

STATEMENT OF MICHAEL GAFFNEY
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Committee on Finance United States Senate
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Introduction

I want to thank the Committee for the opportunity to testify on best practices in tax administration. While currently I am a partner at PricewaterhouseCoopers (PwC) in New York, my comments today primarily will be based upon my experiences at Merrill Lynch, where I was the co-head of global tax from 2000 to 2009. My comments are my own and do not represent the views of PwC or my former employer.

As a leader of a large corporate tax department, I participated in a number of tax administration initiatives that focused on improving the examination process with a primary goal of making it more efficient, accelerating tax examinations, and reducing tax uncertainty. The innovative programs that I participated in primarily were developed by the United Kingdom's tax authority, HMRC, and the IRS. I also participated in certain projects of the OECD's Forum on Tax Administration.

Many of these programs were very successful, and some were less successful, at least in my experience. Less successful programs occurred not because of faulty design or goals of the program itself, but rather because of the inability to consider every possible contingency regarding how the specific program would interact with other tax authority initiatives. Before discussing some of these programs, I will summarize what "worked" and what "didn't work" and will make some observations on how to increase the likelihood of achieving successful outcomes.

The following four aspects of these initiatives worked well and should be considered best practices for any tax administrative program:

- Senior management buy-in by both the taxpayer and the tax authority.
- Frequent, such as monthly or quarterly, face-to-face meetings between senior tax leadership of both the taxpayer and the tax authority to ensure consistency and to address any concerns before they could negatively impact the parties' mutual goals.
- Senior management (of the taxpayer and the tax authority) ensuring the involvement of all levels within their organizations to avoid "no involvement - no commitment" situations.

- A high level of trust and transparency between the taxpayer and the tax authority, which includes the ability to improvise and react to any changes required to ensure the best practice achieves its stated goals.

Aspects of tax administration initiatives that worked less well basically represent the flip side of the best practices identified above. Programs that start with a high-level, senior management buy-in may lose steam for a variety of reasons. For example, changes to senior leadership at either the taxpayer or tax authority; lack of involvement or appropriate training of all levels of employees at both the taxpayer and the tax authority; and the failure of a particular initiative to align with the broader tax administration programs can all result in a program not meeting its full potential.

Now I want to look separately at tax administration programs in the United Kingdom, the United States, and the OECD that I viewed as successful and could be used as a basis for developing new best practices in tax administration.

United Kingdom

The British tax authority, HMRC, for many years has embraced developing an enhanced relationship with taxpayers. My experience with HMRC always was positive, mainly due to the active, continuous involvement and commitment of senior HMRC officials. The UK-initiated enhanced relationship has taken root in many of the initiatives and reports generated by the OECD Forum on Tax Administration.

In my view, a primary reason for the HMRC success with innovative programs has been the role of the Client Relationship Manager ("CRM")¹. The CRM acts as the single point of contact within HMRC for large, complex corporate taxpayers. The skill and judgment of the CRMs have always impressed me, as well as their ability to assemble quickly the appropriate subject matter experts within HMRC to address complex cross border tax issues. While we did not always agree, neither party was disagreeable. There was a high level of respect and civility in all dealings.

In the difficult areas of transfer pricing, competent authority, and advanced pricing agreements (APAs), my experience has been that the HMRC staffs these programs using a "unified team" approach, rather than assembling separate teams for each aspect. I believe this is a best practice as it reduces the time the tax authority spends learning about a particular taxpayer's issues. Further, it allows the HMRC transfer pricing specialists to understand the broader global context of the taxpayer's operation by involving them in the competent authority and APA programs. Understanding the "global picture" of a taxpayer, including the taxpayer's desire to be taxed only once on earnings, helps to avoid delays in resolving these issues and to minimize tax uncertainty that can otherwise be created by transfer pricing.

United States

I will discuss three IRS programs in which I participated between 2000 and 2009: The Limited Issue Focused Examination ("LIFE"), the Accelerated Issue Resolution ("AIR") for IRC Section 475, and the Compliance Assurance Process ("CAP").

¹ For a full description of the CRM role, and how HMRC's Large Business Division is organized, see <http://www.hmrc.gov.uk/lbo/exec-summary.pdf>

Limited Issue Focused Examination: The LIFE program grew out of an earlier unnamed program to accelerate examination cycles to bring taxpayer exams current. The LIFE program was governed by a "memorandum of understanding" (MOU), which set forth the numerical threshold of items to be examined, certain areas that would be subject to examination without regard to a numerical threshold, and a timeline to achieve examination currency. In my experience, the program was largely successful due to the "buy in" at all levels of the IRS and the taxpayer and ownership of the examination at the IRS field level.

