Leading practices for managing the competent authority process for US-based multinational enterprises

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Summary

Under pressure to close revenue gaps and to address perceived aggressive tax positions related to the pricing of cross-border transactions, both the US and foreign tax authorities are imposing very large tax adjustments upon multinational enterprises. When this situation arises, a company potentially could be required to pay tax twice on the same income for the same period—in the local country proposing the adjustment and in the other country where the counterparty to the transaction has already reported the income on its tax return and paid tax on that income. In these instances, it is important for companies to understand and to take advantage of the various forms of assistance available to them under the applicable tax treaties including seeking relief under the mutual agreement procedures (MAP) provided by the Office of the Competent Authority within the tax administration. Requesting MAP assistance in a timely manner and fully engaging in the process are critical success factors for managing the risk of double taxation by multinational enterprises.

The role of treaties

Income tax treaties, also known as income tax conventions, are comprehensive agreements between countries intended to establish a set of rules for the taxation of income as a result of taxpayers conducting cross-border transactions with a related party in another taxing jurisdiction. The great majority of income tax treaties are bilateral, although certain non-US jurisdictions have entered into multilateral agreements. Primarily, these tax treaties serve to facilitate international commerce and investment by mitigating the threat of double taxation and providing greater certainty to companies engaging in cross-border trade. Tax treaties are also seen by governments as a tool to combat fiscal evasion related to income tax and capital gains.

Some countries, including the United States, have also entered into Tax Information Exchange Agreements (TIEAs) with other countries. Narrower in scope than income tax conventions, TIEAs are only intended to promote information exchange and transparency by and between taxpayers and tax authorities primarily with respect to jurisdictions where an income tax treaty has not been entered into between the governments.

Broadly, income tax treaties set out the parameters by which residents—both individuals and corporations—of one country are taxed with respect to income derived from sources within the treaty partner jurisdiction. Generally, the provisions of income tax treaties are reciprocal, meaning that taxpayers resident in one country also receive the same or substantially similar benefits with respect to income from sources in the foreign jurisdiction if residency and other requirements specified in the treaty are met. All authority for conducting negotiations between governments in instances of double taxation flows from the treaty. As such, in the absence of a treaty the recourse available to a taxpayer confronted with the threat of double taxation is quite limited.

Currently the United States has over 60 bilateral treaties with countries around the world covering various aspects of taxation including income tax, withholding tax, value added tax, and other taxes. In addition, the United States has approximately a dozen TIEAs in place.

Model tax conventions

There are several models available for countries to consider when negotiating income tax treaties.

In the US, the US Model Income Tax Convention (US Model), last updated by the US Treasury Department on November 15, 2006, serves as the starting point for treaty negotiations between the United States and other jurisdictions. A key—and often controversial—feature of the US Model is the inclusion of the Limitation on Benefits (LOB) provision in Article 22. The LOB provision is intended to eliminate treaty shopping—an instance in which a company or individual not resident in a treaty country attempts to reposition itself so as to give the appearance of residence in a treaty country and thus access the benefits of the income tax treaty. The position of the US Treasury is that bilateral income tax treaties inure to the benefit of the US's trading partners who offer mutual reciprocal dispensations to US taxpayers. Consequently, treaty shopping would provide concessions to non-treaty countries that have made no corresponding allowances for US taxpayers and would serve as a disincentive for countries to negotiate treaties with the United States.

Most recently updated in 2008, the Organization for Economic Co-operation and Development (OECD) developed its original Model Tax Convention on Income and on Capital (OECD Model) in 1963. The OECD Model has been widely adopted by the OECD member states—as well as more developed non-member countries. Over time, a significant body of commentary has developed regarding the OECD Model that is intended to provide an official interpretation of the convention and confer insight and guidance to governments considering using it as a starting point in treaty negotiations. Generally, the OECD Model is regarded as more favorable to developed countries because its provisions tend to give preference to the taxpayer's country of residence as opposed to the foreign jurisdiction that is the source of the income when levying taxes.

