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Canada-U.S. Tax Accounting: Competent Authority, § 482 Transfers and Joint Audits

*by George Goodrich**

The area I am to cover includes a number of technical tax topics which have been referred to as being "gutsy." The reason they are gutsy is two-fold. First, they generally involve extremely technical points which require participation of the governments of both countries at an extremely high level. Second, often after the tax authorities have completed an examination which involves many of these topics, someone has to face the client and make him aware of the "damages."

I won't repeat or go into all of the discussions that have been held so far today covering cross-border traffic, trade, investment, and the like. It is generally well known that many American companies focus their attention on their North American operations, not just those in the United States. To these businessmen, Canada is not foreign. Their Canadian operations are part of a single business entity that happens to cross national boundaries. While this approach generally makes sense from a business standpoint, it also tends to cause a taxation problem because the different legal and tax structures of the two countries tend to conflict.

Mr. Brown has just spent a considerable period of time alluding to his positive expectations for the proposed provisions of the new treaty which should free us from the harsh consequences when those structures are in conflict. Since I am more skeptical than he might be, as to the timing of the new treaty, and therefore, the timing as to when our expectations may be fulfilled, I am going to concentrate on the treaty that is currently in effect rather than what might be.

The topics which I have been asked to cover today include section 482 of the Internal Revenue Code and its counterpart, section 69 of the Canadian Income Tax Act, the Competent Authority provisions of the Canada-U.S. Treaty which we hope will mitigate some of the harsh consequences I alluded to earlier when the taxing statutes of the respective countries are in conflict, and the newly-announced Joint Audit Programs.

Section 482, and its Canadian counterpart, happen to be a broad two-edged sword in the hands of the respective governments. It generally applies, and therefore generally will be invoked by the taxing authorities, when parties in control of each other are dealing with each other in a non-arm's-length manner. Some of the terms I just used are extremely technical, and yet are critical to understanding the workings of these particular sections. For instance, control, as such, isn't defined in either tax

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statute. Rather, it is the element of control that must be considered. When dealing with other sections of the Internal Revenue Code, we often see control defined as 50 percent and often 80 percent of voting control of the company. Under section 482, one is required to interpret whether or not the parties are in control of each other and, if they are from a subjective standpoint, one must next look to whether or not the parties are transacting business with each other at arm's length. Contrary to the problem in defining "control," one merely has to look at a voluminous set of Regulations for guidance as to the definition of "arm's length."

Section 482 is extremely short, perhaps only a couple of sentences. Unfortunately, it is supported by voluminous Regulations that many consider to be virtually unintelligible in that they attempt to legislate in a subjective area.

Whenever adjustments are proposed to the taxable income of a taxpayer, under the authority of section 482, the general effect on the taxpayer is to cause the creation of taxable income within one taxing jurisdiction by imputing income to the taxpayer. It can readily be seen that when you create income within one jurisdiction, you have double taxation unless you are able to get a correlative adjustment that results in a deduction in the other jurisdiction. In light of the excellent working relationship between the two countries, one might assume that achieving perfect harmony in the tax structures should not be a problem. Nevertheless, if you work in this field on a daily basis, you are undoubtedly aware of the fact that the Internal Revenue Service (IRS) audit activity of many multi-national companies will often not commence until three to five years following the close of the taxable year under audit. By that time, the statute of limitations in Canada has generally expired, and therefore, it is too late to attempt to get a corresponding deduction in Canada. Consequently, double taxation can often result.

The more common business transactions which have been the subject of section 482 adjustments include imputed interest, royalty arrangements, management charges, and intercompany pricing.

For many years, the most common adjustment raised by both countries involved imputed interest where parties were creating loans at nominal or no interest rates. The taxing authorities would generally propose adjustments to place the interest charge on an arm's-length basis. In 1977, however, Canada virtually eliminated the prospect of proposed adjustments in this area by indicating that it would no longer grant a deduction to a Canadian company under an imputed interest concept if interest was not prescribed by a written obligation entered into between the parties.

With respect to royalty arrangements, there continues to be considerable audit activity. U.S. companies continue to export technology and know-how to Canada. Many export such technology and know-how as part of a capital investment in which case the tax consequences generally are solely those of the U.S. taxpayer. Others, however, export the technol-

ogy and know-how in return for a fee.

