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By way of background, I joined Caplin & Drysdale as a member in their Washington office in January 2006. Most recently, I served as Director, International for the Internal Revenue Service during 2004 and 2005. In that capacity, I acted as the U.S. competent authority with responsibility for managing negotiations and achieving resolution on tax controversies with treaty partners of the U.S. concerning specific cases, which typically involved transfer pricing disputes and also permanent establishment, withholding, and treaty interpretation matters.

As competent authority, I was jointly responsible in concert with the APA Program Director for initiating the first bilateral APA with China. And, my tenure also included the execution of formal memoranda of understanding (MOUs) with Canada and Mexico to enhance the relationships with those two key treaty partners significantly and improve the resolution of bilateral tax cases.

In addition, I was involved in the development of U.S. transfer pricing rules concerning the issuance of proposed regulations on cost sharing and intercompany services. My role as Director, International also involved providing guidance to international examiners in the audit of international tax issues. This aspect of my role included the preparation of an IRS checklist to be used by international examiners in the audits of cost-sharing transactions and the development of settlement guidelines to resolve a substantial number of major cases involving the cost-sharing issue.

My professional background includes extensive corporate tax experience with Procter & Gamble, where I served as Director of International Taxes in the corporate headquarters. Subsequently, I worked as Director of Taxes, Europe for five years with Procter & Gamble's operations in Germany. I also served as Vice President of Tax Policy for the National Foreign Trade Council, which represents U.S. multinational companies on international tax matters. And earlier in my career, I worked as Tax Counsel to a Member of the House Ways and Means Committee of the U.S. Congress.

My practice with the firm involves management and resolution of tax controversies at all levels -- exam, appeals, competent authority, and APAs – in both foreign and domestic tax disputes.

As the article below observes, the growing trend among multinational companies is to globalize their business operations in an effort to reduce costs and concurrently to lower the effective tax rate. Significant tax controversies arise as tax administrators from different countries attempt to sort out and reach agreement regarding the tax consequences emanating from these actions by taxpayers. The focal point of the tax controversies, now and in the future, invariably tends to be the treatment of intangibles: who owns them, what is their value, how to apportion the profits attributable to intangibles among the various countries involved, and other related issues. Because of their importance and the huge adjustments that frequently are proposed in these cases, the need for taxpayers to develop a global dispute resolution strategy, and for tax administrators to implement a range of dispute resolution vehicles, including binding arbitration, has become imperative.

Heightened Need for Global Strategies in Tax Disputes

A number of powerful forces at work today supremely challenge tax administrators around the world. Among the various factors which are causing sleepless nights for tax administrators are the following developments, which are routinely occurring as businesses globalize their operations.

Transfer of Functions/Risks By Multinational Companies

As businesses seek to lower the overall cost of their operations, one typical consequence is the transfer of functions (and in many instances risks) from various countries to centralize the performance of these functions and the assumption of risks in low-cost jurisdictions. Quite

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frequently, the transfer of functions will involve a consolidation from many different countries to centralize them into one location. Although many, if not most, of these transfers of functions and risks arise from legitimate business restructurings, quite often there are significant tax savings involved. These various events commonly precipitate major tax controversies involving a potential goodwill tax upon the exit of these functions from high-tax countries which have suffered a sharp decline in corporate tax revenues as a consequence of the transfer. In addition, numerous tax issues commonly arise under the new business arrangement between the entity operating in the low-tax, low-cost jurisdiction and affiliates in the higher tax jurisdictions. The issues include:

- whether the principal has a permanent establishment in one or more of the affiliate jurisdictions;
- the amount of profits to be attributed to the permanent establishment(s);
- the appropriate mark-ups to be applied to various services performed on a cross-border basis;
- whether intangibles are developed locally in any of the affiliate jurisdictions; and
- the extent to which the economic behavior of the parties is consistent with the underlying documentation.

These issues are currently the focus of several working party drafts and meetings at the Organisation for Economic Co-operation and Development (OECD).

There are numerous sub-issues attributable to transfers of functions and risks between sovereign jurisdictions which tax administrators must address in order to reach a bilateral agreement to resolve a particular dispute. Several of the key sub-issues are as follows.

