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Tax Controversy

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Contents

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1. Tax Controversies

1.1 Tax Controversies in this Jurisdiction

Tax controversies in the USA arise in numerous ways. The system of tax in the USA is based on an expectation that taxpayers will properly self-assess taxes due. Income tax controversies usually arise as a result of an Internal Revenue Service (IRS) audit of the taxpayer's tax return. The IRS regularly audits returns filed by individuals, partnerships, corporations and other business entities, and these audits can result in disagreements between the IRS and the taxpayer over one or more items reported on the return. Controversies can also arise from a taxpayer filing a claim for refund of taxes previously paid and such claims for refund can attract more audit scrutiny than a tax return reporting taxes due.

Taxpayers may also disagree with and challenge administrative decisions made by the IRS on a variety of issues. For example, taxpayers may dispute the IRS' determination of an entity's tax-exempt status. Moreover, taxpayers who are subjected to foreign tax may seek relief from double taxation by working through the designated 'competent authorities'. Apart from income tax, controversies can also involve employment, excise, and estate and gift taxes. For example, the IRS may challenge the determination of a worker's employment status or the tax-exempt status of certain benefits provided to employees.

Finally, disputes can arise regarding the scope of information the IRS seeks to obtain for an audit. These disputes can involve the taxpayer being audited and, occasionally, third parties, when the IRS seeks information from a third party to aid in its audit of another party.

1.2 Causes of Tax Controversies

In 2017, the IRS audited almost 1.1 million tax returns, or 0.5% of all returns filed. Most of these were filed by individuals. Approximately 1% of all corporate returns are audited. Overall, audits of individual returns resulted in recommended additional tax of approximately USD4.7 billion and audits of corporate returns resulted in recommended additional tax of approximately USD17 billion (https://www.irs.gov/pub/irs-soi/17databk.pdf). Large corporate taxpayer controversies tend to involve the largest amounts in dispute, with up to billions of dollars at issue for a single two or three-year audit period. These disputes are typically the most complex due to the uncertainty in the law as applied to the underlying facts in these matters.

1.3 Avoidance of Tax Controversies

Tax controversies are best avoided by both the work performed by the taxpayer before filing her or his tax return and, once an audit is initiated, by working co-operatively with the IRS. Prior to filing a tax return, the taxpayer should rigorously develop and organise the relevant facts, review and consider the applicable tax law, and prepare proper supporting documentation. In addition to these best practices, the taxpayer should create an audit file containing all work product supporting her tax reporting positions. This audit file ensures the taxpayer can readily access information to aid in responding to any IRS enquires in the future. Taxpayers frequently engage external advisers (ie, law firms and accounting firms) to help prepare for audits.

Once an audit is initiated, taxpayers can avoid certain tax controversies by providing complete and candid responses to IRS questions. By demonstrating transparency and co-operation with the IRS, a taxpayer can build a productive relationship that results in an efficient audit. Although the IRS may not ultimately agree with a taxpayer's reporting, by responding completely and in a timely manner to the IRS' requests for information, a taxpayer can avoid many potential pitfalls that extend the audit unnecessarily or can even lead to an adjustment because the IRS possesses insufficient information. A good working relationship with the IRS can allow the parties to resolve any taxpayer concerns with the IRS' requests (eg, overbroad, burdensome).

For complex issues, the taxpayer can volunteer to provide the IRS with a presentation to explain key facts and applicable law. The IRS examiners may informally ask questions and thereby enhance their understanding of the issue. This process can accelerate the audit and provide the IRS comfort that it is able comprehensively to develop an understanding of the issue.

Certain tax controversies are unavoidable regardless of the actions taken by the taxpayer. These controversies typically involve situations in which the IRS disagrees with the taxpayer's interpretation of the facts or the law with regard to an issue.

1.4 Efforts to Combat Tax Avoidance

For decades, the IRS has scrutinised transactions that shift profits outside the USA. That focus has intensified in response to recent multilateral efforts to reduce base erosion and combat tax avoidance. As a result, the IRS has allocated significant resources to support these audits. In addition, the IRS has increasingly been using cross-border discovery tools to exchange taxpayer and financial information with other countries.

Further, although the USA has not comprehensively adopted the Organisation for Economic Co-operation and Development's (OECD's) recommended base erosion and profit shifting (BEPS) guidelines, it has adopted country-by-country reporting for large multinationals. Country-by-country reporting requires large multinational taxpayers to provide an annual return to the IRS that breaks down the key elements of its financial statements in each foreign jurisdiction where the company operates. This annual return provides the taxing authorities with visibility into revenue, income, taxes paid and accrued, employment, capital, retained earnings, tangible assets and activities. Moreover, in the USA, legislation enacted in 2017 attempted to combat profit-shifting by lowering the corporate tax rate and imposing a one-time transition tax on offshore earnings.

1.5 Additional Tax Assessments

When the IRS proposes an adjustment to the taxpayer's tax reporting position that results in additional taxes due, the taxpayer may agree to the adjustment or challenge it. If the taxpayer agrees, the tax is assessed and must be paid immediately. If the taxpayer challenges the adjustment, in most cases the taxpayer is offered the opportunity to resolve the outstanding issue(s) administratively with the IRS Office of Appeals (Appeals).

If the matter is not resolved at Appeals, or if the taxpayer chooses not to pursue Appeals, she may challenge the IRS' proposed adjustments in court. The taxpayer has three forum choices for litigation. First, the taxpayer can challenge the proposed adjustment by filing a petition in the Tax Court before paying the proposed additional tax. Alternatively, the taxpayer can challenge the proposed adjustment in either the Court of Federal Claims or the applicable federal district court. To initiate litigation in the Court of Federal Claims or the applicable federal district court, the taxpayer is required first to pay the proposed additional tax, accrued interest and penalties.

Once the additional tax due has been conclusively determined – by agreement or by a court – the IRS 'assesses' the additional tax. Assessment is a technical term for the act of establishing in the IRS system the legal obligation of the taxpayer to pay the additional tax liability. After assessment, the taxpayer receives formal written notification of the additional tax, interest and penalties due, and must pay that liability within ten days.