For instance, it is not uncommon, especially in recent years for the Foreign Investment Review Agency in Canada to require the infusion of technology into a Canadian company in order for the U.S. company to be allowed to complete an acquisition of the Canadian company. In that case, the U.S. company must first secure a ruling from the IRS that the outbound transfer of the technology will be tax free from the U.S. tax standpoint. In this particular case, section 367 controls. If you have not worked with the new section 367 guidelines, I urge you to tread carefully. The 1978 legislation was intended to be a liberalization of these guidelines. However, they still tend to be extremely complex and one should venture into this area only with expert counsel. Should you run afoul of these guidelines, the front-end U.S. tax consequences could be extremely burdensome. While I don't intend to dwell on this subject, there is a companion to section 367 which, if not kept in mind, could bring about equally disastrous results, and that is section 1491 which imposes a toll charge on the value of property contributed to the capital of certain foreign entities. The disturbing part about the application of these sections is that the U.S. company may be forced into contributing technology to the capital of a Canadian affiliate by the Foreign Investment Review Agency or other governmental agencies in a transaction which is designed to make economic sense, and yet because of the conflict in tax statutes, a significant U.S. toll charge may be imposed.

In those instances where the U.S. taxpayer is able to charge for the technology being transferred, the only significant problem would appear to be one involving a matter of the appropriate rate to be charged. Over the years, we have seen considerable activity where the Canadian Government has challenged the rate charged by the U.S. company as being excessive and has proposed disallowances of deductions claimed in Canada with respect to amounts being paid back to the United States. Where the parties eventually agree upon an arm's-length rate with the appropriate taxing authorities, they will generally still be faced with an element of double taxation if they are not able to obtain a deduction in the other country for the amount disallowed.

With respect to management charges, there generally has not been much activity. Where the management charge is properly supported, there should be no problem in obtaining an appropriate deduction by the company receiving the charge. If you are attempting to charge your foreign affiliate an excessive amount, however, and therefore derive a profit from such activity, you are probably not going to be able to obtain the deduction in Canada. Nonetheless, as I stated before, there really has not been significant activity in this particular area.

With respect to the matter of intercompany pricing, we are now seeing increased audit activity. The regulations as to what constitutes arm's-length intercompany pricing are extremely complex and there is a "comparable uncontrolled pricing" concept which one should look to as the

standard.

For many years, the most significant audit activity in the area of pricing involved Canadian import duties. In recent years, the IRS has begun to focus on pricing for income tax purposes, and within the last 12 to 18 months, we have seen a significant increase in similar audit activity by Revenue Canada.

During 1979, Canada, in what appears to be an all-out assault on abusive pricing techniques, announced that it intended to follow OECD 1979 regulations with respect to auditing intercompany pricing transactions. In general, these regulations are modeled after the intercompany pricing regulations supporting section 482. In January, 1980, Canada also announced a very ambitious audit program in the area of intercompany pricing. As I understand it, Revenue Canada intends to audit the 200 largest companies in Canada. They intend to adopt industry-wide programs and develop crack teams or task forces with specific industry expertise in order to audit these companies. Years ago, there was an expressed concern that the Canadian agents generally adopted a low-key approach to auditing, particularly in the area of intercompany pricing. To the contrary, the IRS was regarded as having far superior audit forces descending upon taxpayers with sophisticated computer technology for auditing. The concern expressed was that the Canadian agents were generally at a disadvantage and that the IRS as a result was able to drain significant revenue from Canada. Canada now appears to be heading in that direction, however, with the identification of certain industries, particularly pharmaceutical, textile, steel, and chemical. Revenue Canada now appears to be ready to tackle the giants in cross-border activity. From the United States' standpoint, there is virtually nothing new in terms of audit experience. Nevertheless, the IRS recently announced, through additions to its Manual Supplement, that it is intending to undertake a brand new study under section 482. The purpose of this study will be to identify the frequency and trend of section 482 adjustments and the most prominent type of adjustments between U.S. companies and foreign entities. It is also to identify the geographic location of the foreign entities involved in such adjustments, to determine the geographic area of non-compliance with the provisions of section 482, to develop profiles of the U.S. and foreign entities most likely to be engaged in commercial activities susceptible to section 482, and also to determine whether proposed legislation and regulations should be developed for Department of Treasury consideration. It is understood that no time limit was placed on completion of this study.

