Tax News and Horizon Scanning Podcast Series on Tax Disputes

Episode 2: Tax Disputes in the US

Tanja Velling	Hello and welcome. Across the world tax risk is on the rise. What should you be concerned about and how can you prepare? Those are the questions we set out to answer in this series on tax disputes across G20 countries on six continents. I'm Tanja Velling, co-host of Slaughter and May's regular Tax News podcast. For this episode we've stopped off in the US and I'm delighted to be joined by my colleague, Tax Partner, Dominic Robertson and Clark Armitage, Partner at US law firm Caplin & Drysdale. Clark, can you give us an outline of your career and current practice?
Clark Armitage	Sure, thank you. I have been practising tax law since 1990. I've spent a lot of time in private law firms and about 9 years in the US APA Programme, so I've done a lot of transfer pricing in my practice, but broad international tax experience.
Tanja Velling	That's quite an interesting and varied career! Transfer pricing, that's broadly speaking, a requirement that related party transactions must be recognised on arm's length terms for tax purposes. An APA is an advance pricing agreement, meaning that a taxpayer and one or more tax authorities agree how particular transactions should be priced. Working in the US APA programme must have been super interesting, and I'm sure we'll talk a bit more about APAs in a moment. Another term that I suspect we'll mention is MAP, short for mutual agreement procedure, whereby two or more tax authorities seek to agree international tax disputes. Dominic, do you want to introduce yourself now?
Dominic Robertson	My career is much less distinguished than Clark's and a bit less varied. I have been at Slaughter and May for almost 20 years now. I've got a very broad tax practice doing everything from structuring M&A transactions through to handling transfer pricing and other tax disputes. And in terms of what you're seeing in the transfer pricing world in the US at the minute, Clark, are there particular trends coming out of what you're seeing from the IRS and how they're handling cases?
Clark Armitage	You know, I think that there have been trends for quite a while. You know, the IRS has been looking for very big dollar cases to litigate involving intangibles and some focus, I would say, on technology companies, but much broader than that. They've litigated *Amazon* but they've also litigated *Coca Cola*. I'm not quite sure what goes into their decision-making on which cases to really push to litigation – it's an

	interesting question to think about – but they clearly have a strategy to take certain cases to litigation and I will say it's been very effective in the past few years. They have won a lot of cases and I think they were struggling for a period from maybe the 1990s and the first decade of this century, but they've really recovered very well and won a bunch of big cases and these things tend to go in trends. So, maybe the biggest trend right now is the IRS winning.
Dominic Robertson	And what's the proportion of transfer pricing cases in the US that actually end up in litigation – it sounds like it's quite a lot higher than in the UK?
Clark Armitage	There are a lot of cases in litigation. It's impossible to know exactly what proportion. Drawing back on my experience from my time in the government, you know, at any given time, dozens of transfer pricing cases might be audited. Many of those go into APA or MAP and only a small portion go to litigation, and of course, most of those end up getting settled. I will say that, at some point, a decision was made within the government to take more of these to litigation and they have a tool where they can designate cases for litigation and by-pass other processes and I'm not sure that accounts for all of the difference but they clearly try to move cases in that direction.
Dominic Robertson	That works by effectively the IRS saying to the taxpayer: tough luck, you can't apply for MAP or you can't apply for an APA, we're so far apart, we'll see you in court?
Clark Armitage	Yes, basically, yep.
Dominic Robertson	Wow, which is very different to the UK. We're seeing a lot of transfer pricing cases. A lot, again similar to the US, focussed on intangibles, albeit very often from the other end, so, a lot of cases looking at inbound intangibles where people have been licensing IP, particularly from the United States, or are using IP to generate sales in the UK. Overwhelmingly, those have been resolved through discussions within HMRC.
Tanja Velling	With the more extensive litigation experience in the US, what do you see as key challenges of bringing a transfer pricing case to court and litigating it from a taxpayer's perspective?
Clark Armitage	Well, I think it's an enormous undertaking to litigate a transfer pricing case. The fact development is tremendous, it's very expensive and, of course, that's true for both sides and as a result, the IRS is only going to be willing to take a case to court if it's very big dollar. There are two cases I mentioned earlier, *Amazon* and *Coca Cola*, which happened to have the same judge, Judge Lauber, who had a very analytical approach to these cases and maybe more so than in the last twenty years before his decisions, and I will say the *Amazon* case is basically a law school test for how you evaluate where IP generates value, whether it's in Europe or the US, in that case. So, I think one of the challenges is that the judiciary has brought a much more disciplined approach to doing these valuations, adopted tools that maybe historically it wouldn't have or didn't, and so you really have to face that type of standard of review. Some cases go the other way, they are more sort of gross judgements about,