If the taxpayer does not pay the additional amounts due in a timely manner, the IRS has available powerful tools to collect the liability. For example, the IRS may place a tax lien on the taxpayer's assets notifying potential creditors of the IRS' rights to those assets. Alternatively, the IRS can enforce collection by issuing a levy, which permits the IRS to seize a taxpayer's property to satisfy the outstanding tax debt. To enforce the levy, the IRS can garnish wages, seize financial accounts, or seize and sell a taxpayer's assets.

2. Tax Audits

2.1 Main Rules Determining Tax Audits

The ultimate criteria the IRS uses to select a tax return for examination or audit are not made public. However, the IRS has publicly identified certain information regarding its selection criteria, which focus on the size of the taxpayer, type of entity and type of issue.

Large Businesses

The largest taxpayers in the country are under continuous audit by the IRS. A subset of this group of large business taxpayers, who meet the eligibility criteria, is given the opportunity to participate in the Compliance Assurance Process (CAP) programme, under which the IRS and the company work together to identify and resolve issues before the taxpayer files a tax return. The objective of CAP is to reduce taxpayer burden and uncertainty while simultaneously reducing or eliminating the need for post-filing examinations.

The IRS is also taking steps to move towards issue-based examinations. For example, the IRS Large Business & International (LB&I) division has recently developed a compliance campaign process that targets specific issues affecting large numbers of LB&I taxpayers. The goal of the campaign process is to improve return selection, identify issues representing a risk of non-compliance and maximise the use of limited resources.

Individuals and Small Businesses

For most taxpayers, such as individuals and small businesses, the IRS uses computer programs to identify tax returns that appear to report incorrect amounts or to be inconsistent with information received from third-party documentation (eg, Forms 1099, W-2). Tax returns identified in this way may be audited where the IRS has determined that the potential is high that an examination will result in a change in tax liability.

Although there is no public information selection criteria for high net worth individuals, there is a dedicated group within the IRS, the Global High Wealth Industry Group, that specialises in audits of high-income taxpayers and their closely held entities.

Partnerships

Congress and the IRS recently revised the special rules and procedures applicable to partnerships, which apply to returns filed for partnership taxable years beginning after 31 December 2017. Under the new procedures, the IRS will adjust all partnership-related items at the partnership level and issue a notice of Final Partnership Adjustment (FPA). The partnership has the option of paying the additional tax, interest and penalties asserted in the FPA, 'pushing out' the increased liability to the partners, or challenging the adjustments by filing a petition for readjustment in Tax Court, the Court of Federal Claims, or the applicable federal district court.

2.2 Initiation and Duration of a Tax Audit

The only time constraint on the initiation and completion of an IRS audit is the statute of limitations on assessment.

In most circumstances, the assessment statute expires three years after the date the tax return was filed, but there are notable exceptions. For example, if a taxpayer's return has a substantial omission of gross income (ie, an omission in excess of 25% of the amount of gross income stated in the return), the IRS has up to six years to assess. Further, no time limits apply if the taxpayer fails to file a tax return or files a false or fraudulent return.

An IRS audit can last from a few days to several years. Audits of individuals where the IRS is merely verifying certain basic information tend to be relatively short and are often conducted entirely by written correspondence. By contrast, audits of large businesses typically take years to complete.

An audit does not suspend the running of the statute of limitations. Therefore, to accommodate an IRS audit that extends beyond the date the statute of limitations is set to expire, the taxpayer and the IRS must both execute an agreement to extend the statute of limitations. Most large businesses execute a series of agreements extending the statute of limitations because the IRS typically initiates the audit long after the return was filed, and because audits of large businesses can span years.

If an audit has become unnecessarily protracted, the taxpayer can refuse further extensions of the statute of limitations. But that approach has potentially severe consequences: if the taxpayer refuses to extend the statute of limitations, the IRS will often finalise the contemplated adjustments and terminate the administrative process through the issuance of a statutory notice of deficiency, forcing the taxpayer to file in court in order to challenge the adjustments.

Alternatively, if the taxpayer refuses to extend the assessment statute and the IRS wants more information to complete the audit, the IRS may issue a special 'designated summons'. A summons designated under I.R.C. § 6503(j) suspends the assessment statute until the taxpayer has furnished the information requested.

2.3 Location and Procedure of Tax Audits

The IRS typically audits large businesses by placing an audit team on site. This allows the IRS more efficiently to obtain the information required to examine the taxpayer's return. IRS audits of small businesses and individuals are often less complicated than audits of large businesses, and typically take place entirely by correspondence and telephone contact with the IRS.

The IRS always requires documentation substantiating the taxpayer's reporting. The IRS' authority to obtain information from taxpayers is extremely broad. It may seek any information necessary to evaluate the correctness of the taxpayer's return. Some courts have even endorsed the IRS' ability to undertake a 'fishing expedition'.

The primary tool used by the IRS to obtain taxpayer documentation is the Information Document Request (IDR). Typically IDRs ask for documents, but the IRS can also issue IDRs that request narrative responses (eg, asking a taxpayer to state its legal position for a certain reporting position) or that seek employee interviews.

If the IRS determines an IDR response is inadequate, it may issue an administrative summons to compel a taxpayer's cooperation. If a taxpayer fails to comply with a summons, the IRS may seek to enforce the summons in federal district court.

The IRS may also issue summonses to third parties that may have information relevant to the audit of the taxpayer. These summonses can be issued to third-party record-keepers that may have bank records or other similar information, transactional counterparties, or the taxpayer's advisers.

2.4 Areas of Special Attention in Tax Audits

The IRS generally instructs its agents to examine all large, unusual or questionable items on a return. The IRS uses a wide variety of methods to identify issues to audit. For example, the IRS publishes 'audit technique guides' that assist IRS examiners by providing insight into issues and accounting methods unique to specific industries.

The IRS also scrutinises required disclosures. Taxpayers have an obligation to disclose certain tax positions based on objective criteria, identifying these issues for audit. For example, large taxpayers with at least USD10 million in assets are required to inform the IRS of any "uncertain tax positions" by filing a 'Schedule UTP'. This schedule must include a concise description of all transactions for which the taxpayer has (i) recorded a reserve on its audited financial statements, or (ii) has not recorded a reserve because the taxpayer intends to litigate the position. Moreover, taxpayers are required to disclose certain "reportable transactions" and "transactions of interest" as designated by the IRS. Taxpayers also disclose positions taken on the return contrary to regulations, as well as positions where disclosure may help mitigate potential penalties.