As I indicated earlier, if you are faced with section 482-type adjustments, you generally are faced with the practical problem of double taxation. As I also indicated earlier, relief measures intended to minimize the element of double taxation may not be available if the issue raised in one country in a year in which the statute of limitations has already expired in the other country. This timing problem has generally caused taxpayers

to attempt to settle these proposed adjustments at the agent level, often arriving at settlements which were purely arbitrary and which could not be relied upon as a precedent for later years. For those taxpayers who appealed the agent's findings, Appellate Division settlements were often unsatisfactory and in the unusually large cases, taxpayers often ended up litigating the issues. While the courts in many instances have tended to favor the taxpayers, it has generally proven to be an extremely lengthy and costly proceeding. Notwithstanding the extremely favorable treaty between the United States and Canada which supposedly granted relief from double taxation, no procedures were formally established by the countries to provide the relief from double taxation. Therefore, taxpayers were forced to choose the alternate means already referred to.

The apparent solution appeared on the horizon in 1970 with the publication of Revenue Procedure 70-18. The purpose of this ruling was to spell out in detail the formal procedures for seeking relief from double taxation and providing in particular that the authorities of the respective countries would endeavor to reach a settlement favorable to the taxpayer consistent with the intent of the treaty. It also provided, however, that in the event the taxpayer did not agree to the findings of the Competent Authority, the taxpayer would still pursue other administrative remedies to avoid double taxation. In 1971, Canada published Information Circular 71-17 which outlined the Competent Authority proceedings from a Canadian viewpoint. To date, those two publications are the only formal pronouncements by any governments in establishing written Competent Authority procedures.

Since those publications, numerous appeals have been made to the Competent Authorities of the respective countries in an effort to obtain relief from double taxation. The success of the programs is difficult to measure. The most recent figures quoted by Treasury officials indicated that there were perhaps over 1,000 cases being examined by field agents where section 482 was an issue. To date, approximately 400 cases have been submitted to Competent Authority. Full relief has been granted in almost half of those cases, and almost half of the total cases submitted have involved Canada.

The procedures for invoking Competent Authority in the United States require first that there must be an element of double taxation. Therefore, there must be an adverse action taken by one of the countries. For instance, if the IRS would impute income to a U.S. taxpayer, an element of double taxation is imminent. But actual double taxation does not result until such time as an application for deduction in Canada has been denied. Should that take place, the element of double taxation has then occurred, and the taxpayer may then invoke the Competent Authority procedures in order to obtain relief from double taxation.

As a general requirement in seeking Competent Authority relief from double taxation in the United States, one needs only to complete the information specifically requested in Revenue Procedure 70-18. The con-

cern of the U.S. Competent Authority is that he receives the case at the earliest possible date so that he can set the wheels in motion insofar as approaching his counterpart in the other country. In general, there is no such thing as failing to file properly. If sufficient information has not been provided in the original filing or as negotiations proceed, when additional information is needed, a request will be made of the taxpayer to submit that additional information at that time.

In instances in which the taxpayer agrees with the findings of the IRS, the taxpayer may wish to supplement the information specifically required in Revenue Procedure 70-18 in order to give the Competent Authority sufficient information to present a convincing case to the Competent Authority of the other country.

Based upon past performance, the U.S. Competent Authority is seeking cases that are well developed. If the examining agent has not developed a case to a point where it stands on its own merits, it is likely that the Competent Authority will choose to reject the case and return it to the field with instructions to the field agent to drop the issue. The rationale of this approach appears to be that the Competent Authority is in a position of being an arbitrator and not a technician. It is not his responsibility to develop the cases, but rather, to present them to the Competent Authority of the other country in as convincing a fashion as possible. His role is to represent both the U.S. government and the U.S. taxpayer in seeking relief from double taxation pursuant to the treaty. If he is to succeed, he must be able to present as convincing an argument as possible. Obviously, he does not want to be negotiating from a weak position and, therefore, may choose not to proceed with a case where it appears he has little chance of either winning the issue or obtaining at least partial relief.

In the early years following the publication of Revenue Procedure 70-18, it appeared that the Competent Authority acted in a somewhat passive role. The scenario generally followed a pattern where the U.S. taxpayer would submit his request for relief from double taxation, the Competent Authority would approach the other country to seek relief, and cases were settled on a somewhat arbitrary basis. The taxpayer was not permitted to participate in any of these negotiations.

