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Impact of Multilateral Tax Information Exchange Programs

Expansion of Multilateral Tax Information Exchange Programs May Have Significant Implications for Taxpayers with International Operations

INTRODUCTION

As a result of the growth in frequency and complexity of cross-border transactions, and the pressure on tax authorities around the world to generate new sources of fiscal revenue in the current economic climate, most tax authorities are strengthening their efforts to obtain tax information from other tax authorities, with measures ranging from expanding international tax treaties and Tax Information Exchange Agreements ("TIEAs") to expanding multilateral information exchange programs like the Joint International Tax Shelter Information Centre ("JITSIC") and the Leeds Castle Group. In the past, these programs have focused on generating real-time information on so-called "abusive tax avoidance transactions" in order to shut down quickly these perceived abuses. Recently, however, transfer pricing arrangements and other "routine" cross-border transactions are being targeted as well.

While such measures have generated vast amounts of new information about taxpayers and certain types of tax-motivated transactions, such information exchange can often saddle multinational taxpayers with increased compliance burdens and inconsistent, perhaps increased, tax liabilities. This is because the relevant tax authorities may interpret and apply the information collected differently, resulting in divergent and perhaps inconsistent tax treatment across jurisdictions. This is of particular concern in the area of transfer pricing: with the expected increase in joint examinations and information sharing with respect to particular taxpayers, multinational corporations have to be particularly careful to develop tax positions that are consistent across multiple jurisdictions, including transfer pricing arrangements that satisfy the divergent requirements of the various jurisdictions.

This memorandum looks at recent developments in multilateral tax information exchange programs, such as JITSIC, the Leeds Castle Group, the OECD Forum on Tax Administration, and the Seven Country Working Group on Tax Havens, and discusses the implications for taxpayers with international operations.

DISCUSSION

A. INCREASED INTERNATIONAL TAX COMPLIANCE FOCUS

The United States has made international tax compliance a top priority. The Commissioner of the IRS has been speaking for some time about how international issues have become a top priority for the IRS, and more recently, specifically noted that there will be a particular focus on the following areas: transfer pricing, financial instruments, hybrid structures, and withholding taxes.[1] In addition, as part of President Obama's 2010 budget proposal, the IRS would receive funding to hire approximately eight hundred new employees devoted to international enforcement, including revenue agents, economists, and lawyers. In connection with this effort, the IRS Commissioner has announced that international cooperation will include joint examinations with other nations and the development of joint definitions around information reporting requirements.[2] The bottom line is that the IRS is "expanding its already robust cooperation and communications with foreign governments, using both informal and formal mechanisms to ensure U.S. taxpayer compliance."[3]

Currently, the US has tax treaties and cooperative TIEAs with over 70 countries. While such bilateral agreements are quite important in facilitating international tax compliance, this memorandum will focus instead on multilateral information exchange programs, namely, JITSIC, the Leeds Castle Group, the OECD Forum on Tax Administration and the Seven Country Working Group on Tax Havens.

1. JITSIC

a. History

In April 2004, recognizing the tax administration challenges presented by the rapid growth of cross-border transactions, the Internal Revenue Service ("IRS"), Her Majesty's Revenue and Customs ("HMRC"), and the tax authorities of Canada and Australia created JITSIC to identify abusive tax avoidance transactions. JITSIC is headquartered in Washington, DC, where JITSIC personnel from its member tax authorities are located. JITSIC personnel exchange information on an ongoing basis regarding potentially abusive tax schemes, their promoters, and their participants. This exchange of information takes place in accordance with the provisions of the bilateral treaties between each of the countries involved.

The composition of JITSIC has now increased to five member countries plus two countries that are observers. In 2007, a London office was opened, and Japan accepted JITSIC's invitation to become a member. Beginning in September 2008, JITSIC hosted a Chinese observer for a period of three months. At its most recent meeting in January 2009, JITSIC agreed to invite South Korea as an observer in the Washington, DC office during 2009. JITSIC country members further agreed to continue their joint efforts to broaden JITSIC's activities beyond cross-border transactions to include the heightened scrutiny of off-shore arrangements and high net-worth individual taxpayers. JITSIC also reiterated its emphasis on transfer pricing compliance.

b. Significant Developments

A high-profile example of JITSIC's operation was how information sharing through JITSIC enabled the IRS to learn about the existence and operation of certain so-called "foreign tax credit generator" transactions. The US Treasury Department has acknowledged that the US government only became knowledgeable about these transactions through information provided by HMRC tax officials in connection with JITSIC.[4]

