Managing Tax Audits and Appeals 2015

October 1-2, 2015

Washington, DC

New Audit Paradigm: "Issue-Focused" LB&I Examinations

Christopher Larsen –

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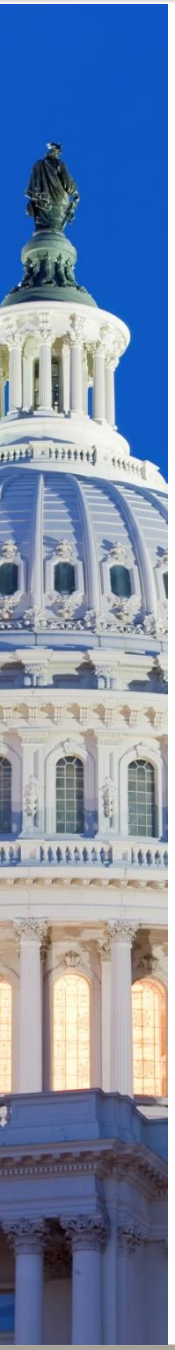
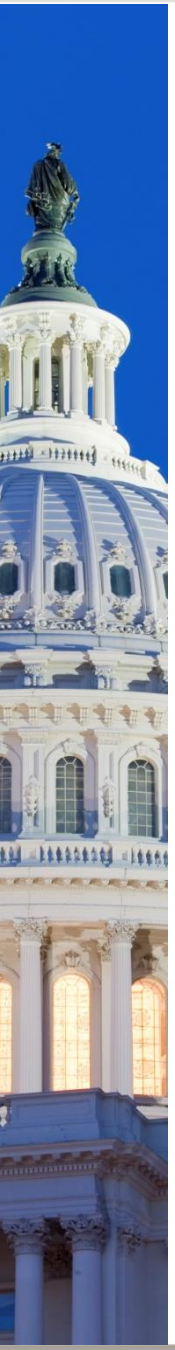
Crowell & Moring, LLP



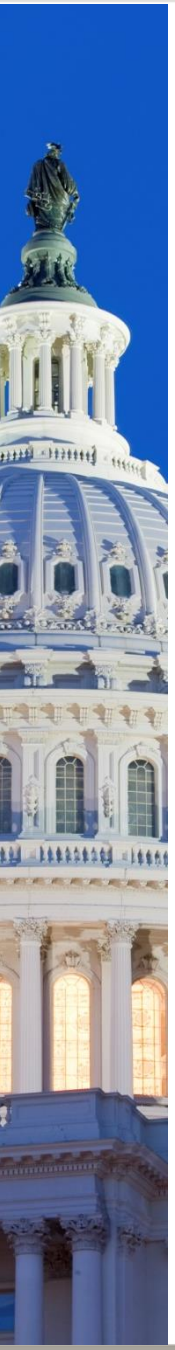
Overview

- Context: What is Really Going On?
- LB&I Reorganization
- Issue Focused Examination Program
- Next Steps And Outstanding Questions



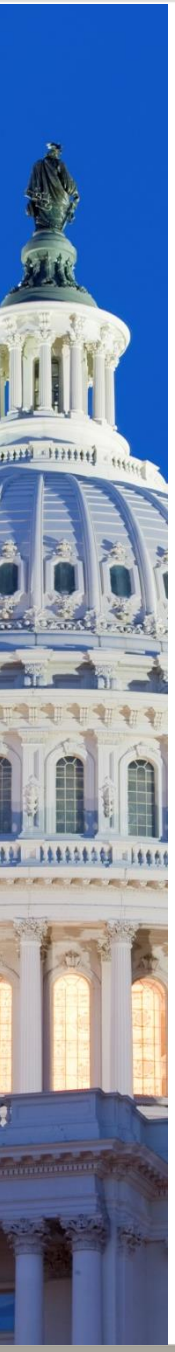
LB&I Reorganization In Context

- Some Recent IRS History:
  - Modified IDR procedures effective March 2014 (LB&I Directive, Feb. 28, 2014)
  - Appeals Judicial Approach & Culture - Phase II (July 2, 2014)
  - Informal Claims Within 30 Days (Sept. 2014)
  - IRS [Draft] Pub. No. 5125 (Released Oct. 2014)
  - Centralized Risk Assessment Pilot Program (Ongoing?)



Current IRS Challenges

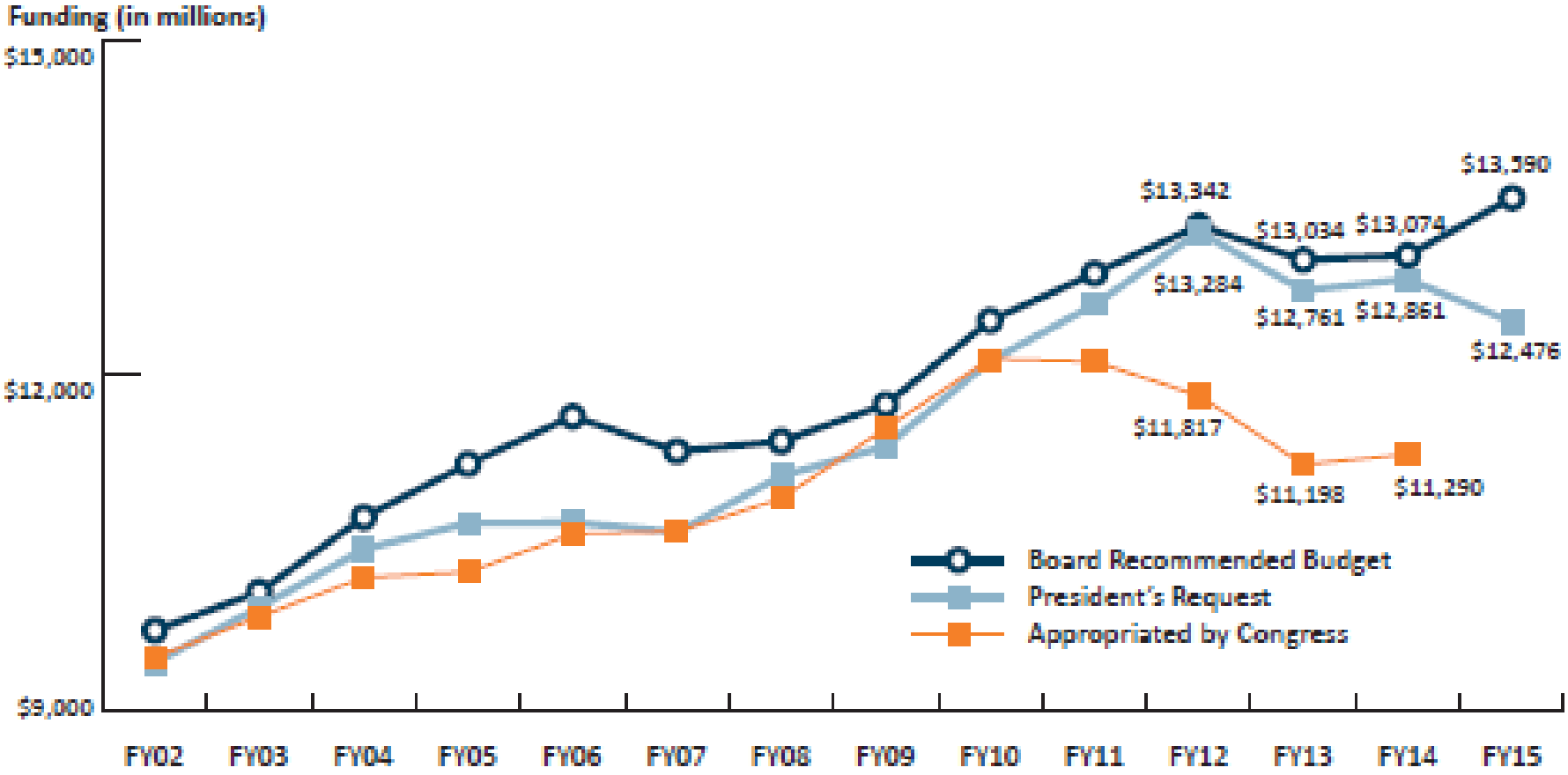
- Funding
  - Over $1B In Budget Cuts Since 2010
  - Training Cut From $172M (2010) To $22M (2013)
- Staffing: Retirements Threaten Brain Drain
  - 50% of LB&I Executives In ‘Acting’ Capacity
  - LB&I Agents Down
  - Appeals Down
- Falling Audit Coverage



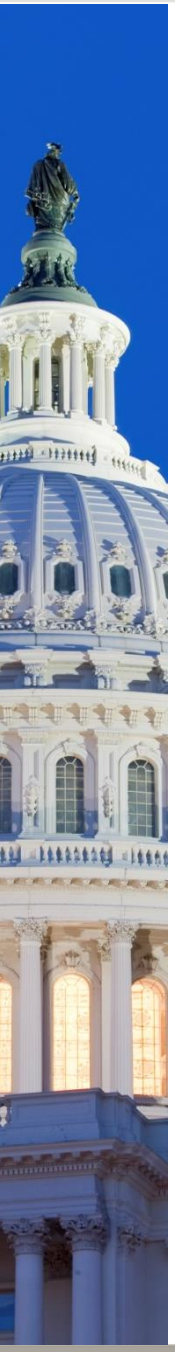
IRS Budget

FIGURE 1.

IRS Funding History, FY2002-2015



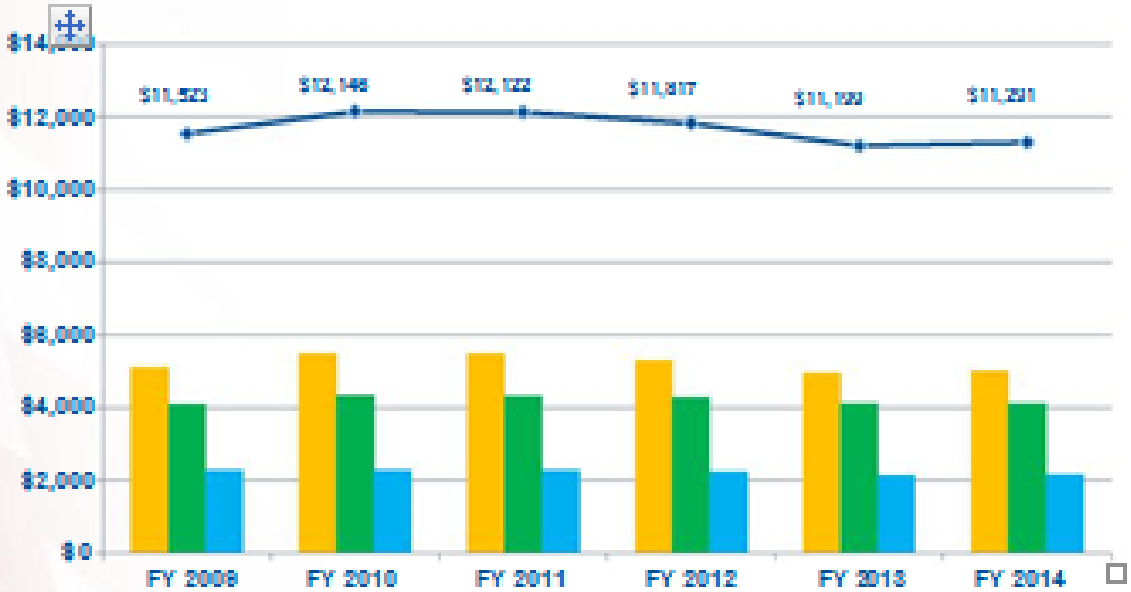
Source: IRS Oversight Board FY2015 Budget Recommendation Special Report



GAO

Funding Trends: IRS's Appropriations Have Declined to Below Fiscal Year 2009 Levels

Figure 1: IRS's Appropriations, Fiscal Years 2009 through 2014 (Dollars in Millions)



IRS presents its budget request through four appropriation accounts: Enforcement, Operations Support, Business Systems Modernization (BSM), and Taxpayer Services.

Legend: FY = fiscal year.

Source: Fiscal years 2009 through 2014 congressional justifications for IRS.

Notes: The fiscal year 2013 levels represent an across the board rescission and reductions required by sequestration. In fiscal year 2014, IRS received $92 million for the improvement of services to taxpayers, refund fraud and identity theft, and international and offshore compliance issues. The operating plan, which has not been approved as of April 11, 2014, proposes allocating $34 million to Taxpayer Services and $58 million to Operations Support. In addition, IRS has proposed to transfer $65.2 million from Enforcement to Operations Support for information technology infrastructure ($40 million) and a program reclassification ($25.2 million). Amounts shown do not include other budgetary resources, such as user fees.

. See appendix I for more information on IRS budget trends, including other budgetary resources.

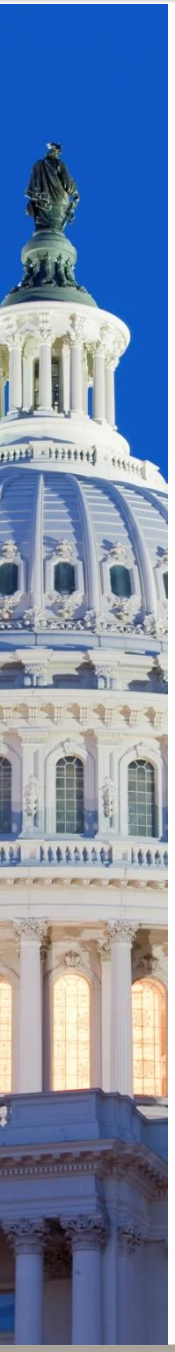
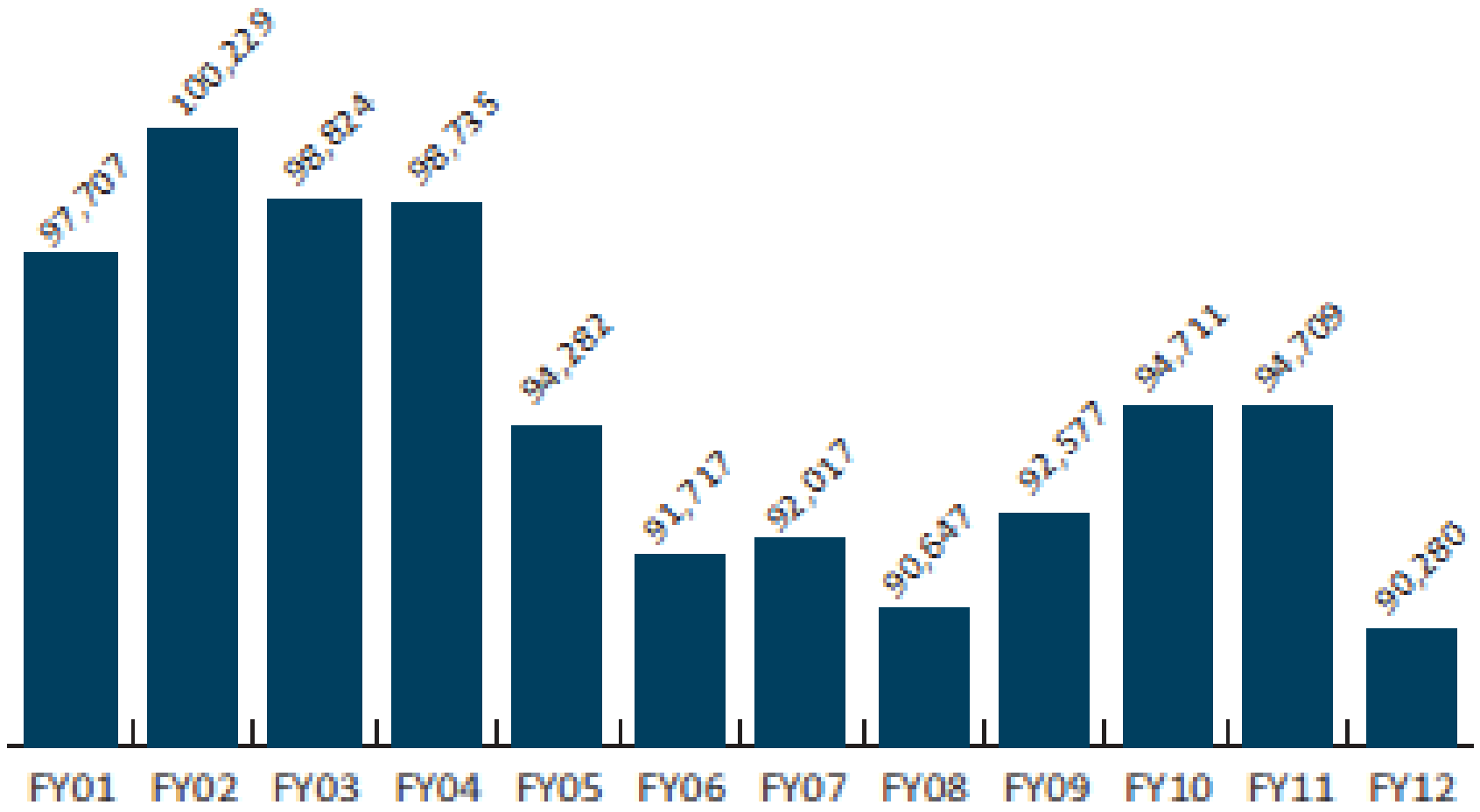
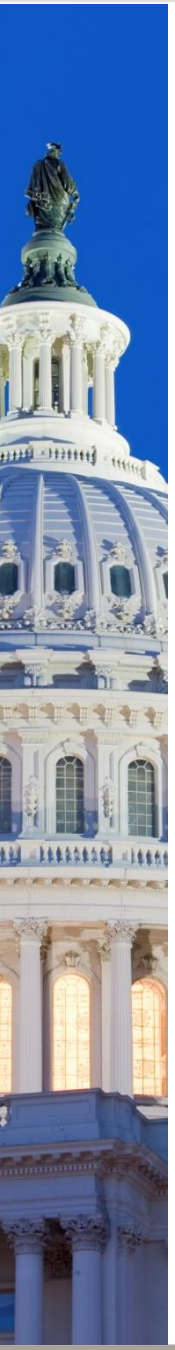


FIGURE 3.