Within the last 12 to 18 months, however, there appears to have been a change in philosophy. The individuals working in the Competent Authority section in Washington are now actively seeking Competent Authority cases so that they might test the various treaty provisions, but more importantly, so that they might establish procedures for working with the various countries. While the taxpayer is still not permitted to participate in the actual negotiations with the Competent Authority of the other country, a taxpayer can now request a pre-filing conference to discuss various aspects of his case. While the Competent Authority will generally not conclude as to the merits of the particular case, they will give the taxpayer insight as to steps he might take in order to complete his filing and often what procedures the taxpayer should follow in certain

countries where the taxpayer has found it difficult to determine exactly what steps to follow in seeking a deduction. For instance, some taxpayers have had a problem determining the procedure to be followed in seeking relief from double taxation in South Africa. One of the critical questions is how to protect the statute of limitations in South Africa. If the Competent Authority has had experience in dealing with that country in an unrelated case, it may advise a taxpayer based upon that prior experience.

One of the obvious concerns of taxpayers faced with an appeal to the Competent Authority is the appropriate time for filing the request. Prior to 1978, the Competent Authorities preferred that cases proceed through the Appellate levels prior to being submitted for their consideration. Apparently, the thinking at that time was that the cases would be better developed since the taxpayer would have been forced to prepare a protest against the Agent's findings, and this additional information would have been part of the case file. It now appears that the Competent Authority is willing to receive the case even if the Agent's report is not completed. Apparently, the theory now is to notify the Competent Authority about the case as soon as possible so that they can begin consideration of the case, and also, so that they can start the administrative process with the Competent Authority of the other contracting country. Where the case is submitted for Competent Authority consideration while the Agent is still in the field, or after the Agent's report has been issued but before any proceedings at the Appellate Division, the case is considered as in "suspense" insofar as further consideration at the IRS level or taking any action with respect to the normal 30-day letter. No further action should be anticipated at the local level until determination has been made by the Competent Authority. One should also be aware of the "early warning letter." One of the critical issues that taxpayers have been forced to cope with in recent years is the matter of the statute of limitations in the foreign jurisdiction. Because of the age of a number of cases that the IRS is just now considering, the statute of limitations in the foreign jurisdiction may have expired prior to the Section 482 issue being raised in the United States. Recently, the IRS adopted a formal policy of issuing a letter to the taxpayer notifying him that the Service intends to raise an issue pursuant to the Section 482. This letter gives the taxpayer specific instructions as to actions he must take insofar as filing claims for refund in the foreign jurisdiction and also in protecting the statute of limitations in the foreign jurisdiction.

This letter is significant. For if at the time the letter is issued the statute of limitations in the foreign jurisdiction has already closed, the Competent Authority in general will not pursue the case, but rather, will return it to the field with instructions to the IRS to drop the issue. If, however, the statute of limitations is still open in the foreign jurisdiction at the time the early warning letter is issued, and if the taxpayer does not take the necessary action to keep the statute of limitations open in the foreign jurisdiction and it subsequently expires prior to the time the

Competent Authority intervenes, the Competent Authority will return the case to the field and permit the adjustment to stand. The key, therefore, is to heed the IRS warning and take the necessary action in order to protect the statute of limitations in the foreign jurisdiction. Taxpayers have been warned that failure to do so will, in most instances, result in double taxation.

Before proceeding with a Competent Authority request, however, one must obviously weigh all the consequences. On the one hand, the U.S. taxpayer is concerned with protecting the statute of limitations in order to avoid the impact of double taxation. On the other hand, he must be aware of the fact that once he proceeds to protect the statute of limitations in the foreign jurisdiction, he may have sufficiently alerted the foreign government to raise concern regarding his tax return and, therefore, may very well have inadvertently caused a full-scale audit. He must keep in mind that in the U.S. system, the Competent Authority Section is not part of the IRS. Therefore, there is not the overriding concern of the Competent Authority level with collecting revenue, rather, it is in carrying out the provisions of the treaty. On the other hand, in most of the foreign jurisdictions, the Competent Authority is part of the same branch that is responsible for the collection of revenue. Therefore, any Competent Authority proceedings may very well be with the same people who would be responsible for auditing the tax returns in the foreign jurisdiction. Therein lies the potential danger in proceeding without regard to all of the consequences.

