XVI

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TOPIC 8

COMPLIANCE CONTROL AT THE INTERNATIONAL LEVEL

Internal Revenue Service
United States of America

TAX NONCOMPLIANCE

EXAMPLES IN THE UNITED STATES

XVI CIAT General Assembly
Asuncion, Paraguay
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XVI CIAT GENERAL ASSEMBLY
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I. INTRODUCTION

This is my second opportunity to attend a CIAT General Assembly and to share with you my thoughts on tax noncompliance. Certainly, tax administration has many interesting features and these features vary from country to country and depend on the tax being administered, the tax office itself, and the compliance characteristics of the taxpayers involved. On the other hand, as the meetings of this Assembly have shown, our systems share many similar features. Working together, each of us can learn from the other's experiences and find common solutions to our compliance problems.

During this Assembly, I found the decision matrix concept to be especially interesting. That is, it can guide our thinking in a way that better defines the noncompliance questions we face and highlights the important factors at work in these situations. It is in this context that I wish to present the topic of "Compliance Control at the International Level". During this talk I want to share with you the United

States' efforts to enhance international compliance. These include joint efforts with our treaty partners as well as domestic programs. I also will suggest some areas where CIAT members can work together to their mutual benefit.

The major noncompliance issue in the international area is the incorrect reporting of income and expenses among the countries where the taxpayers do business. Other noncompliance issues, such as income from illegal sources and tax evasion, may well cross international boundaries but the influencing factors and the forms of noncompliance in these situations are most similar to domestic noncompliance issues. Therefore, they should be addressed through the normal tools available in each of our respective tax offices. Accordingly, today I will focus on multinational taxpayers and international cooperation as an answer to overcoming the incorrect reporting problem.

II. INTERNATIONAL COOPERATION

We are living in the age of the "Supercompany." The large multinational, with its sophisticated pattern of worldwide operations and financial dealings, presents a formidable challenge to the tax administrator, especially when it comes to an examination of their returns.

In our opinion, the foremost issue in the international area is transfer pricing. By transfer pricing I mean the less-than-arms-length pricing of goods and services between related entities to reduce the overall tax of the affiliated

group. These esoteric tax avoidance techniques have been used to maximize profits by manipulating the market in certain products and services. One way to overcome problems involving the audits of multinational corporations is by increased international cooperation.

The framework for the U.S.'s international cooperation efforts is a system of income, estate and gift tax treaties with foreign countries. These treaties usually provide for exchanges of relevant tax information between the United States and its treaty partners. These exchange provisions make it possible to carry on our compliance cooperation at the international level. Similar provisions certainly exist for many of your countries as well.

Five conditions must exist if international cooperation is to prove an effective weapon against noncompliance. And these five conditions apply no matter which countries are involved.

First, there must be viable tax treaties.

Second, the treaty partners must develop and exchange detailed expert knowledge on the essential tax aspects of the multinational taxpayer. This includes financial facts, structure of the organization, and patterns of operations.

Third, the partners must identify specific areas with potential tax noncompliance issues.

Fourth, they must develop special tax auditing techniques peculiar to the operations and practices of the multinational.

And fifth, they must agree on administrative assistance in tax matters and in procedures leading to the formation of international audit teams, coordination of examinations, and the pooling of tax information.

III. HISTORY OF U.S. EFFORTS AT INTERNATIONAL COOPERATION

When it come to international cooperation, we in the U.S. Internal Revenue Service still have a way to go before reaching our goal. But some of our recent findings point the way to a successful multinational corporation audit program in the future. Our audit experience and dealings with treaty partners have taught us new techniques for curbing international abuses and noncompliance. We are working with our treaty partners to put these techniques to use. Our efforts can be divided into four activities:

1) the Simultaneous Examination Program,

2) industrywide exchanges of information,

3) spontaneous exchanges of information, and

4) participation with regional international groups.

A. Simultaneous Examination Program

The Simultaneous Examination Program is a very effective method for combatting international noncompliance. This program was established between the United States and certain treaty partners as a way of improving and facilitating exchanges of information under the income tax treaties.

The United States has five Simultaneous Examination Programs with treaty partners. The first was established with Canada in 1977 and followed by the United Kingdom in 1978. Programs were established with the Federal Republic of Germany and France in 1979. Our latest Simultaneous Examination Program was established with Norway in 1981.

Simply stated, this program provides that personnel of the United States and its treaty partners can examine related taxpayers within their respective jurisdictions and meet periodically to discuss issues of mutual concern as well as the availability of information to assist in examining a taxpayer.