Value of Functions/Risks

The value of the functions/risks that are transferred can become a source of controversy between the tax authorities in the affected countries. Issues abound when tax authorities examine the details of a transfer of risks and/or functions, but some of the more critical issues are identified by the following questions:

- Are the distributors in the affiliate countries true stripped/limited-risk distributors or do they perform more extensive entrepreneurial functions?
- If contract manufacturing is performed, does the manufacturing function which pre-dates the restructuring possess local manufacturing intangibles which must be compensated?
- Are the services delivered by the principal, which is based in a low-tax jurisdiction, premium or high-priced services that are embedded with intangibles?

Local Intangibles

As investments by multinational companies in countries with key markets continue to rise sharply, the issue of whether local intangibles have been developed will intensify, especially if a taxpayer's market share in a particular category rises and the profit margins associated with unit sales increase. The question of whether marketing-related costs were deducted locally is also a factor in many cases. The question of whether locally developed intangibles exist is an issue in several cases under our treaty-provided mutual agreement procedures involving foreign-initiated adjustments and is a major area of dispute in the pending litigation of the *Glaxo Case*.

Intangibles Embedded in Premium Services

Intangibles that may be embedded in the performance of high-priced, premium-value services are also an issue. The United States and many other nations - developed and less developed alike - are focusing on the transfer pricing implications arising from the performance of cross-border services. There will continue to be a high volume of clerical, administrative support services provided on a cross-border basis which is predominantly driven by the desire of multinational companies to reduce their overall cost structure. In those cases, the extent of the mark-up involved - or whether a mark-up should be added at all - will remain a source of controversy until the United States, the OECD and other stakeholders harmonize the treatment of administrative services. However, the area in which controversy is likely to increase, in terms of both the number of cases and the amount of adjustments per case, concerns the pricing of premium-valued services, in which the question arises as to the presence of embedded intangibles. The Internal Revenue Service (IRS) has committed to issuing new regulations on inter-company services by the end of the current business plan year and the OECD continues to press ahead with its working group project to gain a consensus among member countries on the issue.

Rules on Permanent Establishment and Attribution of Profits

Through various working parties, the OECD is proceeding to revise various rules in its commentary defining when a

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permanent establishment exists and the extent to which profits are attributable to the permanent establishment. While these efforts are intended to provide clarity in areas of uncertain application under the existing commentary and model treaty, the drafts that have been publicly circulated have caused considerable controversy in the business community, especially among US multinational companies, which view the proposed revisions to the permanent establishment and attribution of profits rules as an expansion of source-based taxation that is likely to cause more instances of double taxation.

Cost Location Savings

An issue of increasing importance in double tax disputes involves the question of how to apportion the savings derived from the performance of functions in low-cost locations. This issue typically arises in connection with the outsourcing of manufacturing and other functions to low-cost locations. This is an area where clarity and alignment are lacking and desperately needed. The IRS has unsuccessfully sought to shift a significant part of the cost savings to the United States when the manufacturing or other functions are performed in low-cost locations. Due to a series of defeats which the IRS has suffered in litigation on the issue of location savings, its current position on the issue is in a state of flux. Meanwhile, other countries have adopted varying positions on the issue of cost savings, ranging from theoretical approaches that apply a form of residual profit-split to more pragmatic, revenue-driven methods. At present, it can safely be said that there is not a single approach for apportioning the benefits of location savings that is uniformly followed among either developed or less developed nations.

Agreement on Use of Comparables

As tax disputes become more complex and the amount in controversy continues to increase, it is imperative that tax administrators reach a consensus on the parameters for determining which comparables to use in resolving a tax dispute. There are a number of issues involving the acceptance (or lack thereof) of comparables that complicate the ability to resolve double tax cases. One such factor relates to the geographical criteria that may be established by tax administrators as a prerequisite to acceptance of one or more comparables. For instance, should a comparable be rejected if the transaction does not occur within the country in which the adjustment is proposed? And should regional or global comparables be allowed? In some instances, there are limitations on financial disclosure of public data that render it extremely difficult to rely on local comparables. The question of whether tax administrations should be allowed to benchmark taxpayers based on non-public financial data from other taxpayers (so-called "secret comparables") remains controversial.

Global Strategies in Resolving Tax Disputes

As businesses further their globalization efforts, the need for effective dispute resolution strategies assumes added importance. To meet this challenge, governments will strive to protect their corporate tax base while still adhering to their tax treaty obligation to reduce or eliminate double taxation. Under these circumstances, the ability to reach a conceptual agreement concerning the standards to be applied in tax disputes is crucial.