To date, *de minimis* return has been a key concept in settling Competent Authority cases. We've had experiences in which issues involving less than \$25,000 in tax were generally considered to be too insignificant to be accepted by the Competent Authority and so are returned to the field with instructions to drop the issue. We also understand that issues involving an excess of \$100,000 in tax are rarely considered *de minimis* and, therefore, would not be automatically dropped, with the exception of issues involving approximately \$100,000 in tax where it relates particularly to intercompany pricing with taxpayers located in Canada. It would appear that the question of whether or not an issue falls within the *de minimis* guidelines will depend upon the amount of activity at the Competent Authority level between two particular countries. Since the United States has had considerable experience in working with Canada, the *de minimis* level would appear to be greater in order to eliminate the number of nuisance cases. There also appears to be a practical measure that the Competent Authorities are attempting to apply, and that is, where the issue that has been appealed to the Competent Authority has been corrected in a later year, and therefore, it is unlikely to set a precedent, Competent Authority has been known to return such cases to the field with instructions to drop the issue.

Earlier, I mentioned the issue of early warning letters and the necessity of taxpayers to protect the statute of limitations in the foreign juris-

diction. This topic points out a key problem area in dealing at the Competent Authority level and that is, that with respect to many countries, we are not certain of the applicable statute of limitations nor the procedure used, if any, to extend the statute of limitations. For instance, there is some controversy regarding the Belgian Treaty as to whether or not the treaty overrides local law to extend the statute of limitations in connection with Competent Authority proceedings in all instances, or only with respect to issues involving a corporation with a branch in the corresponding country, as opposed to a corporation with a subsidiary in the other country. The key question here is whether or not the Treaty which provides for relief from double taxation is applicable in instances of economic double taxation or de facto double taxation.

With respect to the Scandinavian countries, we have had virtually no experience at the Competent Authority level and, therefore, virtually no experience in protecting the statute of limitations in those countries.

With respect to Canada, for a number of years there was no formal procedure to protect the statute of limitations. However, a couple of years ago, Canada did institute a formal waiver procedure whereby a taxpayer could voluntarily open the statute of limitations for Competent Authority consideration. Initially, when this voluntary waiver system was adopted, there was concern as to whether or not voluntarily waiving the statute of limitations caused the statute for that particular year to remain open forever. Subsequently, a technical interpretation was released which clarified this matter and indicated that the statute was open solely for Competent Authority consideration.

Within the past six months, there has been further clarification from the U.S. Competent Authority of actions which taxpayers might take which may be a barrier to Competent Authority proceedings. Specifically, if the taxpayer in the foreign jurisdiction undergoes an audit by the taxing authorities of that particular country, and enters into a closing agreement in order to settle the tax case, the Competent Authority of that country may be unwilling to consider a case which arises in subsequent years and which would require overturning a closing agreement with respect to that particular year. The U.S. Competent Authority has made it known that where a taxpayer enters into a closing agreement in the foreign jurisdiction, Competent Authority relief will generally not be available with respect to transactions that might otherwise affect that particular taxable year. Taxpayers are, therefore, placed in a very difficult position in that a foreign jurisdiction may very well audit a taxpayer for a particular year well in advance of the IRS auditing a U.S. taxpayer for the same year. If the taxpayer in the foreign jurisdiction finds that it is to his advantage to enter into a closing agreement with respect to a particular year, he may be precluding Competent Authority relief if an issue of double taxation is raised in a subsequent year. Taxpayers are forced to gamble whether a favorable settlement with a foreign government outweighs the potential future consequences if the IRS audits the taxpayer

and if double taxation issues will be proposed.

A significant barrier to Competent Authority proceeding over the past years has been the timing of the completion of cases. I am familiar with a particular case that took approximately five years to resolve from the time of the initial submission to Competent Authority. Quoted sources from Washington now indicate that the average case takes from 12 to 15 months. Experience in the field would indicate that perhaps 15 to 24 months is a more accurate figure. In any event, it is a lot shorter than it was during the early 1970's. From my personal experience, every effort is being made by the Competent Authorities to expedite the cases.