Number of Full-Time Equivalents, FY2001-2014

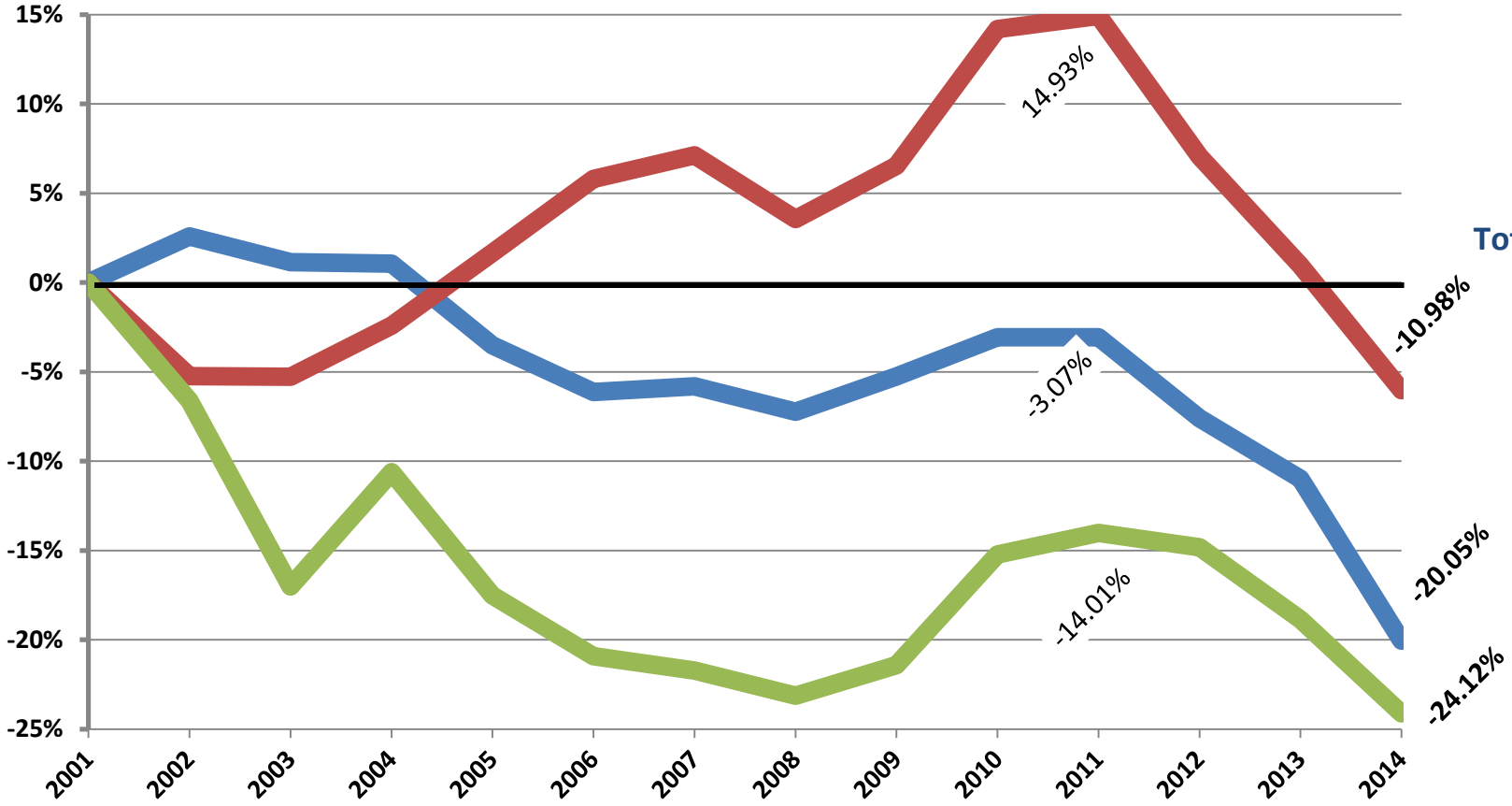


Source: IRS Data Book



IRS Staffing

Changes in IRS Workforce 2001-2014



Revenue Agents
12,154 in 2001
11,422 in 2014

Total IRS Personnel
97,707 in 2001
78,121 in 2014

Appeals Officers
999 in 2001
758 in 2014

Source: IRS Data Book Table 30.

GAO

Performance Trends: Return Examination and Collection Coverage Measures Show Decline

Figure 3: IRS Return Examination and Collection Coverage Measures, Fiscal Years 2009 through 2013 Actual and Fiscal Year 2014 and 2015 Targets

Source: GAO analysis of fiscal years 2009 through 2014 congressional justifications for IRS.

For more information on coverage measures, see appendix III.

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LB&I Pre-Reorganization

LB&I Organization Chart

- Elizabeth Wagner, Sr. Advisor to LB&I Commissioner
- Nick Gaudioso, Executive Assistant (Commissioner)
- Janice Larkin, Executive Assistant (Commissioner)
- Robert Aug, Executive Assistant (Operations) (A)
- Imelda Deniz-Vasquez, Executive Assistant (Technical) (A)
- Lillie Williams, Executive Assistant (Operations) (Int'l) (A)
- Steve Martin, Executive Assistant (Technical) (Int'l) (A)
- Donna Helm, Executive Assistant (Operations) (HMP) (A)
- Kevin Schlatmann, Executive Assistant (Technical) (HMP)
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- Mark Nyman, Executive Assistant, (Operations) (CTM) (A)
- Dwight Redigo Philips, Executive Assistant (GHW) (A)
- Cathy J. Vaughn, Executive Assistant, (Operations) (RFTH)
- Diane R. Wright, Executive Assistant, (Technical) (RFTH) (A)
- Stella Kui, Executive Assistant, (Operations) (FS)
- Deborah Inganamorte, Executive Assistant, (Technical), (FS)

LB&I Commissioner
Douglas O'Donnell

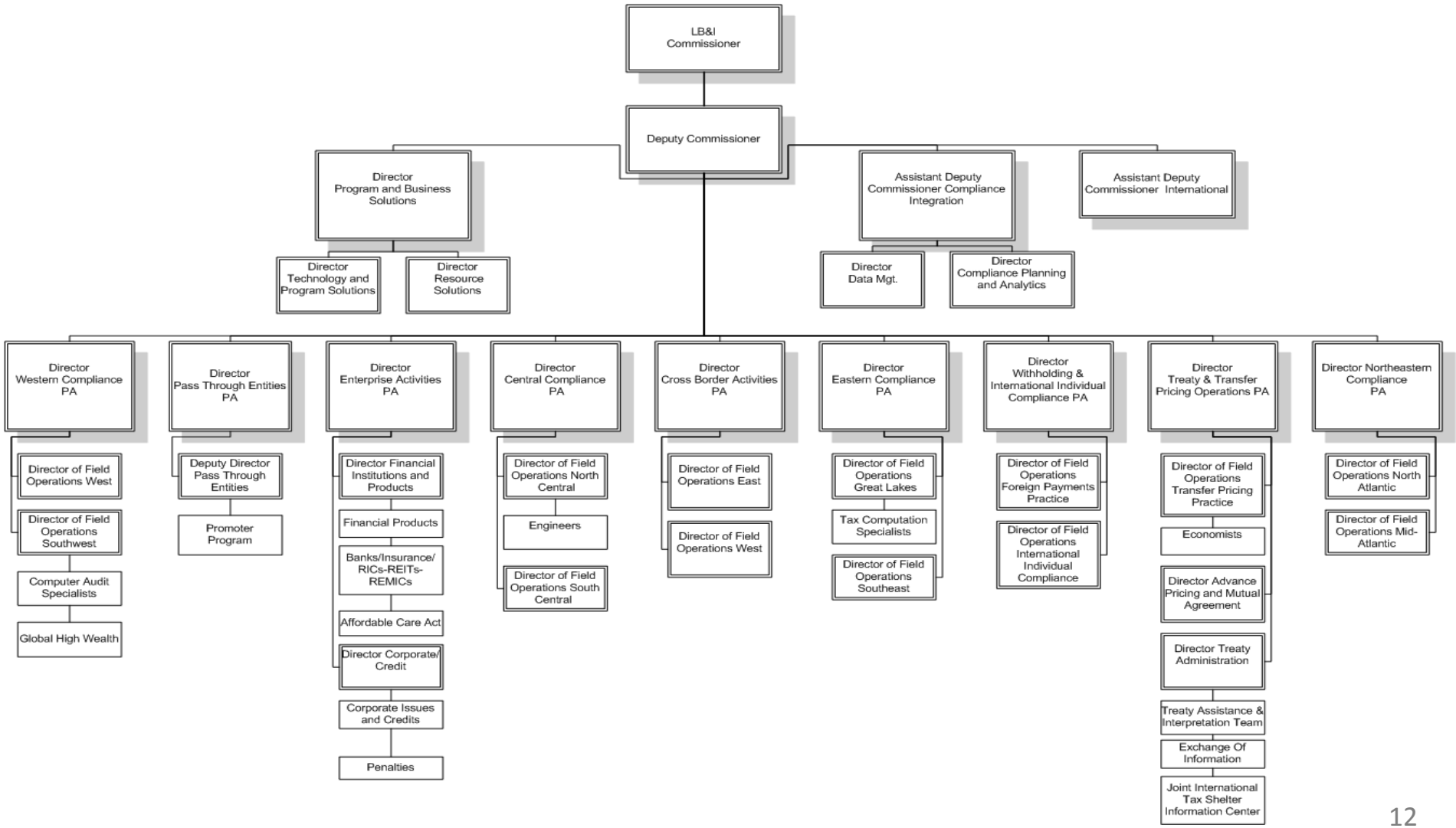
Deputy Commissioner (Domestic)	Deputy Commissioner (International)	Shared Support	Pre-Filing & Technical Guidance
Sergio Arellano (A)	**Dave Horton (A)**	**Susan Latham, Dir.**	**Tina Meaux, Dir.**
Communications, Technology & Media: **Cheryl Claybough, Dir.**; Scott Ballint, DFO NW (A); Paul Curtis, DFO SW (A)	Assistant Deputy Commissioner (International): **Theodore Setzer (A)**	Business Systems Planning: **Dean Wilkerson, Dir.**	Deputy Director: **Pam Drenthe (A)**
Financial Services: **Rosemary Sereti, Dir.**; Johanna McGeady, DFO Fin Prod; Barbara L. Harris, DFO NY	International Business Compliance: **Sharon Porter, Dir. (A)**; Jolanta Sanders, DFO E; Margie Maxwell, DFO W (A); William Holmes, Dir., IDM; David Oyler, Dir., FPP (A)	Management & Finance: **Keith Walker, Dir.**	Deputy Director: **Holly Paz**
Global High Wealth: **Cheryl Claybough, Dir. (A)**	International Individual Compliance: **Cathy Jones, Dir. (A)**; Clifford Scherwinski, DFO **(A)**	Planning, Analysis, Inventory & Research: **Christopher Larsen, Dir.**	Assistant Deputy Director: **Ingrid Mathis**
Heavy Manufacturing & Pharmaceutical: **Lavena Williams, Dir. (A)**; Dennis Figg, DFO NE (A); Donald Sniezek, DFO SE (A)	Transfer Pricing Operations: **David Varley, Dir. (A)**; Hareesh Dhawale, Dir., APMA	Equity, Diversity & Inclusion: **Rona Evans, Dir.**	
Natural Resources & Construction: **Kathy Robbins, Dir.**; Khin Chow, DFO W (A); Daniel LaFortune, DFO E (A); Stephen Whiteaker, DFO Eng.		Division Planning, Oversight Reporting & Liaison: **Michael Boccarossa, Dir.**	
Retailers, Food, Transportation & Healthcare: **Kimberly Edwards, Dir. (A)**; Carol T. Brown, DFO E (A); Pete Puzakulics, DFO W (A); Brian Calhoun, DFO CAS (A)			

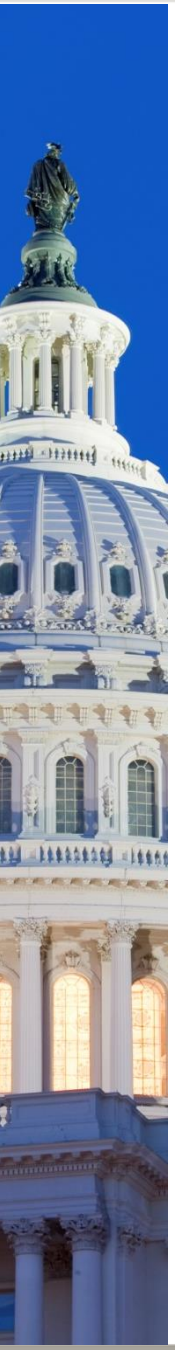
(A) = Acting

Rev. September 8, 2015

IRS Large Business & International

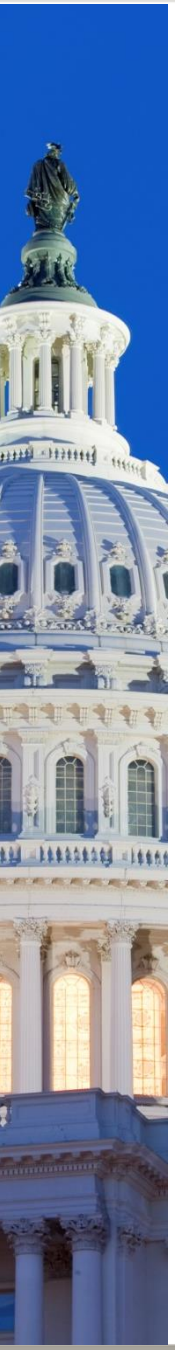
LB&I Reorganization





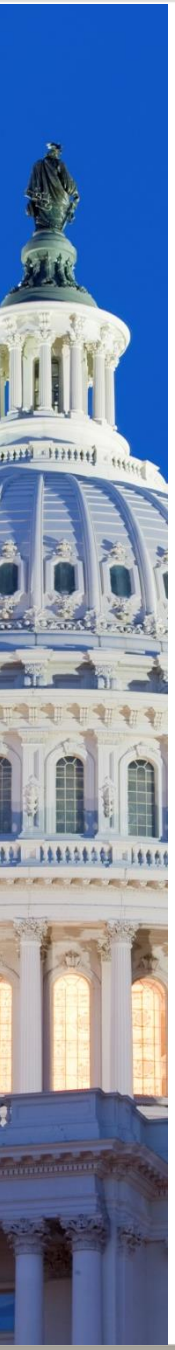
LB&I Reorganization

- Four Pillars of Reorganization
  - Flexible, Better Trained Workforce
  - Data Analytics Identify Non-Compliance Areas
  - Tailored Treatment Of Issues
  - Integrated Feedback Loops Improve Processes
- Changes to LB&I Organization Chart Create “One LB&I”
  - International/Domestic Deputy Commissioners Merge
  - Two Assistant Deputy Commissioners: International, and Compliance Integration