The authority for the Simultaneous Examination Program lies in the exchange of information provisions of the tax treaties. The treaties govern the conduct of these examinations and any information exchanged.

Through this program we and our treaty partners are working to determine the correct income tax liabilities of taxpayers whose costs of operation are shared by and profits allocated among taxpayers residing in other countries. We also seek to develop techniques and formulas for evaluating arm's-length transfer pricing between related taxpayers and exchanging studies and analyses of transfer pricing practices.

We are establishing guidelines for evaluating transactions affected by transfer pricing, research and development, rent or royalty payments, and market changes in currency. We also are exchanging information on techniques of tax avoidance that affect each country's tax administration.

Finally, we are developing guidelines for exchanging information that may be used by each country in examining multinational enterprises, especially those with transactions in tax havens.

How do we choose a case for simultaneous examination? Several criteria go into that decision, including volume of worldwide sales, size of worldwide assets, extent of activities in tax havens, extent of activities in the United States and the treaty country, and whether the tax year for both countries is the same.

After choosing a taxpayer for simultaneous examination, the U.S. and the treaty partner exchange letters formally selecting the taxpayer to be examined and naming each country's representative who will act for each competent authority. Before the examination begins, the designated representatives meet to discuss audit plans, identify potential simultaneous audit issues, and establish target dates. The representatives meet periodically to discuss the progress of their examinations, development of audit issues, and availability of information to be exchanged.

Additionally, the United States must inform the taxpayer that it is under simultaneous examination. The treaty partner usually coordinates advising its taxpayer with the United States. The designated representatives do not actually exchange information. Instead, the U.S. and treaty partner exchange letters containing this information.

Either country may withdraw from a simultaneous examination by notifying the other of its intent.

The Internal Revenue Service has conducted at least one simultaneous examination with each of our treaty partners. Each time we have been pleased with the conduct of these examinations and the information received. We also believe the reverse situation is true. Through the Simultaneous Examination Program, U.S. audit teams have obtained information helpful in developing various audit issues. Usually, we could not have obtained this information from the U.S. taxpayer because the books and records were located in other countries outside our jurisdiction.

-- Illustration of a Simultaneous Examination

Let me conclude my discussion of the benefits to be gained from a Simultaneous Examination Program with an illustration that is further outlined in the Appendix of my printed remarks. In one case worked jointly with the Canadian tax authorities, a European taxpayer (the parent corporation) had operating subsidiary corporations in both the United States and Canada. Additionally, the European parent controlled a third subsidiary corporation located in a tax haven country outside our jurisdiction and the jurisdiction of Canada.

The U.S. audit team knew the tax haven affiliate purchased goods from the U.S. corporation and sold these goods to the Canadian corporation. On each transaction, a substantial profit was retained by the tax haven affiliate. Through the simultaneous examination process of the two treaty countries, it was discovered that Canadian goods were also being purchased by the tax haven affiliate for resale to the U.S. corporation. Again, a substantial profit was retained by the tax haven affiliate. In fact, it profited on each transaction no matter which corporation made the original sale.

As the examination of both the Canadian and U.S. taxpayers progressed, the audit teams exchanged information from the accounting books and records of each taxpayer, invoices representing both sales and purchases of goods, contracts, financial reports, and any other relevant information allowable under the treaty provisions. Working closely together, the audit teams, including economists were able to establish a proper "arm's-length" price for the goods. As a result, each treaty participant was able to effectively control the international noncompliance they encountered.

One additional example may better outline just how effective this program can be and how it actually works.

We were examining a case where the parent corporation located in a tax haven country, operated a branch operation in the United States and a wholly owned subsidiary in one of our treaty partner countries. The United States needed to develop facts concerning the transfer pricing of goods and whether the income should be sourced in the United States or, as the taxpayer claimed, in the parent company's tax haven country. Our treaty partner, although not concerned with the sourcing of income, was having difficulty in obtaining information on the arm's length price of goods being purchased from the foreign parent company. By using the simultaneous examination approach we were able to exchange the necessary information about the arm's length prices, as well as where certain income should be properly sourced.

Some of the specific information exchanged with out treaty partner included pricing contracts for the sale of goods to unrelated parties, internal correspondence on company pricing policies, economic reports and an analysis of the functions performed by various companies within the worldwide group of related companies (e.g., manufacturing, R&D, marketing, etc.) As a result of this examination, the taxpayer agreed to substantial United States tax adjustments where we previously had difficulty in penetrating the taxpayers organizational and operational structure. Our treaty partner, using information we supplied on pricing transactions, has proposed a significant reduction in the transfer prices paid for goods purchased from the tax haven parent company.

