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The Shifting Paradigm in International Transfer Pricing Enforcement: Key IRS Implementation Challenges

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This commentary examines the emerging new paradigm in IRS transfer pricing enforcement. The paradigm is based primarily on principles underlying the APA Program, where I served as Director (and in other capacities) until February 2011. Conceptually, the new paradigm offers potential benefits to both taxpayers and tax authorities, but its ultimate success will depend on its effective implementation by the IRS and its broad acceptance by taxpayers. For that to happen, the IRS will need to overcome a number of key implementation challenges.

The Shifting Paradigm

Neither taxpayers nor tax authorities are happy with the status quo in international tax enforcement generally or transfer pricing specifically. Transfer pricing disputes, in particular, are too numerous, too costly, too contentious, too time-consuming, and too unpredictable. Over the near term, the situation is likely to get worse, as a result of globalization and the widespread fiscal crisis and as the IRS and foreign tax authorities gear up for more controversy.

In response to the growing pressure on global tax administration, taxpayers and tax authorities have been looking proactively for ways to improve the efficiency and effectiveness of transfer pricing enforcement. This search has led to the emergence of a new international enforcement paradigm that would move away from the traditional adversarial process to a more open, cooperative, and interactive system. This new system is supposed to benefit taxpayers and tax authorities alike by minimizing disputes and resolving them more quickly, thereby saving significant costs, increasing certainty, and providing other benefits to both sides. With the encouragement of the Organization for Economic Cooperation and Development (OECD), the IRS and a few foreign tax authorities — most notably, Australia, the Netherlands, and the United Kingdom — have begun implementing the new system by adopting a mix of enforcement strategies, processes, and tools, focusing on:

- Development of ''enhanced relationship'' arrangements intended to increase cooperation, communication, and interaction between taxpayers and tax authorities, thereby building trust;
- Earlier and increased disclosure by taxpayers to highlight potential problem areas;
- Increased upfront risk assessments of taxpayers by tax authorities to focus resources on the most aggressive taxpayers;
- Increased information sharing between tax authorities to improve cross-border transparency;
- New forms of cross-border collaboration, such as joint audits, to create a more seamless bilateral enforcement environment;
- Greater use of pre- and post-filing alternative dispute resolution processes, such as Advance Pricing Agreements (APAs), to provide greater certainty.

The IRS has fully embraced the new paradigm, adopting and updating a host of new and old initiatives within the past year, such as:

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- restructuring the Large Business and International (LB&I) division to centralize primary responsibility for the IRS international program;
- initiating a ''transfer pricing pilot'' involving personnel from the field, the U.S. Competent Authority, field counsel, the APA Program, and Associate Chief Counsel (International) (ACCI) to ''test drive'' the new paradigm in a small number of transfer pricing audits.
- creating the Transfer Pricing Practice (TPP) within the restructured LB&I to succeed the transfer pricing pilot and manage IRS-wide transfer pricing enforcement;
- expanding and making permanent the real-time audit process known as the Compliance Assurance Process (CAP) and adding a new ''CAP maintenance phase'' that rewards compliant CAP taxpayers with less audit scrutiny;
- establishing the Quality Examination Process (QEP) to allow taxpayers to engage systematically in the tax examination process from the earliest planning stages through resolution of all issues and completion of the case;
- releasing Schedule UTP, which requires corporate taxpayers to disclose uncertain U.S. tax positions;[1]
- introducing new efficiency measures within the APA Program to improve case processing times (e.g., pooling of APA and Tax Treaty office resources and eliminating the ''hand off'' of bilateral APAs between the two offices);
- incorporating arbitration provisions in a few recently updated U.S. income tax treaties (e.g., Canada, Germany, Belgium) to resolve prolonged Competent Authority disputes; and
- engaging in joint audits with foreign tax authorities (e.g., Australia and the United Kingdom).

Key IRS Implementation Challenges

The foregoing IRS initiatives represent a blend of ''carrots and sticks'' designed to drive taxpayers toward cooperation and away from confrontation. Although the language may suggest otherwise, the goal is not to create a ''kinder, gentler'' IRS, but rather it's to encourage taxpayers, through a complementary set of incentives and disincentives, to adopt lower-risk tax strategies because it's in their objective self-interest to do so.[2] For that to happen in large numbers, however, the IRS will need to demonstrate that it's capable of following through on its promises and carrying out its threats. Taxpayers are understandably wary about the IRS's ability to do either one.

What can the IRS do to overcome taxpayer skepticism?

First, it needs to develop a clear, objective reward system for the most compliant taxpayers. The new CAP maintenance phase, which contemplates a reduced level of audit review based on a taxpayer's experience in CAP and its history of tax compliance and risk, represents one such reward for lower-risk taxpayers. So too does the APA Program, which provides early resolution, certainty, and other important benefits to taxpayers that voluntarily enter a process that resolves transfer pricing issues on a more open, cooperative, and principled basis. Additional well-defined rewards for low-risk behavior are needed, along with rewards that potentially benefit larger pools of taxpayers.