	sort of relative strengths, but in the *Amazon* case at least, it was really very technical and analytical based on the specific codes that were being developed at different times, so you face that kind of detailed scrutiny of your facts.
Dominic Robertson	And how do you go about in a case like that, actually getting a judge who will probably not be an expert coder or an expert in the relevant industry, actually to understand what the key value drivers are when you've got the tax authority taking the opposite position of saying, well it's all being driven by something completely different?
Clark Armitage	Well, it becomes the battle of the experts and this has long been true in US courts, where some of the decisions that have come down maybe have 7, 8, 9 experts on each side giving their testimony on very specific details of the analysis. Historically I think, the IRS maybe struggled to match taxpayers in that regard. I don't think that's true now. I think they have just as much access to effective experts as taxpayers do, and they're using it, and to good effect for them.
Tanja Velling	And would courts tend to hear expert witnesses one by one? How common is the practice – I believe it's referred to as "hot-tubbing" – where multiple experts would give evidence at the same time?
Clark Armitage	I have heard about that. I haven't participated in that and I think the norm is still, you know, you engage, you as the taxpayer or the IRS engage with an expert, you know, tell them the facts, hope that they have your view of the world and develop a rapport as a result of that engagement.
Dominic Robertson	It's an area where, and I think we might come onto this with Australia, where I understand that hot-tubbing expert witnesses is very common.
Tanja Velling	Indeed, Australia will be the next stop in this series. I'll make sure to ask our expert guest, Angela Wood, about this and transfer pricing more generally.
Dominic Robertson	It's an area where I think the UK tribunals and UK advisors have got a lot to learn from countries like the US, Australia, India where there's been much more transfer pricing litigation as to actually how to practically run the hearing which, I think, the first time it happens in the UK and we have to say to a judge: well there are 65 different issues for you to decide and you've got 20 experts to cross-examine, they will struggle ultimately first time around. They will find that a little difficult and the challenge for taxpayers and their advisers will be to make sure that that process is navigated as smoothly as possible.
Tanja Velling	So, we've now discussed litigation quite a bit. But maybe we could take a step back for a moment and what are the ways in which you can mitigate the risk of there being a transfer pricing challenge in the first place?
Clark Armitage	Well, one is to just be cautious and not take aggressive positions. You know, I think that that is in fact what many taxpayers do. They just don't push the envelope. From a US perspective, in a post-GILTI era, where your effective rate in the US is not very

