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Tax Controversy

USA: Trends & Developments

Brian Kittle, Joel Williamson, Anthony Pastore and Samantha Bear
Mayer Brown

practiceguides.chambers.com

2021

Trends and Developments

Contributed by:

Brian Kittle, Joel Williamson, Anthony Pastore and Samantha Bear

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In 2021, the COVID-19 pandemic continues to change how US taxpayers, the Internal Revenue Service (IRS), and courts approach tax controversies. On the one hand, the pandemic – as well as years of budget cuts – have made tax enforcement more difficult. On the other hand, the IRS is trying to compensate by pursuing taxpayers more efficiently and by focusing on high-value cases, particularly those involving large corporate taxpayers that are thought to present a significant risk of non-compliance. As explained below, the IRS has developed an issue-focused approach to enforcement and has used technology and new techniques to audit taxpayers remotely during the pandemic. Buoyed by recent wins in court, the IRS is focusing more of its attention on international tax issues and, more specifically, transfer pricing. And the IRS has been co-ordinating more with foreign taxing authorities, potentially increasing global pressure on US companies.

LB&I “Campaigns” and the Issue-Focused Approach

Traditionally, the IRS initiated audits by selecting particular taxpayers for examination. But in an era of reduced resources, the IRS responded by pursuing a new strategy: the “campaign.” In a campaign, the IRS’s Large Business and International Division (LB&I) selects a tax issue for audit, rather than auditing every potential issue on a taxpayer’s return. In theory, campaigns are supposed to help LB&I more efficiently target enforcement where it matters most for compliance.

Since the campaigns began in early 2017, the IRS has maintained a website that describes

each active campaign in a short paragraph and, in some cases, provides a “treatment stream.” For example, the IRS recently kicked off a new campaign dedicated to the 2017 Tax Cuts and Jobs Act (TCJA), the goal of which “is to identify transactions, restructuring and technical issues and better understand taxpayer behavior under the new law.” According to the IRS, “[t]he treatment streams for this campaign may include examinations, soft letters, outreach, new and improved practice units and development of future issue-based campaigns.” Little additional detail has been provided.

In practice, it has been unclear what effect, if any, campaigns have been having on tax enforcement. In 2019, the IRS’s watchdog concluded that the “campaign program as a whole has not met initial expectations.” It also suggested that LB&I had not developed a well-reasoned process for selecting campaigns.

That said, the list of campaigns at least provides a glimpse into the IRS’s enforcement priorities. One of the biggest priorities is clearly the TCJA: beyond the campaign described above, the IRS has announced several others aimed at discrete issues arising out of the TCJA. Recently, we have seen a significant uptick in campaign-style enforcement of TCJA-related issues. And we have even seen the IRS use campaign audits to educate their own auditors about TCJA issues facing large corporate taxpayers.

The campaigns should be viewed as part of a wider effort by the IRS to more efficiently focus enforcement on specific issues. For example, since 2014, the IRS has maintained a central

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repository of training materials, called Practice Units, on hot-button issues of interest to the IRS. The IRS also recently created a new position – the National Strategic Litigation Counsel – aimed at co-ordinating the IRS’s efforts in pursuing tax cases to litigation.

Another extension of the issue-focused approach impacts IRS Appeals, the internal appellate function within the IRS. The IRS has long held out Appeals as independent from its examiners. But, recently, in an effort to increase its capabilities on specific issues, Appeals has begun inviting subject-matter experts to Appeals meetings. While this development might help Appeals officers understand the relevant issues better, it has also raised questions about Appeals’s independence and marks a shift in how taxpayers have to approach an Appeal in that they should expect to have to convince a panel personnel.

With a new administration that seems focused on increasing enforcement on corporate taxpayers, it is very possible that Congress will pump more resources into the IRS for enforcement, and the IRS in turn will expend more resources on existing campaigns and roll out new ones in a more organised way. Indeed, the new administration has pledged more money for the IRS, and high-level IRS personnel have already signalled that they intend to spend that money to increase enforcement. US taxpayers would therefore be well advised to stay abreast of the campaigns and watch out for campaign issues in their own audits.

Remote Audits and Court Proceedings

After a brief COVID-induced pause in the spring of 2020, the IRS resumed auditing taxpayers. Rather than a return to normal, though, the IRS has transitioned to performing audits remotely. Perhaps coincidentally – or perhaps due in part to cost and time savings – the transition

to remote audits has been accompanied by a marked increase in auditing activity.

Before the pandemic, the IRS typically audited large corporate taxpayers in person. It was common for large companies to set aside dedicated office space for IRS examiners in their corporate offices. IRS examiners might request in-person interviews (or even depositions) of key company employees to carry out the audit. And, for certain issues, IRS examiners would make in-person “site visits” to manufacturing plants or other important company locations (this is especially true in transfer pricing where the “value-add” of a manufacturing plant might be the crux of the issue in the case).