Large Businesses

At the beginning of an LB&I audit, the IRS obtains financial information from the taxpayer – typically in electronic form – and uses this information in combination with the taxpayer's return to conduct a risk assessment to identify any items warranting further examination. The IRS also reviews any taxpayer disclosures and typically examines issues by issuing specific IDRs.

In addition, the IRS is required to obtain all transfer pricing documentation at the beginning of any multinational corporation's audit. Taxpayers must maintain transfer pricing documentation for all significant intercompany transactions and provide it upon an IRS request. The IRS also typically asks for documentation related to significant mergers, acquisitions, or restructurings that occurred during the audit period.

The IRS has also identified certain 'campaign' issues as potentially involving a high risk of tax avoidance or non-compliance. If a taxpayer's return involves any of the campaign issues, it can expect such campaign issue to be a significant focus of its audit. As of April 2019, the IRS has identified 45 campaigns.

2.5 Impact of Rules Concerning Cross-border Exchanges of Information and Mutual Assistance Between Tax Authorities on Tax Audits

The increasing use of cross-border information exchange and mutual assistance among tax authorities has resulted in more frequent co-ordination of audits and sharing of information between the USA and foreign jurisdictions. These methods include the Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC) and Mutual Agreement Procedures (MAPs). JITSIC is an agreement between members of the OECD's Forum on Tax Administration that is intended to identify and curb tax avoidance transactions. Through JITSIC, countries share expertise, best practices and experience, along with information about abusive transactions, the promoters and the taxpayers involved, with no requirement to notify the taxpayers involved.

MAPs in tax treaties outline the procedures by which the two countries will work together to determine the proper tax due in each jurisdiction to prevent double taxation. Taxpayers can file a MAP request with respect to adjustments proposed during the IRS examination process or with respect to foreign-initiated adjustments. Once a MAP request is initiated, the relevant competent authorities typically share detailed information about the issue.

Large Businesses

Large multinational taxpayers are increasingly likely to encounter requests for assistance and information from different taxing authorities. This trend is likely to accelerate with the additional transparency afforded by BEPS' country-by-country reporting. Taxpayers with more than USD850 million in worldwide revenue are now required to file country-by-country reports with the USA. This information will be shared with other jurisdictions with which the USA has information-sharing arrangements. Likewise, foreign jurisdictions will share corresponding information reported by the taxpayer in the foreign jurisdiction. As this additional information is made available, it is expected that significant additional controversy may arise, whether due to additional transparency or due simply to the fact that the IRS is obtaining information from new sources.

Small Businesses and Individuals

There are also several regimes in place to facilitate the exchange of information among tax authorities concerning certain foreign financial assets held by individuals. For example, the Foreign Account Tax Compliance Act requires foreign financial institutions to report to the IRS certain information on foreign accounts held by US taxpayers.

More recently, the OECD has adopted a similar approach for exchanging information pertaining to foreign financial assets outside the USA through the implementation of the Common Reporting Standard, a global standard for the automatic exchange of financial account information.

2.6 Strategic Points for Consideration During Tax Audits

Different strategic and tactical considerations are implicated depending on the unique circumstances of each audit. As discussed in **1.3 Avoidance of Tax Controversies**, one important strategic consideration in an audit is developing and maintaining a candid, co-operative relationship with the IRS.

Another key strategic consideration is whether, and to what extent, to extend the statute of limitations to permit further IRS examination. As explained in **2.2 Initiation and Duration of a Tax Audit**, the IRS must complete the audit before the assessment statute expires. However, a taxpayer's decision regarding whether to extend the statute of limitations has implications. Extending subjects the taxpayer to further IRS scrutiny, but refusing to extend may result in the issuance of a statutory notice of deficiency, forcing a taxpayer to litigate if she disagrees with the IRS conclusions.

In addition, taxpayers are confronted with the tactical question of whether to elevate to IRS management their concerns regarding an audit. IRS rules authorise the elevation of procedural issues, such as the length or scope of the audit, and substantive issues, such as the taxpayer's view that the IRS audit team is making adjustments inconsistent with the applicable law.

Finally, taxpayers must decide whether to turn over to the IRS privileged information, such as tax opinions, which the IRS frequently demands. The taxpayer must weigh numerous considerations in resolving that issue, including whether privilege waiver has more benefit than the potential costs of disclosing such advice.

3. Administrative Litigation

3.1 Administrative Claim Phase

IRS Appeals

Appeals resolves disputes between the taxpayer and the IRS by providing an independent review of the audit team's determinations. Unlike audit examiners, Appeals has the authority to resolve cases based upon a consideration of the parties' hazards of litigating the issue. The procedural path to Appeals begins by the IRS' issuance of a 30-day letter. The taxpayer presents its position regarding the adjustments raised in the 30-day letter by submitting a 'Protest', which sets forth the relevant facts and legal analysis. The IRS frequently responds to the taxpayer's Protest with a rebuttal. Then the entire file is transferred to Appeals for consideration.

Appeals assigns large cases to an appeals team case leader (ATCL). For more complex cases, subject matter experts (eg, specialised economists, experts in international tax law or other specialties, etc) can be assigned to assist the ATCL. The parties then engage in settlement discussions.

In virtually all cases a taxpayer has the right to review by Appeals. In certain limited circumstances, however, the IRS can determine that a case should not go to Appeals. First, when the case presents recurring, significant legal issues affecting a large number of taxpayers, the IRS can designate the case for litigation. Designated cases typically cannot be settled, even in litigation, without a full concession by the taxpayer. Second, the IRS can determine that Appeals consideration is inconsistent with the "sound administration of tax laws."

A taxpayer is not obligated to pursue Appeals prior to litigation and may inform the IRS it prefers litigation, in which case the IRS will not issue a 30-day letter. Taxpayers who have not pursued Appeals and are litigating in Tax Court can be given the opportunity for Appeals review during litigation.

