Managing Global Tax Controversy: A Primer for the U.S. Multinational

By Nancy Chassman and Charles Nelson

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Some applaud it. Others decry it. Whichever the viewpoint, there is universal recognition among international tax practitioners that the global landscape has dramatically shifted in recent years to a world of broad tax information exchange between countries. For the U.S. multinational enterprise, that means significantly increased tax risk as tax authorities readily exchange information through formal and informal mechanisms that not long ago would have been seen as a violation of confidential taxpayer information. This article looks at these recent developments in international cooperation among tax administrators, including global dispute resolution tools, and provides some practical considerations for the U.S. multinational taxpayer.

The Global Landscape

One of the most noteworthy developments in tax transparency has been the country-by-country (CbC) reporting requirements adopted in the report on base erosion and profit shifting. Sponsored by the OECD and the G-20,1 the stated goal of the BEPS project was to reduce an MNE’s artificial shifting of profits to low-tax jurisdictions through tax planning strategies by offering a series of legislative proposals to be adopted by participating countries. The final BEPS report, issued in October 2015, identified 15 areas in which action is needed to address profit shifting.

Under Action 13 of the BEPS report, participating countries require large MNEs (defined as businesses with annual revenue of at least €750 million) to file an annual report with the tax authorities in the parent company’s jurisdiction.2 The OECD’s objective in creating the CbC reporting concept was to help ensure proper transfer pricing and to direct countries’ audit resources. The CbC report will provide a summary of the consolidated group’s business operations in each country. In the report, the MNE must list the tax jurisdiction of each of its constituent entities, and for each of these jurisdictions, the MNE must provide a breakdown of its revenue, profit before tax, taxes paid and accrued, stated capital, accumulated earnings, number of employees, tangible assets, and the types of business activities it engages in.3 The CbC reporting requirements are generally scheduled to be implemented for fiscal years beginning in 2016, with the first reports to be filed by the end of 2017.4 Treasury issued final regulations for the implementation of CbC reporting for U.S. parent companies on June 30, 2016. Reg. section 1.6038-4 largely follows the BEPS recommendations, and applies to U.S. MNEs with at least $850 million in annual revenue, effective for tax years beginning on or after June 30, 2016.5

Although CbC reporting is primarily intended to address transfer pricing issues, the information gathered from the reports is not limited to that purpose and can be used by tax authorities for other

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1The G-20 is a forum on economic cooperation composed of the leaders of 20 of the world’s largest economies.
3Id. at 33-35.
4Id. at 20-21.
5The information will be reported on Form 8975, “Country-by-Country Report.”
COMMENTARY / TAX PRACTICE

tax issues. From the taxpayer’s perspective, the CbC report has the potential to subject it to increased tax exposure if the information is misinterpreted by aggressive or misinformation tax authorities. CbC reports will be automatically shared by the tax authorities in the parent company’s jurisdiction with those of the company’s other jurisdictions. The OECD recently issued guidance to help multinationals implement CbC reporting. In addition, the OECD issued a multilateral competent authority agreement on the exchange of CbC reports, which has already been signed by 44 countries.

In addition to concerns about CbC reporting under BEPS, a growing number of formal and informal mechanisms allow tax authorities in different countries to exchange taxpayer information. Most obvious are the many bilateral tax treaties, which contain broad provisions for countries to share taxpayer information for any tax-related reason. For example, article 26 of the 2016 U.S. Model Income Tax Convention requires tax authorities to “exchange such information as is foreseeably relevant” to carry out the provisions of the treaty or of domestic tax law, “including information relating to the assessment or collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes.” Even when there is no tax treaty in place between two countries, bilateral tax information exchange agreements generally provide similar information sharing requirements. In recent years the implementation of TIEAs has increased in astounding numbers.

Beyond these bilateral exchange mechanisms, many countries are also parties to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which originally entered into force in 1995 and was modified in 2010. Article 5 of the multilateral convention permits each country to request information about a specific taxpayer or transaction from the tax authorities of another country. Under article 7, countries are generally permitted to share their own information about taxpayers with other countries that may be interested, even if those other countries themselves do not request the information. Articles 4 and 6 provide that two countries may agree to automatically share taxpayer information that is foreseeably relevant to the administration and enforcement of domestic tax law according to procedures established by mutual agreement. Thus, the multilateral convention authorizes an expansive regime of information sharing between countries. However, articles 8 and 9 go further, expanding information sharing by allowing joint audits. For example, when the tax authorities of two countries have a common interest in examining a single taxpayer, they are authorized to do so simultaneously, each within its own territory, and to coordinate and exchange the information each obtains. Tax authorities are also permitted to allow a foreign country’s representative to participate in a domestic audit. Although joint audits are rare and largely limited to transfer pricing cases, the mere fact that they are possible presents yet another challenge for MNEs and raises the stakes of the CbC taxpayer to be certain that its positions are consistent across jurisdictions.