	different necessarily from your effective rate for income earned offshore, you know, it doesn't make as much difference as it did when rates were either 35 in the US and zero offshore, you know.
Dominic Robertson	Yes.
Clark Armitage	Another way and I see this a lot in my practice is, for those issues that you're concerned about, not so much whether you're being aggressive or not, but where the issue is uncertain, go to APA in the first instance so that you can lay out that uncertainty for the government and get, you know, sort of their positive engagement on that issue.
Dominic Robertson	And do you still have a lot of unilateral APAs agreed in the United States?
Clark Armitage	About a year ago, the IRS said: we're going to be more selective about the types of APAs we're taking. We don't want to take cases where there's really not a controversy. And so what kinds of cases don't have controversy? When it's bilateral, it's very difficult for the IRS to say there's no controversy here. So, the ones that are likely to come into the cross hairs of that policy are unilateral APAs and we've seen that a bit. There is one other thing that the IRS has pressed in the last year or two: that's ICAP, International Compliance Assurance Programme – the OECD's programme – and they really are pushing, encouraging taxpayers to try to use ICAP. My impression is there are not very many cases yet and its elective, on taxpayers' part. I have spoken to clients about it from time to time. It requires quite a leap of faith to get into it. ICAP is basically a process where you put multiple countries at the table to discuss how much transfer pricing risk there is in a particular issue and the results of that might be a comfort letter that says we don't see a lot of risk or they might conclude that you do have some risk and either press you to engage in some kind of discussion, maybe a bilateral APA, or resolve something through a local exam, a local audit.
Dominic Robertson	HMRC in the UK are also pushing ICAP as a potential solution in a lot of cases. Again, it is still very early days to see how successful that is, but the hope is, if there are multi-lateral disputes around where profit sits, is it US, Ireland, UK, that it could be an efficient way of sorting that out. I think a big part of the challenge will actually be finding opportunities for multiple tax authorities to sit down and actually engage views openly with one another.
Tanja Velling	In general, would you think that multilateralism is the future? I've had a quick look actually at the US statistics and it seems that the applications for multilateral APAs are much lower in number than for bilateral. Where do you see this go in the future?

Clark Armitage	Well, I will talk about the past as prelude hopefully possibly to the future. I was in the government for 9 years. Several different times when I was there, there was an effort to get joint audits off the ground with other countries and that has never really taken hold. I think it is very, very difficult: sharing of information, timing, staffing, you know, it really hasn't worked and that is one anecdote. Another is multilateral APAs. I inherited, when I first got to the government, an APA. Actually, it was five APAs. There was a unilateral with the taxpayer and four bilaterals and that originally had been an octa-lateral APA proposal, right. Well, that didn't work.
Dominic Robertson	You're never finding time to have any meetings and you're always falling down to the lowest possible standard there.
Clark Armitage	That's exactly right. The largest number of parties I have seen in an APA was five.
Dominic Robertson	Any particular countries that are appearing in a lot of cases? Any particular challenges that your clients are facing?
Clark Armitage	Obviously, my window on this is limited to my clients and the clients of my firm but, yeah, we are seeing a lot of activity in India. No surprise to anybody. I heard a statistic a few years ago that India accounted for 70% of transfer pricing controversy worldwide. It doesn't seem out of the realm of possibility to me. We have a lot of work that involves Indian adjustments in multiple different businesses, all sorts of different businesses now. They are very aggressive on their audits but, once you get outside of that audit function, our experience has been very good in India, both in litigation – we haven't participated directly obviously but our clients have been very successful in litigation. It's an incredibly transparent and appropriate process. It takes a long time, but it takes a long time to litigate anywhere in the transfer pricing space, so I don't see any fault there. So, I think, they've been really effective in litigation and, on the MAP side, we have also seen very principled outcomes and I actually had a discussion with an Indian advisor who said it is not only for that way, Clark.
Tanja Velling	How interesting! When our tax disputes series reaches in India, we'll have to get Mukesh Butani's views in relation to this. But let's move on to talk a bit about arbitration in international tax disputes.
Clark Armitage	A lot of US treaties don't have mandatory arbitration, but have arbitration that can be chosen by the two competent authorities. In practice, I've never seen that happen with the United States. We do have mandatory binary arbitration with half a dozen countries now and the style of arbitration is binding two-sided arbitration where each country puts up their

