

# ***IRS Hot Topics***

A Washington National Tax Services (WNTS)

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## *IRS increases focus on permanent establishment issues*

The IRS has historically considered the examination of permanent establishment (PE) issues as a low priority because PE issues are difficult to identify and difficult to develop. Over the last few years, however, they have had several projects to examine protective returns. We believe the results of those examinations have not been productive because the IRS agents were not properly trained to conduct a functional analysis and were not equipped to look at the proper records and ask the right questions. As a result of the poor results of these projects, it is our understanding that the International Division of the IRS is going to try a new approach which will include:

- Selecting and then examining a larger number of protective tax returns that indicate the foreign taxpayer has no U.S. permanent establishment,

- Training more international agents on what is a permanent establishment and how to identify foreign companies that are engaged in a U.S. trade or business with effectively connected income, and
- Assigning PE specialists to assist international examiners in developing PE issues.

### ***Background***

The increased emphasis by the IRS to conduct more PE examinations will create an environment where PE issue identification will become more prevalent. It is clear that many foreign companies are doing more business in the U.S., and many foreign governments are raising PE issues during their examinations of U.S. companies. This often leads to competent authority proceedings, which proceedings have contributed to the higher visibility of PE issues within the IRS. As a result of these trends,



many corporate taxpayers are increasingly vulnerable to IRS inquiries. These include:

***Protective filers of Form 1120F*** - the protective filing of Form 1120F provides the IRS with an indication of potential PE issues. However, failure to protectively file Form 1120F risks the loss of deductions and credits (including the ability to carryover losses from a loss year) if the IRS were to succeed in establishing a PE issue.

***Foreign corporations without any formal presence in the U.S.*** - Operating on a global scale in a 24/7 business environment and sending employees on business trips to the U.S. can expose foreign-based companies that may be unaware of a potential U.S. PE issue.

***Foreign corporations with an unexpected change in their business operations in the U.S.*** - Unexpected changes in business conditions, such as a hurricane in the Caribbean that causes a foreign business to temporarily relocate to the U.S., can create a new PE.

***Foreign companies operating offshore in the Gulf of Mexico*** - Foreign companies operating in the Gulf of Mexico on or around an oil rig may be unaware of the provisions of IRC Section 638, which identifies the outer continental shelf as U.S. territory.

## ***Asserting PE - What taxpayers can expect from the IRS***

A foreign corporation conducting business in the U.S. must determine if it is engaged in a trade or business in the U.S. or, in the event a treaty applies, whether the company has a PE in the U.S. If the company is unsure of its effectively connected income or whether it has any income attributable to a PE, it may file a protective return

pursuant to Treas. Reg. § 1.882-4(a)(3)(iv). By filing this return, the company will not lose the right to deduct expenses if the company is ultimately found to have a presence in the U.S. and to owe tax. Where a treaty applies, IRS international examiners are taught to consult the applicable treaty. After conducting a treaty review, the international examiner uses a series of procedures, including analysis of publically available data, Information Document Requests (IDRs), interviews and a functional analysis similar to a transfer pricing case.

One of the most important (and inadvertently damaging) IRS audit tools may be a review of the taxpayer's own website. For example, if a foreign-based corporation's website has a contact information list that includes U.S. locations, that list could be seen as prima facie evidence of a U.S. operation. If the website suggests that company performs services in the U.S., the taxpayer will have a hard time overcoming the assertion that there is a PE.

During a PE examination, the IRS will issue a series of IDRs that may include a request for an organizational chart of the entire group, so the examiner can determine operational control and business locations. The IDRs may also include requests for a listing of all related partnerships and joint ventures and a request for a description of how the operations in the U.S. are run. The IRS examiner will also ask to interview key employees of the company. In these interviews the IRS is looking to draw a connection between the type and importance of any activities performed in the U.S., and they will use the information they gather in these interviews to develop their PE conclusions.

## *PwC observation*

We believe that the IRS will be conducting more permanent establishment examinations over the next few years. Taxpayers should be aware of their exposure and conduct ongoing monitoring and regular risk assessments as necessary.

Taxpayers that have been notified of an audit and have concern about PE scrutiny should work through the relevant factors and should perform a functional analysis to ascertain the technical strengths and weaknesses of their positions.

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