The taxpayer and IRS can also attempt to resolve issues even before the audit has been completed. First, taxpayers may request referral of an issue to Appeals while the IRS continues to audit other issues, referred to as 'Early Referral'. Second, prior to the completion of an audit, taxpayers may request that Appeals mediate the resolution of one or more issues between the taxpayer and the audit team through Fast Track Settlement (FTS). The key difference between FTS and Early Referral is that for FTS the audit team must agree to the settlement terms and therefore FTS allows the audit team to consider the hazards of litigation.

Administrative Claim Phase

If the taxpayer declines Appeals consideration, or if all issues are not resolved in Appeals, the IRS will issue a statutory notice of deficiency, which permits the taxpayer to litigate in the Tax Court by filing a petition within 90 days.

The only circumstance in which a taxpayer must establish that she or he has exhausted the administrative process is when she or he elects to litigate in federal district court or the Court of Federal Claims. Before filing in these courts, a taxpayer is required to pay the disputed tax and lodge a timely administrative claim for refund with the IRS. This administrative claim is largely procedural, does not permit the taxpayer a hearing or other adjudicative vehicle and does not typically represent a meaningful opportunity for the taxpayer to have the IRS' initial decision reconsidered. The claim for refund must set forth the facts and legal bases that support the taxpayer's position.

3.2 Deadline for Administrative Claims

If the taxpayer goes to Appeals, there is no formal deadline by which the process must be completed, provided that the taxpayer may need to agree to further extensions of the statute of limitations on assessment.

If the IRS does not act on an administrative claim for refund within six months of the date the claim is filed, a taxpayer can file suit in federal district court or in the Court of Federal Claims. If the IRS formally denies the administrative claim for refund, the taxpayer must file any lawsuit within two years of the date the claim for refund was formally denied.

4. Judicial Litigation: First Instance

4.1 Initiation of Judicial Tax Litigation

At the conclusion of an audit, or the Appeals process, the IRS issues a statutory notice of deficiency. If the taxpayer chooses to litigate in Tax Court, she or he must file a petition in the Tax Court within 90 days of the notice. If the taxpayer chooses to litigate in the Court of Federal Claims or federal district court, she or he must pay the amount of tax asserted in the statutory notice of deficiency, file an administrative claim for refund with the IRS and, once the IRS denies the claim (or fails to act on it within six months), sue for a refund in the relevant court.

Partnerships can challenge the audit adjustments determined in the FPA by filing a petition for readjustment in Tax Court, the Court of Federal Claims, or the federal district court in which the partnership's principal place of business is located. If the petition for readjustment is filed in the Court of Federal Claims or federal district court, the partnership must first deposit the amount of additional tax, interest and penalties asserted in the Final Partnership Adjustment.

A bankrupt taxpayer may also challenge its tax liability in bankruptcy court. The bankruptcy code allows a bankrupt taxpayer to obtain a determination of tax liability for any tax year within the jurisdiction of the bankruptcy court.

4.2 Procedure of Judicial Tax Litigation

There are three phases to litigation in the USA: pre-trial, trial and post-trial. Civil tax cases in the USA are typically conducted before a judge (ie, a 'bench trial'). The discussion below focuses primarily on bench trial procedures.

Pre-trial

This phase is generally focused on discovery and issues that can be resolved without a trial. The parties are expected to exchange documents and information, and take deposition testimony of fact and expert witnesses in advance of trial to permit each side to prepare its case adequately and give an opportunity for a full factual airing that may facilitate resolution of the case prior to trial. In most cases, the IRS is the party who is seeking information from the taxpayer because the taxpayer is the one with the information supporting its position. Although the parties are expected to conduct discovery without significant involvement from the court, the parties can file motions with the court to assist in resolving any disputes.

Apart from discovery, the parties may seek rulings from the court on issues that can be decided without a trial (ie, summary judgment rulings). These rulings can dispose of a case entirely, or may only resolve a portion of a case.

Trial

At trial, the taxpayer and the government each present the relevant facts and expert evidence to the judge in support of their respective positions. The judge evaluates the credibility and probative value of the evidence in order to resolve all factual disputes. Evidence presented at trial can include documents, fact witness testimony and expert witness testimony.

Post-trial

Following trial, each party submits briefing to the court in which it explains how the evidence presented at trial supports its case. Once a case is fully submitted to the court, there is no specified timeframe in which the court must rule. By contrast, for cases tried before a jury in federal district court, the jury renders a verdict immediately following the trial. Following the trial court's decision, either party can appeal the decision to an appellate court. Often, after the court renders an opinion in a case, the parties must engage in a computations process to apply the court's legal and factual rulings to determine the correct tax liability for the year(s) at issue. The court will resolve any disputes between the parties over the final computation of tax liability.

4.3 Relevance of Evidence in Judicial Tax Litigation

Developing the factual record to support a taxpayer's case is critical. Although there are cases that involve only disputed legal issues and no disputed facts, those cases are rare. More frequently, the IRS and taxpayer disagree on the facts.

Trial evidence may consist of documents, fact witness testimony, summary evidence and expert opinions.

- *Documents* – most tax cases involve an extensive documentary record, including transactional documents, emails, PowerPoint presentations, memoranda, etc.
- *Fact witness testimony* – each party can call fact witnesses to testify at trial. Typically fact witnesses are taxpayer employees, officers or directors (for large cases), but third parties such as advisers or counterparties may also testify. Moreover, the taxpayer may call IRS witnesses to testify, for example, if the taxpayer is trying to prove that the IRS' actions were arbitrary and capricious.
- *Summaries* – voluminous data (such as sales records or financial information) can be summarised and presented as evidence at trial in order to make the presentation of such evidence easier for the court to comprehend.
- *Expert opinions* – experts draft reports detailing their opinions and provide testimony at trial. Experts may also provide rebuttals to the opposing side's expert reports.
- *Stipulations* – the parties can agree to certain facts or legal conclusions and memorialise these agreements in a document that is submitted to the court for it to rely on in rendering its opinion. In Tax Court, the parties must stipulate to all agreed facts and legal conclusions. In district court and the Court of Federal Claims, the parties are permitted to stipulate, but are not required to do so.

