

# *IRS Hot Topics*

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*Clients with operations outside the United States may be subject to income tax examinations by IRS agents in the foreign country*

Under the Internal Revenue Code, United States citizens and residents, domestic corporations and partnerships and, in some situations, foreign corporations operating within the United States must report their worldwide income and are subject to tax on their worldwide income. As a result, the Internal Revenue Service conducts income tax examinations both within the United States and also in foreign countries.

For example, the IRS may examine foreign books and records and interview foreign-based taxpayer personnel to review Treasury Regulation § 1.861-8 taxable income allocations, to examine controlled foreign corporations, to determine whether a taxpayer charges an arm's-

length price for products or services pursuant to Internal Revenue Code § 482 and to examine individuals living outside the United States. To conduct these examinations, the IRS historically has sent an agent - or a team consisting of agents and industry specialists - to a foreign country to conduct interviews and to review books, ledgers and other source documents.

*What is the process for an IRS agent to travel overseas to conduct the examinations?*

For IRS personnel to travel and work in a foreign country, the IRS must receive approval from the foreign country in



which the work will be performed. To receive approval, a taxpayer first issues a confirmation or invitation letter to the IRS agent who will visit the foreign location. The invitation letter lists the dates of the scheduled appointments, the name of a contact person at the taxpayer's foreign location and the address where the examination is to be held. This information is required by the foreign country.

The examining agent will then seek authorization from the agent's Manager, Territory Manager and Director of Field Operations. If those supervisors authorize the foreign examination, the agent submits a request to the IRS Foreign Travel Office. The Foreign Travel Office, with the assistance of the U.S. State Department, will seek clearance from the foreign country to perform the foreign examination.

### *What are some of the rules?*

Some countries allow IRS personnel to conduct examinations on their soil; the U.S. tax authority reciprocates. In addition, some income tax treaties allow foreign examinations under certain circumstances. For example, Article 27 of the U.S.-France income tax treaty permits an examining agent from one country to go to the other country to conduct interviews and review books and records after the taxpayer and the competent authority give their consent.

Several countries allow the IRS to conduct examinations of U.S. individuals living in the foreign country as well as foreign corporations controlled by a U.S. entity. In other cases, some foreign countries do not allow the IRS to conduct examinations that involve reviewing bank information, sometimes even when a foreign bank operating in the U.S. is the subject of the examination. The foreign government will not allow its taxpayers

to provide any bank-related information that lists individual names to the IRS. After the UBS case, though, several countries are relaxing their rules in this regard.

### *PwC observations*

It has been the IRS position that revenue agents should conduct their examinations where the books and records and taxpayer personnel are located. Based on past experiences with examinations conducted outside the United States, the IRS has performed a functional analysis in addition to reviewing books and other source documents. As part of this analysis, the agent will focus on interviewing corporate personnel to determine what activities they perform and what the relationship of the activities are to the income, expense items or credits that should be reported in the tax return. In addition, the agents are visiting the overseas operation to determine whether an arm's-length charge is made in transfer pricing cases.

Clients with operations in foreign countries should be aware the IRS sends its agents overseas to conduct examinations of their foreign operations. They should also be aware when the IRS conducts these audits and be sure that the foreign offices are prepared for the audit and have the necessary records and information to prepare for an IRS examination just as they would prepare for an examination in the United States.

Also, with the IRS' push to conduct simultaneous examinations of multinational companies with treaty partners and the increase in the exchange of information program, it is a logical conclusion that the number of IRS agents traveling to foreign offices will continue to increase.

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*For more information, please do not hesitate to contact the Tax Controversy and Dispute Resolution Team:*

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