KPMG

Under Pressure: US International Tax Controversy

June 11, 2024

Ahead of the wave

2024 U.S. Cross-Border Tax Conference

Notices

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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

With you today

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Agenda

IRS International Tax and Transfer Pricing Enforcement	• TCJA provisions • Economic substance doctrine
US Transfer Pricing Cases and Transfer Pricing Penalties	• Implications
Procedural Options	• Advance Pricing Agreement Program • Mutual Agreement Programs • International Compliance Assurance Process
Key Takeaways	

2024 U.S. Cross-Border Tax Conference

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US International Tax and Transfer Pricing Enforcement

Initiatives and Programs

Inflation Reduction Act funding

$80 billion in additional funding (now minus $20 billion)

Majority earmarked for enforcement (conduct examinations and provide legal support)

- Increased hiring of experienced personnel
- Announcement of several initiatives/campaigns
- Increase use of artificial intelligence (AI) and data analytics

Taxpayers to enforcement focus

- Large corporations
- Large partnerships
- High income / high wealth individuals

Intent to increase audit rates

- Triple audit rate of large corporations (over $250 million in assets) by 2026
- Ten-fold increase in large partnership audits by 2026

Targeted areas of enforcement – corporations

Expansion of Large Corporate Compliance (LCC) program

- LCC program includes largest and most complex corporate taxpayers (average assets of more than $24 billion and average taxable income of approximately $526 million)
- IRS plans to expand LCC program by starting an additional 60 audits of large corporate taxpayers as new hires are onboarded

Large foreign-owned corporations transfer pricing initiative

- Discussed later

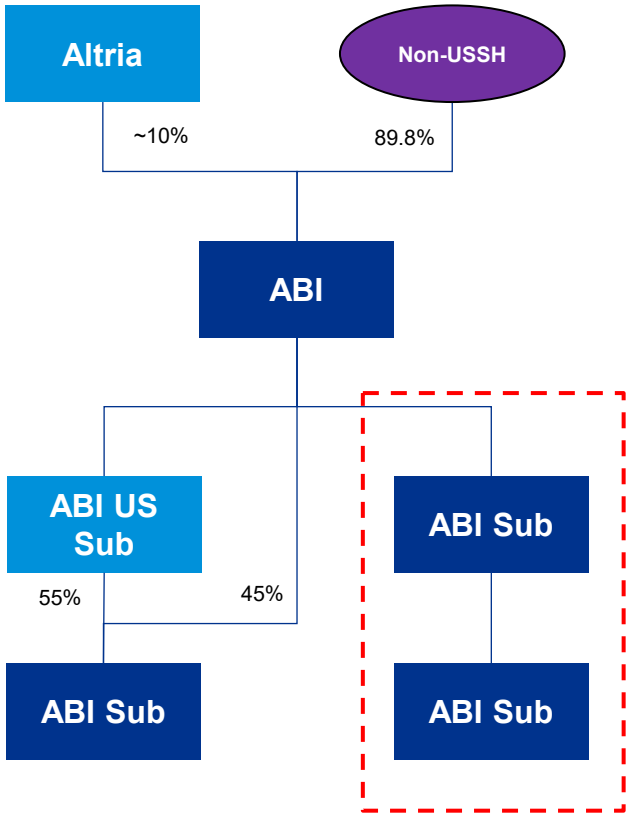
Personal use of business aircraft

- Initiative announced in February 2024 focused on corporations, partnerships, and high-income individuals to determine whether for tax purposes the use of jets is being properly allocated between business and personal use
- Potential compliance areas include deduction allowance and limitation, depreciation, excise tax compliance, and imputed income

TCJA Issues

- FDII substantiation
- Expense allocation
  - SBC and FDII
  - FDII prepayments and SG&A
  - Treas. Reg. 1.861-17 issues
- Constitutional challenges
  - Section 965 (*Moore, Altria*)
  - 958(b)(4) repeal
- Regulation challenges (e.g., *FedEx, Liberty Global, Sysco*)