The significance of each piece of evidence is determined by the judge or jury based upon its probative value and credibility. For example, testimony by the taxpayer that property is worth USD100 – in the absence of any corroborating evidence – may be viewed as self-serving and, therefore, lacking credibility. In contrast, an expert opinion, well-grounded in documented evidence supporting the value of the property, may be very credible and persuasive.

In some cases, a party may dispute the scope of its discovery obligations because, for example, the party believes its adversary is overreaching and in those circumstances, court intervention may be necessary to resolve the discovery dispute. The Tax Court has expressed a preference for as much co-operation between the parties, informal discovery and stipulation as possible in an effort to minimise factual disputes. It has implemented procedures that motivate parties to resolve their factual differences without involvement of the court. By contrast, in federal district court where non-tax commercial cases are also heard, discovery can be more expansive.

Procedurally, litigation in the USA requires disclosure of virtually all relevant evidence in advance of trial. These rules also permit each party the opportunity to contest the admissibility of any evidence. For example, a taxpayer may depose an IRS expert and develop a record that permits it to challenge the admissibility of the expert's opinions on the basis that the expert is unqualified, or his opinion is unfounded.

It is critical to ensure that any evidence a taxpayer believes is relevant and probative to an issue is admitted into evidence at trial. Pre-trial disclosures have no relevance to the trial proceeding unless they are admitted into evidence because the judge or jury is not permitted to consider anything other than evidence in the trial record.

4.4 Burden of Proof in Judicial Tax Litigation
In civil tax litigation, the taxpayer typically has the burden of proving by a preponderance of the evidence that the IRS' determination is incorrect. In some types of cases, including transfer-pricing cases, the taxpayer must demonstrate that the IRS abused its discretion in adjusting the taxpayer's liability. In criminal tax litigation proceedings, the IRS has the burden of proving beyond a reasonable doubt that the taxpayer is guilty of the charged offence.

Although the taxpayer typically has the burden in civil cases, the burden can shift to the government in some instances, including where the government raises a new issue in its answer that was not raised during the audit.

4.5 Strategic Options in Judicial Tax Litigation
There are many strategic considerations when proceeding to litigation. The first significant decision is court selection. Tax controversies are litigated in three different forums: (i) Tax Court; (ii) the Court of Federal Claims; and (iii) the applicable federal district court. There are a number of factors to consider in selecting a forum.

- *Whether to pay the tax* – a taxpayer is permitted to litigate a tax controversy in the Tax Court without paying the tax due. To litigate in the Court of Federal Claims or federal district court, however, a taxpayer must first pay the tax and then seek a refund. Thus, whether the taxpayer is willing to pay the amount of tax claimed by the IRS is a key issue in forum selection.
- *Applicable law* – the law applicable to a tax controversy is determined by the forum in which the taxpayer chooses to litigate. The Tax Court and federal district court apply the law of the circuit in which the taxpayer resides. By contrast, the Court of Federal Claims applies the law of the Federal Circuit Court of Appeals, which may differ from the law of the circuit within which the taxpayer resides. Consequently, taxpayers must pay special attention to the potentially applicable appellate law in selecting a litigation forum.
- *Discovery* – another key difference between the Tax Court and the other forums is discovery. The Tax Court is generally more conservative with respect to discovery, limiting depositions of fact witnesses and, in many cases, prohibiting expert depositions. The Court of Federal Claims and federal district courts, in contrast, generally permit more extensive discovery, including depositions of expert witnesses.
- *Settlement discussions* – litigating in the Tax Court can provide the opportunity for review by Appeals, as long as the case has not been officially designated for litigation or the IRS determines that it will not allow Appeals consideration. Because cases in Tax Court are tried by IRS attorneys, any settlement discussions will be with the IRS. By contrast, cases litigated in federal district court or the Court of Federal Claims do not have the opportunity for Appeals consideration and any settlement discussions will be with the Department of Justice attorneys representing the government. In addition, the Congressional Joint Committee on Taxation must review any settlements that would result in refunds over certain dollar thresholds.
- *Juries* – all Tax Court and Court of Federal Claims cases are bench trials. Jury trials are generally available in federal district court if one of the parties makes a jury demand, but parties rarely elect to try their tax case in front of a jury.

4.6 Relevance of Jurisprudence and Guidelines to Judicial Tax Litigation
A trial court is generally bound to apply the precedent of the appellate court to which its decision may be appealed. In addition, the Tax Court generally applies its own prior precedent, particularly when there is no governing appellate precedent. Decisions of the Tax Court and federal district courts are appealable to the circuit court for the circuit within which the taxpayer resides. Decisions of the Court of Federal Claims are appealable to the Federal Circuit. The result of this system is that a taxpayer may face different law depending upon the forum within which it chooses to litigate.

The decisions of other courts – ie, those of courts to which the decision is not appealable – are relevant only to the extent the trial court finds them persuasive, as such precedent is not binding on the trial court. Similarly, the decisions of foreign courts, scholarly articles, OECD reports, etc, are all potentially relevant and helpful to a trial court, to the extent they are persuasive, but are not binding precedent.

5. Judicial Litigation: Appeals

5.1 System for Appealing Judicial Tax Litigation
After a trial-level decision, cases may be appealed to the applicable appellate court as a matter of right, provided that appeals from Tax Court cases generally do not stay assessment or collection of the deficiency unless the taxpayer posts bond. Cases tried in the Tax Court and federal district court are appealable to the circuit court for the circuit within which the taxpayer resides. Cases tried in the Court of Federal Claims are appealable to the Federal Circuit. Once a case is appealed, a panel of three judges typically reviews any briefs filed and hears any scheduled oral argument. After review, the panel will render a decision. Parties may request a rehearing or rehearing en banc of an adverse decision, although such requests are rarely granted.

Decisions by an appellate court may be reviewed by the US Supreme Court, but such reviews are discretionary.