The Joint International Tax Shelter Information and Collaboration Network (JITSIC), which was formed in 2004 by just a handful of countries, provides an additional means for countries to quickly exchange taxpayer information under existing treaties and TIEAs. There are 35 participating countries in JITSIC, with each participating jurisdiction having a single point of contact to coordinate information exchange. JITSIC also provides a mechanism for tax authorities to share their expertise, practices, and experience.

The OECD has also established the Global Forum on Transparency and Exchange of Information for Tax Purposes, which now has 133 member countries. The forum’s purpose is to implement international standards for the exchange of taxpayer information on request and the automatic exchange of taxpayer information under existing bilateral and multilateral information sharing agreements. The forum conducts peer reviews to ensure that member countries are properly implementing these standards.

In 2014 the OECD published a common reporting standard for countries to automatically exchange information about some financial accounts held by foreign owners. The approach is modeled after the implementation of the Foreign Account Tax Compliance Act in the United States. Along with the

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6Id. at 22.
8United States Model Income Tax Convention, at 64 (Feb. 17, 2016).
9EY, “Tax Administration Without Borders,” at 20 (Nov. 2, 2009) (stating that more than 100 new TIEAs have been signed since 2009).
11FATCA, sections 1471 through 1474, was enacted in 2010. FATCA imposes a withholding tax on some U.S.-source income.
common reporting standard, the OECD has published a model protocol authorizing countries to automatically and spontaneously exchange taxpayer information under a TIEA.12

Recent revelations of hidden offshore accounts in the Panama Papers,13 although not strictly relevant for MNEs, underscore the increased scrutiny tax authorities are now giving to international transactions. JITSIC responded to news of the Panama Papers by convening a special meeting of senior tax officials to discuss the possibility of additional information sharing and cooperation and to identify global tax compliance risks.

If the level of information exchange from these numerous arsenals of tax administrators had not already raised serious concerns for MNEs, on April 19 it was announced that the OECD, the IMF, the United Nations, and the World Bank formed a new group, the Platform for Collaboration on Tax, to further increase tax cooperation among international organizations and for countries to share information.14 One of the platform’s stated aims is to provide greater support to developing countries and to help them implement the provisions of the BEPS report. While the direction and breadth of activity to come from this alliance of powerful organizations is yet to be seen, the creation of this new collaboration makes it incumbent on the U.S. MNE to have a viable framework in place to understand and manage the company’s global tax risk and tax controversies.

It is clear that U.S. multinationals now exist in a world of expansive information reporting, sharing, and cooperation among countries and that they must have a framework to deal with the implications that arise from this global setting. MNEs should have the requisite internal coordination and connectivity to handle tax controversies across the globe. Because of the various mechanisms for governments to exchange information, MNEs should assume that any information they give to one tax authority — whether through mandatory reporting requirements like the CbC reports or through audits — will be shared with the tax authorities in other interested countries. Without effective global tax controversy management, MNEs may unknowingly take inconsistent tax positions and could inadvertently jeopardize their audit strategies, as well as their reputations with tax authorities. Also, government authorities could now conceivably have more information about a company’s operations than the employees or advisers who are handling the company’s audits in a given country.

Basic information available to tax authorities about an MNE’s revenue and assets in each country provided through CbC reports and other means could cause some tax authorities, particularly in developing countries, to target companies with large amounts of revenue, even if that general information does not present a complete picture of the company’s operations. In some countries, penalty structures may force companies to settle disputes quickly rather than to litigate matters further and risk increasing penalties. To help avoid those situations, MNEs should determine when those types of audits are most likely to occur and which issues are most likely to arise so that they may direct resources for audit readiness. If disputes involving positions in multiple countries arise, when appropriate MNEs should use the various dispute resolution tools.

Several recent high-profile examples illustrate the problems that can arise without effective global management of tax risks and controversies. In 2012, for example, Starbucks Corp. faced a public backlash in the United Kingdom when it came to light that the company paid no U.K. taxes because of various transfer pricing transactions. In what appeared to be an effort to alleviate the public relations crisis, the company voluntarily committed to pay at least £20 million in income taxes in 2013 and 2014.15 Amazon.com Inc. and Google also faced negative publicity in the United Kingdom after it was revealed that they had paid only small amounts of income tax on very large amounts of gross revenue.16 Those public relations problems might have been avoided if proper attention were paid to reputational risk on a global level.