Altria's 958 Case



Facts

- Through 12/31/2023, Altria Group Inc. ("**Altria**") owned ~10% (vote and value) of Anheuser-Busch InBev SA/NV ("**ABI**")
  - Altria could nominate 2 out of 15 board members; with Voting & Support Agreement, near-certain election
- No other USSH of ABI under section 958(a)

Procedural Posture

- Timely paid taxes for 2017 and timely filed a claim for refund
- Filed claim on May 1, 2022, with the US District Court for EDVA
- IRS filed an answer on August 2, 2023
- Case on hold pending *Moore* decision, which could impact outcome

Arguments

- Constitutionally, the government cannot tax the mere ownership of stock; a taxpayer must actually or constructively realize income
  - Subpart F is a narrow exception to deferral of income, but **requires control**
- Congressional intent

Section 7701(o) - Codification of economic substance

Applies to transactions entered into on or after March 31, 2010.

If the Economic Substance Doctrine (the ESD) is relevant, the transaction will be considered to have economic substance only if both:

- It changes the taxpayer's economic position (apart from federal income tax benefits) in a meaningful way, ***and***
- The taxpayer has a substantial purpose (apart from the federal income tax effects) for entering into the transaction.

Section 6662 penalty:

- Strict liability penalty (no "reasonable cause" exception) for underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in new section 7701(o), *or failing to meet the requirements of any similar rule of law*.
- 20% penalty, increased to 40% if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return or a statement attached to the return.

Economic substance: Basic business transactions

Section 7701(o) is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.

- The choice between capitalizing a business enterprise with debt or equity.
- US person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment.
- The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C.
- The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

Economic substance: Trends

Increase in use following IRS removal of requirement to obtain supervisory approval (up to DFO) before asserting economic substance.

Liberty Global

- Effectively removed the “if relevant” inquiry.
- Dismissed reliance on “basic business transactions” principle.
- Case currently on appeal to 10th Circuit – decision anticipated by end of 2024

Disclosure issues

Disclosures getting additional scrutiny

- Ensure that disclosures are sufficient (review revised Schedule UTP instructions and revisit Form 8275 guidance)
- Consider whether a Form 8275-R should be filed if contrary regulations come out after return filing
- Potential challenges to IRS's broad interpretation of adequate disclosure
- White House proposal to make Form 8275-R mandatory (penalties up to $200,000 if not filed)

Pending Tax Court case regarding disallowed section 245A deduction

- IRS asserting penalties for nondisclosed noneconomic substance transaction under 6662(i) and for disregard of regulations under 6662(b)(1)
- Although taxpayer's position was disclosed on a Schedule UTP, the IRS is arguing that the disclosure was not sufficiently detailed
- IRS argues that the taxpayer should have filed a Form 8275-R because its position was contrary to temporary regulations that were released after the transaction

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US Transfer Pricing Cases and Penalties

Current judicial landscape and emerging issues

Transfer pricing controversy trends – IRS / US

- Exam teams not constrained to follow results from prior audits and have been revisiting previously agreed-to transfer pricing
- IRS Campaigns and “nudge letters”
- IRS emboldened by recent TP wins
- Increased assertion of transfer pricing penalties
- Increasing IRS focus on partnerships could lead to thorny TP issues
- State TP issues continue to increase in relevant states
- TP GLAM

Transfer pricing controversies

Selection of Method / Tested Party

- Because transfer pricing, especially the pricing of intangibles and other nonroutine contributions, often involves issues on which reasonable minds can differ, two or more analyses can be reasonable but yield different results.
- The ability of both the IRS and the taxpayer to choose one-sided methods and tested parties, which are concepts enshrined in the section 482 regulations, exacerbates the penalties issue.

Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE)

- Tax authorities are looking closer at where DEMPE functions are being performed.
- Starting to see an increase in information exchange requests from other tax authorities.

Transfer pricing penalties

Trends

- Increased assertion of penalties, even with Big 4 documentation (*e.g.*, *Amgen*, *Eaton*, *Microsemi*, *Perrigo*, and *Sysco* cases)
  - Historical experience: penalty application was infrequent, and TP documentation, even if not technically compliant, would protect from penalties
  - TIGTA report (2019) analyzed penalty application in LB&I cases:
    - Accuracy-related penalties were seldom proposed in cases where they applied
    - Over 90% of proposed penalties eliminated in Appeals
- Renewed IRS focus: LB&I directive (2018) announces heightened scrutiny of documentation
  - Focus on reasonableness and adequacy of documentation, including need for explicit best method analysis and conclusion
  - LB&I examiners will consider info outside of the documentation in determining adequacy
  - Transfer Pricing Examination Process (2018) highlights role of documentation in audit risk assessments
- Heightened Scrutiny: LB&I FAQs (Apr. 2020) reiterates commitment to scrutiny of documentation
  - IRS believes quality of TP documentation has declined and the FAQs lay out best practices for documentation
  - FAQs place emphasis on role of quality documentation in deselecting issues for audit
  - Note that best practices are not § 6662 requirements (need to weigh costs and benefits)
- Takeaway: just having documentation doesn't cut it anymore!

Trends in US court cases

- IRS continues to focus on the CPM as the best method (*Medtronic, Coca-Cola, Amgen*)
- Taxpayers cannot rely on prior agreements (*Medtronic, Coca-Cola*)
- Challenge to economic substance of arrangements (*Perrigo*)
- Penalties increasingly asserted (*Amgen*)
- Regulation challenges (*3M, Abbott*)

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Procedural Updates

APA, MAP, ICAP

Transfer pricing controversy resolution options

U.S. options for resolving transfer pricing controversy

- IRS Examination
- Appeals (administrative appeals)
- Litigation (court of law)
- Mutual Agreement Procedure (Competent Authority)
- Advance Pricing Agreements (including with rollback to past years)

Foreign country options for resolving transfer pricing controversy

- Options are typically broadly similar outside the U.S.
- Potential differences:
  - The specific procedural options available for administrative and courts;
  - The access to treaty relief, or effective MAP relief even if there is a treaty; and
  - The ability to use APAs to resolve controversies (e.g., access to rollback)

ICAP – addresses transfer pricing and PE issues

Began in 2018 as a pilot program and became permanent in 2020

- 20 cases completed between January 2018 and October 2023

Multilateral risk assessment for transfer pricing and PE issues

- On average, five tax administrations participate
- Compare:
  - ICAP-inspired European Trust and Cooperation Approach (ETACA) pilot
  - U.S. Compliance Assurance Process (CAP)

Process

- Selection
- Risk assessment
- Issue resolution
- Outcomes

Operates via exchange of information (EOI) agreements and does not require bilateral tax treaties

- Allows for engagement with non-treaty partner jurisdictions

Participating jurisdictions

Argentina	Finland	Norway
Australia	France	Poland
Austria	Germany	Portugal
Belgium	Ireland	**Singapore**
Canada	Italy	Spain
Chile	Japan	United Kingdom
Colombia	Luxembourg	United States
Denmark	Netherlands	

Participating jurisdictions as of April 2024.