An unanswered question at this time is how to proceed with multi-country issues. Where the taxpayer is faced with potential double taxation involving a number of countries, some treaty and some non-treaty countries, there is serious doubt as to how to proceed. The practice appears to be to carve out the non-treaty countries and to put those cases into suspense. The Competent Authorities would then proceed with seeking relief from double taxation with the treaty countries. The cases involving the non-treaty countries would then have to be covered at the Appellate Division. There is no clear-cut authority, but it would appear that settlement at the Competent Authority level with respect to the treaty countries might be a technical precedent for settling the non-treaty country cases at the Appellate Division level.

Overall, with respect to Competent Authority proceedings and particularly those involving Canada, the procedures established to date appear to be working extremely well. Canada and the United States are the only two countries with written procedures outlining the steps to be taken and the mechanics of seeking relief. Other countries, such as the United Kingdom, France and West Germany, have not yet adopted formal written procedures on how to seek Competent Authority relief, notwithstanding the fact that there have been a significant number of cases appealed to the Competent Authorities of those particular countries.

Leaving the Competent Authority area, I would now like to spend a few moments covering a topic that has been referred to by Mr. Brown in certain of his articles written in the various Canadian tax journals as "witch-hunting." I'm referring particularly to the joint audit programs. These programs have evoked considerable concern among taxpayers in both the United States and Canada. Earlier, this year, the United States announced that it had entered into working arrangements with France and West Germany for the simultaneous audit of multi-national companies operating in both jurisdictions. Outside of the formal announcement, little else was written about this particular procedure. Perhaps not much was said at this time since approximately two years ago, the United States and Canada jointly announced a similar program which evoked considerable emotion, particularly on the Canadian side. I feel the reason for all of the concern is perhaps the vagueness of the term "joint audits." As I indicated, some have referred to the programs as a "witch-hunt,"

with each country going after the other. The reaction in the United States and Canada is understandable since both U.S. and Canadian taxpayers generally have been free to plan their business affairs to minimize their tax liability totally within the legal structure of the taxing system. Suddenly, the two governments announce that they are going to team up against the taxpayer, and one can see the reason for the obvious concern of the taxpayers.

The current Canada-U.S. Treaty provides in four separate articles for the joint audits of the multinationals. These articles generally provide that if one country feels that there is an opportunity for potential evasion of taxes, it may communicate directly with the taxing authorities of the other country. The key appears to be that the treaty does provide that upon request, one government may furnish information about taxpayers of the other country physically present within that country. In light of those provisions that have existed in the treaty for a considerable period of time, the United States and Canada in 1977 announced the joint audit program. The stated objectives of the program were to develop guidelines for the exchange of information which would be used by the countries in their examination within their respective jurisdictions. The second purpose was to exchange information on new or apparent patterns or techniques of tax avoidance that had come to their attention. The third was to determine a taxpayer's correct liability. The fourth, to develop techniques and formulas for evaluating arm's-length pricing methods, and the fifth was to develop guidelines for evaluating tax haven transactions.

The major targets of the joint audit programs between the United States and Canada appear to be the multinationals doing business in both countries. In 1977, when the joint audit program was announced a lot of the concern expressed in Canada arose since many felt that the joint audit program would merely result in a drain of revenue from Canada. There was also confusion as to the focus of the examinations. In the IRS Manual Supplement covering joint audits, there was discussion concerning Section 482-type transactions which would imply that the focus of the audit would be taxpayer transactions taking place between the two respective countries. Canada, however, generally referred to transactions involving third countries such as tax haven countries as being the focus of the examinations. A further question that had to be resolved was who had prime responsibility for the joint audit. That appeared to be resolved in favor of the host country, that is, for example, if a U.S. parent corporation had a Canadian subsidiary, the prime responsibility would lie with the IRS.

Obviously, if a taxpayer is to be the subject of a joint audit, one would think the taxpayer would have great interest in knowing whether or not he was the subject of a joint audit program. Both the United States and Canada in announcing the program indicated that they would notify taxpayers at the time they had been selected as the target of a joint audit program. The United Kingdom, however, has indicated that

there is no compulsion to notify taxpayers, and that they plan to conduct such audits in secrecy. There is obvious opportunity for disagreement on this issue of joint audits between the United States and the United Kingdom.

