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Resolution of International Tax Disputes: US Experience

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Marc M. Levey
1114 Avenue of the Americas
New York, New York 10036
Marc.levey@bakermckenzie.com
Phone: 212 89103944

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Tax Controversy – Basics

- During Audit, IRS Issues NOPAs As Completed, Proposing Specific Adjustments.
- NOPA Contents –
 - Quantifies adjustment.
 - Facts & analysis underlying adjustment.
 - Supporting economist and expert reports.
- SEC Disclosure Implications

Tax Controversy – Basics

- 30-Day Letter & RAR.
 - Issued at end of audit.
 - Essentially a repackaging of NOPAs.
 - Ticket to IRS Appeals (conditioned on Form 872).
- Notice of Deficiency.
 - Issued at end of IRS administrative process.
 - Ticket to court.
 - Deficiency forum -- Tax Court.
 - No pay to play.
 - Refund forums -- Federal Claims/District Court.
 - Must pay to play.

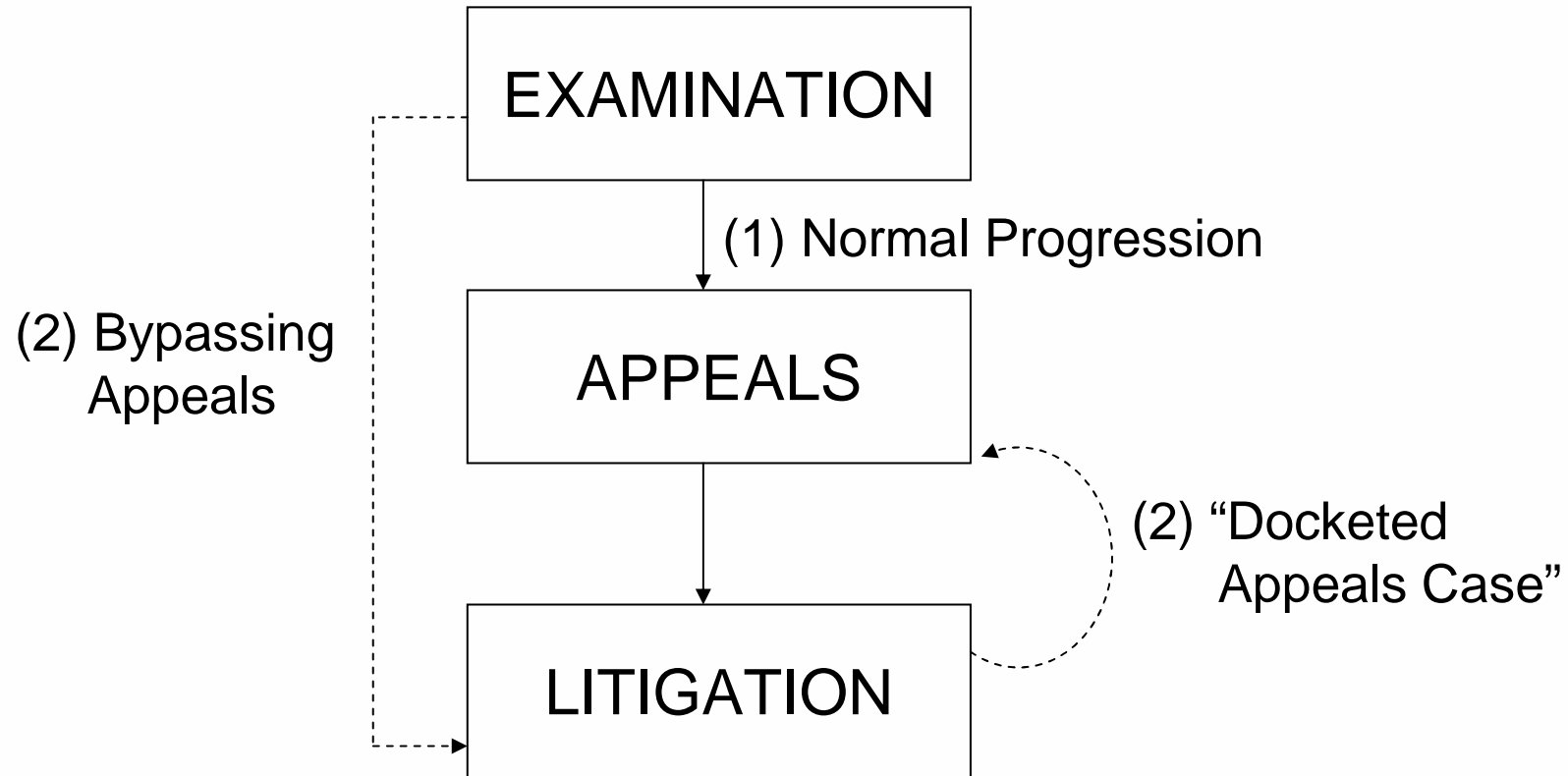
Taxpayer's Dispute Resolution Strategies