Developing countries tend to prefer the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model), most recently updated in 2011. First issued in 1980, the UN Model explicitly states that an intention of the convention is to promote tax treaties that "contribute to the furtherance of the development aims of developing countries." The UN Model seeks to achieve this goal by addressing issues of specific interest to developing countries. For example, the UN Model provides for more lenient standards than the OECD Model or the US Model for a foreign taxpayer to have a permanent establishment (PE) in the host country. Presently, the majority of countries with which the United States does not have a treaty overwhelmingly favor the UN Model and are reluctant to enter into negotiations where the US Model is the starting point.

"Competent Authority" defined

Often erroneously seen by smaller taxpayers as only the domain of large enterprises, MAP is an important tool for taxpayers—both individuals and corporations—to manage situations in which the actions of one or both of the treaty participants result in taxation in contravention of treaty provisions. The term "Competent Authority" is used in income tax treaties to identify the designee or representative in each of the jurisdictions who will be responsible for implementing the treaty and its provisions. In the text of the treaty, the role of the Competent Authority is defined and generally includes serving as the primary point of contact for both for taxpayers and the other Competent Authority in MAP. Depending on the treaty, there may be a single Competent Authority or different individuals designated as the Competent Authority for different activities.

The US Competent Authority responsible for administering the operating provisions of income tax treaties is the Deputy Commissioner (International), Large Business & International (LB&I) Division of the US Internal Revenue Service. Currently, that position is held by Michael Danilack. The US Competent Authority derives his authority through delegation from the US Treasury Secretary.

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The MAP process

In the United States, a request for MAP assistance can be filed once a taxpayer identifies a situation in which a tax is or may be levied by a foreign tax authority in contravention of an existing tax treaty.

In instances in which the IRS is initiating the adjustment, MAP relief may be requested following receipt of written notice of the proposed adjustment (e.g., Form 5701) by the taxpayer. Generally, the US Competent Authority will deny requests for assistance as premature when the taxpayer has not been informed in writing of a proposed adjustment.

The specific procedures for seeking relief from the US Competent Authority are set forth in Rev. Proc. 2006-54, 2006-2 C.B. 1035. In light of the recent IRS restructuring, which moved the Advance Pricing Agreement (APA) function out of the Office of Chief Counsel and combined it with the MAP teams under the LB&I Division, IRS officials have remarked publicly that a new revenue procedure reflecting the IRS realignment is forthcoming. Although changes to the existing procedure are expected, the overarching leading practices for taxpayers to manage the MAP process likely will remain consistent with current procedures.

Rev. Proc 2006-54 sets out the form of the request as a letter addressed to the US Competent Authority. The letter must contain specific information including the relevant facts and circumstances leading up to the instance of double taxation, the relevant treaty provisions, descriptions and details of the transactions and entities involved, as well as certain other factual, financial, and administrative documentation and statements. It must also include as attachments any powers of attorney for the taxpayer's appointed representatives, a penalty of perjury statement, and a statement authorizing the US Competent Authority to disclose the materials submitted to it by the taxpayer to the Competent Authority office of the relevant foreign jurisdiction.

If litigation in the United States has already commenced with respect to the issue for which relief is being sought, a copy of the request must also be filed with the Office of Associate Chief Counsel (International). However, taxpayers should note that there is no guarantee that a request will be accepted into the program in these instances. If the request relates to an adjustment initiated by the United States, the appropriate local IRS office must also be copied. In the latter case, generally, when a request for MAP is filed and accepted, the IRS will suspend further administrative action until the MAP process is concluded. Exceptions to this approach include matters already being litigated and those instances

where the US Competent Authority requests the assistance of the IRS Examination personnel.

Generally, at some point after a taxpayer's request for assistance is accepted, the US Competent Authority will convene a meeting with its foreign counterpart and attempt to resolve the dispute in a mutually beneficial manner. Prior to organizing a meeting, the US Competent Authority may issue due diligence questions, exchange position papers with the foreign Competent Authority, or take other administrative actions. Negotiations may also take place outside of a formal meeting. It is important to note that although the taxpayer may have meetings with both the US and foreign Competent Authority, taxpayers are not allowed to participate in the formal meetings between the US Competent Authority and the foreign Competent Authority. Thus, the onus is on the taxpayer to provide the Competent Authority that is seeking relief on its behalf with all relevant and necessary information and supporting documentation—both in the initial request and throughout the negotiations process when asked to do so—to provide the Competent Authority with the facts and analysis necessary to effectively negotiate a resolution on its behalf.