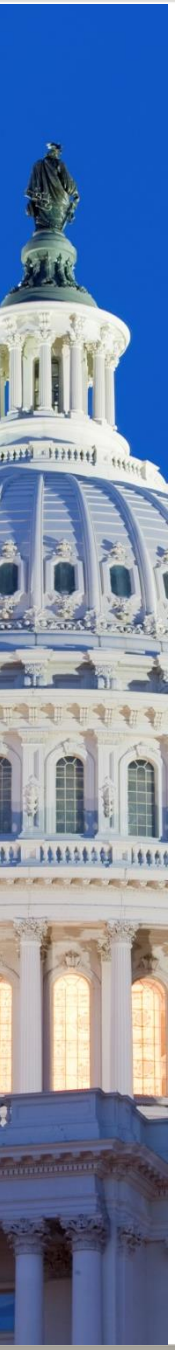
LB&I Reorganization

- Practice Groups
  - Build On Knowledge Management, Fold in IPNs/IPGs
  - Develop Practice Units
  - Example – Transfer Pricing Practice
- 5 Substantive Groups:
  - Passthrough Entities; Enterprise Activities; Cross-Border Activities; Withholding & International Individual Compliance; and Treaty and Transfer Pricing Operations
- 4 Geographic Groups:
  - Western (Oakland); Central (Houston); Eastern (Downers Grove); and Northeastern (New York)



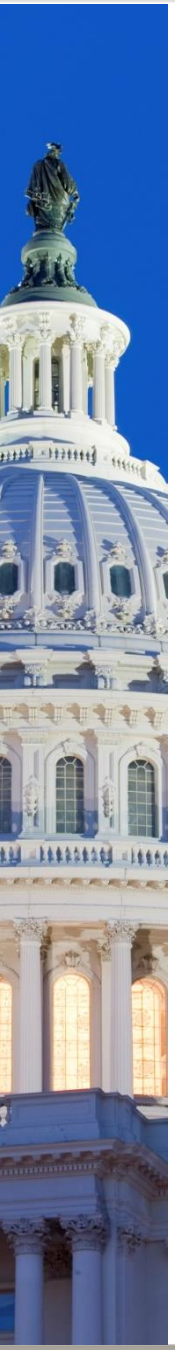
Issue Focused Exam Process

- Eliminate Coordinated Industry Case (CIC) Program
  - Audit Issues Rather Than Returns, But . . .
    - Largest Taxpayers Still Have Continuous Audits
    - Examiners May Still Identify Their Own Issues
- Centralization Of Issue Selection
  - Governance Board Decides Issues To Address, And How
  - Issues Pre-Identified For Examiners
- Campaign Approach:
  - Identify Areas Of Greatest Non-Compliance
  - Deploy Resources To That Area
  - Transparent To Taxpayers
  - Examples: Offshore Disclosure, Tax Shelters



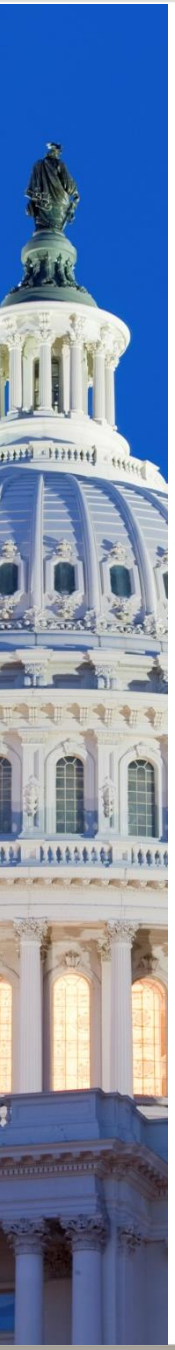
Issue Focused Exam Process

- Resolve Issues At Lowest Level
  - Exam To Seek Taxpayer Agreement On Facts Before NOPA
  - Exam Team Must Consider Fast Track Settlement
- Intersections With Earlier Directives
  - IDR Directive - Reach Agreed Facts
  - AJAC - No New Issues/Facts, Or Reopening Issues, At Appeals
  - Informal claims Within 30 Days With Full Factual/Legal Support
- New Rules Of Engagement (Coming Soon)
  - Taxpayer Concerns Routed To Issue Experts?



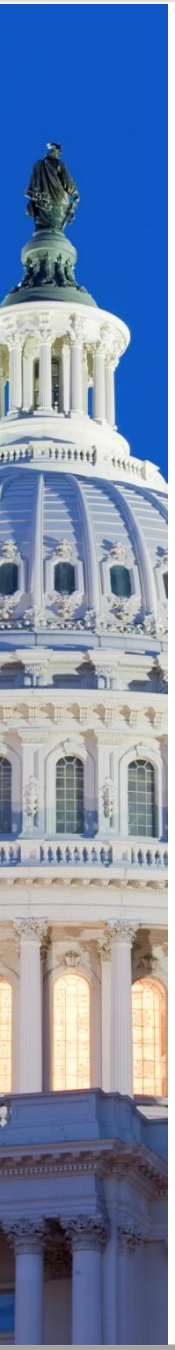
Issue Focused Exam Process

- Impact For Exam Team
  - Allocation Of Authority To Field
  - Pre-Audit Issue Selection
  - "Just-In-Time Training"
  - Track/Deploy Examiners Based On Knowledge, Abilities
  - Resources Spent On IRS Issues Rather Than Claims
- Impact For Taxpayers
  - Rev. Proc. 94-69 Disclosures
  - Issue Teams Cycle On/Off Exam
  - Coordination Among Issue Teams
  - Rules of Engagement
  - Reduced Ability To Negotiate Global Settlements?



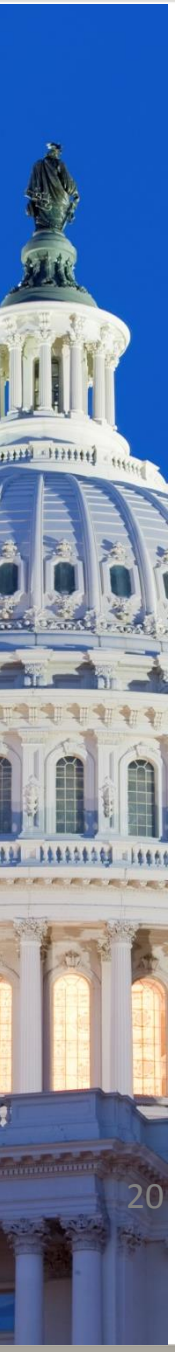
Risk Assessment: How Will Exam Find The Issues To Audit?

- Roles Of Issue Teams/Governance Board?
- Role of PAIR?
  - Leveraging Taxpayer Disclosures (e.g., Schedule UTP)
  - Other "Data Analytics"?
- Lists of "Hot Issues" (Tiered Issues Redux?)



Next Steps/Outstanding Questions

- Keeping Case Management/Discretion At Field Level?
- Rev. Proc. 94-69 Disclosures
- Impact On Settlement Negotiations?
- Rules of Engagement?
- Impact on CAP?



Questions / Comments …

IRS Hires Outside Counsel

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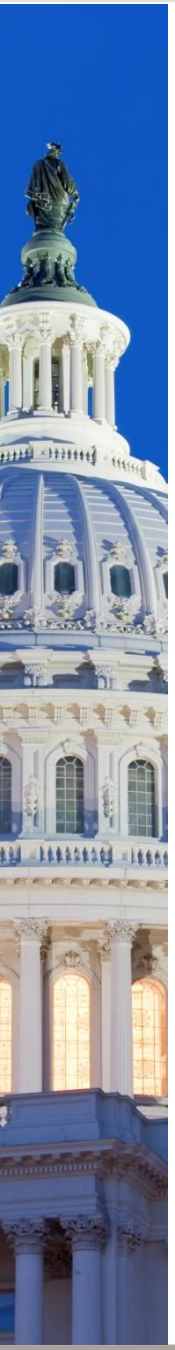
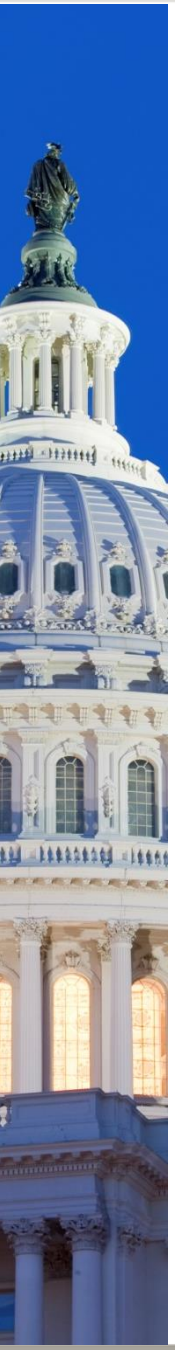


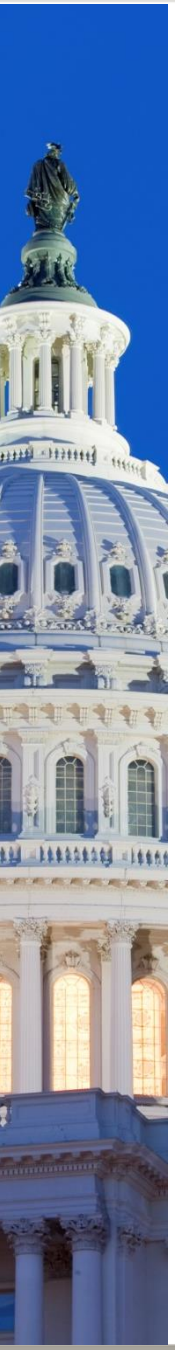
Background

- IRS Loss In *Veritas*
  - Transfer Pricing - Cost Sharing Buy-In
  - Tax Court Rejects Testimony Of IRS Expert In Support Of Income Method
  - IRS Decides Not To Appeal
- IRS Issues AOD 2010-005
  - Rejects *Veritas* Holding
  - Critical Of Tax Court's Fact Finding



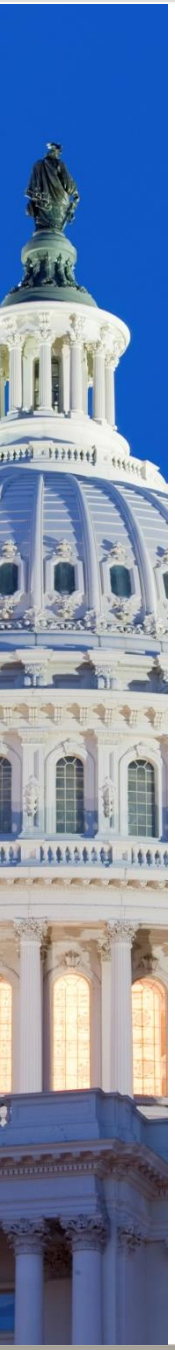
Tax Court In *Veritas*

After an extensive stipulation process, a lengthy trial, the receipt of more than 1,400 exhibits, and the testimony of a myriad of witnesses, our analysis of whether respondent's $1.675 billion allocation is arbitrary, capricious, or unreasonable hinges primarily on the testimony of Hatch. Put bluntly, his testimony was unsupported, unreliable, and thoroughly unconvincing. Indeed, the credible elements of his testimony were the numerous concessions and capitulations.



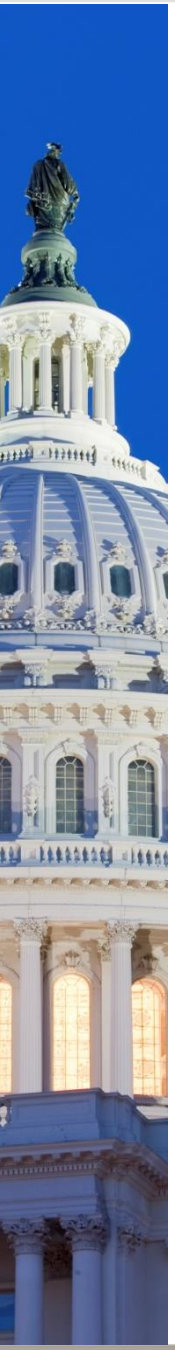
IRS Hires Quinn Emanuel

- IRS Audits Microsoft's Cost Sharing Arrangements
- Hires Outside Counsel To Assist In Developing Case At Audit ($2.2 M Contract)
- Temporary Section 6103 Regulations Facilitate Sharing Of Summonsed Materials, Testimony
- Notifies Microsoft That Quinn Emanuel Lawyers May Attend Witness Interviews



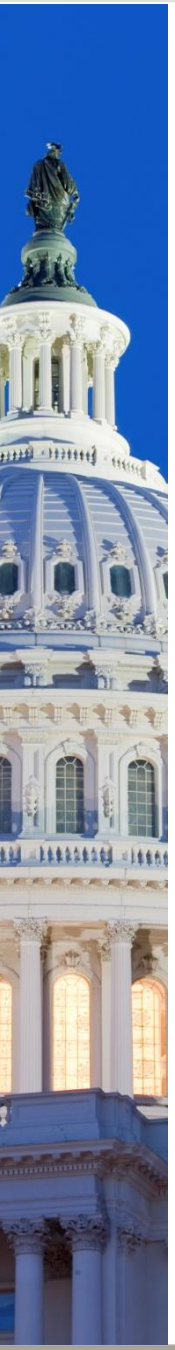
Microsoft Summons Enforcement Proceeding (W.D. WA)

- Oct. 2014 - IRS Issues Designated Summonses, Brings Enforcement Action
- Microsoft Objects To Quinn Emanuel's Involvement In Audit
  - Challenge to Statutory Authority Under § 7602
  - Challenge to Temporary Regulations Under APA
  - Attack On Statute Of Limitations Waiver
- June 2015 - Court Grants Evidentiary Hearing, To Be Held On Nov. 5.



Commentary

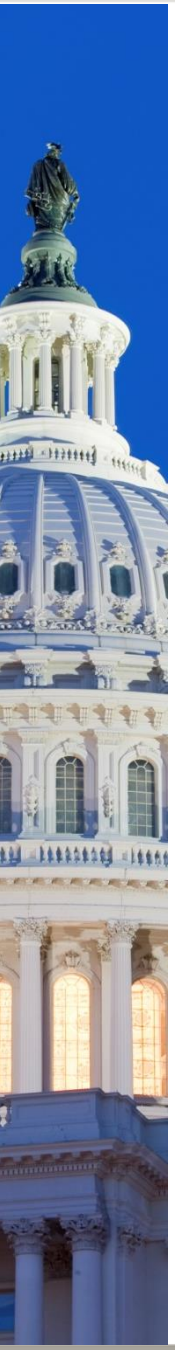
- S. Gibson - Insult To IRS Chief Counsel And Tax Division Lawyers?
- R. Pies - Other Agencies Hire Outside Counsel For Big Ticket Litigation, Why Not IRS?
- How Does IRS, As A Law Enforcement Agency, Ensure Fidelity To Its Mission When Working Through Outside Counsel?