- Multiple Objectives –
 - Resolve controversy. What is “success?”
 - Defend return: Seek IRS concession or favorable opinion.
 - Settle between return and IRS positions.
 - Avoid penalties.
 - Manage financial statement implications.
 - Minimize potential double taxation.
 - Control costs of dispute.
- No Guaranteed Route to Success –

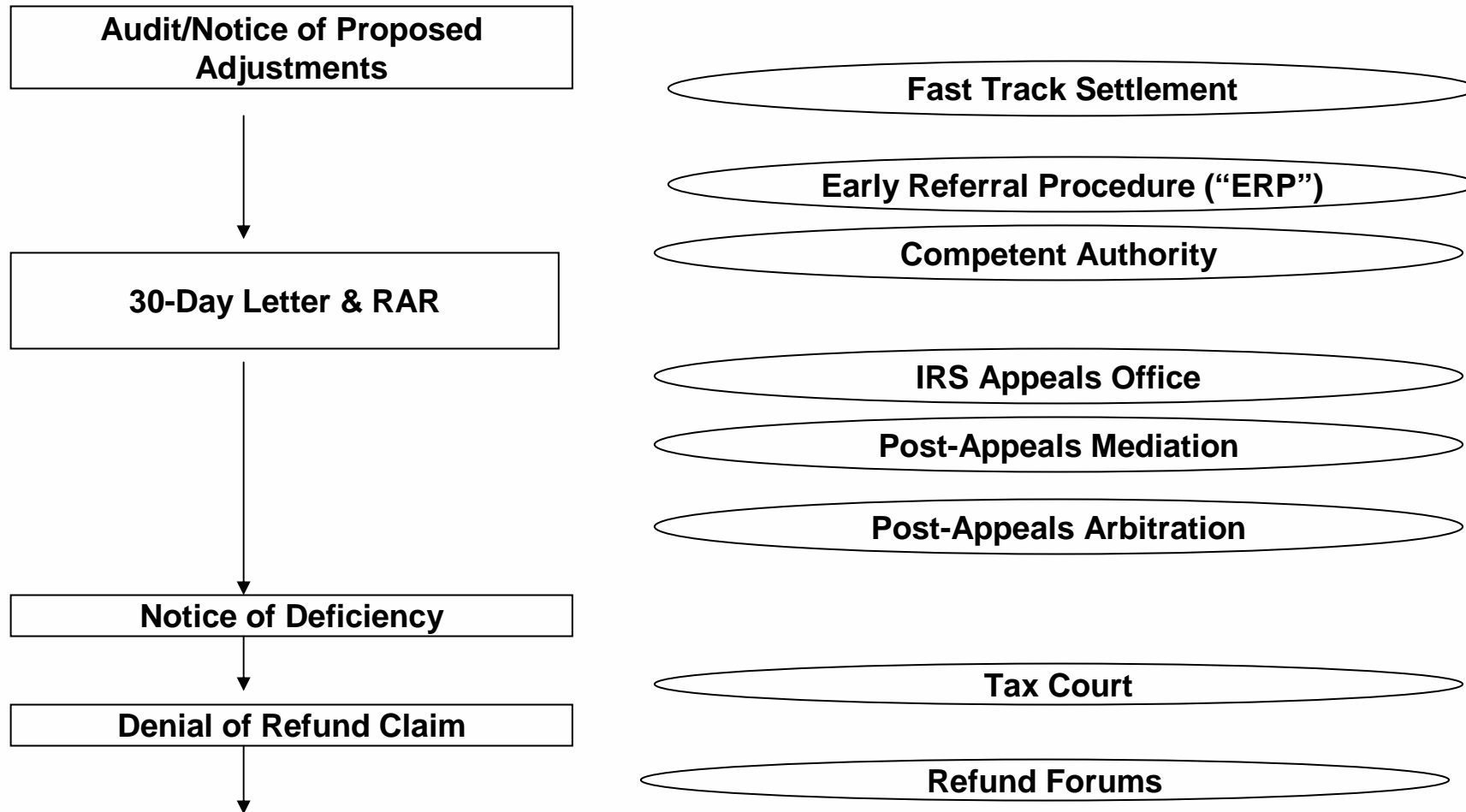
Choice of Forum Strategies

- Tax Controversy Is Not Linear in Movement:
 - Case can move forward, backward or sideways.
 - Large cast of potential decision makers.
- Major Strategic Decisions: Choosing or Moving Between Possible Forums in Order to Best Position Case for Favorable Resolution.

Traditional Dispute Resolution Forums



Alternative Forums for Tax Controversies



IRS Appeals -- “Let’s Make a Deal”

- IRS Appeals -- IRS Primary Settlement Forum.
 - Appeals’ mission – fair resolution based on litigation hazards.
 - Appeals Officer attempts to place value (e.g., 40%/60%) on IRS litigating hazards.
 - Appeals or Taxpayer should concede a factually or legally weak adjustment (i.e., the “20% Rule”).

Pre-Protest Planning

- Identification of All Unagreed Issues.
 - Query Inclusion of Affirmative Adjustments
- Develop Facts & Supporting Arguments.
- Assess Litigation Hazards Value of Each Protested Issue.
 - Query inclusion of “weak” issues.
- Other Strategic Considerations—
 - Impact of carryovers & correlative adjustments.
 - “Missed” theories or adjustments by IRS.

IRS Appeals – Normal Conference Process

- Examination “*Ex Parte*” Rules.
- Opening Conference.
- Specific Issues Conferences.

IRS Appeals – Examination “*Ex Parte*” Rules

- § 1001(a) of 1998 Tax Act Bars Appeals from *Ex Parte* Communications with Examination Team on the “Substance” of Issues, Unless Taxpayer Given Reasonable Opportunity to Participate.