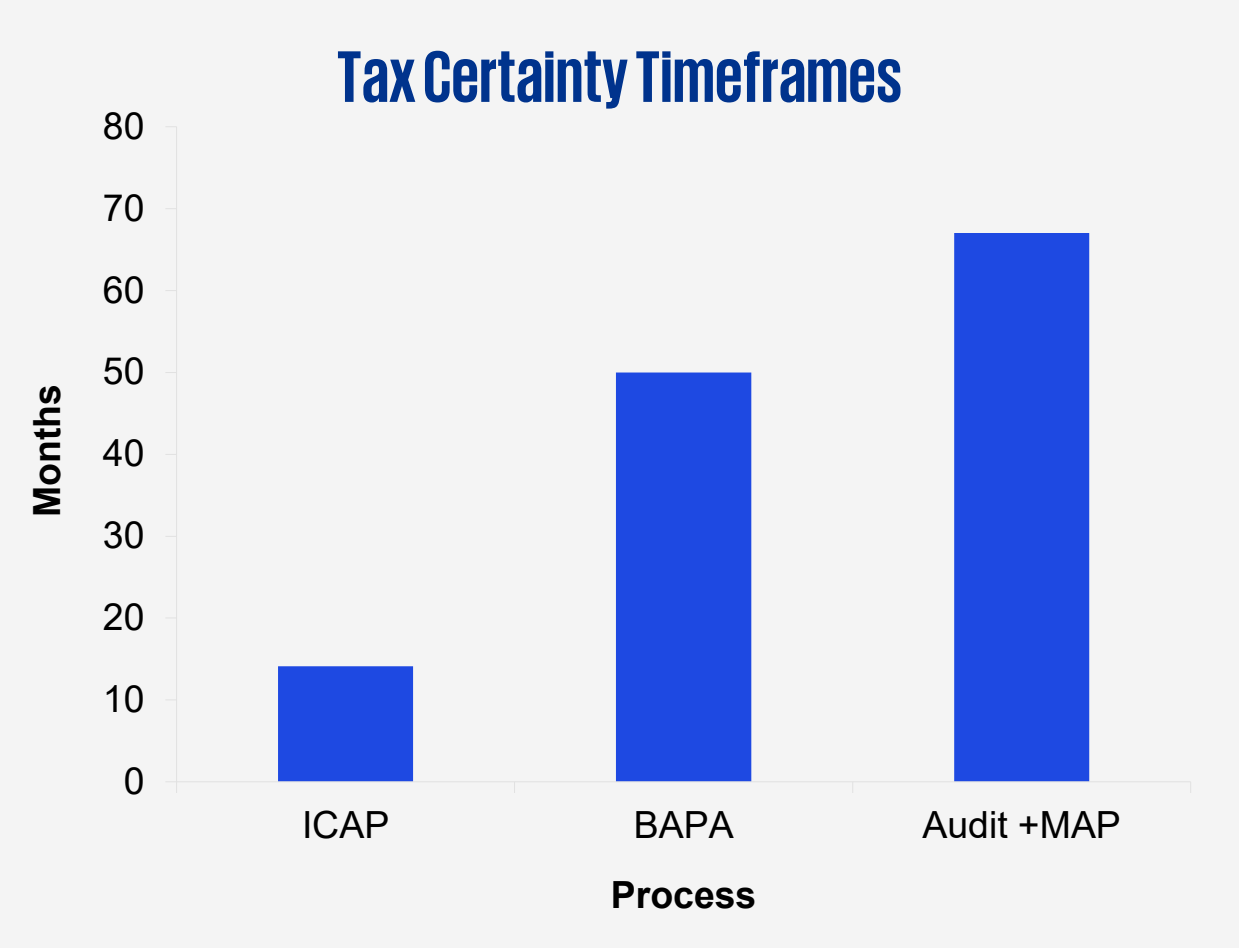
Blue text indicates jurisdictions that are not U.S. treaty partners.