The IRS Mission Statement

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

- Statement describes IRS's role and public's expectations of IRS.
- The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.



Questions

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Updates on U.S. Transfer Pricing

John Hinman, Assistant to Director,
Transfer Pricing Operations

John Hughes, Senior International Advisor,
Transfer Pricing Operations

Crowell & Moring LLP Tax Seminar

October 1, 2015

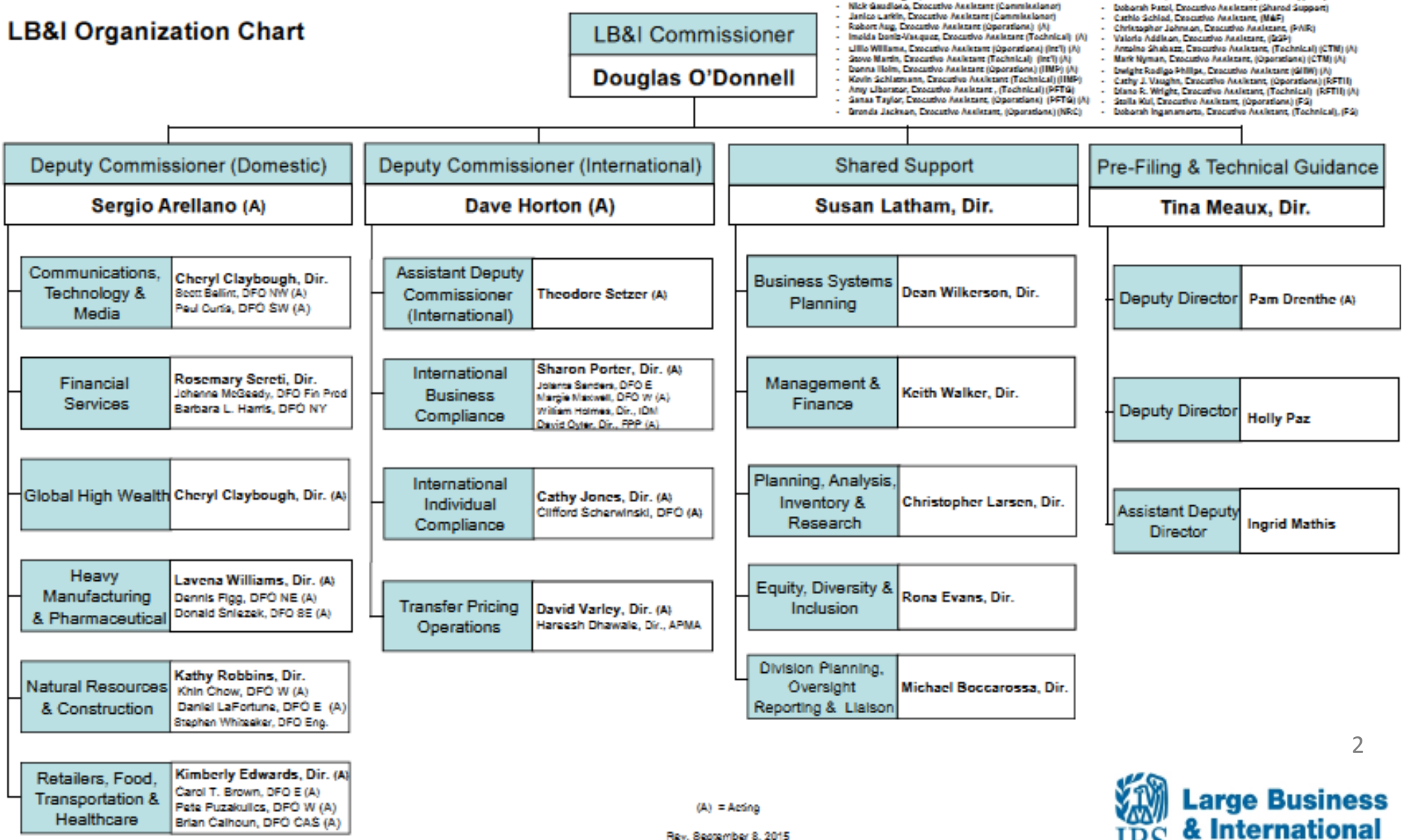
IRS Large Business & International

Updates on U.S. Transfer Pricing

- LB&I Organization Restructure and Impact to Transfer Pricing Organization (TPO)
- Transfer Pricing Examinations & the Audit Roadmap
- International Practice Service
- APMA Organization
- New APA & CA Procedures

Updates on U.S. Transfer Pricing: LB&I Restructure

LB&I Organization Chart



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(A) = Acting

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Updates on U.S. Transfer Pricing: LB&I Restructure

- Why Restructure LB&I
  - Greater efficiencies in line with budget challenges
  - More agility to design compliance strategies and evaluate intended compliance outcomes
  - Principles of Restructure
    - Flexible, well-trained workforce
    - Better return selection
    - Tailored treatments
    - Integrated feedback loop
- Proposed LB&I Restructure
  - Domestic and International under one LB&I Deputy Commissioner for greater cohesion

Updates on U.S. Transfer Pricing: LB&I Restructure

- Proposed LB&I Restructure
  - Nine practice areas, including Transfer Pricing Office
    - Five Subject Matter practice areas
    - Four Compliance practice areas
  - Centralized approach to assessing compliance risk
  - Driven by campaign concept and strategies to close compliance gap
    - A campaign can include exams and/or alternate treatment
  - Move away from CIC or “continuous” exam paradigm to issue focus

Updates on U.S. Transfer Pricing: LB&I Restructure

- What restructure means for TPO:
  - TPP & APMA will remain under the TPO Director & Treaty Administration (JITSIC, TAIT,EOI) will become part of TPO
  - TPO will be a Subject Matter Practice Area
  - Income Shifting IPNs will embed in TPP
  - TPP will expand/ APMA recently expanded
  - TPP will identify, lead & participate in campaigns
  - Consistent with original goals of TPP
    - Better case selection
    - Strategic litigation
    - Improve training and increase skills

Updates on U.S. Transfer Pricing: LB&I Restructure

- What LB&I restructure means for you
  - Little change in the short term
  - Shift to centralized return / issue selection and campaign structures will be long term effort
  - Eventually CIC designation and procedures will end
  - Issue teams and campaign teams will drive exams in the future- consistent with exam reengineering
  - Other treatment streams – remains to be seen

Updates on U.S. Transfer Pricing: The Audit Roadmap

- Transfer Pricing Audit Roadmap
  - Good foundational platform for procedural (not substantive) guidance in anticipation of expansion
    - Focus on socializing it more broadly within LB&I and with taxpayers
    - Encourages two-way communication and transparency
    - Opportunity to showcase reasonableness of the numbers
    - Expectation of a fully developed case puts greater burden on everyone to cooperate or face burdensome audit
    - Resolution is a desired goal
  - We are in the process of refreshing and updating the Roadmap

Updates on U.S. Transfer Pricing: The Audit Roadmap

- The Audit Roadmap: Taxpayer Takeaways
  - Provide comprehensive presentations of your transactions, studies and accounting
  - Be open to in helping us understand the critical facts and agreeing to what the critical facts are
  - Respect our need to independently verify and judge
  - Take opportunity to dialogue about the progress of the transfer pricing exam
  - Be clear about your willingness to resolve

Updates on U.S. Transfer Pricing: International Practice Service (IPS)

- International Practice Service (IPS)
  - Managed within IPNs (Int'l Practice Networks)
  - Part of International's knowledge sharing and knowledge transfer efforts
  - Library of published technical units
  - Transaction based approach to training
  - Released both internally and externally
    - Focus on issues and strategies
  - IPS Units for income shifting is very robust
    - 25 published units to date; 25+ in process

Updates on U.S. Transfer Pricing: International Practice Service (IPS)

- Examples: http://www.irs.gov/Businesses/Corporations/International-Practice-Units

2015	
09-10-2015	Inbound Liquidation of a Foreign Corporation into a U.S. Corporate Shareholder
09-09-2015	Accounting for Intangibles and Services Associated with the Sale of Tangible Property - Outbound
08-28-2015	Foreign-To-Foreign Transactions – IRC 367(b) Overview
08-28-2015	Overview of IRC 482
08-21-2015	Short Term Loan Exclusion from United States Property
08-21-2015	Bona Fide Residence Test for Purposes of Qualifying for IRC § 911 Tax Benefits
08-21-2015	U.S. Persons Residing Abroad Claiming Additional Child Tax Credit
08-21-2015	Calculating Foreign Earned Income Exclusion -Self-Employed Individual
08-21-2015	Sourcing of Fringe Benefits for FTC Limitation
08-21-2015	U.S. Territories – Determining Bona Fide Residency Status
08-21-2015	Sourcing of Salary and Compensation
08-21-2015	Calculating Foreign Earned Income Exclusion -Employee
08-21-2015	Payee Documentation for Treaty Benefits
08-21-2015	Effectively Connected Income (ECI)
08-04-2015	Branch-Level Interest Tax Concepts
08-04-2015	Non-Services FDAP Income
07-17-2015	CFC Purchased From Related Party with Same Country Sales
07-17-2015	CFC Sale to Related Party With Same Country Unrelated Party Manufacturing
07-17-2015	Receipt of Dividends or Interest from a Related CFC

2014	
12-15-2014	Interest Income Derived by CFC or QBU Engaged in Banking Financing or Similar Business
12-15-2014	Computing Foreign Base Company Income
12-15-2014	Subpart F Overview
12-15-2014	Disposition of a Portion of an Integrated Hedge
12-15-2014	Asset Valuation using the FMV Method for Interest Expense Allocation to Calculate FTC Limitation
12-15-2014	Overview of Interest Expense Allocation and Apportionment in Calculation of the FTC Limitation
12-15-2014	French Foreign Tax Credits
12-15-2014	Exhaustion of Remedies
12-15-2014	Exhaustion of Remedies and Transfer Pricing
12-15-2014	Exhaustion of Remedies in Non Transfer Pricing Situations
12-15-2014	How to Allocate and Apportion Research and Experimental Expenses
12-15-2014	Interest Expense Limitation Computation under IRC 163j
12-15-2014	Issuing a Formal Document Request when a US Taxpayer is Unresponsive to an IDR
12-15-2014	Section 861 Home Office and Stewardship Expenses
12-15-2014	License of Foreign Owned Intangible Property by US Entity
12-15-2014	Management Fees
12-15-2014	Purchase of Tangible Goods from a Foreign Parent CUP Method
12-15-2014	CPM Simple Distributor Inbound
12-15-2014	Foreign Shareholder Activities and Duplicative Services
12-15-2014	Best Method Determination for an Inbound Distributor
12-15-2014	Services Cost Method Inbound Services

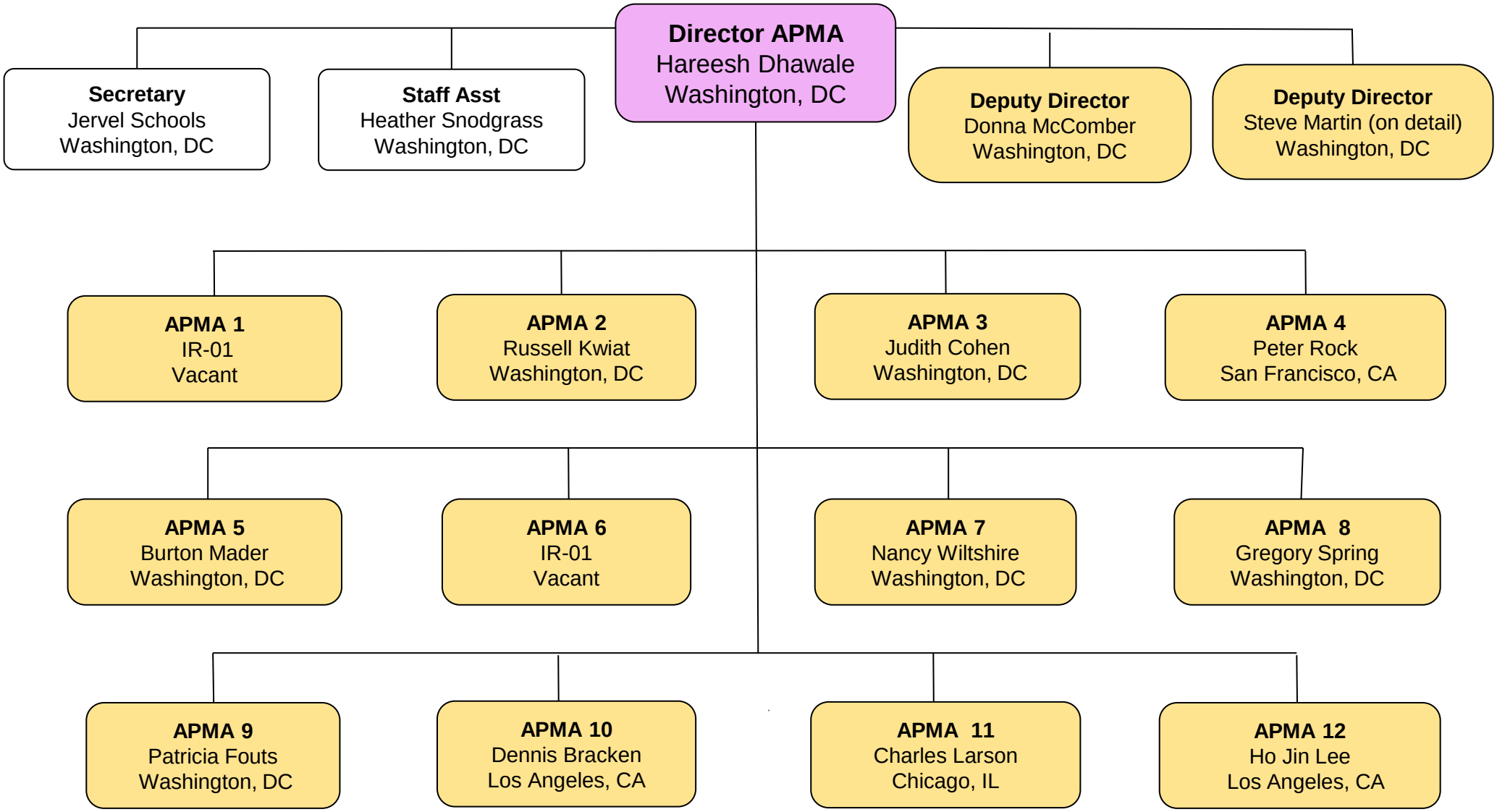
Updates on U.S. Transfer Pricing: IRS Appeals

- Effect of new Appeals Approach
  - Appeals Judicial Approach and Culture (AJAC)
    - Emphasis on evaluating the facts and arguments and positions of the parties as submitted.
    - No independent fact finding by Appeals
    - New facts, arguments and positions will not be considered or will be returned to Exam for reconsideration
  - Premium on getting it right the first time
    - Hiding the ball won't be rewarded.
    - Throwing the case over the fence for Appeals to figure out won't work.
  - Statute Considerations

Updates on U.S. Transfer Pricing: APMA Organization

- Overview of APMA Responsibilities
  - Transfer pricing and allocation issues in
    - Advance Pricing Agreements
    - Competent Authority double taxation cases
- 2012 Restructuring
  - Competent Authority and APA combined
  - APA moved from Chief Counsel to LB&I
  - Treaty issues other than transfer pricing and allocation moved to Treaty Assistance and Interpretation Team (TAIT)

Updates on U.S. Transfer Pricing: APMA Organization



Updates on U.S. Transfer Pricing: APMA Organization

- Assignment of Cases to Senior Managers
- Assignment of Economists
- Role of Economists
  - APA
  - Competent authority
  - Exam (TPP)