-- Multilateral Simultaneous Examinations

We would like to expand the simultaneous examination concept into multilateral simultaneous examinations. For example, since the United States has Simultaneous Examination Programs with Canada and the United Kingdom, the competent authorities of the three countries could agree to simultaneously examine a taxpayer conducting business in all three jurisdictions. Thus our bilateral exchanges could be enlarged to the benefit of three or more treaty partners.

B. Industrywide Exchanges of Information

Industrywide exchanges of information enable treaty partners to identify and discuss international tax issues that are common to a selected industry. These exchanges have helped us to understand better the worldwide operations and practices of certain industries. They also contribute to more in-depth examinations by participating treaty countries. The United States is currently participating in four industrywide exchanges with treaty partners. We have exchanges on the oil industry with Canada, Norway, the United Kingdom and Germany; on pharmaceuticals with Canada; on grain with Canada; on banking with Germany; and, we have recently begun exchanges on the oil and aluminum industries with the tax officials of Australia.

-- Industry Specialization Program

All industrywide exchanges of information in the international area are an expansion of our domestic industry specialization program. In our domestic program the industrywide specialist is a highly skilled Examination Division case manager who serves as a specialist and coordinator in matters pertaining to a designated industry. The specialist is responsible for conducting industrywide examinations, regularly surveying industry trends, reviewing financial statements, and coordinating industry issues with IRS personnel throughout the United States.

We have industry specialists in fourteen industries that include aerospace, air transportation, banking, chemical, construction, data processing, forest products, insurance, petroleum, pharmaceutical, railroad transportation, steel, tractor/heavy equipment and utilities.

-- Treaty Partner Cooperation

We wanted to expand the technical expertise of our industry specialists, so we added international issues to their coordination responsibilities in certain industries. This gave birth to our concept of industrywide exchanges of information, which may be conducted under the provisions of the various income tax treaties.

How do we handle industrywide exchanges?

First, before an exchange begins, the U.S. and the treaty partner trade letters defining the scope of the industrywide exchange.

Then, the tax authorities of each country meet periodically to discuss various topics pertaining to the industry selected for the exchange. We don't discuss taxpayer information during these meetings. But we do exchange general information, such as industry pricing methods and general information on industry trends.

The topics of these discussions may include current industry events, commercial transportation costs, mutual tax issues, the need for special studies, different methods of establishing arm's-length pricing standards and seminars on major international issues.

I would like to point out that we can conduct industrywide exchanges on industries other than those listed earlier under the Industry Specialization Program. For example, the United States will be conducting an exchange on the aluminum industry with Australia. Though the United States doesn't have an industry spcialist for aluminum, each country has experts available to conduct the exchange adequately.

The IRS is very pleased with results of these industrywide exchanges of information now going on. These exchanges have improved the quality of our examinations and reduced the time

our examiners need to obtain information for their audits. What's more, as a result of these exchanges, several cases have been added to the simultaneous examination programs with different treaty partners.

Industrywide exchanges, either bilateral or multilateral, certainly improve international compliance because examiners, by sharing views with treaty partners, gain a better understanding of the various noncompliance areas.

C. Spontaneous Exchange of Information

Sometimes we give our treaty partners information without their asking for it. This is information discovered during an audit that suggests or establishes noncompliance with the treaty partner's tax laws. For many years we resisted such spontaneous exchanges of information. However, we now make such information available to the United Kingdom, France, and the Federal Republic of Germany and they reciprocate. This activity is still in an early stage of implementation but we feel it's an excellent way of combatting international noncompliance. Through these exchanges we obtain information that otherwise would not be available during the normal course of an audit and so do our treaty partners.

D. Other Exchanges of Information

There are two other important information exchange activities under our tax treaties.

Most income tax treaties provide for automatic exchanges of routine information. Generally speaking, these exchanges include investment income, such as interest, dividends and royalties received and taxes withheld by one country on income payments to residents of another country covered by the treaty.

The income tax treaties also allow specific requests for information. For example, one country's competent authority makes a written request to a treaty partner for specific information and explaining why that information is needed.

Specific requests for information must identify the taxpayer and the information desired. In addition, the request must relate to a person or entity subject to the treaty partner's tax laws. The information must be requested in good faith about transactions or material facts necessary to determine a tax liability covered by the treaty.