 - Taxpayer never should decline opportunity to participate.
 - Rev. Proc. 2000-43 permits certain non-substantive *ex parte* communications with Exam, as well as all *ex parte* communications with Counsel (other than Exam’s attorney advisor).
- *Ex Parte* Rules Benefit Taxpayer.

IRS Appeals – Exam’s “*Ex Parte*” Meeting

- Exam Typically Invited to First Part of Opening Appeals Conference.
- Ground Rules –
 - Exam may make oral presentation.
 - Appeals may question Exam on specific adjustments.
 - Appeals may request supplemental information.
 - Taxpayer supposed to be “fly on the wall:” cross examination opportunity varies.
 - Taxpayer may glean Appeals’ hazards assessment.

IRS Appeals – Opening Conference

- Exam Dismissed After *Ex Parte* Conference.
- Opening Conference Generally Limited to Housekeeping Matters:
 - Overall timetable for Appeals Case.
 - Clarify Appeals Officers' issue responsibility.
 - Set order for discussion of issues.
 - Summary concession of weak issues.
 - Request for supplemental submissions.

IRS Appeals – Specific Issues Conferences

- Conference May Cover One or Multiple Issues.
 - Trend toward 2-day conferences and multiple issues.
- Conference on Issue's Merits.
 - Oral presentation by Taxpayer and Appeals.
 - Expect spirited and free flowing discussion.
 - Objective: realistic hazards assessment by Appeals and Taxpayer.
- Issues Settlement.
 - Issue-by-issue resolution.
 - Package resolution (“horse trading”).

IRS Appeals Concerns

- Appeals Officers' Quality, Negotiation Skills, Objectivity & Independence Vary.
- Influence of Appeals Economists.
- Threats to Independence:
 - Increasing number of “Emerging” and “Coordinated” Issues.
 - Joint Committee (“JCT”) review of >\$2M overpayments.