Another troubling development is the increasing number of “dawn raids,” particularly in European countries. In a dawn raid, tax authorities conduct a

received by foreign financial institutions unless they disclose information about accounts held by U.S. citizens to the IRS. Under various intergovernmental agreements implementing FATCA, FFIs will report the required information to their respective governments, which will then provide the information to the IRS.12

The Panama Papers are a set of more than 11 million leaked documents that were held by Mossack Fonseca & Co., a Panamanian law firm. The documents detail hidden offshore accounts purportedly held by world leaders, celebrities, and others.13


surprise search of a taxpayer’s offices, usually early in the morning, and seize computers and documents in order to find information that may be relevant to tax disputes. In some countries, dawn raids are not limited to criminal tax evasion cases and can be used to gather evidence in civil tax controversies. As an example, in April 2016, Italian authorities conducted a raid of Procter & Gamble’s Rome offices, alleging the company avoided Italian taxes through a Swiss subsidiary.\(^{17}\) Through effective management of tax risk and controversies, a taxpayer can reduce the risk of these types of raids by avoiding taking inconsistent positions, improving its reputation with tax authorities, and taking into account tax authorities that are particularly aggressive.

Further, the recent referendum vote in the United Kingdom to leave the EU (the so-called “Brexit”) adds another complication in managing tax controversies. Although the long-term implications of the U.K. decision are yet to be seen, in the immediate aftermath, financial markets and the value of the British pound plummeted. This uncertainty and potential period of economic instability may have a knock-on effect of increased tax audit activity, since tax authorities have shown to be more aggressive during economic downturns.\(^{18}\) The U.S. multinational would be best prepared to defend any increase in tax controversies in Europe and elsewhere if it had systems and processes in place to proactively manage global tax disputes.

**Alternative Dispute Resolution**

For transfer pricing matters, there already exist several procedures for MNEs and tax authorities to settle disputes and coordinate adjustments across countries. For example, many bilateral income tax treaties provide procedures for a taxpayer to resolve tax disputes affecting both countries. Under article 25 of the U.S. model income tax convention, if actions by the tax authorities in one of the contracting states could result in double taxation, the taxpayer may invoke a mutual agreement procedure (MAP) and present its case to the competent authorities of each country, regardless of the remedies existing under domestic law or of the statute of limitations for tax refunds. If the taxpayer objects to an action of one country’s tax authorities, that objection appears to be justified, and the taxpayer has not been able to resolve the issue by itself, the competent authorities of the two countries must work together and attempt to resolve the issue in order to avoid double taxation. If the competent authorities are not able to resolve the issue on their own, the issue can be submitted for arbitration. If the taxpayer accepts the decision of the arbitration panel, it is binding on both countries. The MAP process is most applicable in transfer pricing cases, when double taxation could result if an adjustment to income in one country is not offset by a corresponding deduction in the other country. MAPs ensure that the taxpayer will not be whipsawed by inconsistent transfer pricing adjustments and will not have to face two different countries’ audits on the same issue.

Action 14 of the BEPS report further strengthens the MAP process by requiring countries to adopt minimum standards in MAP cases. For example, participating countries would be required to include MAP provisions in all future tax treaties and to provide access to MAP in all transfer pricing cases.\(^{19}\) Countries would commit to resolve MAP cases within an average time of 24 months\(^ {20}\) and would publish guidance and procedures explaining how taxpayers can access the MAP process.\(^ {21}\) Twenty developed countries have agreed to adopt a mechanism for binding arbitration in MAP cases.\(^ {22}\)

Although MAPs can prevent inconsistent treatment of transactions in only two countries, in the European Union the EU arbitration convention provides a mechanism to resolve tax issues that could affect a taxpayer’s positions in multiple member states. The convention provides that if a transfer pricing dispute in one EU country concerns other EU countries, the taxpayer can present the issue to the country’s competent authority and identify any other countries that may be implicated. The competent authorities of those interested countries must then attempt to resolve the issue by mutual agreement; if they cannot come to a resolution to avoid double taxation, the convention provides a mechanism for binding arbitration.