	position and the arbitration panel must select one or the other. They can't draw their own conclusions.
Dominic Robertson	Baseball arbitration.
Clark Armitage	I didn't want to use that term but…
Dominic Robertson	It's crossed the Atlantic and come here as well.
Clark Armitage	I don't think cricket would be apt …
Dominic Robertson	Not at all, no!
Clark Armitage	Yes, baseball arbitration and just to give you a little background on that. I was in the government when we, the IRS, were negotiating MOUs with several countries over what that arbitration process would look like and it ends up being, you know, each government gets to pick one arbitrator, the two arbitrators then pick a third; there's a panel of available people. A lot of times, it's a UK person who is reached out to as being that third party and there was a spate of early arbitration decisions – all this is rumour, by the way, you know, there's no data that's been publicised about this – but there were seven arbitrations that came to conclusion; they were all between the United States and Canada (not any other country), and the US won all seven. I don't know the truth of that, but whether or not it was true, there have been, apparently, none since and it's been at least a decade since there's been an arbitration, I believe.
Dominic Robertson	We always like a good rumour, it's always helpful.
Tanja Velling	And assuming that rumour is true, what do you think might have been the reason for the decline in arbitration after the initial spate of cases?
Clark Armitage	That's actually a testament to the success of the binary approach to arbitration where you select one or the other. The notion is that the two parties get to the courthouse steps in this case, the arbitration panel steps, and say, if I go for this aggressive position, I'm going to lose in arbitration. So, it pushes people to the middle and so much so that they end up resolving the case without arbitration, and we have definitely seen that in our practice. In Canadian cases, you get right up to the eleventh hour just before the arbitration deadline and there is a formal deadline that's agreed at a moment in time, earlier obviously, between the two governments and, right before it gets there, they agree the case. We have had people in our office, at our firm, be staffed to handle arbitrations and then it never happens, you know. I

	think that's the norm now and, again, I think that's a testament to the success of arbitration.
Dominic Robertson	What we're seeing at the moment, its slightly early days for the UK, but we have got mandatory binding arbitration in a lot of our treaties post-BEPS for those parties that have signed up to that in the Multilateral Instrument. I've got a case going through MAP at the moment where the fact that both tax authorities know, if you can't sort this out within three years, it will go to arbitration and you might get a better result, you might get a much worse result, it's quite a powerful incentive on the two tax authorities to come up with a solution which keeps both parties unhappy, but that's the nature of a compromise.
Tanja Velling	Any other interesting developments that we should be aware of?
Clark Armitage	Some of the current litigation has involved section 965 of the Tax Code which is the big deemed mandatory repatriation of earnings that occurred back in 2017 and, you know, we have a Supreme Court case which is a rarity for tax in the US right now, called *Moore*, that involves the constitutionality of that section. And it's a very, very interesting case and a lot of speculation about what's going to happen. But, in my firm, we believe that there is going to be a judgement, however limited, in favour of the taxpayer there, and the reason for that is because normally the Supreme Court doesn't take cases that don't involve a split in the lower courts, the Circuit Courts of Appeal, and presents a tax issue. What does the challenge involve? It involves, you know, our constitution allows basically for poll taxes and about 100 years ago, little more than 100 years ago, they decided that was not enough revenue and so they imposed an income tax. To do that, they felt the need for a constitutional amendment that said an income tax need not be proportionate to population by state and so an income tax is permissible. What's an income tax? And what the deemed mandatory repatriation of earnings did was it took up to, I think, 24 years of earnings and required you to include all of those today, even though there was no cash distribution.
Dominic Robertson	And that would include an awful lot of technology companies that had accrued significant earnings offshore, hadn't at that stage distributed those back to the United States.
Clark Armitage	Absolutely, yeah and it was a huge revenue raiser. They're still seeing the benefits of that revenue raised because, if you were elected, you could choose to pay the tax over 8 years, and the last 2 years of that 8-year period was something like 45% of the tax bite. So, there is still a lot of revenue coming from, 2 more years, I think. Companies cannot challenge the constitutionality of the tax in the same way that individuals can. And the individual who brought this case owns 11% of an Indian company, I think, and, in order to be subject to this repatriation section 965, you have to own at least