Updates on U.S. Transfer Pricing: New APA and CA Procedures

- New Revenue Procedures (August 12)
  - Rev. Proc. 2015-40 (Competent authority)
  - Rev. Proc. 2015-41 (APAs)
- Reasons for Updates
  - Reorganization (including move of APA to LB&I from Chief Counsel)
  - Codify existing “Best Practices”
  - Increase efficiency in light of shrinking IRS resources

Updates on U.S. Transfer Pricing: New APA and CA Procedures

- Notable APA procedures
  - Pre-filing mandatory conferences and memoranda
  - Voluntary (including anonymous) pre-filing conferences
  - Codification of interrelated issues practice
  - Expand rollback opportunities
  - Statutes of limitations
  - Detailed content and organizational requirements
  - Procedural changes in review of denials

Updates on U.S. Transfer Pricing: New APA and CA Procedures

- Notable Competent Authority procedures
  - Encourage early Competent Authority involvement
    - Prior to IRS Appeals
    - Fast track permitted
  - Encourage pre-filing conferences
  - Interrelated issues practice
  - Competent Authority Repatriation (CAR) (Rev. Proc. 99-32 relief)
  - Detailed form and content requirements
  - Procedure to confirm submission is complete

Updates on U.S. Transfer Pricing: Competent Authority Arbitration

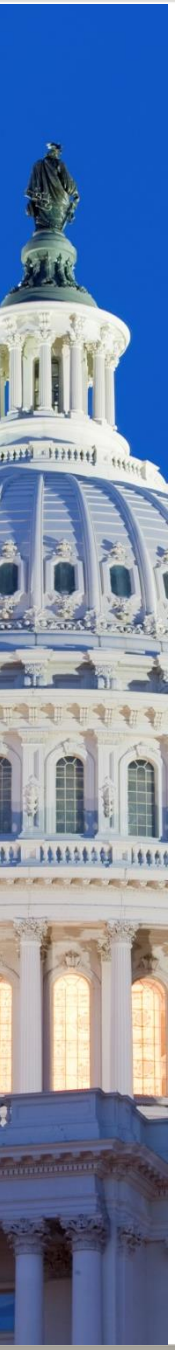
- Mandatory 2 years after submission complete
- Baseball-style arbitration
  - Currently arbitration protocols with Canada, Germany, France, & Belgium
  - Japan, Spain, & Switzerland awaiting Senate approval
- Effective dispute resolution tool

A Primer on Multistate Tax Audits

Greg Matson
Executive Director, Multistate Tax Commission

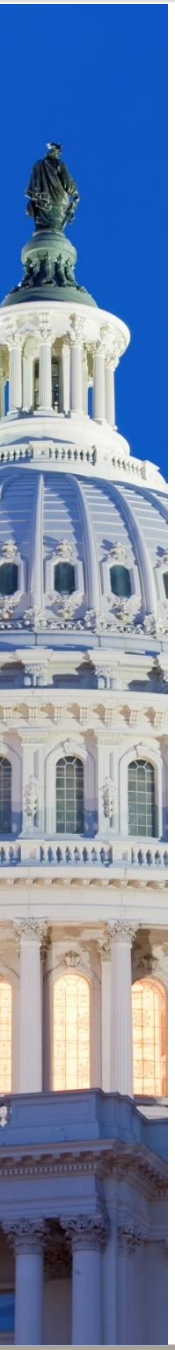
Don Griswold
Partner, Crowell & Moring

Jeremy Abrams
Counsel, Crowell & Moring (moderator)

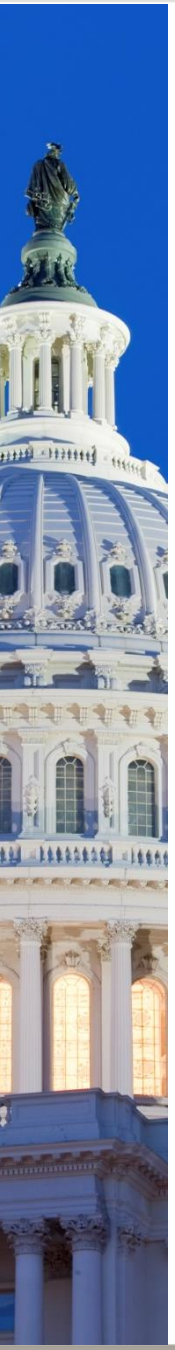


Agenda

- The Multistate Tax Commission's Joint Audit Program
- Special Issues in Multistate Audits
- Arm's-Length Adjustment Service (ALAS) Project
- Miscellaneous Services and Resources
- Q & A

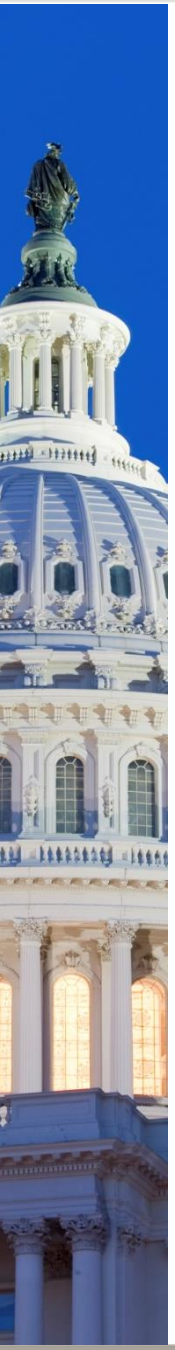


The MTC's Joint Audit Program



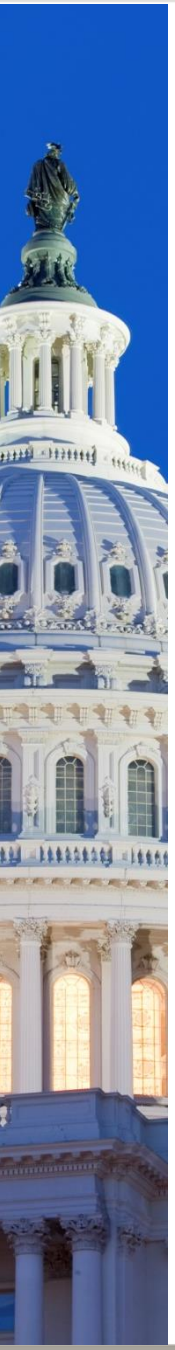
Joint Audit Program

- Operates under authority of the Multistate Tax Compact and state contracts
- The Commission does not have independent assessment or collection authority
- 27 states participate in the program (24 for income tax audits, 17 for sales & use tax audits, and 1 observing state)

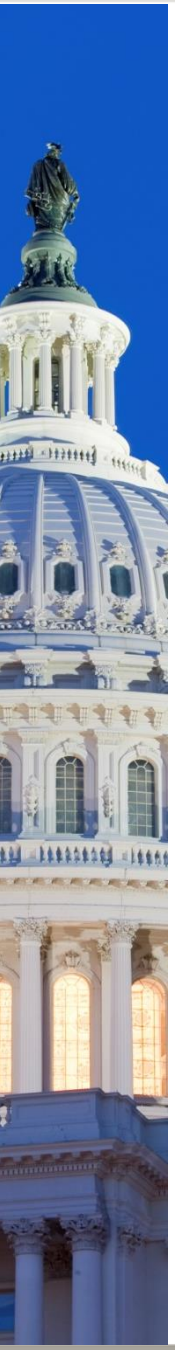


Joint Audit Program

- The Audit Committee oversees the Joint Audit Program, including audit selections.
- Joint Audit Program issued proposed assessments totaling nearly $300 million for participating states for the last four completed fiscal years.

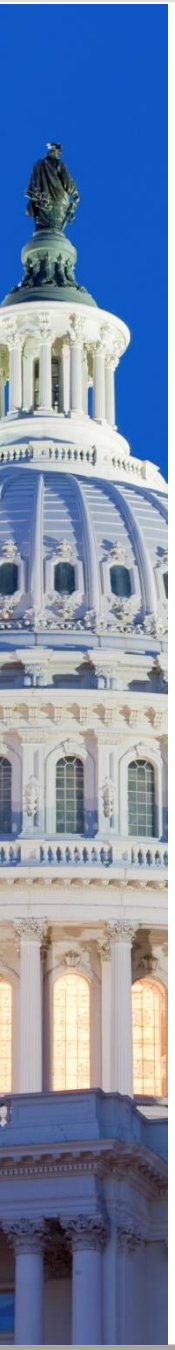


Special Issues In Multistate Audits

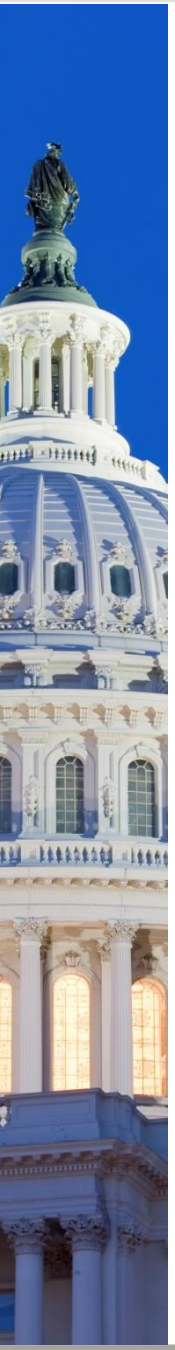


Special Issues

- Compact Litigation
  - California, Michigan, Oregon, Texas, Minnesota
- Challenges to Audit Authority

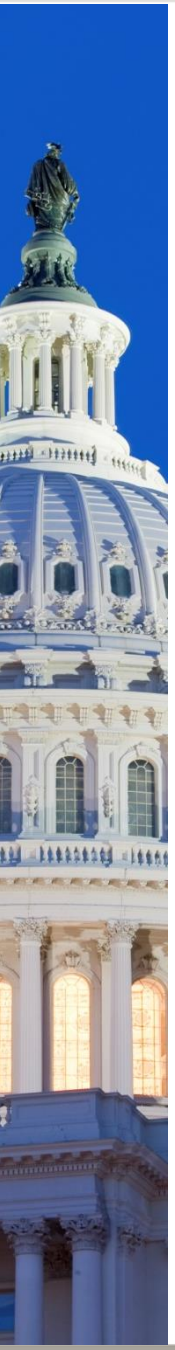


The MTC's Arm's-Length Adjustment Service (ALAS) Project



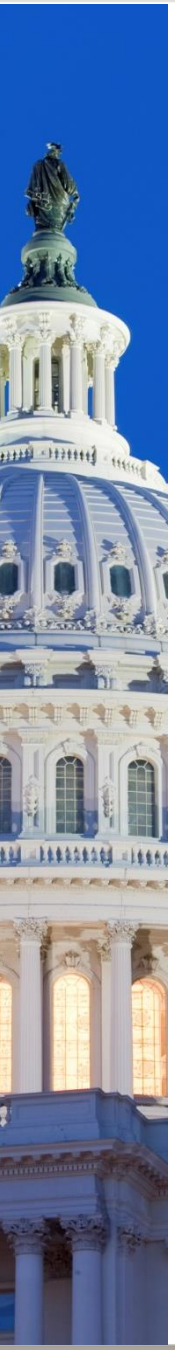
States Behaving Badly: (Transfer Pricing Status Quo)

- Discretionary "482-type" Authority
  - Example
    - Colo. Rev. Stat. § 39-22-303(6)
  - Limitations on Authority?
- Questionable Audit Techniques
  - Contract Auditors No More?
    - *Microsoft* (DC OAH '12); *BP Products* (settlement)
    - New Jersey, North Carolina
  - An Almanac, Seriously?!?!



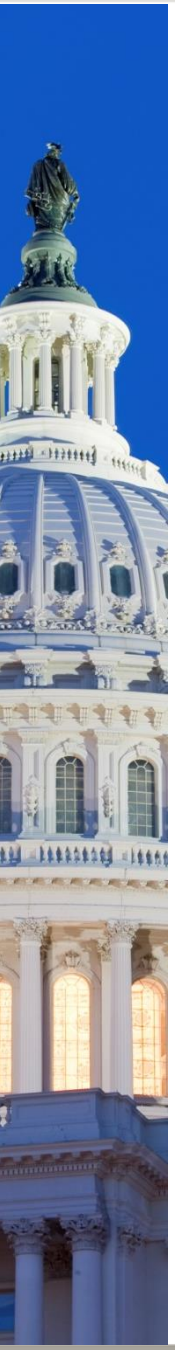
Arms-Length Adjustment Service (ALAS)

- A project of states and the Commission to assist states in the identification, audit, and litigation of transfer-pricing issues
- Estimated billions in state revenue are uncollected each year due to improperly valued transactions between related parties
- Economic and related services are too expensive for states to acquire on their own
- States want to share the expense of developing their in-house capacities



ALAS

- The Commission's Executive Committee approved the design document on May 7, 2015
- Development and initial operation of the service will span four years, beginning upon implementation
- $2 million annual budget
- Gradual roll out – audit adjustments are anticipated primarily in the third and fourth years



ALAS

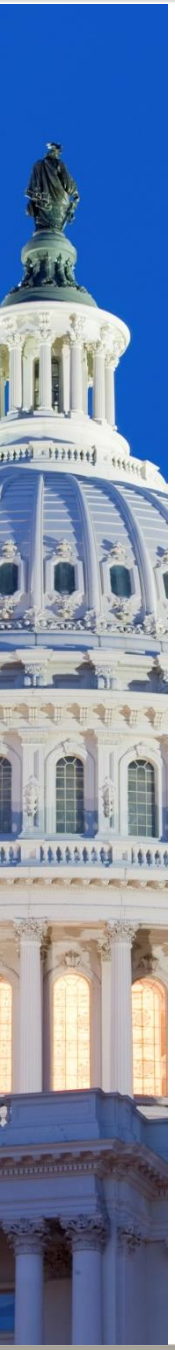
Two Major Components –

- Advanced economic and technical expertise

  Analyze taxpayer-provided transfer-pricing studies and, when appropriate, recommend alternatives to taxpayer positions

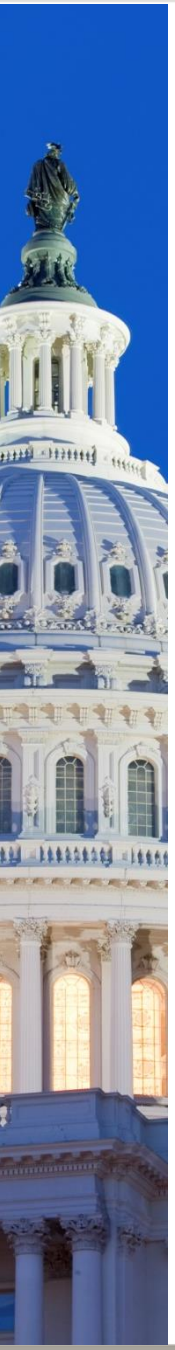
- Enhanced state capacity to use the expertise

  Train state staff, establish information exchanges, help states improve their administrative and compliance processes, expand Joint Audit coverage for related party transactions, help states develop and resolve cases, support states in defending their work in litigation, and update states on developments related to transfer pricing



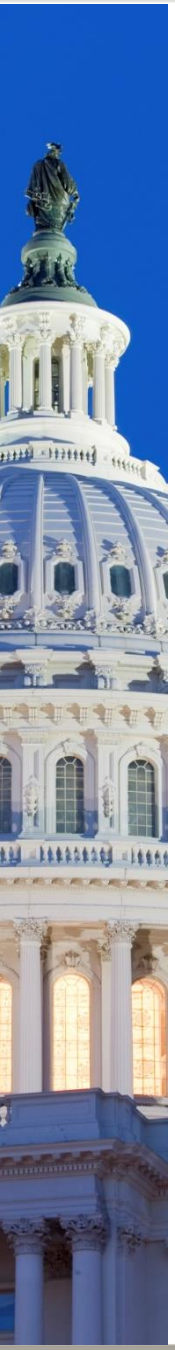
ALAS

- The core staff will consist of a tax manager with expertise in audit processes, an attorney with related-party and transfer-pricing expertise, and a senior economist with transfer pricing experience
- Other staff will include an internal auditor to conduct non-economic audits of transfer pricing studies that do not require the skills of an economist, e.g., examine calculations, selection of comparable prices, and business purpose
- The design plan anticipates hiring additional in-house, transfer-pricing economists at the fifteenth and twenty-fourth months