E. Participation in Regional International Groups

The United States participates in two regional groups designed to improve international tax administration and compliance. The first is the Group of Four, consisting of the United States, the United Kingdom, Germany, and France. This group was established in 1970. It has aided all the participants greatly in improving their tax administration as well as our joint international compliance efforts.

The other group is the Pacific Association of Tax Administrators, known as PATA, formed in 1980. PATA consists of the United States, Canada, Japan, and Australia.

These groups meet annually to discuss many topics of mutual interest. These meetings usually are attended by tax administrators responsible for policy decisions in their organizations. However, if we find we need to discuss certain matters at a working level, we may call a special meeting. For example, a Group of Four member is planning to issue certain rules on transfer pricing determinations. In order to gain a better understanding of the matter, the Group asked its members to send representatives to present their views on the proposed rules.

The United States strongly endorses regional participation in efforts to improve international tax administration and compliance. Through these efforts we all share views and experiences. And each participant comes away with ideas on legislative needs and areas requiring additional enforcement attention.

IV. DOMESTIC ACTIVITIES

The IRS has taken several internal actions to improve the international aspects of its examinations and to identify the scope of international noncompliance. Two of the more important actions are the increased visibility of international expertise in the examination process and our focus on taxpayers with tax haven involvement.

-- International Enforcement Activities

We attain this heightened international expertise through our International Enforcement Program, which oversees the efforts of some 240 international examiners throughout the country. Most examinations of large multinational enterprises are handled by a group of examiners under a "team audit" concept. Overall responsiblity for a team audit rests with one person - the case manager. The balance of the team consists of a variety of support personnel, including specialists who handle unique and complex areas of the audit, such as engineering issues and employment and excise taxes.

Since the early 1960's, the Internal Revenue Service has recognized the importance of using international expertise on the audit of large multinationals. Lower tax rates, bank secrecy laws or other preferential treatment in many foreign countries provide U.S. taxpayers with the incentive to shift their profits outside the reach of the U.S. tax collector. Our audit findings support this fact. During the past two years, international examiners have recommended audit changes with a potential tax value of $4.6 billion. That's about $10 million per specialist per year.

We attribute these impressive results to many factors. First, our international staffing has increased at an average annual rate of 7 percent since 1974. Moreover, we have put considerable time and effort into improving our training program. The basic class for new specialists was updated to

consolidate all the changes in tax law since 1970. We also developed an advanced course to keep our experienced examiners technically sharp and aware of the latest tax planning techniques used by the multinational firms. Further, we have strengthened our training material to educate regular examination personnel concerning the recognition of international issues and how to get the international expert involved in the audit. As you know, our international program depends on referrals from the regular examination program and we believe that a more informed examiner results in a more effective compliance program.

-- Study on Tax Havens

In January 1981, the IRS issued a report following an 18-month study of tax havens and their uses by U.S. persons. The study and report came about as a response to a Congressional inquiry. It was conducted by the IRS, the U.S. Department of the Justice, and the U.S. Treasury Department.

The study shows that the use of tax havens is a growing problem and affects the tax systems of most countries. The number of multinational companies operating in tax haven countries and has grown rapidly in the past decade. Statistics show that banking activity in these countries also has grown rapidly.

The report describes many tax schemes used to avoid taxes and makes recommendations for legislative, technical, treaty, and administrative changes. The IRS presently has taken these recommendations under advisement.

Although the term tax haven is not defined, it basically is a country or jurisdiction that has no or a very low tax rate, widely enforced bank or commercial secrecy laws, and banking plays a disproportionately active role in the economy. Other characteristics of such countries that make them attractive as tax havens are modern communications, lack of exchange controls and good transportation facilities. It is not necessary for a tax haven to possess all these characteristics. Sometimes a country will be considered a tax haven because of a single tax incentive it offers or because of a tax treaty offers some favorable treatment on certain types of income.

Tax administrators must be concerned with the use of tax havens by their citizens since tax havens have become billion dollar industries. Multinational businesses are able to structure their transactions through tax haven countries and sometimes avoid paying taxes to any government.

How do we fight the use of tax havens? That's an extremely difficult task, mainly because most tax havens have extensive secrecy laws and because they do not actively participate in tax treaties. One method to combat taxpayers using tax havens is through the cooperation between countries whose citizens are exploiting them to avoid tax. As I said earlier, the United States has entered into a Simultaneous Examination Program with several countries in an effort to focus on tax haven abuses.

V. A ROLE FOR CIAT

So far I've talked about the United States' efforts at international cooperation. But what about CIAT?