The transition to remote audits, necessitated by the coronavirus, has significantly impacted how the IRS and taxpayers approach audits. The biggest change of all may be interpersonal: it is far less common in the pandemic era for the taxpayer and the IRS agents to be in the same room together. Whether this phenomenon benefits taxpayers is an open question. Perhaps an impersonal audit experience – where technology keeps the parties at a distance – is preferable. Or, maybe the clearest communication occurs when everybody is in the same room, since large Zoom meetings often result in presentations, as opposed to an active exchange of positions and discussion of their respective merits. Most likely, it depends.

The logistics of a remote audit are also drastically different. Witness interviews are particularly challenging, because witnesses, taxpayers’ counsel and representatives, and IRS questioners are usually in different locations, sometimes in different countries. Additionally, draft information document requests (IDRs) that would typically require an in-person conversation before being finalised are now being discussed by phone. While this has had some positive effects,

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such as having more focused conversations, it has presented challenges too: it is more difficult to engage with the IRS about what information it is actually seeking, as the IRS has limited use of Zoom and other videoconferencing capabilities. Finally, a site visit might now be conducted remotely using a camera, with the IRS agents never setting foot in the company's plant or office.

The IRS has eased some of its rigid procedures to make remote auditing easier. Certain important forms (such as powers of attorney) can now be submitted online, and the IRS is accepting electronic signatures on forms that cannot be filed electronically. The IRS has also temporarily expanded permissible methods to receive and transmit documents, giving taxpayers the option to send documents to the IRS simply as email attachments.

Tax litigation has also gone virtual. Most tax disputes in the USA are litigated in the US Tax Court. In the past, a significant amount of discovery and the trials themselves were in person. After the pandemic began, though, the Tax Court announced that it would begin conducting trials and other proceedings by Zoom. It has viewed these virtual proceedings as a success, and it has signalled that it might seek to conduct trials virtually even after the pandemic ends, at least for disputes involving smaller-dollar issues. We have seen similar trends in other courts – such as federal district courts – where tax disputes are sometimes litigated.

Transfer Pricing Disputes

Whether true or not, the perception has been that the IRS has not fared well in major transfer pricing cases. In the past, the IRS would often assert an adjustment using a transfer pricing method based on profitability, such as the comparable profits method (CPM). In theory, the goal was to indirectly allocate income among controlled

entities so that each entity's operating results are similarly profitable to similarly situated third parties, as opposed to allocating profits directly by reference to specific comparable transactions. But the IRS's CPM approach would often be too aggressive (usually by assigning an unreasonable share of the profits to the US headquarters with almost nothing left for the foreign subsidiaries). It would not prevail because the discerning eye of the court viewed the functional analysis holistically to determine the true drivers of value.

Recently, however, the IRS's fortunes appear to have changed, with wins in the US Tax Court and in other courts. The IRS is likely to try to build upon its momentum by pursuing greater transfer pricing enforcement in 2021 and beyond.

At the same time, the pandemic has made it more difficult for taxpayers to document their transfer pricing. Taxpayers have been forced to account for losses related to COVID-19, which has inevitably prompted scrutiny from the IRS. And the tumultuous past year has made it more challenging for taxpayers to establish a reliable set of transfer pricing "comparables," which are used to measure the arm's-length result.

Beyond the IRS, US states have also focused more attention on transfer pricing. For example, Indiana introduced the first state advanced pricing agreement (APA) programme in the nation. North Carolina established its Voluntary Corporate Transfer Pricing Resolution Initiative and collected roughly USD100 million. And the Multi-state Tax Commission is relaunching its State Intercompany Transactions Advisory Service Committee, signalling more aggressive and coordinated enforcement.

Cross-Border Information Gathering and Sharing

US companies have always faced the prospect of burdensome information-gathering efforts by

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the IRS. Through IDRs, the IRS often requests hundreds, thousands, or even tens of thousands of documents from taxpayers under audit.

Recently, US companies have been confronting a new challenge: they are receiving similarly broad document requests from foreign taxing authorities. The United Kingdom and countries in Europe have been particularly aggressive, but taxing authorities worldwide have been ramping up their information gathering on US companies.

These requests come in one of two ways. The taxing authority could request documents directly, issuing the request either to the US parent or to the foreign subsidiary. Or the taxing authority could invoke the “Exchange of Information” provision in a bilateral tax treaty with the US. In that case, the IRS issues an IDR to the taxpayer on behalf of the taxing authority and has the power to pursue the request as if it were itself auditing the taxpayer.