5.2 Stages in the Tax Appeal Procedure

Once a case has been appealed, the parties file briefs with the appellate court and some cases are selected for oral argument before the court. After oral argument, a three-judge panel will decide the case and issue an opinion. There is no deadline for the court's decision and it may be several months or even over a year before the court issues its opinion. The appellate court's decision may resolve the case; however, it is also possible that the appellate court will remand the case back to the lower court for further findings consistent with the appellate decision. A party dissatisfied with the appellate court's decision may petition for a writ of certiorari with the US Supreme Court.

5.3 Judges and Decisions in Tax Appeals

The appellate process and judicial assignments are discussed in **5.1 System for Appealing Judicial Tax Litigation** and **5.2 Stages in the Tax Appeal Procedure**. Tax Court judges and Court of Federal Claims judges are appointed for 15-year terms. All other US federal judges have life tenure.

6. Alternative Dispute Resolution (ADR) Mechanisms

6.1 Mechanisms for Tax-related ADR in this Jurisdiction

In the USA, there is no ADR mechanism available prior to litigation. Although Appeals uses various ADR-type mechanisms, it is generally considered part of the administrative phase of a tax controversy.

Once in court, taxpayers and the IRS can pursue ADR like any other litigants. Most courts have rules that allow the parties to engage in court-supervised arbitration or mediation. For example, Tax Court Rule 124 permits the parties to request that any factual issue in controversy be resolved through binding arbitration.

6.2 Settlement of Tax Disputes by Means of ADR

See **6.1 Mechanisms for Tax-related ADR in this Jurisdiction**.

6.3 Agreements to Reduce Tax Assessments, Interest or Penalties

See **6.1 Mechanisms for Tax-related ADR in this Jurisdiction**.

6.4 Avoiding Disputes by Means of Binding Advance Information and Ruling Requests

A taxpayer may seek guidance on the proper tax treatment for a particular item in the form of an agreement between the IRS and the taxpayer or a ruling by the IRS.

A 'closing agreement' is a final agreement between the IRS and a taxpayer on a specific issue or liability, and may be entered into before or after the taxpayer files a tax return for the tax year at issue. In the absence of fraud, malfeasance, or misrepresentation of a material fact, both the IRS and the taxpayer are bound by the closing agreement.

A closing agreement entered into before the return is filed is a pre-filing agreement (PFA). A taxpayer may seek a PFA to resolve the treatment of an issue that is likely to be disputed on audit. PFAs may be requested for the present tax year, a prior tax year for which the original tax return is not yet due and certain future tax years. PFAs may be issued in situations concerning well-settled legal principles and in automatic and certain non-automatic accounting method changes.

Prior to filing a tax return, a taxpayer may seek a private letter ruling (PLR), which interprets and applies federal tax laws to the taxpayer's facts – it is essentially a statement as to how the IRS will treat the specific tax issue. A taxpayer who is issued a PLR may rely on it because the IRS is bound with regard to the taxpayer's specific facts. However, other taxpayers may not rely on PLRs as binding precedent because the IRS can revoke or modify a prior ruling if the IRS determines that the PLR was incorrect or not consistent with the current position of the IRS.

When a tax return is in audit or before Appeals, the taxpayer may encourage the audit team to obtain written guidance from the IRS national office on a disputed issue in the form of a technical advice memorandum (TAM). The audit team can also request a TAM, which provides guidance on the interpretation and application of federal tax law to the taxpayer's specific facts, and the taxpayer is allowed to participate in the process. TAMs favourable to the taxpayer are binding on the audit team, but unfavourable TAMs are not.

6.5 Further Particulars Concerning Tax ADR Mechanisms

See **6.1 Mechanisms for Tax-related ADR in this Jurisdiction**.

6.6 Use of ADR in Transfer Pricing and Cases of Indirect Determination of Tax

See **6.1 Mechanisms for Tax-related ADR in this Jurisdiction**. In addition to Appeals-based resolution mechanisms, and as discussed in **3.1 Administrative Claim Phase**, certain US income tax treaties provide for mandatory binding arbitration to resolve eligible cases in which the competent authorities were unable to reach agreement.

7. Administrative and Criminal Tax Offences

7.1 Initiation of Administrative Processes and Criminal Cases

The IRS uses civil tax penalties to deter taxpayers from taking unreasonable tax positions. Criminal tax charges, which can result in monetary fines and jail time for the taxpayer, are reserved for more egregious conduct such as wilful evasion of tax, false returns and obstruction.

A criminal tax case is typically initiated in one of three ways. First, a civil tax audit may lead to a criminal tax investigation if the audit team uncovers potential evidence of criminal violations of the tax laws during the civil audit. Second, an investigation may begin when a whistle-blower or other third party informs the IRS or the Department of Justice of potentially fraudulent or criminal tax activities. Third, a US Attorney's Office may initiate a tax-related criminal investigation.

The IRS Criminal Investigation Division (CID) is responsible for gathering and developing the evidence necessary to prove that a criminal tax offence has occurred. Tax crimes, as detailed in the Internal Revenue Code, include tax evasion, wilful failure to collect or pay withholding tax, filing a false tax return or other tax document, assisting in the preparation of a false return, failing to file a tax return and obstruction of the IRS. CID also develops criminal cases related to taxes that arise under other US statutes, including violations of bank secrecy act laws, money laundering and racketeering.

Once CID begins to investigate a case, the civil examination ordinarily is suspended. A taxpayer may not be aware that she or he is under investigation by CID until very late in the process or even until she or he is formally charged. After investigation, if CID determines that criminal prosecution is warranted, it will refer the case to the Department of Justice Tax Division (DOJ Tax) for further prosecution. In the event that CID or DOJ Tax decides not to pursue a criminal tax case, the civil tax audit typically resumes.

7.2 Stages of Administrative Processes and Criminal Cases

Administrative Criminal Investigation

During the audit, an IRS agent may become aware of "first indicators (or badges) of fraud." Examples of such indicators of fraud include unexplained increases in net worth, bank deposits exceeding reported income and false or altered documents. These indicators are signals that the taxpayer may have taken wilful actions for the purposes of evading tax liability. Once indicators of fraud have been identified, the case is developed to determine and document whether "affirmative acts (firm indications) of fraud" are actually present. Firm indications of fraud are actions establishing that the taxpayer has taken deliberate actions to evade tax liability. Such actions include concealment of bank accounts or other assets, intentional omission of specific items and covering up sources of receipts. If "firm indications" of fraud are determined to be present, the IRS can pursue civil penalties, criminal penalties, or both. If the case proceeds as a criminal case, it is referred to CID as described above.