	10. So, it's the very smallest basic percentage that you could have to get as a test case. No control over whether a distribution could be made by this taxpayer. And so, they're a very sympathetic-looking case and it may be that the court chooses to narrow any decision, assuming that they grant one in favour of the taxpayer, to taxpayers that don't control the timing or the event of a distribution and yet are nonetheless required to have an inclusion under this section 965. That will be interesting because it's tough to distinguish an inclusion under 965 from GILTI inclusions which are…
Dominic Robertson	Which is also deemed income of some kind.
Clark Armitage	Exactly, there's all sorts US tax provisions that don't require a cash payment in order for the owner of whatever the interest is to be subject to current taxation. The Supreme Court asked a lot of questions surrounding this, you know, how do we draw a line? Initially, I thought that the Court would focus on the length of time, 24 years, that's sort of a due process concern, you know, too many years involved there. But they did not ask the parties to brief the due process issue and so it seems unlikely they're going to decide based on the number of years involved. So, we'll see what happens. It's going to come out in the next maybe 2 months.
Dominic Robertson	The amounts at stake in this case are absolutely eyewatering. Just the section 965 alone, I heard the amount at stake was not for the Moore's themselves, but everybody else, 340 billion – and that's not a typo – 340 billion Dollars which is around 5 years of UK corporation tax revenues.
Tanja Velling	Those are indeed eyewatering amounts, but, Clark, I wanted to get your view one more thing if I may. In relation to a transfer pricing, we said that the UK has something, or a lot to learn from the US, and there is something else, I wanted to ask what we might learn from the US experience. So, in April 2022, or since then, we have had a requirement for large businesses to notify an uncertain tax position if it's above a certain amount, and uncertain tax position: broadly, if there is an accounting provision or if the business applied a tax treatment contrary to HMRC's known position which could be something set out in the guidance. I think you have had something similar in the US and what is your experience with that? Does the IRS used this to target audits, for instance?
Clark Armitage	There are a couple of different forms that might be filed with the tax return. One is called a Schedule UTP. Very much like what you suggested on certain tax positions where you have reserve set up. Where your position, your tax return position, might not require reserve but it is not consistent with IRS guidance necessarily, and you might be required to file a Form

	8275 which discloses a position for which there is only reasonable basis, a cogent argument basically, and not substantial authority supporting it. And so, we see those two things all the time. The Schedule UTP: my experience is that it has not been the origin of a transfer pricing adjustment I have seen, or any other adjustment for that matter has not generally come from the Schedule UTP. Mostly the big dollar flow transfer pricing issues are known to the audit and team and, Schedule UTP or no, they sort of know where it stands and that engagement probably leads to greater certainty over time. The taxpayer knows what they are going to get from the audit team and, for that reason, they might not need a Schedule UTP item because they don't have a reserve and so it's may be its sort of a virtuous cycle. I saw a couple of very interesting articles that attempted to quantify the impact of Schedule UTP, and both them concluded that, at best, it was zero and maybe it was even negative. I am not quite sure how it might be negative, but a couple of theories. One is that, well, taxpayers got more compliant because they feared putting something on their Schedule UTP. OK, that kind of makes sense. Another variant of that is that US rates got lower and so sort of the desire to push dollars offshore went down over the last ten years or so. So, both of those things could be true. The third thing that I read (doesn't seem very likely to me) is that they are just putting a lot more pressure on their auditors to not establish a reserve. That pressure has always been there. I don't think it has probably changed because of the Schedule UTP.
Dominic Robertson	It is really interesting to hear the US experience. Having just listened to your summary of the US rules, we have basically shamelessly plagiarised the United States rules. It is still early days, but I think we would expect it would be pretty unusual actually for most large businesses to say, well, on some huge issue, we are going to take a position which is just contrary to HMRC practice and, if they do, they will be telling their tax inspector anyway, rather than just waiting, filing it on this return.
Clark Armitage	Yeah, it does seem very, very similar what is going on. I do think maybe there is a little difference between the UK position which is, if it's contrary to HMRC's position, then you have to disclose it. I don't think that's exactly what we have because that's not part of the Schedule UTP, and the Form 8275 I mentioned really goes to the overall quantum of authority. If you have enough cases, even if the IRS takes a contrary view, if you have enough cases to support your position and that's substantial in relation to the total body of authorities, you don't have the file a Form 8275.
Dominic Robertson	Of course. OK. it's a bit different. Finally we should probably just finish by talking about elections. You may have spotted both of our countries have got elections coming up at some point this year. In one sense, they are opposite ends of the spectrum. In the UK, we don't know