Either way, these requests are presenting US companies with unique challenges.

Privilege

US companies often withhold from the IRS some types of tax-planning documents on the basis of privileges, such as the attorney-client privilege. But with these foreign-initiated requests, US companies have been forced to wrestle with difficult choice-of-law questions when making privilege determinations.

Data privacy

US companies must consider burdensome data-privacy rules in Europe and elsewhere when collecting, reviewing, and producing foreign-based documents for the IRS (through the Exchange of Information process) or the foreign taxing authority.

Possession

It is not always clear which entity in the corporate structure possesses the documents. For example, documents held by a foreign subsidiary might be subject to the request, whereas documents held by the US parent might not be.

Spontaneous document sharing

Anecdotally, we are also seeing greater information sharing between the IRS and foreign taxing authorities. Bilateral tax treaties give the US and many foreign jurisdictions the power to share documents among themselves, even spontaneously. As a result, when US companies produce documents for a foreign taxing authority, they must assume there is a substantial likelihood that the same documents will wind up in the hands of the IRS eventually.

Looking Forward

Two open questions hang over the rest of the year. First, it is unclear how the pandemic will affect tax controversies going forward. Once it recedes, the IRS might choose to abandon its remote-auditing procedures and return to the in-person audit techniques it had used previously. Or it might view those new procedures as a way of increasing efficiency and stick with them. Second, it is unclear how the IRS’s enforcement budget will change. For years, the IRS has struggled with limited resources, which has meant that it simply could not pursue every taxpayer or issue that it wished to challenge. With a new White House and a renewed focus on tax enforcement, though, that is very likely to change, perhaps in the near future. If the IRS were to receive additional resources – which seems increasingly likely – US taxpayers should expect a sharp increase in audits and tax litigation.

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Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes with offices in the Americas, Europe and Asia. The firm's 100-plus tax lawyers are committed to delivering sound, creative and practical tax advice, representing clients at the global, national and local levels. Its deep experience allows it to effectively represent clients in a variety of situations,

including with the structuring of transactions, during tax audits and administrative appeals of audit results, in litigation of tax matters at the trial court and appellate court level, and in ongoing international tax matters such as transfer pricing. Clients include many of the world's largest food, transportation, banking and financial, apparel, healthcare, industrial, pharmaceutical and technology companies, as well as high net worth individuals and high-value estates.

AUTHORS



Brian Kittle co-heads Mayer Brown's Tax Controversy and Transfer Pricing practice and has a deep track record of successfully resolving high-stakes and sophisticated tax

disputes. Brian achieved a rare bench opinion for Cross Refined Coal LLC and its partners, Fidelity Investments, Schneider Electric and AJ Gallagher, in the US Tax Court. He also secured a taxpayer victory for Eaton Corporation in the first case involving a court's consideration of an IRS decision to retroactively cancel an advance pricing agreement. Having clerked at the US Tax Court, he brings an insider's perspective to trial preparation and presentation. Brian frequently speaks on, and authors articles, about substantive and procedural tax issues.



Joel Williamson is co-leader of Mayer Brown's Tax Controversy and Transfer Pricing practice. He has litigated over 60 tax cases. His unprecedented experience includes the trial of seven major

IRC 482 transfer pricing cases. He successfully represented Eaton Corporation in the first case involving a court's consideration of an IRS decision to retroactively cancel an advance pricing agreement. Joel also represented Guidant LLC in a settlement with the IRS of key transfer pricing issues related to the development, manufacturing, and sale of life saving medical device. Joel is a thought leader in the industry and frequently speaks on tax issues.

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Anthony Pastore is an associate in Mayer Brown's Tax Controversy and Transfer Pricing practice. Anthony has represented corporate, partnership, and individual

taxpayers in all stages of tax controversy, including examination, administrative appeal, litigation and trial. He has experience with transfer pricing allocations, debt-equity characterisation, valuations, accounting method changes, substance-over-form arguments and penalties. Anthony focuses a significant portion of his practice on tax matters involving complex discovery, privilege, and document-production issues. As a complement to his controversy practice, Anthony counsels multinationals on the transfer pricing of related-party transactions. He is co-editor of Best Methods, Mayer Brown's blog on transfer pricing issues.

Samantha Bear is an associate in Mayer Brown's Chicago office and a member of the Tax Controversy and Transfer Pricing practice. She has her BA with honours from Brown University and received her JD cum laude from University of Michigan Law School.

Mayer Brown

1221 Avenue of the Americas
New York
NY 10020-1001
United States of America

Tel: 212 506 2187
Email: bkittle@mayerbrown.com
Web: www.mayerbrown.com

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