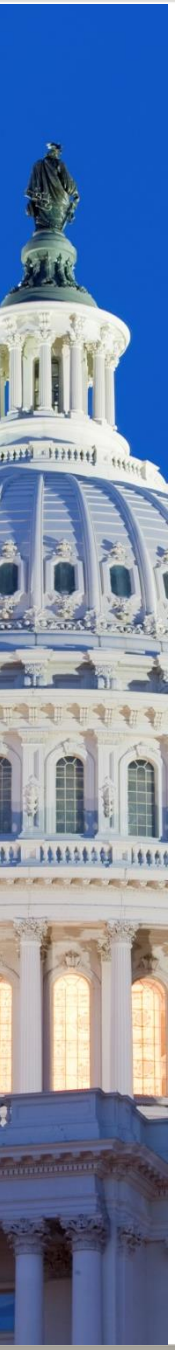
ALAS

- A one-time voluntary disclosure period is included in the program design in year two
- Taxpayers and states will be encouraged to use the Commission's existing alternative dispute resolution process to resolve issues consistently between a taxpayer and multiple states
- This ADR process also sufficient for working out advance agreements between a taxpayer and states when the program is mature enough to work through such issues

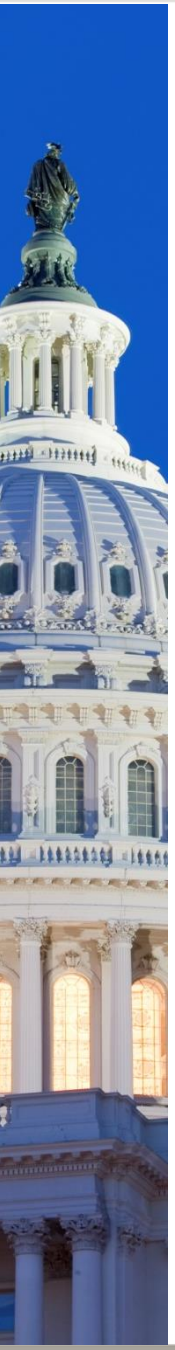


MTC ALAS Project – More Information Available Online

- The ALAS page on the Commission's website: http://www.mtc.gov/The-Commission/Committees/ALAS
- Previous meeting materials and other reference information is available on this page.

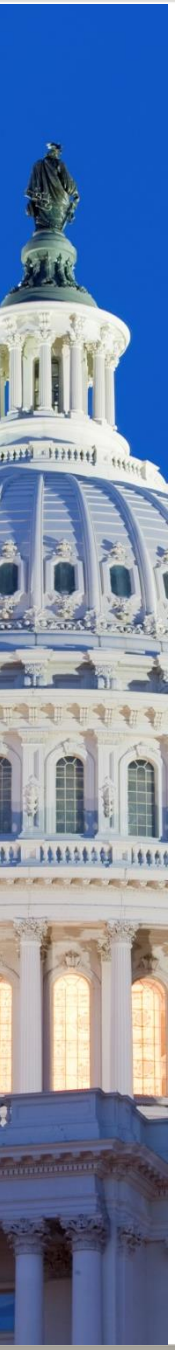


Miscellaneous Services and Resources

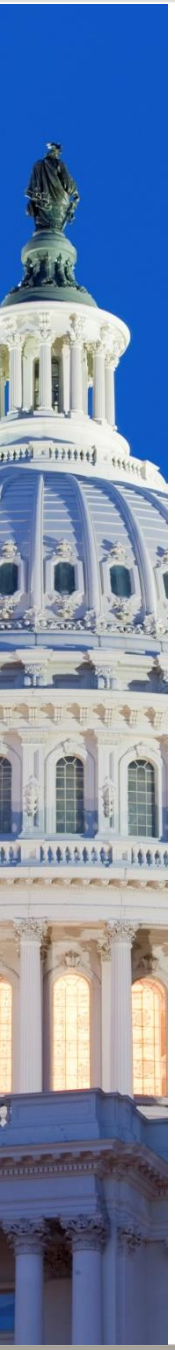


Miscellaneous Services & Resources

- National Nexus Program
- Training Programs
- Amicus Briefs



Q & A



Thank You

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Zero Returns and the Statute of Limitations: *Law Office of John H. Eggertsen* (6th Cir. 2015)

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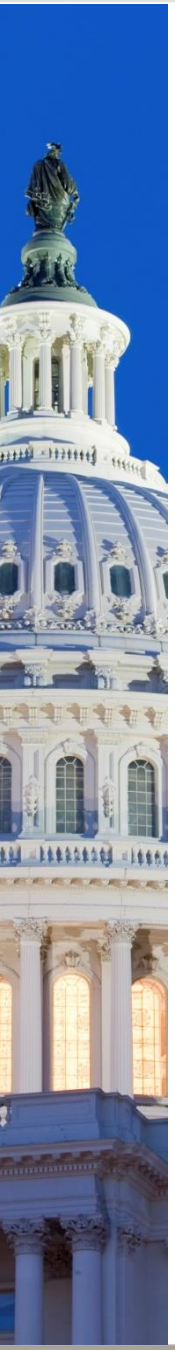
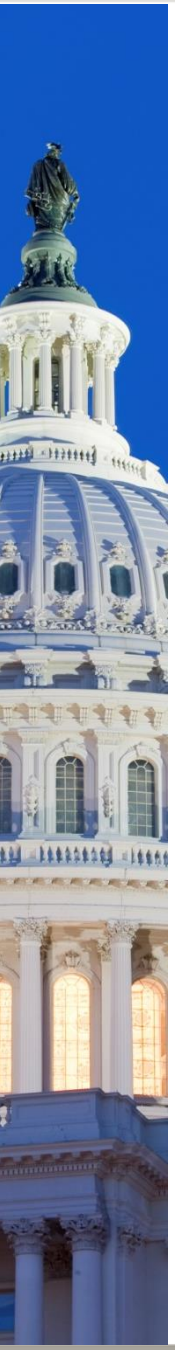


Timeline

1998: S corp. election made and ESOP established

2001: Congress passes legislation mandating that S corp. ESOPs have broad-based ownership

2005: special excise tax comes into effect, S corp tries to comply



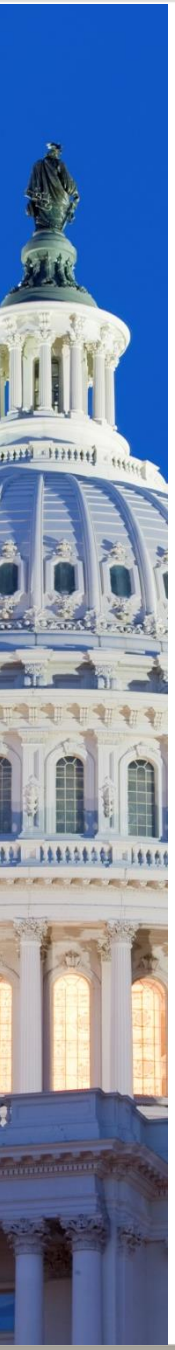
Timeline

2006: S corp. and ESOP file returns for 2005. No form 5330 was filed because it was thought that no excise tax was owed

2008: IRS audit starts

2011: IRS issues deficiency notice to S corp. for excise tax

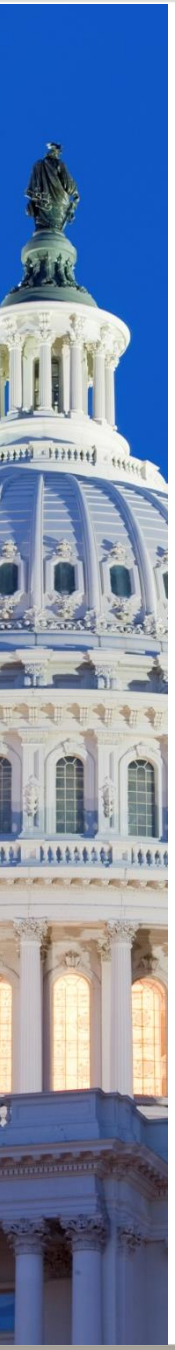
Feb. 2014: Tax Court rules that section 4979A provides the exclusive SOL and that the deficiency notice is time barred.



Timeline

Oct. 2014: Tax Court, on motion for reconsideration, reverses, finding that section 6501 applies and that the notice of deficiency is timely

Sept. 2015: 6th Circuit affirms

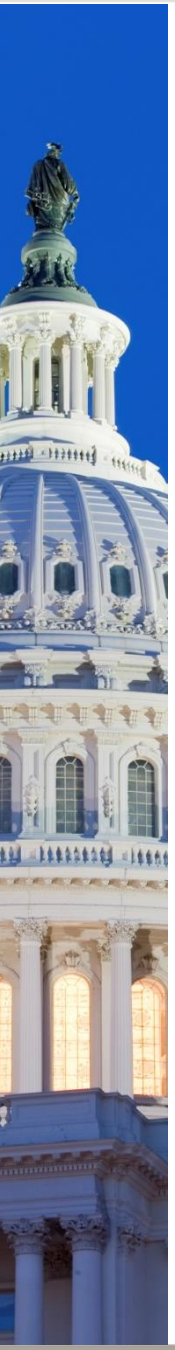


Section 4979A(e)(2)(D)

Statute of limitations The statutory period for the assessment of any tax imposed by this section by reason of paragraph (3) or (4) of subsection (a) shall not expire before the date which is 3 years from the later of—

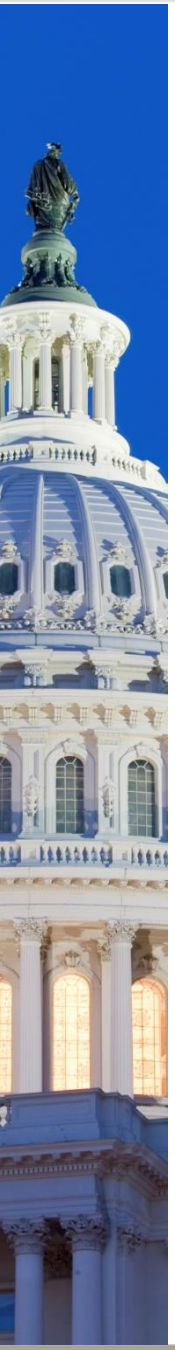
(i) the allocation or ownership referred to in such paragraph giving rise to such tax, or

(ii) the date on which the Secretary is notified of such allocation or ownership.



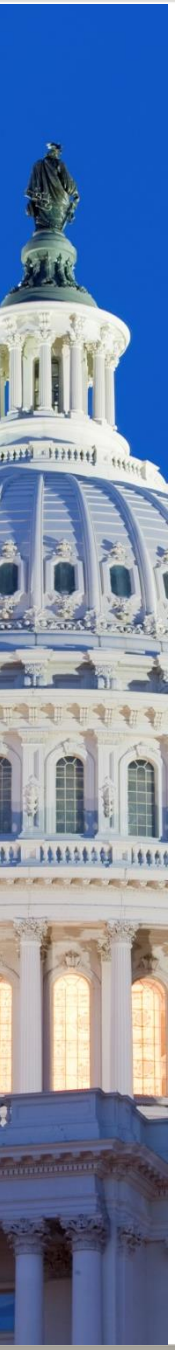
Section 4979A(e)(2)(D)

- Note that section 4979A(e)(2)(D) does not **cut off** the period for assessment. But what was the intent of Congress?



Initial Holding

- The Tax Court found that the 2005 Form 1120S and the 2005 ESOP annual returns, filed in 2006, contained information sufficient to notify the Secretary "of such allocation or ownership."
- Accordingly, the Tax Court initially held that 2011 notice of deficiency was untimely.



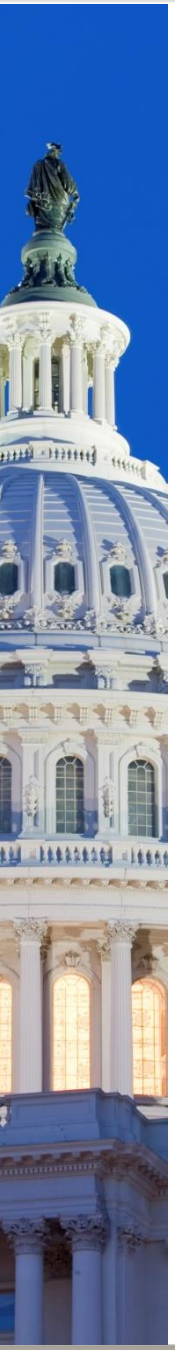
Reconsideration

On a motion for reconsideration, the Tax Court held that section 4979A(e)(2)(D) did not displace section 6501 but only supplemented it.

Hence, section 6501, which keys off a filed return, is operative.

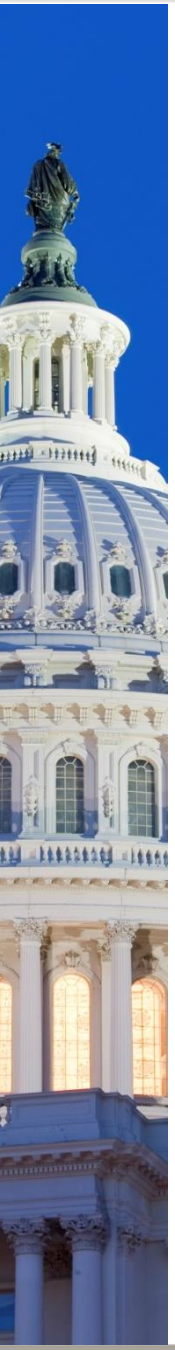
"Form 5330 is the form in which the excise tax . . . is required to be reported."

No Form 5330 was filed.



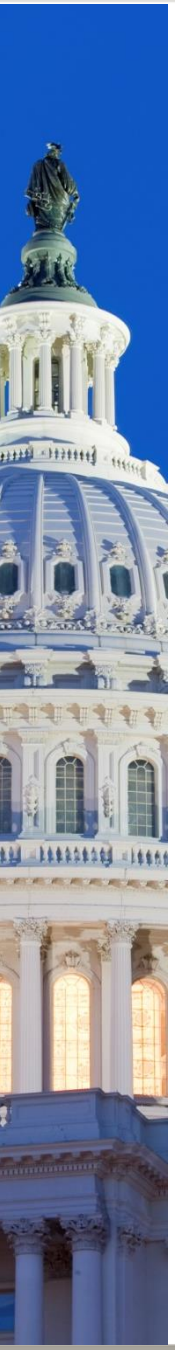
Reconsideration

"[T]he limitations clock may start in some settings even when the taxpayer fails to file the right return—say the taxpayer filed the same return for another reason . . . or filed the wrong return but with all of the necessary information . . . . . A key predicate for this exception is that the return filed must contain 'sufficient data to calculate tax liability.'" *Eggertsen*, Sixth Circuit op.



Final Holding

On motion for reconsideration, the Tax Court held the returns filed did not permit the Secretary to **calculate** the excise tax, and that therefore the SOL was open when the 2011 notice of deficiency was issued.



Lessons learned

- "Special" statutes of limitations may not be deemed to **displace** section 6501.
- In addition to filing the returns required to be filed, thought should be given to filing zero returns for taxes the taxpayer does *not* think it owes.
- Failing that, the taxpayer should make sure enough information is disclosed on the returns it files so that other taxes could in theory be calculated.
- *Eggertsen* teaches that overdisclosure in this sense is a good practice.

Managing Tax Audits and Appeals 2015

Rick Grafmeyer - Partner, Capitol Tax Partners LLP

Brian Callanan - Staff Director & General Counsel, Senate Permanent Subcommittee on Investigations

Zach Rudisill - Tax Counsel, Senator Rob Portman

Anna Taylor - Tax Counsel, Senator Charles Schumer

Federal Tax Policy 2015

Rick Grafmeyer
Capitol Tax Partners, LLP

Politics and Gridlock??