With all of that background, a major question that surfaces is the matter of privacy of information. The Canada-U.S. Treaty does not contain a privacy provision as is in the model treaty, where these matters are generally covered. Therefore, one must look to the local provisions under Canadian law. For the IRS, however, Section 6103 as modified by the Tax Reform Act of 1976, and with the Freedom of Information Act, there is substantial concern about what information will be distributed to the general public. Distribution of such information within the United States could very well cause the release of information regarding the Canadian taxpayers which might violate that taxpayer's rights under Canadian law. It would appear that confidential trade information should be protected, notwithstanding Section 6103, as modified, and the Freedom of Information Act. The IRS Manual Supplement does caution the examining agents involved in these cases regarding requests for information and gives them specific guidelines as to how to proceed.

With that background, let's look at the results of the simultaneous audits of U.S./Canadian taxpayers. In focusing on the results of the joint audit program since then, you can probably make two very superficial comments. First, the results have not been dramatic, and second, the results have been about what was expected. My first comment is based upon the form of conducting the audits and the time frame. In 1978, it was announced that three companies had been targeted for review under the joint audit program. It has taken virtually two full years to complete those examinations. Some of the reasons for such lengthy audits are obvious. The examining agents are not permitted to visit the other country and they are only permitted to use information provided by the other country on request. As might be expected, audits conducted under these arrangements can be extremely lengthy and perhaps, at times, inefficient. The results of the three audits were reported as follows according to the Canadian Minister of Audit, Mr. Gorley. One was recently turned over to the Intelligence Division of the IRS for further review. The second apparently resulted in a significant refund from Canada, and an additional assessment of U.S. taxes of approximately \$5,000,000 relating to intercompany pricing. I don't have any numbers with respect to the third one. It is my understanding, nonetheless, that it eventually was dropped because of numerous complex tax issues.

It is also my understanding that the joint audit program will continue and that the governments are in the process of identifying five additional companies which will be the target of simultaneous audits.

As I indicated earlier, since the original announcement of the United States/Canada Joint Audit Program, the United States has proceeded to develop similar programs with the United Kingdom, France and West

Germany. Last week, in an article in the *Globe and Mail*, it was announced that Canada is now proceeding with similar agreements with other countries and that it is principally looking to the United Kingdom. I don't know if the timing of that announcement had anything to do with the fact that the returns in Canada are due on the 30th of this month, but I do know that in the United States, articles are conveniently published concerning fraudulent activity of U.S. taxpayers around April 15th, therefore, you may be interested in this article. The headlines of this particular announcement are "Nation's Collaborate to Defeat Country's Fleeing Tax Liability." The thrust of the article focuses on multinationals siphoning the income to tax haven countries. Mr. Sherbaniuk said, "In the past, it was relatively easy to spot shams, but recently, multinationals have beefed up tax haven operations making analysis difficult and the question becomes essentially one of reasonableness." They are talking about the joint audit program "that is already viewed as a success by tax officials." The Program has already opened up information and put National Revenue in a much stronger position to challenge companies. Evading taxes by crossing borders could become a returnable offense under a bill currently before Parliament.

I think it is an understatement to speculate that Canada is very serious about the joint audit program. But as food for thought, if you think the bilateral audit may be somewhat of a "witch-hunt," and if you consider further the fact that the United States is now spreading similar agreements to France, West Germany and the United Kingdom, the taxpayer may some day be facing multilateral audits.

From an overall standpoint, I think the tax relations between the United States and Canada are extremely good. The cross border technical tax issues have been boiled down to intercompany pricing and the issue of royalties.

The next couple of years will prove to be extremely interesting from the field agent's standpoint. With the IRS conducting a full-scale study of Section 482, I'm sure we can expect to see increased emphasis in sensitive areas, and my guess is that it will probably come first in the area of intercompany pricing. From the Canadian standpoint, I would predict that the same will be true. It appears that intercompany pricing is going to be the focus and it would also appear that we could expect Canadians to develop industry-wide terms with a narrow expertise in particular fields.

With respect to Competent Authority proceedings, they have always been good between the two countries. I would expect that to continue. The compromises reached between the two countries have generally been satisfactory to the taxpayers, and have demonstrated the sincere effort not to double tax parties operating in both countries.

With respect to the Joint Audit Program, I don't think the fear or the concern that taxpayers will be burdened with adjustments that might not otherwise arise is generally well founded. I feel, to the contrary, that the taxpayers who have to worry about the joint audit program are those

who, if uncovered in any host country audit, would have a lot to fear in the first place.