Need for Agreement on Standards to be Applied

The magnitude of the challenges facing tax administrators and the complexity of the issues to be addressed provide a compelling need for tax administrators to reach agreement on the appropriate standards to be applied in resolving cross-border tax disputes. Conversely, a failure to apply consistent standards by treaty partners frustrates the ability to reach a settlement. Even assuming an agreement to apply identical standards, countries are still unable in a number of cases to reach a settlement. If countries are applying disparate standards to a given set of facts, then agreement becomes virtually impossible. One recent example where two countries recognized the need for a new dispute resolution tool relates to the execution of a memorandum of understanding between Canada and the United States concerning factual disagreements. The memorandum of understanding refers cases to their respective appellate functions for resolution where the two mutual agreement procedure organizations have been unable to reach agreement on the underlying facts of a case. In the absence of a consistent framework to be applied in addressing the issues of a cross-border tax dispute, double taxation is quite likely to ensue.

Additional Resources for Tax Administrations

Virtually all tax administrations possess various tools to resolve tax disputes. Alternatives range from administrative appeals to advance pricing agreements and mutual agreement procedure proceedings on cross-border transactions. If all else fails, there is the ultimate recourse to litigation to resolve a tax

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controversy, but litigation is generally viewed as an expensive and highly inefficient remedy..

However, in order for these various tools to be effective in resolving tax disputes, it is important that adequate resources be provided to tax administrators to manage an ever-increasing inventory of cases. It is also critical that the personnel assigned to these tasks receive adequate training to acquire the necessary skills, which involve both the substantive expertise and skills in negotiation. Many countries assign the same personnel a myriad of functions to perform with minimal support. In addition, the demographics of many developed countries reflect the fact that the current generation of tax administrators is soon to retire. This accentuates the need to provide their replacements with the skills and training necessary to perform the dispute resolution function competently.

As it is increasingly clear that transfer pricing is likely to remain the key focus of cross-border tax controversies, it is important that countries without an advance pricing agreement program develop one. The advance pricing agreement program has proven to be a valuable tool to resolve complex cases with potentially large amounts in controversy, while also acting as an instructional tool for tax administrators concerning the complexity of transfer pricing issues in the cross-border setting.

Binding Arbitration as a Feature of Double Tax Conventions

Mandatory arbitration should become a standard feature of bilateral tax treaties and conventions if tax authorities are to manage successfully increasingly complex cross-border tax disputes involving enormous proposed adjustments. If, as is likely, the issue of intangibles involving a transfer of functions and risks becomes more prominent in tax cases, then binding arbitration will be essential to facilitate case resolution and avoid double taxation. Tax advisers and members of the business community share a real apprehension that the complexity of cases, especially those with substantial adjustments relating to the value of transferred intangibles, will increasingly culminate in cases being unresolved. Binding arbitration prevents that scenario from materializing by imposing a time limit on competent authority personnel to reach an agreement or have the case mandatorily removed from their further participation. Another aspect of arbitration, which both businesses and governments should find appealing, is that it is likely to induce behavioral changes that will cause tax examiners to be more reasonable in their audit examination practices.

Recent developments suggest that the prospects for binding arbitration appear quite promising: the US Treasury recently announced that it had proposed binding arbitration in treaty negotiations with two of its leading treaty partners; Canada reversed its prior position and expressed support for mandatory arbitration during a recent working party meeting of the OECD; and most significantly, the OECD has released a draft recommendation for public comment that proposes to amend the OECD Model Treaty to provide for binding arbitration. These developments represent milestones in the effort to manage effectively the tax issues arising from increasing globalization of business investments and the threats that these developments pose to tax administrators around the world. It is critical, if the global economy is to achieve the lofty goals expected in many countries, that effective dispute resolution strategies be implemented to minimize the possibility of double taxation which could impede economic growth and ultimately corporate tax collections.

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Caplin & Drysdale helps clients plan and evaluate tax-related transactions. The firm's 35 tax lawyers have been designing and reviewing tax strategies for companies, organizations, and individuals throughout the United States and around the world since the firm was founded in Washington, D.C., by former IRS Commissioner Mortimer Caplin 40 years ago.

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