraph 2 of Article 9 makes clear that the country from which relief is requested is

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required to provide correlative relief only if it determines the adjustment is justified, both in terms of principle and in terms of the amount.

This important concept is elaborated on in the OECD Transfer Pricing Guidelines. The preamble to the Guidelines states that "tax administrations are encouraged to take into account the taxpayer's commercial judgement about the application of the arm's length principle in their examination practices and to undertake their analyses of transfer pricing from that perspective." Then, the first section of the guidelines themselves emphasizes the point by saying:

> When independent enterprises transact with each other, the conditions of their commercial and financial relations … ordinarily are determined by market forces. When associated enterprises transact with each other, their commercial and financial relations may not be directly affected by external market forces in the same way, although associated enterprises often seek to replicate the dynamics of market forces in their transactions with each other. Tax administrations should not automatically assume that associated enterprises have sought to manipulate their profits.

The guidelines go on to say:

> It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. … Enterprises respond to economic situations arising from market conditions in their relations with both third parties and associated enterprises. … Tax administrations should keep these considerations in mind to facilitate efficient allocation of their resources in selecting and conducting transfer pricing examinations.

So, to summarize, there's an important principle at work here that can't be overlooked. If the taxpayer has conducted a strong analysis to establish arm's length results under accepted principles and fully documented that effort in both countries, and if it's apparent from the situation that the taxpayer hasn't misused transfer pricing to reduce its overall tax burden, then the treaty should operate to limit the ability of either contracting state to make an adjustment. Personally, I believe this concept is critical to ensuring that both taxpayers and competent authorities are not overwhelmed with proposed adjustments triggered by nothing more than common ownership and some of the subtleties that can lead to pointy-headed debates when applying the arm's length standard.

The third P on my list of four stands for "posture." Adopting the right posture to reach resolution of cross-border tax matters demands that the parties involved maintain a number of important attributes, but first among them is trust; and trust, perhaps, begins with transparency in the tax world.

To be successful at the negotiating table, CA teams need to work to ensure complete bilateral factual transparency. There is nothing that will undercut a relationship more, no matter what the setting, than a failure to share factual information, or worse yet,

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an attempt to skew facts in one's favour. Trust is simply not possible unless facts are shared openly and honestly.

Nor can the taxpayer be left out of the trust equation. A very important aspect of finding the right posture at the competent authority table is about trusting the taxpayer. Personally, I believe that relatively few multinational enterprises are engaged in global tax evasion schemes and that most are looking to gain certainty and reduce compliance costs. There may not be universal agreement on that, but regardless of one's opinion on the subject, it goes without question that the competent authority process can be greatly hindered by unwarranted suspicion of the taxpayer, and can be greatly helped if competent authority teams dialogue with the taxpayer to understand fully its position.

Perhaps the most difficult dynamic to deal with in this regard is that the CA team, on the initiating side, is handling a case developed by its field examination function. Field examination teams are, and should be, the much-honored first line of defense against taxpayer non-compliance, but at times, exam teams can adopt myopic, suspicion-laden postures.

To address this, I believe countries need to work to ensure that examiners are aware of considerations arising from the bilateral, or multilateral, nature of adjustments. For example, exam teams need to understand the principles behind making transfer pricing adjustments I described a few minutes ago; and a critical aspect of adopting the right posture in the competent authority process is acknowledging when an examination team has proposed an adjustment that's inconsistent with principle or otherwise not well-reasoned.

In addition, the process on any case can be greatly enhanced if both sides recognize that the first goal should be to understand fully the taxpayer's position and the underlying facts. And taxpayers, of course, should do what they can to assist in that regard. First, a taxpayer should be transparent with its exam team, and indeed educate that team as to the bilateral nature of the transaction under review. Then, a taxpayer must be fully transparent with both CA teams to ensure the transaction is well understood.

The fourth and final P on my list is for "process." It goes without saying that tax administrations must constantly evaluate their processes to ensure they're well-suited to address the demands placed on government in the ever-changing world of taxation. Governments have not done poorly in this regard, and there are many exciting developments underway to improve government processes – for example, the growth in the use of APA processes and the recent birth of the new concept called joint audits.

Our Advance Pricing Agreement program is 20 years old this year, and we should all be proud of its success. Fundamental to the APA process is transparency, and, given that approximately 80 percent of our APA cases are now bilateral, we have strong evidence that kind of open process works very well in the global environment.

The joint audit process, which was recently developed at OECD's Forum on Tax Administration, is a new concept designed to take advantage of what you might call "three-party transparency." A joint audit will involve the taxpayer and at least two governments sitting down together in an audit context. To date, the United States has identified three cases, with two different countries, on which joint audits will begin, and

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we're in discussions with several other countries to identify other taxpayers for which the process would make sense. Again, the process is based on transparency. The taxpayer will be able to present its position and the underlying facts in a single proceeding with exam teams from both countries. A CA representative from each country will be present as well, and, if necessary, resolution will be captured in a Mutual Agreement. In one of the joint audit cases we're considering, it's contemplated that the completed audit and mutual agreement will further emerge – like a butterfly – in a bilateral APA on the issue. So, once we break down the stovepipes associated with traditional processes and replace suspicion with transparency and cooperation, brand new ways of reaching resolution and certainty are achievable. I believe this is what we should be striving for in the global tax arena.

Reconciling the laws and policies of sovereign governments can be a tricky business, and cross-border transactions in today's economy are, of course, evolving. So sorting out the economic source of an item of income in this environment is indeed a challenge. Transparency is critical, and so too is finding the right processes to put governments and the taxpayer in the best postures to resolve cases efficiently and effectively. To paraphrase what I said last year, I welcome the opportunity to engage with all of you, in an open and productive period, as we work together to address the important issues we all face in international tax administration.