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Tax Controversy 2022

USA: Trends & Developments
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Trends and Developments

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Introduction

In 2022, we foresee several trends and developments that will converge to substantially impact tax controversies in the United States. The COVID-19 pandemic will likely continue to change how US taxpayers, the Internal Revenue Service (IRS), and courts approach tax controversies. Modest increases to the IRS's funding – as well as a new “issue-focused” approach – facilitate a more aggressive agency that is increasingly focused on enforcement, especially for corporate taxpayers. And more multilateral, international engagement continues to enhance the ability of the IRS to co-ordinate with foreign taxing authorities, increasing global pressure on US companies.

Increased Enforcement and the IRS's Issue-Focused Approach

In 2015, the IRS Commissioner stated that the agency planned to do “less with less”. Plagued by years of budget cuts and hiring freezes, the IRS was struggling to maintain the same level of enforcement activity that it had maintained previously. The ensuing years were no different: the IRS has spent nearly a decade searching for strategies to make do with its limited resources.

Recently, that trend has begun to reverse itself. Taxpayers are seeing a more aggressive IRS that is increasingly focused on enforcement. The IRS's expenditure has started drifting back up after years of steady declines. Hiring is also trending upward. For example, in January 2022, the IRS announced that it would hire 200 experienced attorneys to focus on tax deals that it claims are “abusive”, including syndicated con-

servation easement transactions and micro-captive insurance arrangements.

Even so, the IRS learned some lessons during the “less-with-less” era that it will likely carry with it going forward. Among those lessons is that the IRS should focus its enforcement activity on “issues”, rather than taxpayers.

An example of the IRS's issue-focused approach is the enforcement “campaign”. Traditionally, the IRS initiated audits by selecting particular taxpayers for examination. But in an era of reduced resources, the IRS's Large Business & International Division (LB&I) started selecting a tax issue for audit, rather than auditing every potential issue on a taxpayer's return. In theory, these enforcement 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 kicked off a campaign dedicated to the 2017 Tax Cuts & Jobs Act, 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 enforce-

ment. 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 provides at least a glimpse into the IRS's enforcement priorities.

We can also glimpse the IRS's enforcement priorities in the agency's so-called "Priority Guidance". The stated goal of the guidance is to identify and prioritise tax issues that should be addressed through regulations and other administrative guidance. But we have seen the IRS focus enforcement on many of the very same topics. As an example, the guidance announces several regulatory projects on issues related to crypto and other virtual currencies, which the IRS has also aggressively pursued in audits and court cases.

The Biden administration has made it clear that it wants to increase enforcement on corporate taxpayers, and Congress has attempted to pump more resources into the IRS for enforcement. The administration's "Build Back Better" plan would have allocated eye-popping sums to the agency to ramp up audits. And while that legislation appears to be stalled, at least at the moment, the desire remains to increase IRS funding substantially.

Remote Audits and Court Proceedings

After a brief 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 their respective merits. Most likely, it depends. This same transition to remote meetings, however, has undoubtedly improved the efficacy of the IRS's Advance Pricing & Mutual Agreement (APMA) Program – providing more comfort to taxpayers navigating the complicated cross-border tax landscape.

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 typically would require an in-person conversation before

being finalised are now being discussed by phone. While this has had some positive effects, 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 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.

In an effort to make remote auditing easier, the IRS has eased some of its rigid procedures, though the reality still poses challenges. Certain important forms (such as powers of attorney) can now be submitted online. And the IRS will continue to accept electronic signatures on forms that cannot be filed electronically at least through October 2023. The IRS will also continue its expansion of permissible methods to receive and transmit documents, allowing taxpayers the option to send documents to the IRS simply as email attachments.

Tax litigation has also gone – intermittently – virtual. Most tax disputes in the United States are litigated in the US Tax Court. In the past, trials were in person. After the pandemic began, though, the Tax Court announced that it would begin conducting trials and other proceedings by Zoom. The procedure forced taxpayers to either proceed remotely (with large disputes posing particularly burdensome logistical challenges) or delay trials until in-person trials resumed. Since then, the Tax Court has followed the larger trends regarding COVID restrictions; sometimes easing restrictions and holding in-person proceedings and sometimes returning to strictly virtual proceedings. 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 and the Court of Federal Claims – 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 2022 and beyond.

Specifically, the IRS has stated that one of its priorities for 2021–22 is to issue regulations under Internal Revenue Code section 482, which address “passive association”: the incidental benefit, or “implicit support”, that an entity receives from lenders because of its association with other members under the same multinational umbrella. Whether the IRS issues proposed regulations (which are persuasive but non-binding), temporary regulations (which have the force of law), or fails to issue new regulations at all this year, multinational enterprises should expect more scrutiny of their transfer pricing allocations – and, perhaps, a departure from the traditional interpretation of the arm's-length

principle. Moreover, developing case law that challenges existing transfer pricing regulations may accelerate this departure.

Beyond the IRS, US states have also focused more attention on transfer pricing. Historically, states relied on their discretionary power to adjust income in transfer pricing disputes. But as more and more states have adopted section 482 or section 482-like statutes, state taxing authorities are more likely to challenge transactions using the arm's-length principle. And the State Intercompany Transactions Advisory Service Committee (relaunched by the Multistate Tax Commission after more than four years of inactivity), finalised an information exchange agreement which may facilitate, signalling more aggressive and co-ordinated enforcement.

Cross-Border Information Gathering and Sharing

US companies have always faced the prospect of burdensome information-gathering efforts by the IRS. Through IDRs, the IRS often requests hundreds, thousands, or even tens of thousands of documents from taxpayers under audit.

Increasingly, 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. And 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, attorney work product doctrine, or tax practitioner privilege (section 7525), 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 to the IRS (through the exchange of information process) or the foreign taxing authority; and
- **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.

Consistent with a global trend towards multilateralism, 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. So when US companies produce documents to 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

In our view, the biggest open question hanging over the rest of the year is whether the White House will secure any legislative changes to the

tax law. The administration's "Build Back Better" proposal would have marked a sea change in corporate taxation, leading to higher tax rates and – in all likelihood – more disputes. The legislation would also have pumped an enormous amount of additional money into the IRS for increased enforcement. At the time of writing, the prospects for that legislation look grim.

But at some point, the US will need to implement the substantial developments occurring at the OECD. For example, the OECD has set a global minimum tax which the administration has endorsed. As another example, the US will need to make changes to the rules on Global Intangible Low-Taxed Income (GILTI) to conform with the OECD's so-called GloBE Rules. So, there is some chance that we will see substantial tax legislation in the US in the upcoming year. US taxpayers would be well advised to stay abreast of any proposed legislative changes, as they will undoubtedly impact tax controversies.

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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. The firm's 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.

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USA TRENDS AND DEVELOPMENTS

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