As a result of the information sharing through JITSIC, these transactions became the subject of a set of US Treasury Regulations that significantly revised the foreign tax credit rules. According to a former director of JITSIC, JITSIC brought together the examination teams of the different countries in auditing these transactions and sharing best practices.[5] Although these transactions were of special interest to the US, other JITSIC countries began questioning foreign tax credit claims under their domestic law as well; an IRS official noted in 2007, "We have some partners in JITSIC that have identical concerns to our own and, where we can, under appropriate treaty provisions, we have exchanged information."[6]

JITSIC has also identified other transactions, such as[7]:

- The marketing of a cross-border transaction involving Canada and the US that involved hundreds of taxpayers and tens of millions of dollars in what the IRS has characterized as improper deductions and unreported income from retirement account withdrawals; and
- Transactions that the IRS has described as the manufacturing of losses by brokers on futures and options transactions for individuals in other JITSIC jurisdictions, leading to a tax loss of more than $100,000,000.

JITSIC has been credited with improving the tax administrators' understanding in a number of other areas, including hybrid instruments; the UK's arbitrage rules, for example, are said to be a direct result of participation in JITSIC.[8] In addition, increased cooperation has led to multiple-jurisdiction audits and joint examinations: the US has already conducted a few simultaneous audits with other jurisdictions in recent years.[9]

Apart from specific initiatives directed towards certain types of transactions, JITSIC has also been credited with facilitating the sharing of best practices among its various member tax administrations. For example, the IRS has become interested in HMRC's "Review of Links with Large Business" program implemented in 2006, pursuant to which HMRC conducted a risk analysis of each of its Large Business Service ("LBS") taxpayers. The risk analysis, which is shared with the LBS taxpayer, results in each LBS taxpayer being characterized as "high-risk" or "low-risk," with low-risk taxpayers subject to audit only every three years, so long as the taxpayer files its returns and complies with other requirements. At least one former IRS official has recommended that the US adopt this program for its own LMSB (large business) taxpayers.[10]

As a result of JITSIC's perceived success, the IRS Commissioner announced in December 2008 that he had asked the IRS international team "to develop a multi-year proposal for expansion of JITSIC beyond its roots in combating tax shelters."[11] Accordingly, earlier this year, the IRS and other tax authorities announced that JITSIC has added four new areas of focus: tax administration issues arising from the global economic environment, offshore arrangements, high net-worth taxpayers (in particular, such taxpayers' use of complex financial vehicles), and transfer pricing compliance. In the words of one IRS official, "It's not just about tax shelters anymore."[12] JITSIC has also been expanding its focus to address small business and tax-exempt issues, including increased attention on cross-border charitable gifting arrangements.[13]

2. Leeds Castle Group

In 2006, the tax authorities of ten countries formed the so-called "Leeds Castle Group," which meets regularly to discuss issues of global and national tax administration, including mutual compliance challenges, tax shelters, and the challenges of increased globalization. The participating countries are Australia, Canada, China, France, Germany, India, Japan, South Korea, the UK, and the US. The formation of this group is particularly significant, since it is the first time China, India, and South Korea have participated in formal, multilateral tax information exchange discussions.[14] According to the IRS, this effort has been largely successful, and the IRS is seeking to apply the same model of international cooperation to emerging issues, including transfer pricing.[15]

3. OECD Forum on Tax Administration

Since 2002, the OECD has sponsored the Forum on Tax Administration ("FTA"), a group consisting of the tax administrators from its 30 member nations plus several other non-member countries. The FTA has promoted dialogue between the tax authorities to identify good tax administration practices and to promote tax enforcement. The FTA's areas of focus include the following:

- Developing a directory of aggressive tax planning schemes in order to identify trends and countermeasures;
- Examining the roles of tax intermediaries, such as lawyers and accountants, in enabling tax evasion;
- Expanding the 2004 Corporate Governance Guidelines to encourage companies to issue a set of tax principles to guide their tax activities; and
- Improving the training of tax officials, especially on international tax matters.