After accepting the case, CID begins its investigation. CID has broad investigatory powers, including the ability to operate undercover, perform surveillance, obtain search warrants and obtain arrest warrants. If CID determines that there is sufficient evidence of a tax crime to meet the required statutory elements, CID will refer the case to DOJ Tax for potential prosecution.

Criminal Tax Case

DOJ Tax, in co-ordination with US Attorneys Offices, is responsible for the prosecution of all criminal tax proceedings. To prevail in court, the government must prove, and the jury must find, that a taxpayer is guilty "beyond a reasonable doubt." After receiving a case from CID, or upon its own initiation, DOJ Tax will evaluate the case to determine whether to present the case to a grand jury for possible indictment. If an indictment is obtained, the taxpayer will be charged in federal district court. The Tax Court and the Court of Federal Claims have no jurisdiction over criminal tax cases. Criminal tax proceedings generally follow the same procedures as other criminal cases in federal district court, including the taxpayer's rights to counsel, a speedy trial and trial by jury.

7.3 Possibility of Fine Reductions

Generally, payment of the assessed tax, interest and penalties will not prevent the tax authorities from bringing a criminal tax case where there is evidence of wilful violations of the tax laws. However, a court may consider a number of factors, such as whether the defendant accepted responsibility for the offence, when deciding whether to impose a monetary fine or incarcerate the taxpayer. If the defendant's upfront payment of the additional tax is viewed as an acceptance of responsibility, this may factor into the sentence imposed by the court.

7.4 Possibility of Agreements to Prevent Trial

As discussed in **7.5 Appeals Against Criminal Tax Decisions**, payment of the assessed tax, interest and penalties after the fact does not prevent criminal tax proceedings. A defendant in a criminal tax case may, however, voluntarily plead guilty and enter into a plea agreement with the government, as is common in all federal criminal cases in the USA. A plea agreement is a contract between the defendant and the prosecutor. With a plea agreement, the parties will avoid the hassle and expense of a criminal tax trial because the defendant has admitted his or her guilt. A taxpayer who pleads guilty may receive a lower sentence than if she or he had proceeded to trial and lost.

In certain cases the government will consider entering into a non-prosecution agreement or deferred prosecution agreement. These contracts with the government permit the taxpayer to avoid trial without pleading guilty and typically are subject to ongoing duties to comply with the law, co-operate with ongoing investigations and take various remedial measures.

7.5 Appeals Against Criminal Tax Decisions

A defendant may challenge a guilty verdict by requesting that the trial judge overturn the jury's guilty verdict and enter a verdict of not guilty. A defendant may also request a new trial or file an appeal to the appropriate appellate court to reverse the conviction. If the appellate court upholds the conviction, the defendant can petition for discretionary review by the US Supreme Court.

7.6 Rules Challenging Transactions and Operations in this Jurisdiction

Transfer pricing and anti-avoidance cases are commonly brought by the IRS as civil tax matters. However, where the tax authorities believe they can prove a wilful intent to evade taxes or a wilful intent to file a false return or submit false documents, or a conspiracy to do any of the same, the tax authorities will consider bringing criminal charges.

8. Cross-border Tax Disputes

8.1 Mechanisms to Deal with Double Taxation

Cross-border tax issues are common for taxpayers that pay taxes in multiple countries. The USA has entered into numerous tax treaties with foreign countries that seek to avoid double taxation of the same income. Instances of double taxation can occur in various contexts, but often arise due to a taxpayer's transfer-pricing positions. Thus, here, the focus is on transfer pricing as representative of the double taxation problem.

In the USA, the IRS Advance Pricing and Mutual Agreement (APMA) programme allows taxpayers to try to resolve cross-border tax disputes without litigation.

First, the US Competent Authority (USCA) provides procedures to address current disputes over transfer pricing under the MAPs contained in relevant tax treaties. Taxpayers can request the assistance of the USCA when they are potentially subject to double taxation that should be mitigated by the relevant tax treaty. In general, the USCA will enter into consultations with the corresponding competent authority of the foreign treaty partner to attempt to resolve instances of double taxation prior to the filing of litigation in either country.

Second, the advance pricing agreement (APA) programme allows taxpayers to obtain certainty as to the transfer-pricing treatment of transactions with the IRS and one or more treaty partners prior to filing the tax return through the negotiation of a unilateral, bilateral, or multilateral APA. In the APA process, the taxpayer, IRS and foreign treaty partner or partners engage in negotiations to determine the appropriate amount of taxable income to be reported by the taxpayer in each country. APAs are generally forward-looking, although they can also relate to previously filed tax returns, as the process can take years for the parties to reach an agreement. This process results in a binding contract between the taxpayer, the IRS and any included treaty partners, which is intended to govern the transfer pricing of the relevant transactions to avoid litigation and the expenditure of resources on the issue during the audit.

The IRS can also unilaterally challenge a taxpayer's transfer-pricing positions and issue a civil assessment as described above. In such cases, the taxpayer can proceed through the normal administrative channels, including Appeals, and if the case is not resolved administratively, proceed to court.

8.2 Application of GAAR/SAAR to Cross-border Situations

The USA does not have a general anti-avoidance rule (GAAR), but the IRS regularly encourages courts to apply certain doctrines when challenging transactions that in form comply with applicable law but, according to the IRS, violate the 'spirit' of the law. For example, the 'substance over form' doctrine seeks to recharacterise a transaction to reflect what the IRS believes to be its true substance. Variations of this doctrine are the step transaction doctrine, which the IRS argues allows it to disregard unnecessary and meaningless steps in a transaction, and conduit principles that the IRS argues can be used to disregard entities the IRS believes serve as mere conduits to alter the tax liabilities of the parties. Another doctrine is the economic substance doctrine, which generally requires a transaction to be profitable on a pre-tax basis and have a non-tax business purpose in order to be respected for US federal income tax purposes.

In addition to these doctrines, different sections of the Code and regulations also have specific anti-avoidance rules depending on the nature of the transaction or the parties involved in the transaction.