Politics and Gridlock (cont.)

- Since 1980, control of Senate has changed six times (House - - three)
- Maj. Of Dem. Senators have never been in minority since 2006
- For entire Senate, 46 Senators have fewer than six years (most since 1982)
- 53 Senators have House experience (most since the 1940s)
- 10 Senators born in 1970s
- $100M to be spent on TV ads before March 2016
- House leadership changes, vote in conference on Oct. 8, entire House on Nov. 2

Focus on 2016

- 2016 GOP seats were part of 2010 wave
- Senate - - GOP 24 seats, 10 Dem. seats
  - Seven GOP seats in states which Obama has won - - Fla., Iowa, Ohio, Pa., Wisc., N.C., and Ind.
- Senate in 2018 - - Dem. seats 24, 8 GOP seats
  - 7-9 toss-ups but only two are GOP seats

2015 Must Dos?

- Debt limit - - Nov. / Dec.
- Highway - - Oct. 29 / Dec.?
- CR - - Dec. 11
- Ex-Im Bank - - same as highway?
- Trade bill - - in conference
- Reconciliation for ACA - - Oct. through Dec.
- Sequestration fix - - Dec.11
- FAA - - March 2016
- Miscellaneous tax accomplishments such as identity theft or charitable or pensions?
- Leftovers from 2014
  - Tax Reform - - only intl.
  - Multiemployer pensions fixes
  - Tax Extenders - - with highways or CR
  - Inversions and Intl reforms as offsets?
  - Internet Tax Freedom / Marketplace Fairness - - Dec.11

Tax Extenders

- Senate - - over 50 provisions for two years
  - Current policy plus
  - Cost $84B (vs. $86B if all extended for two years)
- House - - handful of provisions permanent (R&D, 179, AFE, CFC, S Corp, bonus)
- Deal?
  - All Senate items plus a few perm. House bills
  - “Most” Senate items, several perm. House bills, plus WH item
  - “Most” Senate items

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Managing Tax Audits and Appeals – 2015
Crowell & Moring LLP
Washington, D.C.

October 1 and 2, 2015

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Current Developments in Computing Interest on Refunds and Deficiencies; Interest Netting After Corporate Reorganizations

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Interest Netting Issues

- Pre-enactment claims
- "Same taxpayer" issue
  - Merger/acquisitions
  - Consolidated groups
  - Tracing argument
- Processing suspended—open case indicator

Interest Rates

- **Since 1986, the rate of interest the Internal Revenue Service (IRS) pays on overpayments has been less than it charges on underpayments. Interest rates are issued quarterly, calculated at set percentage points above the federal short-term rate.**

Interest Rates, 4th Quarter 2015(Rev. Rul. 2015-17)

Interest Rates for Underpayments

3% compounded daily

5% for "hot" interest on large corporate underpayments

Interest Rates for Overpayments

2% for corporate taxpayers

3% for non-corporate taxpayers

.5% for large corporate overpayments

Section 6603 Interest

Same Taxpayer Issues

- **Merger-Acquisitions**
  - *Wells Fargo & Co v. U.S.*, case No. 11-108T, Court of Federal Claims.
  - Netting when survivor assumes debts of acquired.
- **Consolidated Groups**
  - Separate member overpayment can be netted with group underpayment (several liability).
  - Separate member underpayment can be netted with group overpayment with tracing (*Magma Power v. U.S.*, 101 Fed Cl 562 (2011)).
- **Tracing of underpayments/overpayments**
  - IRS requiring in all cases

Wells Fargo v. United States, (No. 11-808T) (United States Court of Federal Claims), decided June 27, 2014

Court allowed netting in three merger scenarios:

- **underpayments and overpayments between a pre-merger acquiring corporation and the pre-merger acquired corporation;**
- **underpayments and overpayments between a pre-merger acquiring corporation and the post-merger surviving corporation; and**
- **underpayments and overpayments between a pre-merger acquired corporation and the post-merger surviving corporation.**

Wells Fargo

- **Court held that netting is allowed between an acquired corporation and the surviving entity in a statutory merger because the acquiring corporation becomes the same entity as the acquired corporation as a matter of law and assumes the liabilities of the acquired corporation.**
- **Court rejected the government's "narrow" position that corporations are the "same taxpayer" for netting only if the corporations had the same Taxpayer Identification Number (TIN) when the underpayments and the overpayments occurred.**
- **Court rejected the government's argument that *Energy East Corp. v. United States, 645 F 3d. 1358 (Fed. Cir. 2011)*, and *Magma Power Co. v. United States, 101 Fed. Cl. 562 (2011)* supported its position because those cases did not involve statutory mergers.**

Wells Fargo Litigation Timeline

- **Interlocutory Appeal Granted by Court of Appeals for the Federal Circuit -- February 24, 2015**
- **Government Appeal Brief Filed -- May 13, 2015**
- **Taxpayer Brief Filed -- June 25, 2015**
- **Government Reply Brief Filed -- July 27, 2015**
- **Oral Arguments– November 5, 2015**

Government Arguments

- **The *Energy East* and *Magma Power* decisions are on point.**
- **The "same taxpayer" test of section 6621(d) must be satisfied when the underpayment and overpayment arose.**
- **The entities must have the same TIN to be the same taxpayer (citing *Magma Power*).**
- **In mergers, the surviving corporation is not the same as the corporation from which it acquires assets and liabilities.**
- **Section 6402(a), which allows the government to offset an overpayment of a taxpayer against any liability of "such person" is distinguishable from the "same taxpayer" test of section 6621(d).**

Taxpayer Arguments

- ***Energy East*** **and** ***Magma Power*** **are distinguishable because they do not involve mergers.**
- **TINs are a matter of administrative convenience and do not dictate the result.**
- **It is well-settled law corporate law that the surviving corporation acquires the acquired corporation's assets and liabilities.**
- **Section 6621(d) allows netting in merger situations in which section 6402(a) would apply.**
- **The Service has long recognized that the parties to a merger are the same entity following a merger.**

Wells Fargo—Next Steps

- **Court will address whether netting is permissible where several liability exists—decision not expected until 2016.**
  - Separate member overpayment can be netted with group underpayment (several liability). CCA 200411003; CCA 200707002.
  - Separate member underpayment can be netted with group overpayment with tracing (*Magma Power v. U.S)*.
  - But--CCA 201225011 concludes that the taxpayer must be the same when the respective underpayments and overpayments were made.

Recent Developments in Tax Accounting

Dwight Mersereau

Agenda

- Revised Accounting Method Change Procedures
- Expense Recognition
- Fines & Penalties
- Section 199
- Update on Tangible Property Regulations

Revised Accounting Method Change Procedures

New Method Change Procedures

- Rev. Proc. 2015-13
  - Procedures for "automatic" and "non-automatic" consent method changes are now in one document.
    - Replaces Rev. Proc. 2011-14 and Rev. Proc. 97-27
  - Immediate effective date
    - New guidance applies to all Forms 3115 filed after January 16, 2015 for a year of change ending on or after May 31, 2014.
    - Transition guide - permit a taxpayer to file an automatic accounting method change under the superseded procedures in Rev. Proc. 2011-14 for a tax year ended on or after May 31, 2014, and on or before January 31, 2015.
- Rev. Proc. 2015-14
  - Contains all the available automatic changes
    - Replaces what was formerly the Appendix to Rev. Proc. 2011-14

What Has Changed?

- Shortened Section 481(a) adjustment period for certain taxpayer unfavorable method changes ("positive" adjustment).
  - General rule – 4-year spread for positive, 1-year for negative.
  - If taxpayer files method change while under IRS exam, the adjustment period is two taxable years if not filed in a window period.
  - Taxpayers may elect to take a positive adjustment of less than $50,000 into account in the year of change (previously $25,000).
  - Taxpayers may elect to take a positive adjustment into account in the year of change if change is made in the year of a "eligible acquisition transaction."
    - Applies if transaction occurs during the year of change or before the extended due date of the federal income tax return for the year of change.
    - Election is irrevocable and applies to all changes filed for that year of change.
    - Election can be made even if taxpayer has executed Consent Agreement with a longer adjustment period.

What Has Changed? (cont'd)

- Filing method changes while under IRS exam
  - Being under IRS exam is no longer a "scope limitation."
  - However, unless an exception below applies, there is no audit protection if method change is filed while under IRS exam:
    - "Three-month window": Applies to applications filed in the period beginning on the 15th day of the 7th month of taxpayer's tax year and ends on the 15th day of the 10th month of the taxpayer's tax year.
    - "120 day window": Applies to applications filed in the 120 day period following end of an IRS exam, regardless of whether new cycle has begun.
    - Present method not before director: Applies to a change from a clearly permissible method or from an impermissible method where that method was adopted subsequent to the years under exam.
    - New member of a consolidated group: Applies to certain taxpayers in CAP.
    - Change results in a taxpayer favorable ("negative") section 481(a) adjustment: Applies if adjustment is negative in year of change and would have been in years under exam.
    - IRS has not imposed an adjustment for the item when one exam ends and it is not an issue under consideration in another ongoing cycle.

What Has Changed? (cont'd)

- Special rule for filing Form 3115 for a new member of a consolidated group in CAP
  - Applies to non-automatic method changes.
  - Form 3115 must be filed by the earlier of (i) 90 days after the new member becomes a member of the group or (ii) 30 days after the end of the tax year in which the new member becomes a member of the group.
- Foreign partnerships
  - Clarifies how to file Form 3115 for foreign partnership with no US filing requirement.
  - Any partner authorized to make elections for the partnership may file Form 3115 on behalf of the partnership.
  - Form 3115 is attached to a Form 1065 prepared for purposes of making the method change in accordance with Reg.Sec.1.6031(a)-1(b)(5).
- All copies of Form 3115 are filed at IRS Ogden, UT office (not IRS National Office).
- Updates made to an automatic filing after submitting copy to Ogden.
  - If the section 481(a) adjustment is updated after the Ogden copy is filed, must send copy of any additional correspondence to Ogden.
- Less favorable terms and conditions for CFCs.

Comparison of Procedures, Terms and Conditions

	US Domestic	CFC
120-day window for taxpayers under exam	Available after end of any exam cycle	Not available
90-day window	15th day of 7th month through 15th day of 10th month of tax year, provided under exam 12 months, and method issue not under consideration	15th day of 7th month through 15th day of 10th month of tax year, provided all controlling domestic s/hs under exam 24 months, and issue not under consideration
Issue under consideration	Taxpayer receives written notification that specific accounting method is being examined	Any controlling domestic shareholder receives notification that the treatment of a distribution, deemed distribution, or inclusion, or amount of e&p or foreign taxes deemed paid, is under consideration
Springing audit protection	After exam ends, if no proposed adjustment	After exam ends, and 90 days after all US shareholders notify examining agent, if no proposed adjustment or issue under consideration
Potential limit on audit protection		IRS reserves right to make change in earlier year if deemed paid taxes exceed 150% of average in 3 prior years

Non-Automatic Procedures

- Letter ruling issued (User fee schedule: Appendix A of Rev. Proc. 2015-1)
  - $8,600 user fee/per type of change
  - Single Form 3115 for consolidated groups
  - Members making identical changes
  - $8,600 plus $180 for each additional member
- Year of change
  - Tax year in which Form 3115 filed (may request roll forward)
  - No early applications
  - Limited 9100 relief for late applications

Expense Recognition

AmerGen Energy Co. LLC et al. v. United States

- 112 AFTR 2d 2013-6376 (Fed. Cl. 2013), aff'd, 115 AFTR 2d 2015-1056 (Fed. Cir. 2015).
- Facts
  - Taxpayer purchased three nuclear power plants.
  - The purchase price for each acquisition included cash and the buyer assumed the sellers' decommissioning liabilities.
  - Taxpayer attempted to increase the cost basis of the nuclear power plants by amount of decommissioning liabilities assumed as part of purchase price.
- Holding
  - The court held that Section 461(h) and all events test should be applied to determine when liabilities are incurred for the purpose of cost basis calculations under section 1012.
  - Decommissioning liabilities assumed by the taxpayer had not been "incurred" because economic performance requirement under section 461(h) had not been satisfied.

Mass Mutual Life Insurance Co. v. United States

- 109 AFTR 2d 2012-837 (Fed. Cl. 2012), aff'd, 115 AFTR 2d 2015-1459 (Fed. Cir. 2015).
  - Issue
    - Whether Taxpayer was entitled to a policyholder dividend deduction based on the declared guaranteed minimum dividend amount in the year of declaration.
    - The taxpayer asserted that its liability for the guaranteed amount of the policyholder dividends satisfied the requirements of the "all events test" and that it was entitled to deduct in tax years 1995, 1996, and 1997 a portion of the guaranteed minimum amount of policyholder dividends declared by the taxpayer's board of directors in 1995, 1996, and 1997.
    - The government challenged that the Taxpayer's liability for the dividends was not fixed in the year the dividends were declared, that economic performance had not occurred by year end, and that the taxpayer's dividend guarantees lacked economic substance.

Mass Mutual Life Insurance Co. v. United States

- The government argued:
  - the liability was not established in the year the dividends were guaranteed in the aggregate because the liability to pay the dividends was contingent on other events (such as a policyholder's decision to maintain his or her policy through the policy's anniversary date);
  - that the Taxpayer could not deduct their obligations until the following year because a liability must be fixed before it can be deducted; and
  - even if the liability was fixed, these payments still could not have been deducted until the year they were actually paid because the dividends did not qualify as rebates or refunds that would meet the recurring item exception to the requirement that economic performance or payment occur before a deduction may be taken.
- Holding
  - U.S. Court of Federal Claims upheld the deductibility of the Taxpayer's aggregate, declared, and guaranteed policyholder dividends, and the Federal Circuit affirmed.

Fines and Penalties

Guardian Industries Corp. v Commissioner

- 143 T.C. No. 1 (2014)
  - Facts
    - The European Commission (EC) determined that the Taxpayer participated in a cartel that infringed the competition provisions of the EC Treaty by fixing prices and found the Taxpayer liable for a fine of $30 million (USD).
  - Holding
    - The Tax Court held that the Taxpayer's payment to the EC was not deductible pursuant to IRC section 162(f) because:
      - The phrase "government of a foreign country," used in Treas. Reg. § 1.162-21(a) may refer both to the government of a single foreign country and to the governments of two or more foreign countries, such as the EC.
      - The EC is an entity serving as an instrumentality of the EU Member States within the meaning of Treas. Reg. § 1.162-21(a)(2) and (3).

Fresenius Medical Care Holdings, Inc. v. United States

- 114 AFTR 2d 2014-5688 (D. Mass. 2014), aff'd, 763 F.3d 64 (1st Cir. 2014)
- Facts
  - Between 1993 and 1997, whistleblowers brought a series of civil actions against the taxpayer under the False Claims Act (FCA). The government opened civil and criminal investigations into the taxpayer's federally funded health care programs. In 2000, the taxpayer entered into a criminal plea and civil settlement agreements with the government. The taxpayer was to pay over $486 million; over $101 million was for criminal fines and the remaining $385 million was to absolve the taxpayer from civil liability.
  - It was agreed the criminal fines were not deductible and $192.5 million of the civil settlement was deductible; the taxpayer and government did not agree on the tax treatment of the remaining $192.5 million.
  - The settlement agreement stated that it didn't constitute a tax characterization for the amounts paid. It also stated that nothing in the agreement is punitive in purpose or effect (it was not clear that language had anything to do with taxes).
- The taxpayer argued that no portion of the remaining amount was punitive because of the "purpose and effect" statement.
- The government argued Fresenius had to prove the parties agreed that the damages were compensatory when they signed the settlement agreement.
- Holding
  - A jury found that $95 million of the $192.5 million in dispute was deductible and the First Circuit affirmed.
  - In determining the tax treatment of a FCA civil settlement, a court may consider factors beyond the mere presence or absence of a tax characterization agreement between the government and the settling party.

