CAPLIN & DRYSDALE

INDEPTH FEATURE Reprint October 2023

GLOBAL TAX

Financier Worldwide canvasses the opinions of leading professionals around the world on the latest trends in global tax.

UNITED STATES

Caplin & Drysdale

Respondent

J. CLARK ARMITAGE
Member
Caplin & Drysdale
+1 (202) 862 5078
carmitage@capdale.com

J. Clark Armitage is a member of Caplin & Drysdale. He served for eight years with the IRS APA Program and uses that experience to advise multinational corporations on transfer pricing matters. He also advises on other US international tax issues, including sourcing of income and expense, US trade or business issues, the US federal income tax implications of bona fide Puerto Rican residency and status under Puerto Rico Act 20, Act 22, Act 60 and Act 73, and issues arising under the Tax Cuts and Jobs Act of 2017, such as GILTI, FDII, BEAT and foreign tax credit basketing.

REPRINT

Caplin & Drysdale

Q. What do you consider to be among the key developments affecting corporate tax in the US over the last year or so?

A. The Supreme Court will likely overturn section 965, the 2017 statute that deemed US shareholders of controlled foreign corporations to have repatriated the earnings of up to the last 30 years, when it rules in *Moore v. United States*. The decision could have far-reaching implications if the court bases its decision on the conclusion that the Moores, who were minority shareholders in an Indian corporation, did not 'realise' the income. Other situations where income is not realised may include Subpart F, the global intangible low-taxed income (GILTI) regime, partnership taxation, S corporation taxation, the accumulated earnings tax, and others, many of which are central elements of the US income taxation statutory scheme. A decision should be out in the first half of 2024.

Q. To what extent have tax authorities in the US increased their monitoring and enforcement activities?

A. In legislation passed in 2021, the US dramatically increased the budget – by $80bn over 10 years – of its tax enforcement arm, the Internal Revenue Service (IRS). In April 2023, the IRS published a plan for spending the monies. The plan dedicates some $46bn to enforcement activities, an increase of 69 percent. The plan makes clear that the IRS will focus its enforcement effort on high-net-worth individuals. While the fruits of the IRS efforts have not yet been seen in a material way, it can be expected that the audit rate on high-net-worth individuals will increase materially in the immediate future.

Q. How are tax authorities approaching the issue of transfer pricing? In your experience, do companies tend to underestimate the risks and challenges in this area?

A. The IRS continues aggressive efforts to audit and enforce the transfer pricing (TP) rules. These efforts have led to numerous large adjustments and resulting court cases involving large US-based multinationals. Companies understand the risks of IRS TP enforcement and generally

Caplin & Drysdale

With its increased budget, we expect the IRS to expand the scope of its TP enforcement efforts to ensure high-net-worth individuals are properly pricing transactions among their closely held companies.

are well prepared to defend their positions. The preparation includes developing documentation to avoid penalties, filing for advance pricing agreements and ensuring global consistency of their TP approaches. With its increased budget, we expect the IRS to expand the scope of its TP enforcement efforts to ensure high-net-worth individuals are properly pricing transactions among their closely held companies. Our experience is that most closely held companies have a strategy for ensuring their TP is appropriate, but that they often have fewer resources to dedicate to documentation and other pre-audit compliance efforts. They likely are as or more vulnerable to a TP audit than large multinational companies. We will have to wait and see exactly how the IRS approaches this space.

Q. How would you describe tax laws in the US as they relate to foreign entities? Are there any unique regulatory aspects, whether positive or negative, that need to be considered?

A. The US taxes foreign persons, including non-resident alien individuals and foreign corporations, on their US source income

Caplin & Drysdale

and on income effectively connected with the conduct of a trade or business in the US. These rules are complex, not well-understood by foreign persons and contain numerous traps for the unwary. One confusing rule is section 864(c)(8), which taxes certain foreign persons on gains from the sale of interests in partnerships engaged in US trade or business activities. This treatment contrasts with the treatment of gain from the sale of interests in C corporations and S corporations, which generally escape US taxation. Also, foreign corporations with relatively little US activity may be treated as engaged in a US trade or business and required to file corporate income tax returns on forms 1120-F. Failure to do so may result in significant penalties, including denial of certain deductions, such as the corporation may be taxed on its gross income rather than its taxable income. Every situation is different. Foreign corporations and individuals with some income from US activities should consult a US tax adviser.