8.3 Challenges to International Transfer Pricing Adjustments

In the USA, transfer-pricing adjustments have typically been challenged in domestic courts, principally the Tax Court, which has extensive experience with transfer-pricing cases. Because the dollars at issue in transfer-pricing cases are typically significant, the Tax Court allows resolution of disputes before payment of the additional tax (unlike federal district court or the Court of Federal Claims).

The USCA may assist with transfer-pricing issues for taxable periods involved in current litigation as long as the issue has not previously been under the jurisdiction of Appeals. In addition, a taxpayer may request assistance from the USCA in seeking correlative relief from a treaty partner in accordance with a final court decision or litigation settlement with the IRS or DOJ Tax.

8.4 Unilateral/Bilateral Advance Pricing Agreements

From 1991 through 2017, the IRS executed 1,713 APAs. Of these, 590 were unilateral, 1,108 were bilateral and 15 were multilateral. Because the APA process can be lengthy and involve significant volumes of information to be presented, taxpayers typically engage outside advisers to assist in APA requests. The APA process involves several key stages.

- *Pre-filing conference* – the taxpayer meets with representatives from APMA for a pre-filing conference. Prior to the conference, the taxpayer submits a memorandum containing background information and an outline of the issues.
- *Submission of APA request* – the formal APA request must include certain information, including a summary of the request, years at issue, proposed transfer pricing methods and relevant documentation. The taxpayer must also pay a user fee.
- *Review and opening conference* – the APA team will review the request and determine whether further information is required. Once the APA team leader determines that the request is complete, an opening conference will be held to facilitate the APA team's understanding of the issues.
- *Negotiations* – throughout the process, the APA team will discuss questions or concerns they may have about the request, or the APA team's provisional views, and continue to gather information.
- *Involvement of foreign competent authority if bilateral/multilateral* – the APA team will consider requests from foreign competent authorities and may ask the taxpayer to make a presentation jointly to the APA team and the foreign competent authorities. Ultimately, the APA team will present its position to the foreign competent authorities and endeavour to reach a competent authority resolution that will underlie the APA that will be executed between the taxpayer and the IRS.
- *Execution of APA if agreed* – in unilateral, bilateral or multilateral APAs, to the extent the parties agree to the tax treatment, they will execute an agreement detailing the resolution, including the tax years involved.
- *Ongoing compliance* – after the execution of an APA, taxpayers are typically required to provide annual reports in which the taxpayer demonstrates that no material facts have changed and that the taxpayer is continuing to follow the agreement.

Taxpayers may exit the APA process at any time; however, the user fee will typically not be refunded.

8.5 Litigation Relating to Cross-border Situations

A significant portion of recent high-stakes tax litigation in the USA involves cross-border situations. Over the past decade in particular, transfer pricing and cross-border financing transactions have generated the most significant litigation measured in terms of dollars at stake. Although other cross-border issues, such as withholding tax disputes, continue to receive attention during IRS audits, taxpayers and the IRS often resolve such disputes at the administrative level and thus litigation is less prevalent.

Considering the complexities associated with cross-border transactions and the valuation issues typically associated with such transactions, cases involving cross-border transactions are likely to continue in the coming years.

Recent tax legislation in the USA, referred to as 2017 'tax reform', was intended to disincentivise the holding of IP offshore, particularly through the lowering of the corporate tax rate. Tax litigation in the USA over cross-border issues could be further mitigated by broader jurisdictional alignment on international taxation rules, particularly around transfer pricing standards.

9. Costs/Fees

9.1 Costs/Fees Relating to Administrative Litigation

As discussed above, tax litigation can occur both before payment of the disputed liability, in Tax Court, or post-payment, in the refund jurisdictions of the federal district courts and the Court of Federal Claims. In Tax Court, a taxpayer is not required to pay the taxes, penalties and interest asserted by the IRS prior to the litigation, but the taxpayer must post bond to avoid collection while seeking appellate review of an adverse Tax Court decision. Where litigation is post-payment, the taxpayer is required to pay the tax, interest and penalties due for the year fully before seeking a refund.

9.2 Judicial Court Fees

Each court has a small filing fee associated with filing a petition or complaint, which is waivable upon a showing of need. If a taxpayer prevails in a tax-refund lawsuit, the IRS will refund the tax, penalties and interest previously paid plus overpayment interest.

In certain situations, a prevailing taxpayer can ask the court to require the government to pay its court costs and legal fees. This remedy is only available to taxpayers with a net worth under certain specified limits and is thus generally limited to individuals and small businesses.

9.3 Indemnities
The court's decision is final and applies to the tax years at issue. If identical issues exist for other tax years, the court's decision for the years at issue will typically also apply to those other years.

9.4 Costs of Alternative Dispute Resolution
Several of the ADR mechanisms have user fees associated with them. For example, in order to obtain a PLR or PFA, the taxpayer must pay the specified user fee, which is set by the IRS from time to time.

10. Statistics

10.1 Pending Tax Court Cases
Exact statistics on the number of tax cases are limited. However, an overwhelming majority of tax disputes are heard in the Tax Court in comparison to the federal district courts and the Court of Federal Claims.

A recent estimate of total cases in Tax Court comes from the U.S. Tax Court Fiscal Year 2020 Congressional Budget Justification, submitted by the Tax Court to Congress, reflecting the number of Tax Court cases filed and closed, per year, from Fiscal Year 2010 through Fiscal Year 2018. Each year, between 25,000 and 31,000 cases were filed, and between 26,000 and 33,000 cases were closed.

10.2 Cases Relating to Different Taxes
There is no reliable data regarding the number of cases initiated and terminated each year relating to different taxes.

10.3 Parties Succeeding in Litigation
There is no reliable data available regarding the party (tax authorities or taxpayers) that succeeds in litigation.

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11. Strategies

11.1 Strategic Guidelines in Tax Controversies
There are many strategic considerations to consider when working on a tax controversy at all stages of the dispute. These strategies are outlined throughout this chapter, in particular in **2.6 Strategic Points for Consideration During Tax Audits** and **4.1 Initiation of Judicial Tax Litigation**.