Timeframes and outcomes

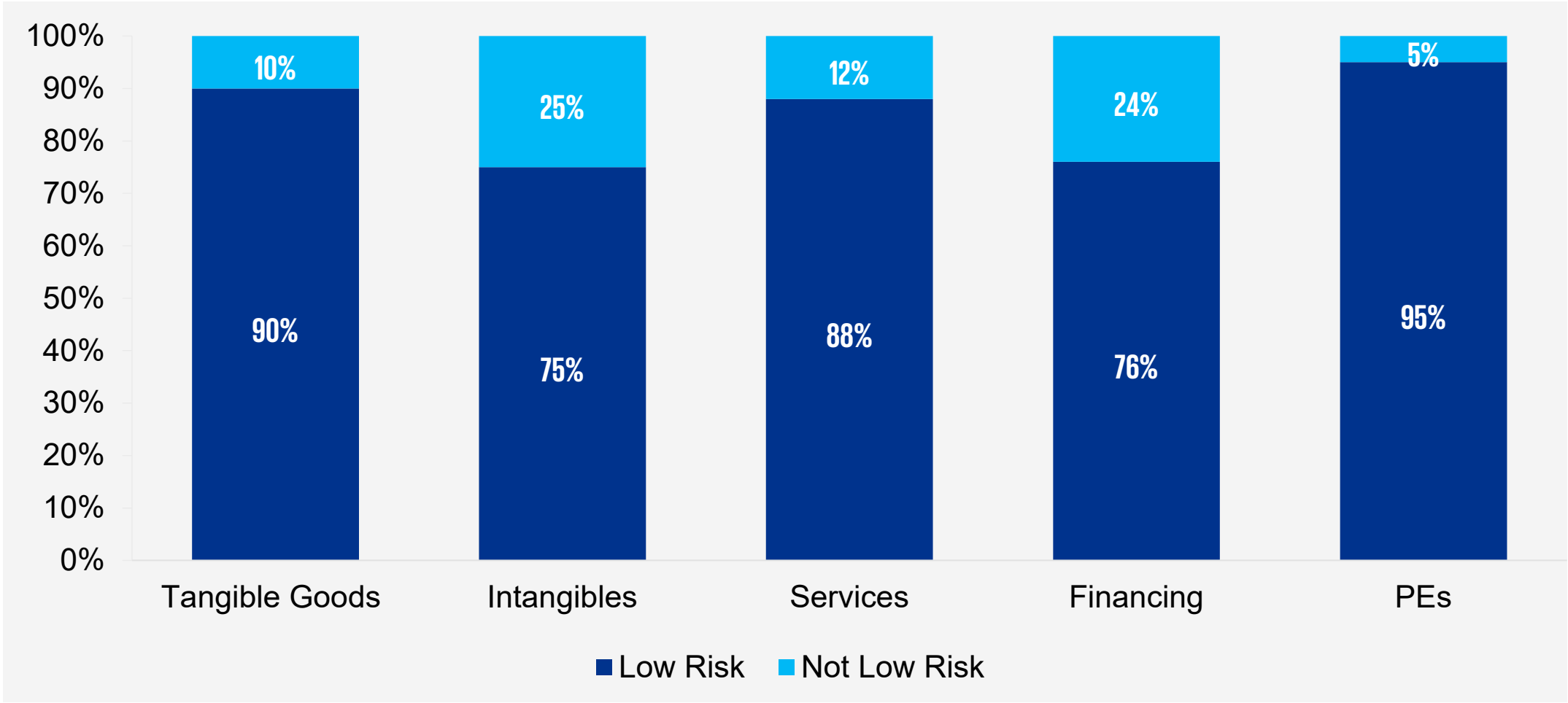
ICAP takes on average slightly more than one year (excluding time for preparation of submission materials by MNE)

This is significantly faster than either obtaining a bilateral APA or going through an audit followed by a MAP case to resolve double taxation