In September 2006, the FTA issued the "Seoul Declaration," which identified international tax noncompliance as a "multi-faceted problem" and declared the member countries' commitment to cross-border information sharing and improved "practical cooperation" to counter noncompliance.[16]

Following the issuance of the Seoul Declaration, the OECD's Tax Intermediaries Project was initiated. This effort focused on the role that "intermediaries," such as attorneys, accountants, and other advisers, played in promoting tax avoidance transactions. As part of this project, consultations took place during 2006 and 2007 in the UK and the US with corporate taxpayers, investment bankers, and accounting and legal professionals. A working group was formed to analyze the information obtained during these consultations. The ultimate published study by the working group was intended to provide a global baseline for intermediary activities. The report was released in January 2008 and examined the tripartite relationship among tax administrators, taxpayers, and tax intermediaries. The report urged tax authorities to build cooperative relationships with corporate taxpayers, by applying standards of impartiality, proportionality, openness, responsiveness, and an understanding based on commercial awareness to all taxpayers and by using effective risk-management policies to allocate resources to high-risk taxpayers, in order to obtain greater disclosure and cooperation from corporate taxpayers.

The US Treasury Department has been largely satisfied with the work coming out of the OECD; in 2007, John Harrington, acting Treasury international tax counsel at the time, observed, "We have worked with other countries, particularly through the OECD, to raise international standards of information exchange…We have made great strides…It is now rare for a country to insist that it can only exchange information in which it has a domestic tax interest."[17] The IRS has reiterated its commitment to the FTA; in a June 2008 statement, the IRS Commissioner announced that the IRS "remains active in its bilateral and multilateral international tax administration efforts, including the [OECD's] Forum of Tax Administrators."[18] He also noted that the OECD has now agreed to study the role of banks in tax administration and compliance: "I intend to actively work with my colleagues around the world to ensure taxpayers and the banks that facilitate tax evasion receive increased attention."[19]

4. Seven Country Working Group on Tax Havens

The Seven Country Working Group on Tax Havens, consisting of Australia, Canada, France, Germany, Japan, the UK, and the US, has been issuing international alerts on tax-motivated transactions and tax havens. Several such alerts have been issued to date on matters including captive insurance, offshore trusts and partnerships, and withholding taxes. Even though the group's major initiative is the issuance of international alerts to its member tax administrations on tax-motivated transactions involving domestic taxpayers and tax havens, the members also exchange information bilaterally regarding cases and promoters, share research and information on transactions encountered and strategies adopted, and conduct joint training sessions.

B. IMPACT OF MULTILATERAL TAX INFORMATION EXCHANGE PROGRAMS

What is the impact of all of these programs on tax administration around the world?

Government officials from the US and the UK have highly praised the accomplishments of these programs to date. The IRS Commissioner testified before the US Congress in March 2009 that JITSIC has

> proved to be another important arrow in our quiver…The results, to date, have been promising. The U.S. has received information regarding transactions of which it had not been previously aware. Indeed, in light of the complexity of the transactions, and considering the inherent difficulty normally associated with obtaining taxpayer-specific shelter information from foreign countries, it is unlikely that these transactions would have been uncovered and understood, but for JITSIC.[20]

A former IRS Commissioner proclaimed that JITSIC is "huge" and that its future impact will be "truly profound."[21] More specifically, a former director of JITSIC noted that the real-time exchange of information by JITSIC "has saved the IRS years in terms of uncovering abusive transactions."[22] An HMRC official used more colorful language, promising to make US practitioners' "blood pressure rise" by publicizing how the work of JITSIC, the FTA, and the Leeds Castle Group helps tax authorities close the gap on abusive cross-border tax evasion.[23]

Perhaps the most dramatic evidence of the influence of JITSIC and similar programs is found in the response of tax practitioners: according to a November 2008 survey by Ernst & Young of 285 international tax professionals (the majority of whom were employed by US corporations), 20% of respondents have begun to experience the effects of tax authority cooperation; 59% of those respondents have seen such cooperation in the form of treaty information exchange; 30% have "experienced joint audits"; and 23% have experienced the activities of JITSIC and other international tax authority groups.[24]

CONCLUSION

Under the current economic climate, in which there is significant pressure on tax authorities worldwide to generate revenue, most tax authorities are strengthening their efforts to obtain tax information from other tax authorities, including through the expanded use of multilateral information exchange programs like JITSIC, the Leeds Castle Group, the FTA, and the Seven Country Working Group on Tax Havens. There is no doubt that this increased coordination and cooperation among tax authorities will have a significant impact on taxpayers with operations in multiple jurisdictions. Consequently, taxpayers must be careful to develop positions that are consistent across multiple jurisdictions and consider how information disclosed to the tax authority in one jurisdiction will be interpreted and used by a tax authority in another jurisdiction in which the taxpayer operates.