Before entering into a related-party transaction, the MNE may consider the option of an advance pricing agreement with one or more tax authorities. Under an APA, a taxpayer and one or more governments agree to a method under which future transactions will be valued. APAs are a useful tool for a taxpayer to obtain greater certainty and reduce the costs associated with future disputes. However, they have had mixed success in some circumstances

\(^{17}\)“P&G Under Investigation in Italian Tax Probe, Sources Say,” DTR No. 130, at I-1 (July 7, 2016).
\(^{18}\)See PwC, “Managing Tax Controversy Challenges on the Horizon,” at 5 (stating that tax authorities have become more aggressive as the need for tax revenue increases).

\(^{20}\)Id. at 15.
\(^{21}\)Id. at 18.
\(^{22}\)Id. at 41.
because of difficulties associated with the length of time to complete an APA and uneven levels of cooperation among countries. Moreover, new rules promulgated by the IRS in Rev. Proc. 2015-41 could present additional challenges for an MNE seeking to enter into an APA with the IRS. Under these rules, taxpayers submitting APA requests may be required to expand the scope of the request to cover transactions in previous years or to cover other related issues. The revenue procedure also increased user fees and expanded documentation requirements.

Global Tax Controversy Management

While those devices for dispute resolution are viable options to help resolve tax controversies in some instances, they do not resolve the fundamental concerns posed by the dramatic increase of tax information exchange and cooperation on a global scale. MNEs must develop their own platforms for internal information exchange and cooperation. The MNE can present its most formidable position in any tax dispute when it is audit-ready. To be blindsided in a tax audit by a tax authority having knowledge about the company’s tax positions in other jurisdictions that might be inconsistent or problematic for a position taken in that country’s audit is undesirable at best and could result in additional tax risks. Beyond the immediate tax adjustment and potential penalty exposure, there could be reputational or regulatory risks as well as an adverse financial accounting impact. With a viable structure in place to capture, record, and monitor global tax controversy activity, an MNE will be well placed to understand and mitigate these tax risks.

An effective framework for an MNE to manage tax controversies in every jurisdiction in which it operates requires a three-pronged strategy focused on people, process, and technology.

The MNE should first make a comprehensive assessment of its existing personnel managing tax controversies in every jurisdiction and the resources that are available to them. If the internal team in a given country is inadequate to address the likelihood and complexity of tax disputes there, the company should consider reallocating resources.

It is useful for companies to create an internal network to ensure that important information about tax controversies in one country is made available to personnel working on tax controversies in other countries where similar issues may arise. That may be achieved by appointing regional tax controversy managers to oversee tax controversies in their respective regions, who would then report regional developments to a centralized global tax controversy lead.

The MNE should further consider putting in place a set of procedures to streamline how tax disputes are handled. It is useful to have a policy document that details the MNE’s objectives, policies, and procedures in dealing with tax controversies, which would then be circulated to the entire tax department. Also, the MNE should establish communication protocols across the global tax controversy team.

As tax issues become increasingly consequential for U.S. multinational corporations, it is advisable for formalized global tax controversy management procedures to be established and integrated in the company’s corporate governance. Senior management should be kept informed of major issues and global trends in the company’s tax controversies so that they can make strategic decisions based on up-to-date, complete information. The MNE should also consider forming a committee to evaluate risk and ensure that the company does not take tax positions that are above the company’s level of risk tolerance. That would enable more consistency in positions taken in the planning stages of a transaction, further ensuring that there is consistency under audit.

MNEs need to know what information is being shared with tax authorities, where the same tax issues repeatedly arise, and which countries have particularly aggressive tax authorities. A shared database is useful in that regard. For example, employees handling tax controversies in a particular country could enter information about each audit into a database that would be accessible to employees handling tax controversies in other countries. The database should capture critical data on all tax controversies within the MNE and should be designed in an accessible manner. This information could then be reported to senior tax management to analyze and make informed decisions on the management of the most significant tax controversies.

Also, it can be helpful to create a technology tool to monitor the MNE’s significant tax controversy matters. That tool should identify key tax controversy risk items and establish criteria for evaluating the risk level of each item. That can help identify the company’s significant exposures and which tax controversies should be more closely monitored.

Those tools not only help an MNE avoid taking inconsistent positions, but they could also create a way for tax management to analyze trends, determine which countries are scrutinizing which types of issues, track the progress of major tax controversies, and assess how much money is at stake on a
global level. Technology can also assist companies in keeping track of what information has been provided to tax authorities in an audit and what information is likely to be shared with tax authorities in other countries. Being on top and in front of a company’s tax controversies will ensure that MNEs are well placed to navigate this rapidly changing environment.

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