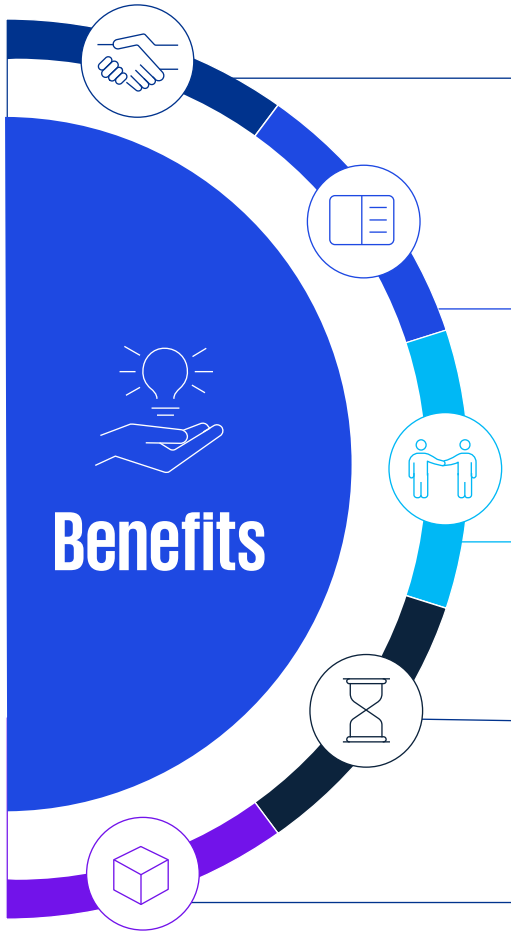
As tax administrations gain additional experience with ICAP, more timing efficiencies may develop



Outcomes by issue



Benefits



Simultaneous engagement with multiple tax administrations

- Establish and bolster relationships with IRS and other tax administrations
  - ICAP personnel more reasonable than field auditors
- Ability to socialize prior resolutions
- "Peer pressure" element
- Ability to engage with non-treaty partners (e.g., Singapore) can be invaluable

Comfort/"practical certainty"

- Outcome letters
- In practice, even "not low risk" transactions unlikely to be audited in some countries
- Audit readiness defense file

Issue resolution

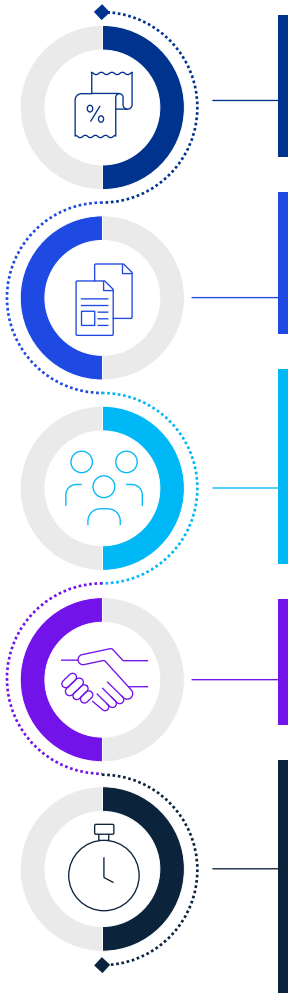
- Expedited resolutions within ICAP
- Synergy with subsequent processes, e.g., springboard for MAP/APA application

Cost savings, limited time, and resource commitment in comparison to (multiple) local audits and subsequent MAP cases

Halo effects

- Roll-forward
- Effect in non-participating jurisdictions
- ESG

Practical points



- Taxpayers with ICAP experience view the program favorably
  - BIAC survey found 80% would go through ICAP again
- Standardized documentation requirements (unlike bespoke APA submission)
  - Role of CbCR – benefit of pre-assessing risk indicators internally
- All participating jurisdictions see complete package
  - Taxpayers wishing to tailor scope of ICAP should socialize this in pre-application discussions with lead tax administration
- Importance of close coordination and good working relationship with lead tax administration (IRS for U.S. MNEs), but also an opportunity to develop this relationship
- Ambitious timing can pose an obstacle to successfully obtaining “low risk” outcomes, especially for complex transactions
  - “Not low risk” can mean two things: high risk, or tax authorities lacked sufficient time to become comfortable with “low risk” label

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Key Takeaways

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