

FEATURED PERSPECTIVE

Shifting IRS Enforcement Strategies: U.S. Inbounds Take Note

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In this article, the authors discuss some important reasons why foreign-based multinationals doing business in the U.S. should be up to speed on the current U.S. approach to international tax enforcement.

The past few years have seen tax administrations in countries around the world taking a closer look at the tax positions of multinational enterprises. The United States is no exception to this trend. While many

prominent U.S. tax controversies have involved U.S.-based "outbound" multinationals, there are important reasons why foreign-based multinationals doing business in the U.S. (U.S. inbounds) also should be up to speed on the U.S. approach to international tax enforcement.

In recent years, the IRS has taken a strategic, issue-focused approach to international tax enforcement. This approach distinguishes between issues that relate to all types of taxpayers — business and individual, outbound and inbound — and those that relate to a specific type of taxpayer, such as U.S. inbounds. This article will address IRS international enforcement strategies and practices of particular interest to U.S. inbounds.

In the past, the IRS Large Business and International Division has focused much of its enforcement resources on U.S. outbound taxpayers, and recently it has acknowledged that its enforcement efforts may be out of balance in that regard. Also, as the G-20/OECD initiative to address base erosion and profit shifting advances, the IRS will be interested in any new principles favoring source country taxation, such as a lower permanent establishment threshold. That is, the IRS will not be able to afford further tolerating the situation in which other governments focus enforcement on U.S. inbound investment and stretch existing principles to extend their taxing rights over U.S.-based multinationals, while the IRS polices outbound transactions and gives a lighter touch to the inbound activities of foreign-based multinational enterprises. If the new international tax rules tend to favor source taxation, the United States will likely look at what it's doing in that area even more closely.

U.S. officials increasingly see actions by tax officials in other jurisdictions that seem driven by a view that the international tax rules are broken, leading them to conclude they must do anything they can to protect their jurisdiction's tax base, including taking extreme

positions on audit. The danger to the United States is that the country's revenue base will be put increasingly at risk by other countries' assertions of the right to tax that revenue. The IRS will need to work with outbound business taxpayers in the face of these challenges, moving more toward the perspective found in the competent authority setting of "What's the right answer globally?" Increased scrutiny of U.S. inbounds is likely to provide the IRS a counterbalance to what will be, in many instances, an otherwise defensive position within the mutual agreement procedure network.

Integrated International Program

The changes to LB&I's international program in recent years were designed to improve the efficiency and effectiveness of the organization by aligning operations around strategy. This includes making full use of the data available to the IRS, developing training that will enable agents to deliver on the strategy, and building a strong knowledge management organization to capture and leverage the collective expertise of the LB&I workforce.

Some recently formed groups within LB&I's international program are part of the backbone to implementing its international strategy. For example, the international data management group is intended to help LB&I harness the data that is increasingly available, such as through the Foreign Account Tax Compliance Act regime. The international practice networks (IPNs) form a critical linkage between the agents in the field nationwide and the strategy, including through the development of training and reference materials in the form of practice units. These groups will work with others in LB&I's international program and the broader field to ensure that IRS agents approach taxpayers' international issues armed with the substantial information available as well as the tools needed to examine those issues thoroughly and efficiently. The structure that allows LB&I personnel to strategically frame, identify, and target issues is the international matrix.

The International Matrix

With "faces" that acknowledge the differences between tax planning goals of inbound and outbound taxpayers and of corporations and individuals, the international matrix provides a framework for an agent to identify and examine high-risk issues of a given taxpayer. By building knowledge management, data capture, and data analysis around the matrix, LB&I will increasingly approach international issues with a strategic perspective. Basing its enforcement activities on taxpayers' planning will enable LB&I to address key areas of noncompliance, and the collection of data, including examination results, within the framework of the matrix will allow the organization to continually adapt and realign its focus as taxpayer behaviors shift over time.

The matrix has a foundation in issues common to all international taxpayers — treaties, information gather-

ing, foreign currency, and organization/restructuring. It also outlines the strategic priorities of specific taxpayer categories, designed to reflect a planning perspective and the life cycle of a given structure or tax strategy. Issues relevant to business inbound taxpayers are divided into four categories: jurisdiction to tax, income shifting, inbound financing, and repatriation/withholding. Specific tax issues, or strategic priorities, are identified within these categories, as shown in Table 1.

The matrix provides agents with the context for a given taxpayer's return and tax characteristics up front and lays out potential key areas of tax exposure. Armed with this information at the outset of an examination, agents should be able to quickly identify which issues on the matrix may be present for the taxpayer, and to issue targeted requests to narrow the list of possible issues to those presenting the greatest potential.

Knowledge Management, Practice Units

As part of its knowledge management focus, the IRS formed IPNs that are structured around the issues laid out in the international matrix. Each IPN is administered and led by a steering committee that includes LB&I technical specialists, area and National Office counsel, and other key players. An IPN itself includes any agent that chooses to participate by joining regular discussions of technical issues and best practices. Those events are a platform through which agents are able to share their experience and knowledge or seek out suggestions of best practices from colleagues nationwide. Through the IPN and knowledge management framework, an agent, having no prior experience with U.S. inbounds, would be able to connect with and learn from another agent, perhaps on the other side of the country, who has extensive experience in that space. The IPNs form the platform for this connectivity, which, if fully harnessed, has the potential to dramatically reduce the learning curve and information asymmetry that often leads to less thorough and less effective audits. Spearheaded by the IPNs, LB&I has created a series of practice units, which are slide decks designed to provide examiners with the practical tools they need to develop a given international issue. On December 15 the IRS publicly released 46 practice units, a sampling of the units developed. The practice units shown in Table 2 and released on December 15 cover topics related to U.S. inbounds.