Accelerated Issue Resolution for IRC Section 475: AIR also was a successful program in which the IRS exam team, assisted by local counsel and specialists, worked with the taxpayer to ensure that the mark-to-market processes and procedures required for U.S. generally accepted accounting principles (GAAP), regulatory, and other non-tax purposes were sufficiently robust to be used for tax purposes under section 475. I believe the approach of working together to ensure a strong understanding of a taxpayer's business enables the tax authority to more effectively plan its examination, which produces cost benefits for the tax authority and the taxpayer.

Compliance Assurance Process: Begun in 2005, CAP is effectively an examination in real time, with the goal of having the bulk of the exam conducted prior to filing the company's tax return. The CAP MOU requires that issues or transactions that have a significant impact on the taxpayer's federal taxable income be disclosed to the IRS. Under CAP, the IRS endeavors to provide the taxpayer with certainty on these issues or transactions prior to filing the return.

CAP worked quite well for most of the items examined, with the exception of items that later were determined to be potentially subject to exam under a separate IRS program, known as the issue tiering program. The IRS LB&I division adopted an issue tiering strategy in 2006 to "ensure that high-risk compliance issues are properly addressed and treated consistently across the division for all LB&I taxpayers that are involved in the issue."² Despite the CAP MOU requirement that the IRS provide an issue resolution agreement prior to the tax return being filed, the subsequent creation of the tiering program effectively nullified the CAP MOU. Essentially, the rolling out of the tiering process did not appear to be fully coordinated with the CAP program, creating diffused responsibility and the lack of an identified owner within the IRS. The recent "good news" is that CAP is being extended beyond a pilot phase to be a permanent part of the tax administration landscape in the United States, which holds out hope that certain "kinks" that I experienced may have been worked out in how CAP coexists with other IRS initiatives.³

OECD Forum on Tax Administration

The OECD Forum on Tax Administration (FTA), established in July 2002, currently is led by IRS Commissioner Doug Shulman and includes the lead tax administrators from over 30 countries.⁴ The FTA's mission includes bringing together senior tax administrators to share

² See IRS LB&I site: <http://www.irs.gov/businesses/corporations/article/0,,id=200574,00.html>

³ IR-2011-32, March 31, 2011

⁴ Countries currently participating include Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong China, Hungary, Iceland, India, Indonesia, Ireland, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico,

information and experiences and to develop successful international best practices for resolving particular tax administration issues. In a similar fashion to how the OECD attempts to coordinate tax policy, "the FTA looks to develop effective responses to important administrative issues in a collaborative fashion and engages in exploratory dialogue on a range of administration issues that may emerge in the medium to long term."⁵

The FTA put forth the idea of conducting joint examinations as part of its Istanbul communiqué of September 16, 2010. I believe the conduct of a joint exam could be a useful tool to accelerate tax certainty in today's complex global environment and it would make sense to roll out this concept on a pilot basis for taxpayers that volunteer for such a program. When properly structured and managed, a joint exam, including the insertion of competent authority personnel as part of the joint exam process, could significantly reduce the cost of administration for certain taxpayers and the participating tax authorities. For example, a joint exam could be helpful in resolving transfer pricing disputes as well as accelerating tax certainty for transactions that are subject to differing tax rules in each jurisdiction involved in the exam. Specific areas of concern in a joint return pilot include the impact on employee interviews, document production, and the involvement of other countries that lack a seat at the joint audit table (for example, in triangular cases involving one or more non-treaty countries and the treatment of confidentiality and other issues in that context).

Concluding Comments

Taxpayers today expend significant time and resources to comply with an increasingly complex tax code and frequently encounter issues for which there is no clear answer. Similarly, the IRS devotes significant time and resources to administer the tax laws. Given this substantial and shared burden, pursuing initiatives to make the tax administration process more efficient, reduce costs, and minimize tax uncertainty is a goal that all parties have a mutual interest in working together to achieve.

Looking back on my experience of what has worked well and what has not, there are some lessons to take away in trying to facilitate the likelihood of the success of programs to increase the efficiency of tax administration.

- First and foremost, any program should begin with the tax authority and taxpayers working collaboratively to define the goals and the procedures and processes to implement the program. The involvement of senior leadership within the tax authority and the taxpayer is an essential element for success.
- Second, the program should be evaluated on how well it achieves the following criteria:
 - Enhance mutual trust between taxpayers and the tax authority;
 - Alleviate tax uncertainty;

Netherlands, New Zealand, Norway, People's Republic of China, Poland, Portugal, Russian Federation, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

⁵ http://www.oecd.org/about/0,3347,en_2649_33749_1_1_1_1_1,00.html

- Provide consistency in application of the law; and
- Reduce compliance and examination burdens.

Once again, I would like to thank the Committee for the opportunity to testify today, and look forward to answering any questions you may have.