Although every US income tax treaty provides for MAP, the specific procedures in the foreign jurisdictions vary by country and may change with or without notice to taxpayers.

Depending upon the jurisdiction with which the US Competent Authority is negotiating, the time between acceptance of a request and final disposition may vary widely. Competent authorities of certain treaty countries with whom the US Competent Authority meets on a regular basis (which includes Canada, Mexico, and the United Kingdom) may, depending on the issue, be able to conclude the process more quickly than competent authorities of treaty countries with whom the U.S. Competent Authority does not frequently confer.

The United States has recently agreed in treaty protocols to consider mandatory binding arbitration if the two sides endeavor but are unable to reach an agreement. Arbitration is included in treaties with Germany, France, Canada, Belgium, and just recently, Japan. It is included in the treaty with Switzerland that is currently under consideration for ratification in the US Senate, and is likely to be included in other protocols and treaties presently under consideration.

Leading practices

As noted above, treaty partners have different procedures for addressing MAP requests some of which mirror the US process and some of which have their own local approach and nuances. Also, as a result of the IRS restructuring, there likely will be a new set of guidance in the near term that may change certain aspects of the US MAP process. However, as set forth below, there are overarching leading practices that will continue to allow taxpayers to best position themselves to successfully seek and conclude MAP requests regardless of procedural details.

Treaty awareness

MAP assistance is only available when there is a treaty between the taxpayer's host country and the country from which the foreign income is sourced. Taxpayers and their counsel are best advised to be diligent in investigating and understanding the requirements set forth in the existing and proposed income tax treaties in the jurisdictions in which they currently or plan to conduct business. Upfront knowledge of the remedies available to a taxpayer under the treaty—as well as the categories of taxation covered by the treaty—is important due diligence. For example, several treaties require a notification to the other treaty partner within a specified timeframe of the potential filing of a MAP request as a result of audit activity by the other treaty partner. Failure to make these filings could result in a denial of the MAP request.

Be transparent

Although some taxpayers recoil at the depth and breadth of information required at the start and throughout the MAP process, open, honest, and transparent communication and information exchange with the respective Competent Authorities are necessary to achieve the most successful outcome. The Competent Authority from whom assistance is requested cannot appropriately advocate for the taxpayer with imprecise or incomplete data.

Global perspective, local advice

Due to varying practices and procedures as well as the nuances and differences in business culture between the United States and its treaty partners, taxpayers are well advised to retain the services of advisors with knowledge, familiarity, and a physical presence in the jurisdictions involved. Capable local advisors should have experience with the unique deadlines and proceedings of court actions, bond applications, and other necessary events in the foreign jurisdiction. Identifying and appropriately employing skilled advisors is essential to achieving a successful outcome for the taxpayer.

Act promptly, understand the options

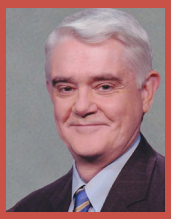
The earlier a taxpayer identifies an issue requiring a request for MAP relief and takes action, the greater the likelihood of success. Further, many US taxpayers are unaware of the various administrative options available to them, particularly in the case of double taxation arising from an action by the IRS. For example, alternative approaches include commencing a Simultaneous Appeals Procedure (SAP) together with a MAP request. Although not widely used, this approach provides for the assigned IRS Appeals officer to work in concert with the US Competent Authority to resolve the issue before the foreign tax authority is contacted. Taxpayers and their counsel should proactively educate themselves on the various administrative options available so as to select the alternative that best fits their facts and circumstances.

Overall, MAP is an important tool for taxpayers doing business internationally. A thorough understanding of the relevant tax treaties and the administrative procedures for each operating jurisdiction should be considered essential due diligence in managing cross-border transactions. By taking action promptly and fully engaging in the MAP process, taxpayers can achieve successful outcomes that ultimately mitigate enterprise risk.

Contacts

To have a deeper conversation about Competent Authority, please contact:

Richard Barrett
Principal
+1 (202) 414-1480
richard.f.barrett@us.pwc.com



Barry Shott
Managing Director
+1 (646) 471-1288
barry.shott@us.pwc.com

Elizabeth A. Sweigart
Director
+1 (713) 356-4344
elizabeth.a.sweigart@us.pwc.com

www.pwc.com

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