Well, we in the United States feel that CIAT is an excellent forum for exchanging views and achieving the goal of increasing international cooperation in compliance. However, the individual countries must look beyond CIAT meetings and see if bilateral exchanges with CIAT members or other countries would not be beneficial. We urge you to review existing treaties or consider establishing treaties. The benefits that you could derive from these treaties could be substantial.

-- The Future

I would like to extend an invitation to all CIAT members to meet with the Internal Revenue Service and discuss further our international tax enforcement efforts. In addition, we could explore ways of exchanging technical "know how" and conducting regional and industrywide exchanges that could benefit you and your treaty partners.

Exchanging "know how" could include providing certain training material on a variety of international tax issues such as foreign tax credits and transfer pricing and discussing the uses of economists, computer audit specialists, and engineers in the actual conduct of examinations.

Regional exchanges could focus on certain industries that affect all or many CIAT members.

Exchanges on bauxite and aluminum with Brazil, the Dominican Republic, Haiti, Jamaica, and Surinam might be productive -- particularly to discuss the new approaches to indexing in this industry. Oil could be the subject of an exchange with Mexico, Venezuela and other CIAT participants interested in our methodology in establishing arm's-length prices of crude oil and related products. And just about any participant who needs a greater understanding of various aspects of banking might want to set up an exchange on that industry.

Finally, I'd like to discuss an area that concerns all of us -- narcotics trafficking and the money it generates. For example, huge amounts of cash are flowing in and out of the United States, particularly in the State of Florida. Money goes out to finance narcotics purchases then returns for investment. Funds also are going to tax havens for investment, safekeeping, or to disguise the true source of the money, for example loans rather than income.

All our tax systems suffer when these large amounts of illegal income escape taxation. Therefore, all of us might consider setting up information exchanges on narcotics trafficking. These exchanges would be similar to those now used or proposed for legitimate industries. I'm convinced that all our countries could benefit and I would appreciate hearing your views on this subject.

VI. CONCLUSION

The degree of international noncompliance differs for all countries. Lack of information on ways to curb these abuses of the tax laws has impeded many countries.

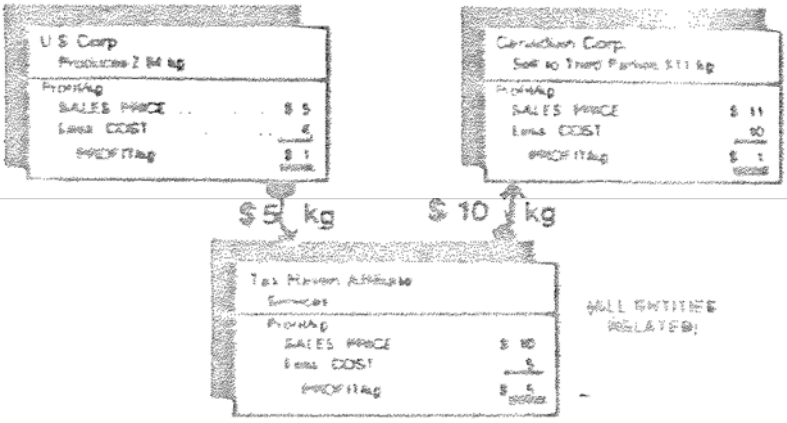
However, in the last few years we have made great strides in dealing with international noncompliance. Provisions for exchange of information in income tax treaties have enabled us to get information that we wouldn't have gotten any other way. Through Simultaneous Examination Programs, industrywide exchanges of information and spontaneous exchanges of information, the United States and its treaty partners are dealing more effectively with international abuses of the tax laws.

Members of CIAT have a lot to gain from international cooperation. Working together we can combat transfer pricing, the use of tax havens, unreported income from illegal sources, and other noncompliance schemes. Once more, I urge you to get involved in bilateral and multilateral discussions. Let's make international cooperation our common goal for the future!

* * *

VII. APPENDIX

Illustration - Case with Canada



Block Diagram

KEY POINTS

1) Hypothetical figures are used for illustrative purposes.

2) All entities related.

3) Tax haven entity buys goods from U.S. entity at $5/KG.

4) Tax haven entity profits at $5/KG. (NOTE: U.S. and treaty partner entities have a gross profit of only $1/KG. This indicates a transfer pricing problem).

5) Examination teams of U.S. and treaty partner work together and exchange information to determine a proper arm's-length price.

6) Flow of goods bought by tax haven entity from treaty partner entity and sold to U.S. entity is not shown.