While the first set of practice units released to the public is not a comprehensive listing of the units developed, the breadth of coverage of issues concerning U.S. inbounds demonstrates the substantial resources LB&I has devoted to educating its field personnel on the nuances of this taxpayer population. These units cover tax technical issues as well as issue-development and information-gathering techniques, increasing the likelihood of more rigorous inquiries and more aggressive use of specific provisions. For example, the unit covering issuance of a formal document request directs

Table 1. International Matrix for Business Inbounds

Jurisdiction to Tax	Income Shifting	Inbound Financing	Repatriation/Withholding
Strategic Priorities			
FCCs	Transfer Pricing for FCCs	Loans through low-tax affiliates	FDAP payments
U.S. Branches/PEs		Hybrid Instruments	Branch Profits Tax
Agency Branches/PEs	U.S. Branch/PE Allocations	Cashless Debt	Branch Level Interest Tax
Specialized Treatments	Gain Exportation/Loss Utilization	Foreign Parent Guarantees	FIRPTA
		Other Strategies	ECI through Partnerships
Treaties			
Foreign Currency			
Information Gathering			
Organizations/Restructuring			

readers to units that discuss section 6038A when documents are in the possession of a foreign shareholder.

The practice units represent a radical change in the way the IRS collects and disseminates information, and in how the IRS trains international examiners. Past IRS training was generally rule-based, built around particular code sections. The new system is designed for the realities of LB&I examinations, in which a given tax return will present a number of potential issues appropriate for examination. Each practice unit starts off by outlining a situation the agent may see on audit. The unit then maps out a path for the exam, answering questions such as what facts are relevant, what questions you should ask the taxpayer, what information is needed to evaluate this issue, and what other groups within LB&I should be consulted.

When the practice units outline the rules that come into play, they do so within the context of the fact pattern, for example, describing considerations when applying the comparable uncontrolled price method to the

purchase of tangible goods from a foreign parent. This enhances the efficiency of the audit process by avoiding the hunt-and-peck type of audit that is more likely when agents need to figure out when the rules they learned actually come into play. The practice units lend themselves to an audit in which the agents have the full strategic picture of the transaction and can ask the right questions early in the process. While the practice units are a broader resource, they also can be used for training, and the feedback from agents has been that the practice units are an excellent training tool.

The practice units will also serve an important role as LB&I's workforce continues to evolve. The IRS faces demographic and budgetary pressures, with retirements shrinking its workforce and little opportunity to make up for those losses through hiring. As these pressures continue to mount, LB&I will need to be able to deploy its personnel more flexibly, enabling them to successfully target the issues most important to the U.S. fisc. The practice units are an example of the type of practical materials that will be necessary to prepare

Table 2. Practice Units Released December 15, 2014

	Inbound Income Shifting	Inbound Financing	Repatriation/ Withholding
	Management Fees	Interest Expense Limitation Computation Under Section 163(j)	Branch Profits Tax
	Purchase of Tangible Goods From a Foreign Parent CUP Method		
	CPM Simple Distributor Inbound		
	Foreign Shareholder Activities and Duplicative Services		
	Best Method Determination for an Inbound Distributor		
	Services Cost Method (Inbound Services)		
	Arm's-Length Standard		
	Outbound Liquidation of U.S. Corp to Foreign Parent — Section 367(e)(2) Overview		
	License of Foreign-Owned Intangible Property to U.S. Entity		
	Comparability Analysis for Tangible Goods Transactions		
	Review of Transfer Pricing Documentation by Inbound Taxpayers		
	Section 861 — Home Office and Stewardship Expenses		
Treaties	Creation of a PE Through the Activities of Seconded Employees in the United States		
	Limitation on Benefits Issues: Publicly Traded Test		

LB&I's agents — whether an international examiner, revenue agent, or other role within the division — to successfully examine international issues or other issues that are strategically important to the IRS and its enforcement efforts.

LB&I's Use of Data

An additional development in LB&I's international organization was the creation of the international data management group and an increased focus on the generation and use of meaningful data concerning examinations. The focus on data began with issue identification, and specific projects were geared toward ensuring that tax returns with meaningful and productive issues, identified through data analysis, were properly examined.

Great effort was taken to ensure that the information related to the progress and outcome of examinations was aligned to the issues defined in the matrix. This was accomplished through a Uniform Issue Code list that aligns with the strategic priorities in the matrix and the regular compilation and reporting of data on the progress and outcomes of exams in the field. This back-end data is intended to identify which particular issues are viable and productive and ensure that LB&I continues to properly allocate its limited resources. The increased line of sight into the issues under examination nationwide and their potential also has implications for resource allocation midexam, including involvement of specialists such as the transfer pricing practice.

Conclusion

The IRS is facing a number of pressures both internal, primarily budget cuts and workforce planning issues — and external, such as aggressive foreign tax authorities. The changes to the IRS international enforcement program have been designed to allow the agency to be successful in this new environment.

Some of these changes will unquestionably affect U.S. inbound taxpayers. For example, an increase in the proportion of LB&I agents examining international issues, and in particular inbound issues, will mean that companies whose size or location might have kept them off the international audit radar screen could find themselves targets of more rigorous audits than they have come to expect.

Companies should be aware that as development and adoption of the practice units continues to expand and networking through the IPN becomes increasingly standard practice, their IRS examiners will likely be better prepared, more likely to start an audit with a targeted focus, and more aware of potential information sources and information-gathering tools. Preparing for and defending an IRS examination in the future will therefore require an equally strategic approach and one that may differ from strategies that have previously been effective. ◆