Q. Have you seen an increase in tax disputes in the US? What lessons can companies learn from recent settlements, prosecutions, penalties and court rulings?

A. The IRS focuses its enforcement efforts on 'campaign' issues. A complete list of current campaigns is provided on the IRS website. In our experience, the IRS directs substantial resources toward these campaigns. A campaign audit is characterised by a routinised fact development approach that is orchestrated by a campaign team. That team develops and uses a standard list of questions – provided to the taxpayer in an information document request (IDR) – which may or may not be apt for a particular taxpayer. The process can, therefore, be lengthy, cumbersome and expensive, even if the taxpayer has little or no exposure. Taxpayers can defend these audits by teaming with a tax adviser, which will allow them to sidestep, where appropriate and feasible, the standardised audit approach, for example by presenting a narrative defending the taxpayer's position on the issue. These efforts can be successful, which reflects a pragmatism at the IRS on its approach to campaign audits. It is often necessary to find the right audience within the IRS to address the particular taxpayer's situation most effectively.

Caplin & Drysdale

Q. What is your advice to a company that finds itself subject to a tax-related audit, investigation or enquiry?

A. When confronted with an IRS audit, the taxpayer should take stock of the situation. For example, if the audit is a 'campaign' audit, the taxpayer should assess its exposure on that issue. The taxpayer should also develop an audit defence plan. The plan should be specific to the issues identified by the IRS, assess risk on those issues, evaluate how full facts may be garnered to support the taxpayer's position and include a strategy for defending against an adjustment. While engaging with the IRS, the taxpayer should avoid steps that might complicate its defence efforts, such as disclosing documents that may cause a waiver of the attorney-client or work product privileges. The taxpayer also should be conscious of its defences, such as the pending expiration of the statute of limitations on IRS audit and assessment. The complexity and scope of these considerations generally obliges taxpayers to seek counsel to assist with or lead the audit defence. In our experience, the IRS generally does not pursue issues shown to lack merit.

Q. What steps can companies take to ensure they maintain robust tax compliance processes while maximising tax efficient structures?

A. Companies' tax compliance efforts must adapt to evolving IRS compliance requirements and enforcement approaches. At the same time, companies do not have unlimited budgets and must prioritise their efforts in any environment. One important area for businesses engaged in material cross-border, related-party transactions is TP compliance. Large multinationals generally maintain TP documentation that covers large-volume transactions and meets the requirements of IRS regulations. Smaller companies and closely held corporations must decide whether preparing TP documentation is the best use of more-limited resources. This evaluation requires identifying material cross-border transactions, considering whether the existing pricing approach is one that allows for a high degree of variability in pricing, meaning it could allow the company to shift income from one jurisdiction to another, and understanding whether that particular type of transaction is likely to be audited.

Caplin & Drysdale

In our experience, transactions involving intangibles are the most likely to be audited because each intangible may have unique and material profit potential. Companies without experienced TP personnel may wish to consult with an experienced TP professional – which may be a lawyer with TP experience or a TP economist – to conduct this evaluation. ❑

www.capdale.com

For more than half a century, **CAPLIN & DRYSDALE** has been a leading provider of a full range of tax, tax controversy and related legal services to companies, organisations and individuals throughout the US and around the world. With offices in New York City and Washington DC, the firm also offers counselling on matters relating to bankruptcy, complex litigation, corporate law, creditors' rights, employee benefits, exempt organisations, political activity, private client services and white-collar defence.

J. CLARK ARMITAGE Member
+1 (202) 862 5078
carmitage@capdale.com

CAPLIN & DRYSDALE