Second, the IRS needs to demonstrate that it is capable of detecting and punishing high-risk behavior. That means identifying aggressive taxpayers, focusing adequate resources on those cases, developing a reasonable IRS position, and actually winning a case or two in litigation.[3] Each of these requirements poses a system-wide challenge for the IRS. Of particular importance, we will have to see whether the IRS can effectively absorb and handle the Schedule UTP disclosures, which begin this year.[4]

Third, the IRS field needs to embrace the new paradigm, which represents a sea-change in culture, practice, and expectations. In simple terms, IRS exam teams will be expected to function more like APA

[1] The Australian tax authority recently introduced an uncertain tax position schedule for larger companies (reportable tax position (RTP) schedule). Similar to what happened after the United States adopted the §6662(e) transfer pricing penalty and documentation rules in the early '90s, taxpayers should expect an increasing number of foreign countries to require the disclosure of uncertain foreign tax positions as a way of discouraging taxpayers from over-reporting income in the United States to avoid IRS scrutiny.

[2] To quote Dave Hartnett, Permanent Secretary for Tax, HMRC, speaking at the Institute of Chartered Accountants of England and Wales, Hardman Lecture, Nov. 12, 2009, ''it is about changing behavior by ensuring there are hard-edged benefits to business occupying the low-risk space.''

[3] It also means neutralizing over-aggressive foreign tax authorities by initiating audits of taxpayers from select countries to counterbalance the growing number of foreign-initiated transfer pricing adjustments, which now represent approximately 80% of IRS double-tax cases.

[4] IRS Deputy Commissioner for Services and Enforcement Steven Miller announced on June 7, 2011, at the OECD international tax conference in Washington, D.C., that the IRS will not ''initially'' send Schedule UTP forms to field agents conducting examinations. Instead, Schedules UTP will be reviewed by a centralized unit to identify significant issues, areas that may need to be addressed through regulations and legislation, and potential further cases. Miller said that the agency is ''treading carefully'' and expects ''lots of bumps'' as the process gets under way.

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teams (and Competent Authority analysts and IRS Appeals officers). By that, I mean that they'll be expected to work as part of a cross-functional team, share responsibility and decision-making, and, perhaps most far reaching, reach agreement in all but the most extreme cases. It will be an administrative challenge for the IRS to train and monitor the hundreds of IRS exam teams that will be executing the new system one case at a time. At the moment, taxpayers perceive a significant disconnect between the stated policies and the reality on the ground, a perception consistent with my impression from the transfer pricing pilot that audit teams will be slow to lower their guard.

Fourth, to minimize controversy, the IRS will need to take more reasonable substantive positions. No doubt, taxpayers will continue to fight the IRS position in cases involving cost-sharing buy-ins, §936 restructurings, the definition of ''intangibles,'' and high value-added services, where the IRS's legal positions have been widely challenged — successfully in some cases without much contrition from the IRS (see, e.g., the IRS action on decision (AOD) in *Veritas*). Of equal importance, taxpayers will continue to challenge IRS audit positions that are novel, aggressive, results-oriented, or otherwise poorly developed. In particular, the IRS economic analysis in audits will need to become more principled and sophisticated if transfer pricing disputes are to be minimized.

Fifth, to increase taxpayer certainty, the IRS will need to issue more public guidance (provided the substance of such guidance is reasonable (see above comment)).[5] The arm's-length standard is inherently imprecise and fact-dependent, but it is possible to provide more administrable rules (e.g., simpler transfer pricing methods [6] and safe harbors,[7] as the OECD is now exploring) and greater transparency of IRS practices and policies (e.g., more disclosure of APA Program experience) to reduce uncertainty for both taxpayers and the IRS. In my view, increasing taxpayer certainty is an essential element of the new paradigm and the *quid pro quo* for Schedule UTP.

Sixth, the IRS will need to balance the need for centralized review and coordination within LB&I with the need for independent decision-making at the exam level. Hopefully, LB&I has learned a few lessons from the issue management teams (IMTs) responsible for cost-sharing buy-ins and §936 restructurings. In both IMTs, centralized coordination, combined with a debatable IRS position, led to a one-size-fits-all approach that has, in turn, led to a growing backlog of cases, paralysis at the audit level, and an agitating shift in settlement responsibility to IRS Appeals. At a minimum, taxpayers will need to know who within the IRS has final decision-making authority in their individual cases and/or on particular issues, e.g., the audit team, the TPP, the U.S. Competent Authority, field counsel, ACCI, etc.[8]

Seventh, the IRS will need to work with foreign tax authorities to develop a more efficient and effective global resolution process. Reflecting that businesses now operate in a globalized economy, more than 50% of world trade involves related-party transactions. As a result of new business models, such transactions have also become more varied and complex and involve an increasing number of countries. Not surprisingly, these developments have put increasing pressure on global tax administration. As transfer pricing audits have increased, so too have the number and the value of cross-border controversies. The result is significantly increased Competent Authority caseloads[9] and an increased threat of unrelieved double taxation. Treaty arbitration will help resolve drawn-out bilateral disputes, but only if countries are willing to adopt *and* use it. Joint audits are also a potential step in the right direction, but they're untested as a process, have been blessed to date by only a handful of tax authorities, are incapable of resolving more than a small percent-

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[5] Query the fate of the long-delayed global dealing regulations, which after years of effort were all but final in January 2009.