Emerging & Coordinated Issues

- Emerging Issue = Issue Being Studied by National Office for Formal Guidance.
 - Appeals settlement subject to oversight.
- Coordinated Issue = Issue Subject to LMSB or Appeals Coordination.
 - Appeals settlement subject to Appeals Coordinated Issue Coordinator's ("CIC") approval.

Tier I Issue – Issues of High Strategic Importance

- Nonqualified Deferred Executive Compensation § 409A
- Research & Experimentation (“R&E”) Credit Claims
- Transfer of Intangibles Offshore/Cost Sharing
- Tax Shelter – Distressed Asset/Debt
- Tax Shelter – Redemption Bogus Optional Basis
- Listed Abusive Tax Shelters and Transactions

Tier II Issues – Issues of Significant Compliance Risk

- Tier II issues are those involving areas of potential high non-compliance and/or significant compliance risk to LMSB or an Industry.
- Tier II includes emerging issues, where the law is fairly well established, but there is a need for further development, clarification, direction and guidance on LMSB's position.
- Tier II issues require coordination with the Issue Owner Executive. The Executive is responsible for ensuring the disposition or resolution of issues, so as not to hinder LMSB's broader direction and/or guidance.
- The LMSB Compliance Strategy Council will designate Tier II issues.

Tier II Issues – Issues of Significant Compliance Risk

- Casualty Loss: Single Identifiable Property/Capital vs. Repairs
- Enhanced Oil Recovery Credit IRC 43
- Extraterritorial Income Exclusion Effective Date and Transition Rules
- Gift Cards: Deferral of Income
- Healthcare Accounting Issues: Contractual Allowance
- Interchange and Merchant Discount Fees
- Non-Performing Loans

Tier II Issues – Issues of Significant Compliance Risk

- Specified Liability Losses, IRC 172(f)
- Super Completed Contract Method
- Upfront Fees, Milestone Payments & Royalties in the Biotech & Pharmaceutical Industries

Tier III Issues – Issues of Industry Importance

- Tier III issues typically are industry-related, and have been identified as issues that should be considered by LMSB teams while conducting their risk analyses.
- Teams selecting Tier III issues for examination should use available direction, guidance and/or Audit Technique Guidelines in the development and resolution of the issue to ensure consistence throughout LMSB.
- LMSB Industries, working in conjunction with other examiners, technical advisors and specialists, will identify Tier III issues.

Closing Appeals Case with Continuing Issue

- Appeals Settlement Only Binding for Years Under Appeals Jurisdiction.
- Query Impact of Unfavorable Settlement on Taxpayer Wanting Better Resolution in Subsequent Years?
 - IRS likely to assume Taxpayer will accept same resolution for subsequent years.
 - QUERY factual/legal rationale for better resolution?
 - Document Taxpayer's position that Appeals resolution not appropriate for later years.

Carrying Forward Favorable Appeals Settlement of Continuing Issue

- Examination Has Discretion to Adopt Appeals Settlement of Continuing Issue.
- Techniques for Binding Examination:
 - Closing Agreement negotiated with Appeals.
 - Advance Issue Resolution (“AIR”) with Exam.
- Alternative: Gauge Appeals Willingness to Settle Continuing Issue on Same Basis for Subsequent Years.
 - Address in Appeals Case Memorandum (“ACM”).
 - Use ERP to Push Subsequent Years Up to Appeals.

Post Appeals Mediation (PAM)

- PAM Represents **Third** Bite At Appeals Settlement.
- PAM Available at Taxpayer's Request if Settlement Negotiations Fail to Resolve Issue.
 - Current Appeals practice is to acquiesce to Taxpayer's PAM request.
- PAM Envisions Two Professionally Trained Mediators Overseeing Nonbinding Settlement Mediation Between Taxpayer and Appeals Officer.
- Mediation = Compromise.

Post Appeals Arbitration

- Arbitration ≠ Mediation.
- Available Only For Unagreed Factual Issues.
- Arbitration Conducted Before Mutually Agreed Appeals or Independent Arbitrator.
- Arbitration May Involve Evidentiary Hearing (and Presumably IRS Counsel).
- Arbitration Results in **Binding** Determination (discretionary or baseball style award).

