

DEALING WITH THE IRS

Multinationals, Foreign Accounts Under Scrutiny

The IRS is keeping a close eye on multinational corporations and wealthy individuals with offshore accounts to ensure that they are not sidestepping their U.S. tax obligations, IRS Commissioner Douglas Shulman told attendees of the 21st Annual George Washington University International Tax Conference last month.

IRS Focuses on Multinational Corporations

With the emergence of the global economy, the number of multinational organizations has skyrocketed—from 3,000 in 1990 to more than 63,000 in 2007, Shulman said, adding that “the value of foreign tax credits being claimed increased by more than 25 percent in just two years from 2005 to 2007.”

Many corporations “are genuinely trying to comply with the myriad of international tax laws they face and to avoid double taxation,” Shulman said. “Legitimate practices to minimize tax exposure are also essential for U.S. corporations to operate and remain competitive in the global marketplace where foreign-based corporations have such tools at their disposal.

“However, we have also seen some corporations constructing

transactions to avoid tax entirely on certain income, or trying to go beyond the avoidance of double taxation and engage in ‘double-dip’ transactions whereby they get a deduction or credit for the same amount in two countries,” he continued.

Foreign profits for U.S.-based corporations more than tripled between 1994 and 2004, jumping from \$89 billion to \$298 billion, according to Shulman. Fifty-eight percent of that profit was earned in low tax or no tax jurisdictions, he said. “And this gives pause to some U.S. taxpayers and policymakers who want to be sure that that these corporations are paying their fair share at home.”

That was a concern long before the current economic crisis surfaced. “A 2007 Taxpayer Attitude Survey found that 80 percent of respondents believe that it is very important that IRS ‘ensure that large corporations are reporting and paying their taxes honestly.’ Compare this to 68 percent for small businesses,” Shulman said.

Given the current economic climate, “... I believe that the events of the past year will create increased public pressure on corporate taxpayers to adhere to not only the letter of the law, but the spirit of their home country law,” he said.

Three Areas of Particular Interest

For corporate taxpayers, the IRS is focusing on three specific areas:

1. Transfer pricing. “This is one of the most difficult areas for both tax authorities and taxpayers. I recognize that transfer pricing is not easy to manage—even for those taxpayers that aim to steer clear of any grey area,” Shulman said.

He discussed three transfer pricing topics:

■ **Cost sharing.** “Cost sharing involves those taxpayers aggressively pursuing transfer pricing schemes to shift income out of the U.S. to low or no tax jurisdictions. One of the most common is to transfer a valuable intangible for less than arms-length compensation,” he said. “The IRS has been vigorously attacking many of these transactions where we see corporate taxpayers crossing the line. In addition to pursuing cases in the audit and exam cycle, we are also working on temporary regulations related to cost sharing.”

■ **Contract manufacturing.** This refers to taxpayers trying to avoid subpart F income in foreign locations that do not have sufficient manufacturing activity, according

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to Shulman. "The IRS and Treasury are also working on regulations in this area that will make it more difficult for taxpayers to use this abusive tax planning."

■ **Global dealing.** This topic involves financial institutions attempting to book transactions (e.g., loans and swaps) in low or no tax jurisdictions and then arguing "that a disproportionate amount of the profit should be allocated to the low-or-no tax jurisdiction," he explained.

2. Hybrid structures. "These can include hybrid entities or hybrid instruments. Regardless of the form, their underlying purpose is to either exclude income from taxation or obtain double deductions/credits in various jurisdictions," said Shulman.

Foreign Tax Credit (FTC) generators are one of the most problematic of these structures, according to Shulman. "In my opinion, FTC generator transactions are examples of situations where certain taxpayers may be trending toward the 'bad actor' end of the spectrum. Without venturing into the legal nuances, I view this issue very simply. Foreign tax credits were designed by Congress to help U.S. taxpayers avoid double taxation. Common sense would indicate that, where a single payment of foreign tax generates credits for two taxpayers, these transactions deserve closer scrutiny."

3. Withholding taxes. The IRS recently added withholding taxes to its Tier I list of issues. "The tier issue process will provide the needed organizational priority and coordination to ensure taxpayer compliance with the U.S. withholding tax provisions," he said. "Our compliance efforts will span efforts to ensure individual, business and corporate taxpayers understand and fulfill their

withholding tax filing obligations to addressing transactions that attempt to circumvent withholding taxes or claiming improper tax treaty withholding rates."

Unreported Off-Shore Accounts Eyed

In the individual taxpayer arena, the IRS is using a variety of tools to focus on unreported off-shore accounts. "Given the ease with which capital moves around the world, the IRS must and will remain vigilant to ensure that wealthy individuals don't use offshore accounts to avoid paying their U.S. taxes," Shulman said.

The IRS is using the following "tools" in this area:

■ **Qualified Intermediary (QI) Program.** "QI gives the IRS an important line of sight into the activities of foreign banks and other financial institutions. It also provides detailed information reporting that the IRS did not receive before this program was implemented," he said. "... By bringing foreign financial institutions more directly into the U.S. tax information reporting system, we can better ensure that U.S. persons are properly paying tax on foreign account activity, and that foreign persons are subject to the proper withholding tax rates."

Shulman acknowledged that "the QI program is a maturing, and complex program and there are flaws that must be addressed," but the IRS is taking steps to improve it. For example, under QI amendments being considered, "financial institutions that are QIs must provide early notification of material failure of internal controls. They must also improve evaluation of risk of circumvention of U.S. taxation by U.S. persons. And they must include audit oversight by a U.S. auditor."

■ **Informants.** "Since the inception of the Whistleblower

Office in 2007, the IRS has received hundreds of tips on financial institutions and individuals with foreign accounts and international compliance issues. Some of these have become big money cases," Shulman said. "Dozens of these tips involve the names of individuals with offshore accounts; others involve the names and practices of financial institutions in those countries that typically have strict bank secrecy laws."

■ **John Doe summonses.** Tips provided by informants can lead to information the IRS needs to pursue John Doe summonses. "The IRS generally uses the John Doe summons authority to identify individuals, groups or classes of U.S. taxpayers whose member identities are unknown, who are involved in specific areas of tax noncompliance and who cannot be identified through other means," Shulman explained. "For example, we would use

this type of summons when we know that taxpayers use offshore bank accounts to avoid paying taxes, but we do not know their identities."

■ **Criminal investigations.** The IRS is devoting more resources "to investigating the misuse of foreign entities and the use of foreign bank accounts to hide taxable income and is currently pursuing hundreds of criminal investigations of U.S. taxpayers for offshore tax evasion," he said. ■