[6] On June 10, 2011, the OECD released the results of a survey of transfer pricing simplification measures adopted by various OECD and non-OECD countries. Twenty-seven of the 33 responding countries reported that they have simplification measures in place, primarily aimed at small and medium-sized businesses, small transactions, and low value-added services. Only nine countries reported that they have simplified transfer pricing methods, such as safe harbor arm's-length ranges. The United States was one of the nine countries, citing the safe harbor interest rates for loans, the cost-only services cost method for services, and the simplified APA procedures for small business APAs. The OECD survey can be found at www.oecd.org/dataoecd/55/41/48131481.pdf.

[7] For an excellent article on possible safe harbor methods, see Lewis, ''Shortcuts for Small Fry: Why the IRS Should Reconsider Transfer Pricing Safe Harbors for Small Taxpayers, Transactions,'' 19 *BNA Tax Mgmt. Transfer Pricing Report* 5-3 (4/21/11). Safe harbors need not be limited to small taxpayers and small transactions, but could also be used for run-of-the-mill transactions (e.g., simple distribution, manufacturing, and services) regardless of taxpayer size or the amount at issue.

[8] IRS Deputy Commissioner (International) Mike Danilack said at a recent transfer pricing conference that ''[i]t shouldn't matter whether you're working in the field or with the Competent Authority, they should all be on the same page in terms of principles.'' BNA/Baker & McKenzie Transfer Pricing Conference, Washington, D.C. (6/9/11). Even so, taxpayers will want to know which part of the IRS will have the final say when an exam team, the TPP, ACCI, and/or the U.S. Competent Authority disagree, as commonly happens, on the application of those principles to the specific facts and circumstances of a case.

[9] According to OECD statistics, new Competent Authority cases among OECD members increased nearly 65% from 2006 to 2009.

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age of disputes, and will be even more complicated to administer in a multilateral setting. No doubt, more countries need to accept the new paradigm, and all countries need to consider adopting new and better cross-border resolution mechanisms, especially of a multilateral nature, to keep up with the changing landscape.[10]

Finally, effective implementation of the new system will require substantial additional resources — for personnel, for training, for travel, for information technology, etc. Given the obvious budget constraints and the competing demands within the IRS for resources (e.g., to implement FATCA and the health care reform legislation), it seems inconceivable that LB&I, ACCI, and field counsel will have sufficient resources in the near term to stand up the TPP; expand the Competent Authority office; engage in new, expensive joint audits; fund the required training; satisfy the ever-increasing demand for APAs; pursue high-stakes litigation; and provide needed public guidance on a timely basis. The shortfall will almost surely compromise the logic and rationale of the overall system, although, ironically, it may also force more discipline on the IRS to focus on the most aggressive taxpayers.

Although I support the general concept, it is easier for me to be more skeptical than hopeful about its implementation. Obviously, this is not the first effort by the IRS to reform its transfer pricing enforcement, yet the problems persist. Overcoming the foregoing challenges and persuading thousands of taxpayers, hundreds of IRS exam teams, and tens of foreign tax authorities to choose cooperation over controversy in meaningful numbers will require much more than good intentions and a short-term commitment. On the other hand, the status quo is not very appealing (except for tax controversy advisors!). So for what it's worth, my advice is as follows:

- For IRS exam teams, get with the program;
- For taxpayers, trust but verify;
- For foreign tax authorities, follow Mike Danilack's four ''Ps'':

  (1) accept the ''proposition'' that when the United States and a foreign country sign a tax treaty, they are agreeing to tax the profits of a multinational enterprise in a way that avoids double taxation;

  (2) apply the arm's-length standard in a ''principled'' manner by focusing on the appropriate economic return associated with the relevant transaction in each country;

  (3) adopt the appropriate negotiating ''posture,'' meaning be flexible, avoid competitive tendencies, ensure factual transparency, and limit skepticism about taxpayer positions; and

  (4) develop innovative ''processes'' to allow more effective and efficient resolution of cross-border disputes on both a bilateral and a multilateral basis.[11]

[10] See also fn. 3, above.

[11] See prepared remarks of Mike Danilack at a meeting of the U.S. Branch of the International Fiscal Association (IFA), delivered in Atlanta, Georgia, on Feb. 25, 2011.

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