	exactly when the election will be, but we certainly know what the result will be. In the US, you know it is going to be a Tuesday in early November, but the result is absolutely unclear at this point. If you were getting out your crystal ball and telling clients what they could maybe expect in US tax terms after the election, what would be the two or three top things on your list?
Clark Armitage	It is very hard to predict. We could have one party controlling the White House, another party controlling one or both of the Chambers. And so, you know, it is much, much harder to get tax legislation completed which is partly why it tends to be huge, huge slugs of activity every five years.
Tanja Velling	Looking at this from a long-term perspective, what you would probably want to know is whether the US will implement the OECD-developed global minimum tax, often referred to as Pillar Two. What's your view on this, Clark?
Clark Armitage	I think many people in the US would say: hey, we inspired that. Remember GILTI?! And so, you refined it a little bit, but we are not sure we agree with all that. But I do think, over time, that the US almost has to adopt Pillar Two because they are not just ceding the authority to tax if they don't. They are ceding tax dollars and, you know, if you don't have a minimum tax of at least 15%, you are going to see some erosion of your tax base.
Dominic Robertson	But that only gets through if the Democrats win the House and the Senate as well, presumably?
Clark Armitage	Yes.
Dominic Robertson	Looks quite unlikely that someone will get a clean sweep?
Clark Armitage	I just don't know. I mean I love to be able to tell you something. You know, one of the things that happens in our system is the parties reposition themselves constantly to get 51% of the vote and so you are always at loggerheads. In the context of tax litigation, it is very, very hard to get, for a majority party to get tax legislation through, if the minority does not like it.
Dominic Robertson	And on Pillar Two, it sems to me the introduction of UTPR, when that comes into effect in the UK and elsewhere formally in 2025, there would be a bit of a grace period for businesses, but at some point in the late 2020s. In the UK, that's at the moment expected to raise 500 million a year just in the UK and bluntly most of that 500 million is coming from US corporations. And you can see a world where US legislators decide: why are we handing over billions of dollars a year in tax revenue, or allowing the UK and Germany and France and elsewhere to collect billions of dollars of tax revenue, which we could collect if only we got around to passing Pillar Two and accepting, perhaps grudgingly, a slightly modified version of GILTI?

Clark Armitage	Yeah, I think that that is a realistic thought process. A couple of counterpoints. One is that we have a treaty network, and is that taxation consistent with the treaty? The IRS might argue otherwise. Even if it is, I can see the US bringing out all their tools here. Trade, investment treaties, you know, whatever it is. I do think that, at some point, those tools because – if the rest of the world is adopting and the US is the lone outlier, it is just not realistic to be in constant conflict, you know. And that is why I think at some point we will get to Pillar Two very likely, but probably not in the next couple of years.
Tanja Velling	I guess that is a good note to finish on, and if I was asked to summarise, I would say that we've heard that, in the US, transfer prising is clearly a key tax risk, but not the only one. And the IRS is clearly not afraid of taking cases to litigation especially if big amounts are involved. So, taxpayers would do well to make sure that they take reasonable positions and engage early, for instance, to agree an APA with the IRS and clearly, we have lots of exciting developments coming up, not least the pending Supreme Court case where we're expecting a decision on the 2017 tax reform and then clearly the US election. Overall, I'd say this was a fascination conversation. So, thank you very much, Clark and Dominic, for sharing your insights.
Clark Armitage	Thank you both very much for having me participate in this. I appreciate it.
Dominic Robertson	Thank you very much.
Tanja Velling	And that leaves me to thank you for listening. This was the second of six episodes in our special series on tax disputes. Next week, Tax Disputes Partner Richard Jeens and I will speak to Angela Wood, Partner at Clayton Utz in Australia. If you subscribe to Slaughter and May's Tax News podcast or our Horizon Scanning show, you'll be notified when the new episode is released. For more insights from Slaughter and May's tax department, please go to the European Tax Blog, www.europeantax.blog, or follow us on Twitter, @SlaughterMayTax. Or just drop us an email.