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ENDNOTES

[1] Prepared Remarks of Douglas H. Shulman, Commissioner of Internal Revenue, before the Organization for Economic Co-operation and Development, Washington, DC, June 2, 2009.

[2] Coder, Jeremiah, "Exam Coordination and Information Sharing are Crucial, International Officials Say," 2009 TNT 89-13, May 12, 2009 (quoting Barry Shott, deputy commissioner (international) with the IRS Large and Midsize Business Division: "The IRS is looking at opportunities to do joint examinations with other countries.").

[3] Tax Executives Institute, "IRS Discusses Administrative Issues with Tax Executives Institute," 2009 TNT 75-29, April 22, 2009.

[4] See, *e.g.*, Goulder, Robert, "Government Learned of Foreign Tax Credit Abuse Through International Information Exchanges," 2007 TNT 93-5, May 14, 2007.

[5] Nadal, Lisa, "JITSIC Puts U.S. Antiabuse Effort on Fast Track, Former Director Says," 2008 TNT 205-11, October 22, 2008.

[6] Goulder, Robert, "IRS Targets Foreign Tax Credit Generators," 2007 TNT 48-4, March 12, 2007.

[7] Internal Revenue Service, "IRS Announces Expansion of Joint International Tax Shelter Information Centre," 2007 TNT 101-11, May 24, 2007.

[8] Ernst & Young, "Tax Administration Goes Global: Complexity, Risks, Opportunities," 2007 TNT 39-48, February 27, 2007.

[9] Ernst & Young, "Tax Administration Goes Global: Complexity, Risks, Opportunities," 2007 TNT 39-48, February 27, 2007, citing "Ng Discusses IRS's Renewed Focus on International Activities, Gives Update on Penalties, Cost-Sharing Cases," 229 Daily Tax Report at J-1, Nov. 29, 2006 (in which Frank Ng, IRS deputy commissioner (international), states that the IRS is conducting an average of approximately four simultaneous audits per year). See also, Coder, Jeremiah, "Exam Coordination and Information Sharing are Crucial, International Officials Say," 2009 WTD 89-8, May 11, 2009, in which Barry Shott, deputy commissioner (international) with the IRS LMSB Division, states that the IRS is looking at opportunities to do joint examinations with other countries.

[10] Nadal, Lisa, "JITSIC Puts U.S. Antiabuse Effort on Fast Track, Former Director Says," 2008 TNT 205-11, October 22, 2008.

[11] Internal Revenue Service, "Shulman Discusses Emerging Trends in International Tax Administration," 2008 TNT 236-10, December 9, 2008.

[12] Coder, Jeremiah, "Exam Coordination and Information Sharing are Crucial, International Officials Say," 2009 TNT 89-13, May 12, 2009.

[13] Nadal, Lisa, "JITSIC Puts U.S. Antiabuse Effort on Fast Track, Former Director Says," 2008 TNT 205-11, October 22, 2008.

[14] Ernst & Young, "Tax Administration Goes Global: Complexity, Risks, Opportunities," 2007 TNT 39-48, February 27, 2007.

[15] Internal Revenue Service, "Shulman Discusses Emerging Trends in International Tax Administration," 2008 TNT 237-10, December 9, 2008.

[16] Third Meeting of the OECD Forum on Tax Administration, "Final Seoul Declaration," September 15, 2006.

ENDNOTES *Continued*

17 Harrington, John, "Treasury's Acting International Tax Counsel Committed to Improving Tax Compliance," 2007 TNT 87-34, May 4, 2007.

18 Weinberger, Mark A., Ernst & Young, "Shifting Business, Tax Environment Brings Challenges Opportunities," 2008 TNT 171-20, September 3, 2008.

19 *Id.*

20 Shulman, Douglas, "Shulman Describes IRS's 'Unprecedented Focus' on Offshore Tax Avoidance," 2009 TNT 60-60, April 1, 2009.

21 Nutt, Audrey, "IRS, U.K. Revenue are Sharing Information to Target Abusive Tax Arbitrage," 2006 TNT 232-2, December 4, 2006.

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23 Goulder, Robert, "Government Learned of Foreign Tax Credit Abuse Through International Information Exchanges," 2007 TNT 93-5, May 14, 2007.

24 Ernst & Young LLP, "Ernst & Young Survey Finds 95 Percent of Respondents Concerned about New Tax Legislation," 2008 TNT 215-16, November 5, 2008.

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