Litigation

- Multi-Year Marathon
 - Pleadings.
 - Discovery.
 - Pretrial Motions.
 - Stipulations.
 - Trial.
 - Briefing.
- Substantial Majority of Docketed Cases Settle Before Trial
 - Sometimes litigation only means of forcing IRS to realistically assess hazards.

Other Dispute Resolution Procedures

- Fast Track Settlement (“FTS”).
- Early Referral Procedure (“ERP”).
- Competent Authority.

Fast-Track Settlement

- Fast Track Settlement (“FTS”) Tool for Resolving Cases on Audit.
 - If unsuccessful, Taxpayer can file Protest with Appeals.
- Background – Rev. Proc. 2003-40
 - Launched as a pilot program in 2001.
 - Made Permanent in April 2003.
- FTS = Mediation/Compromise.
- 80%-85% FTS Settlement Rate.
 - Approximates Appeals Settlement Rate.

Early Referral Procedure (ERP)

- Allows Taxpayer to Accelerate Appeals Consideration of Unagreed Adjustment During Audit.
 - Requires Exam's issuance of NOPA.
 - Requires Exam's and Appeals' concurrence.
- Normal Appeals Rules Apply.
 - No ex parte communications.
 - Written brief required.
- If Audit Concludes While ERP Issue Still Under Appeals Discussion, Case Converts to Normal Appeals Case.

U.S. Competent Authority (“USCA”) Double Tax Cases

- Treaty Procedure Allows Taxpayer, USCA and Foreign Competent Authority to Agree On Arm's Length Price For U.S. & Foreign Tax Purposes. See Rev. Proc. 2006-54.
 - Based upon Mutual Assistance Provisions (“MAP”) of US Treaties.
 - Only procedure offering double tax relief if related person subject to foreign tax.
- Foreign Related Person Must Be Resident Of Treaty Jurisdiction (60+ U.S. Treaties).

Competent Authority

- MAP is government-to-government (“G-to-G”) negotiation.
 - Taxpayer not directly involved.
 - Limited “transparency.”
- MAP merely obligates G-to-G good faith negotiation.
 - No agreement – 3% of cases.
 - Partial relief agreement – 10% of cases (*i.e.*, no correlative adjustment, but foreign tax credit allowed).
- Exchanges of Information.

Optimize Privilege and Work Product Protection

- Attorney-client privilege.
- Work product doctrine.
- Listed transactions.
- Textron – What it means and does not mean.
 - *See also Regions Financial Corp. & Subs. v. U.S.*
- Documents outside of the United States.

Office of Professional Responsibility

- IRS department that oversees the practice of tax professionals before the IRS.
- Recognized representatives, including attorneys, accountants, and enrolled agents, may practice before the IRS and must complete a power attorney to represent specific taxpayers.

Office of Professional Responsibility

- Practitioners must promptly submit information requested by the IRS unless the representative believes in good faith on reasonable grounds that the information is privileged or the request is of doubtful legality.
 - Tax advice is privileged.
 - IRS' position is that promotion of participation in a tax shelter is not protected confidential communications.
- Practitioners who engage in disreputable conduct are subject to disciplinary action.

Dealing with Summonses

- Section 7602 through 7604 permit the IRS to issue summons to taxpayers and third parties to appear before the IRS or produce records in order to determine the correctness of any return.
- If a person does not comply with a summons, the IRS may apply to the district court to compel compliance with the summons, if the summoned information is properly obtainable.

Dealing with Summonses

- Non-compliance with a valid summons can lead to fines or imprisonment.
- Compliance vs. non-compliance
 - Ambiguous or limited responses, or requests for clarity as compliance.
 - Valid objections such privilege or questionable legality.

Sanctions against preparers

- Section 6694 imposes a penalty for unreasonable positions taken on a return or item on the person who prepares the return for compensation in the amount of the greater of \$1,000 or 50% of the income the preparer derives from the return or claimed item.
- A tax return position not unreasonable if the position was disclosed on the return, there was a reasonable basis for the position, or if the return preparer acted with reasonable cause and in good faith.