

WNTS *Insight*

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IRS focuses on permanent establishment issues; creates combined APA-MAP office

The creation last year of the IRS Large Business and International Division (LB&I) was prompted in great part by the desire of the IRS to improve its administration of international tax issues.

Since then, the division has undertaken important initiatives of tremendous importance to large multinational corporations (MNCs). One initiative involves the IRS administration of permanent establishment (PE) issues; another addresses the IRS Advance Pricing Agreement (APA) Program and the Mutual Agreement Procedure (MAP) for transfer pricing issues.

(For prior discussion of the creation of LB&I, see WNTS Insight, "[IRS realigns LMSB division to increase focus on international tax compliance](#)," August 4, 2010.)

Increased focus on PE issues

The IRS historically has considered examination of PE issues as a relatively low priority because PE issues can be difficult to identify and difficult to develop. Over the last few years, however, the IRS has initiated several projects to examine certain MNC returns. Some observers believe those examinations have not been as productive as possible because the IRS agents did not have sufficient background to conduct a functional analysis and were not prepared to look at the proper records and ask the right questions.

LB&I now has instituted a new approach that will include:

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

- Training more international agents on what is a PE 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 IRS decision to conduct more PE examinations will create an environment in which PE issue identification will become more prevalent. Many foreign companies are doing more business in the United States, and many foreign governments are raising PE issues during their examinations of U.S. companies. This often leads to Competent Authority proceedings, which have contributed to the higher visibility of PE issues within the IRS.

As a result of these trends, many corporate taxpayers have become subject to additional IRS inquiries. These businesses include:

Protective filers of Form 1120F. A protective filing of Form 1120F can provide the IRS with an indication of potential PE issues. At the same time, taxpayers that fail to file protective Forms 1120F risk the loss of deductions and credits (including the ability to carry over losses from a loss year) if the IRS were to succeed in establishing a PE issue.

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

Foreign corporations with an unexpected change in their U.S. business operations. Unexpected changes in business conditions, such as a hurricane in the Caribbean that causes a foreign business temporarily to 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 Code 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 United States must determine if it is engaged in a trade or business in the United States or, in the event a treaty applies, whether the company has a PE in the United States. 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 Reg. sec. 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 United States and to owe tax.

IRS international examiners are taught that when a treaty applies, they are to consult the applicable treaty. After conducting a treaty review, the international examiner uses a series of procedures, including analysis of publicly available data, Information Document Requests (IDRs), interviews, and a functional analysis similar to a transfer pricing case.

In some cases, IRS review of the taxpayer's website may prove to be an important audit resource. For example, if a foreign-based corporation's website has a contact information list that includes U.S. locations, that list might be seen as *prima facie* evidence of a U.S. operation. If the website suggests that company performs services in the United States, the taxpayer might face difficulties overcoming an IRS assertion that a PE exists.

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 also may include requests for a listing of all related partnerships and joint ventures and a request for a description of how the operations in the United States are conducted. The IRS examiner also likely will ask to interview key employees of the company. In conducting these interviews, the IRS is looking to draw a connection between the type and importance of any activities performed in the United States. It will use the information gathered in these interviews to develop its PE conclusions.

Actionable insights

The IRS is expected to conduct more PE examinations over the next few years. Taxpayers should be aware of their potential 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.

New combined APA-MAP office created

The IRS recently announced that the Advance Pricing Agreement (APA) Program and the Tax Treaty Office staff who handle Mutual Agreement Procedure (MAP) transfer pricing cases will be combined into one office in LB&I's international operation. As a result, the APA Program will move from the IRS Office of Chief Counsel to LB&I. The new "Advance Pricing and Mutual Agreement Program" will be directed by one executive, and the office will be under the jurisdiction of the new IRS Transfer Pricing Director, Sam Maruca.

The APA Program -- which negotiates and executes APAs that allow taxpayers to resolve transfer pricing issues prospectively -- historically has worked in combination with the Tax Treaty Office to negotiate and execute bilateral APAs. In the context of bilateral APAs, the APA Office developed the support for the IRS's initial negotiating position, while the Tax Treaty Office primarily negotiated the final position with U.S. treaty partners.

The Tax Treaty Office recently has begun negotiating bilateral APAs from start to finish, to assist with the increasing backlog of APA requests in the APA Program. The realignment is designed to increase staffing available for the APA Program and create efficiencies in the APA process. The realignment also signifies the importance the IRS Commissioner has placed on international tax administration.

The IRS also announced that the Assistant Deputy Commissioner (International), a new position, will head the Competent Authority and international coordination functions to facilitate IRS coordination with U.S. treaty partners on non-transfer pricing matters. The official will be responsible for overseeing the IRS Exchange of Information program, IRS participation in JITSIC (the Joint International Tax Shelter Information Center, a forum for certain governments to share information

about cross-border "tax shelters" and other international tax administration issues), and the OECD, and pursuing Competent Authority agreements with U.S. treaty partners on non-transfer pricing issues. The new official also will be responsible for managing the activities of the IRS Tax Attachés and providing support for negotiating tax treaties and tax information exchange agreements.

Observations

Combining the APA Program and the MAP function into one office with increased staffing should allow the IRS to work through the large backlog of pending APA requests more efficiently. The process for negotiating and executing bilateral APAs should become more streamlined because the same personnel will be assigned to negotiate the terms of a bilateral APA with a taxpayer and with a U.S. treaty partner, by contrast to the prior procedure's required "hand-off" between the APA Office and the Tax Treaty Office.

In the longer term, this realignment should place the IRS in a stronger position to address the continuing surge in the number of APA requests filed and the increasing complexity of these requests. The change also may facilitate more consistency between the initial negotiating positions of the IRS and the final positions negotiated with U.S. treaty partners.

More details regarding the realignment are anticipated, including information on the internal organizational structure of the new "Advance Pricing and Mutual Agreement Program."

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