Section 199

Definition of DPGR

Gross Receipts

Derived from

- **Lease, rental, license, sale, exchange, or other disposition**
  - **Qualifying Production Property (QPP) MPGE by the taxpayer in whole or significant part in U.S.**
  - **Qualified film produced by taxpayer**
  - **Electricity, natural gas, or potable water produced by taxpayer in U.S.**
- **Construction performed by the taxpayer in the U.S.**
- **Engineering or architectural services performed by the taxpayer in the U.S.**

Is "Packaging" a Qualifying MPGE Activity?

- *U.S. v. Timothy Dean, et. al.,* 112 AFTR 2d 2013-5592.
  - Taxpayer incorporated packaged food items into gift baskets or "gift towers" and claimed a section 199 deduction related to such activities.
  - IRS exam team disagreed, pointing out that qualified manufacturing activities do not include packaging, repackaging, labeling, or minor assembly of QPP, if those are the taxpayer's only activities with respect to that QPP.
  - U.S. district court held that Taxpayer was entitled to benefits claimed under section 199, finding that they engaged in a qualified production activity by combining several products into a new product.
    - The court agreed with Taxpayer that Taxpayer's production process "chang[es] the form of an article" within the meaning of Treasury Regulation § 1.199-3(e)(1) and explained that rather than merely enhancing an existing product or combining items, taxpayer creates a new one with a different demand.
    - The court reasoned that designing a gift basket involves decisions as to sizing and colors, selecting materials, and ensuring quality controls and that the creation of the gift basket or tower is a "complex process" using assembly line workers and machines and produces a final product distinct in form and purpose from the individual items inside.

Is "Packaging" a Qualifying MPGE Activity?

- *Precision Dose, Inc. v. U.S. (N.D. IL 9/24/2015).*
  - Taxpayer buys drugs in bulk and sells them in single doses. It claimed a section 199 deduction related to such activities.
  - IRS exam team disagreed, pointing out that qualified manufacturing activities do not include packaging, repackaging, labeling, or minor assembly of QPP, if those are the taxpayer's only activities with respect to that QPP.
  - U.S. district court held that Taxpayer was entitled to benefits claimed under section 199, finding that it engaged in a qualified production activity by creating a "unit doses," a new product.
    - The court agreed with Taxpayer that Taxpayer's production process "is a complex production process that results in a distinct final product," citing *Dean*.

LB&I Directive – Definition of MPGE

- The IRS released a directive on certain activities that, when performed at a retail level, do not meet the definition of manufactured, produced, grown or extracted under Treas. Reg. § 1.199-3(e).
  - Cutting blank keys to a customer's specification;
  - Mixing base paint and a paint coloring agent;
  - Applying garnishments to cake that is not baked where sold;
  - Applying gas to agricultural products to slow or expedite fruit ripening;
  - Storing agricultural products in a controlled environment to extend shelf life; and
  - Maintaining plants and seedlings.

Can a Programming Package be a Qualified Film? TAM 201049029

- Facts:
  - Taxpayer operated cable networks, broadcast television networks, and owned and operated television stations. Programming packages included programs produced by the taxpayer, 3rd party programs, advertisements, and interstitials.
  - IRS challenged that gross receipts from 3rd party programs included in the programming package could be DPGR
- Result: Gross receipts from licensing content in programming packages can be DPGR
  - Programming package offered in the normal course of business treated as a single "item".
  - Programming package must still be "produced" by the taxpayer to qualify. Taxpayer's activities must be substantial in nature.

Open question:

- The memo did not address whether the taxpayer's Broadcast Network's affiliation agreements are licenses of programming packages or of individual programs

Can Distribution of Subscription Packages be Production? CCA 201446022: Issue #1

- Facts:
  - Taxpayer is a multichannel video programming distributor. Taxpayer creates subscription packages of multiple channels of video programming. The subscription packages may include licensed programming and self-produced programming.
- Result: Taxpayer's gross receipts from distribution of subscription packages do not qualify as DPGR
  - Taxpayer did not provide evidence showing that the subscription packages met the 50% compensation test to be qualified films.
  - Even if the subscription packages were qualified films, taxpayer was not the producer of the packages. Taxpayer's production activities were not substantial.
    - The Taxpayer had 5 types of distribution activities which did not relate to production. The memo also notes the limited compensation paid to production personnel.
  - However, Taxpayer could determine that components (i.e., self-produced programming) could be a qualified film.

Can Licensing Fees be Considered Overhead for Safe-Harbour Purposes? CCA 201446022: Issue #2

- Safe harbour: taxpayer is treated as producing a qualified film if direct labour and overhead costs are 20% or more of the unadjusted depreciable basis in the film. Reg. sec. 1.199-3(g)(3)(i)
  - Overhead costs are determined by reference to costs required to be capitalized under sec. 263A, or would be capitalized if sec. 263A applied to the taxpayer
- Result: Taxpayer's licensing fees paid to unrelated programming producers is not overhead
  - Taxpayer was subject to capitalization under sec. 263A.
  - Fees for licensed programming were not subject to sec. 263A: licensed programming was not produced by Taxpayer, and not inventory or property held for resale.

Online Computer Software: GLAM AM2014-008

- IRS concluded that taxpayer-bank's app DID NOT qualify for the 199 deduction.
- Taxpayer produced an app that was downloaded to a user's phone that allowed the user to complete certain banking transactions. Taxpayer gave away the app for free, and attempted to treat certain fees from transactions completed by the app as DPGR. IRS disagreed, citing the following reasons:
  - Although the app was downloaded to a user's phone, the IRS concluded that the app did not constitute a qualifying disposition, as the app did not function without Internet access, and was therefore found to be equivalent to online software.
  - The taxpayer did not generate DPGR, because the app was given away for free. The IRS explained that term "derived from the disposition" of qualifying property is limited to the gross receipts directly derived from the disposition.
  - The taxpayer did not meet either of the online software exceptions (i.e., the self-comparable exception or the third-party comparable exception). The taxpayer-bank did not dispose of its internal software system in a qualifying manner, so it did not satisfy the self-comparable exception. With respect to the third-party comparable exception, the GLAM described a third-party software offered to competitor banks to provide banking services to competitor banks' account holders. Although the third-party app was ultimately used by competitor banks' customers in the same manner as the taxpayer-bank's app, the IRS concluded that end users of the third-party's app were not the relevant customers for purposes of the third-party comparable exception.

Benefits and Burdens Test: *ADVO, Inc. v. Commissioner*

- First Tax Court decision to address the benefits and burdens of ownership test in the context of IRC §199.
- The Tax Court examined whether a taxpayer that hired third-party contract manufacturers to print advertising material retained the benefits and burdens of ownership over the printing activity undertaken by the third parties.
- HOLDING: In holding that the taxpayer did not have the benefits and burdens of ownership over the printing activity, the Tax Court considered in its decision the factors set forth in the examples provided in the §199 regulations and *Suzy's Zoo*, as well as other guidance outside IRC §263A, such as IRC §936 and *Grodt & McKay Realty, Inc. v. Commissioner*. Some of the relevant factors identified in *ADVO* include:
  - when title passes;
  - intent of the parties based on specific contract terms within the agreement;
  - right of possession and day-to-day control over the activities;
  - active and extensive participation in the management and operations of the activities
  - The Tax Court in *ADVO* recognized that the specific factors it analyzed are not the only ones that may be considered in a benefits and burdens analysis.

Benefits and Burdens Test: LB&I Directive (04-1013-008 July 2013)

- Guidance to examiners for determining which party has benefits and burdens of ownership in contract manufacturing arrangements
- Examiners are instructed not to challenge the benefits and burdens of ownership determination if a taxpayer provides these two statements:
  - A statement explaining the basis for the taxpayer's determination that it had the benefits and burdens of ownership in the years under exam
  - Certification statements signed by the taxpayer and the counter party to the contract manufacturing arrangement
- If the statements are not provided, it is presumed that the taxpayer does not have benefits and burdens of ownership
- Supersedes prior directive - LB&I-4-0112-001
- Relevant factors if facts and circumstances test applies

1. was the taxpayer primarily responsible for insuring the work in progress (WIP);
2. did the taxpayer develop the qualifying activity process;
3. did the taxpayer conduct more than 50% of the quality control tests over the WIP;
4. was the taxpayer primarily liable under the "make-good" provisions of the contract;
5. did the taxpayer provide more than 50% of the cost of raw materials and components used to produce the property;
6. did the taxpayer have the greater opportunity for profit increase or decrease from production efficiencies and fluctuations in the cost of labor and overhead.

Update on Tangible Property Regulations

Timeline of Guidance

January 20, 2004	Notice 2004-6 announces government's plan to develop tangibles regs
August 21, 2006	Government issues first set of proposed regulations
March 10, 2008	Government withdraws 2006 proposed regulations and issues new proposal
December 27, 2011	2008 proposed regulations withdrawn and replaced with third proposal (also issued as temporary regulations, so effective immediately)
September 19, 2013	Final regulations published for acquisition costs and for repair and maintenance costs; proposed regulations issued for dispositions
January 24, 2014	Revenue Procedure 2014-16 issued (repair and maintenance)
February 28, 2014	Revenue Procedure 2014-17 issued (dispositions)
August 18, 2014	Final disposition regulations (effective January 1, 2014)
September 18, 2014	Revenue Procedure 2014-54 issued (dispositions)
December 24, 2014	Revenue Procedure 2015-12 (cable IIR)
February 13, 2015	Revenue Procedure 2015-20 (small taxpayers)
March 5, 2015	IRS Q&A

Snapshot of Regulations

Repairs

Default rule

Deduction allowable if not an Improvement

May be allocable to inventory or self-constructed assets under section 263A

Improvements

Unit of property

Capitalize if:

1. Betterment
2. Adaptation, or
3. Restoration

Tangible Property

Acquisitions

Transaction costs

Materials and supplies

De minimis safe harbor

Dispositions

Unit of property

Default rules

General Asset Accounts

Partial dispositions

Common Method Changes and Elections

		Election		Method change	
TPR Section	Item	Election made with affirmative statement	Election made by reporting on the return	Method change with 481(a) adjustment	Method change with limited 481(a)
Acquisition costs	Book de *minimis* policy	✓			
	Materials and supplies				✓
	Election to capitalize and depreciate rotable or temporary spares		✓		
Repairs and improvements	Repairs vs. improvements			✓	
	Book conformity election	✓			
Dispositions	Partial disposition		✓		
	Late partial disposition election			✓ (2014)	
	Complete asset disposition			✓	

Highlights of Recent Developments

- Final disposition regulations published August 18, 2014
  - Rev. Proc. 2014-54 provides automatic method change procedures for final regulations
- Few changes from regulations proposed in September 2013
  - Clarify application of demolition rules under section 280B in GAAs
  - Determining the adjusted basis of a disposed of asset
    - Reasonable methods permitted if taxpayer does not have accurate information
    - Discounted cost approach for partial dispositions limited to restorations
    - Producer Price Index is allowed for discounting (Consumer Price Index is not)
- Correction of election to capitalize materials and supplies
  - Election made by capitalizing and beginning to depreciate in year placed in service
  - Election not applicable to property acquired and disposed of in same year
  - Applies to elections under temporary regulations, even though regulations withdrawn

Recent IRS Q&A

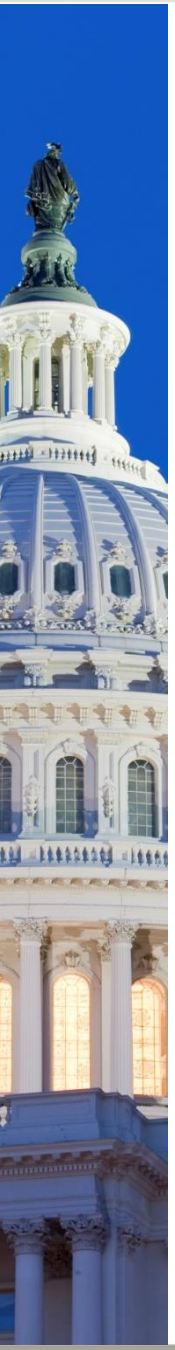
- "Because these final regulations are based primarily on prior law, if you were previously in compliance with the rules you generally will be in compliance with the final regulations and generally no action is required. If you are not in compliance or otherwise want to change your method of accounting to use the safe harbor for routine maintenance, you should file Form 3115, Application for Change in Accounting Method, and compute a section 481(a) adjustment."

Questions?

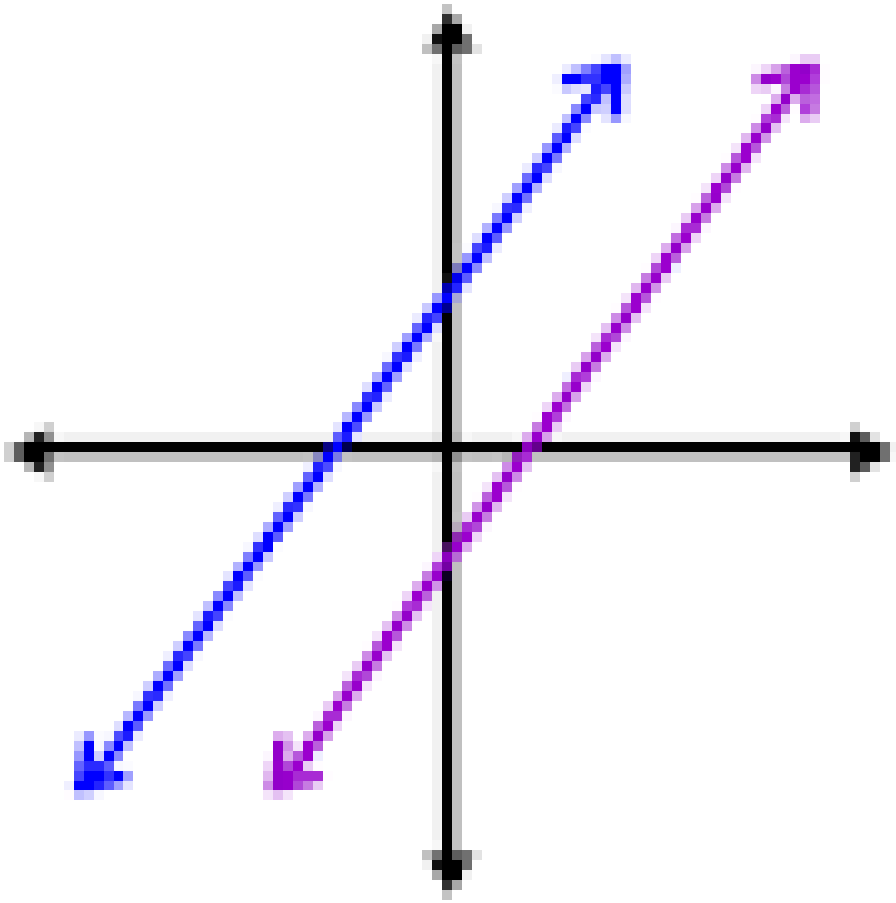
Hot Audit Issues:

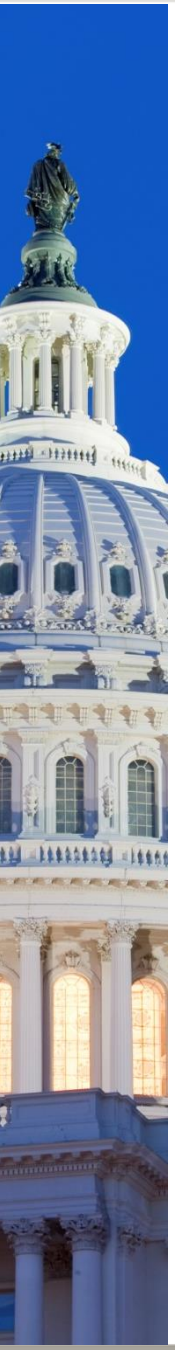
1. **Parallel Audits**
2. **Reopening Audits**
3. **IDR Enforcement and Summons**

Shelley Leonard



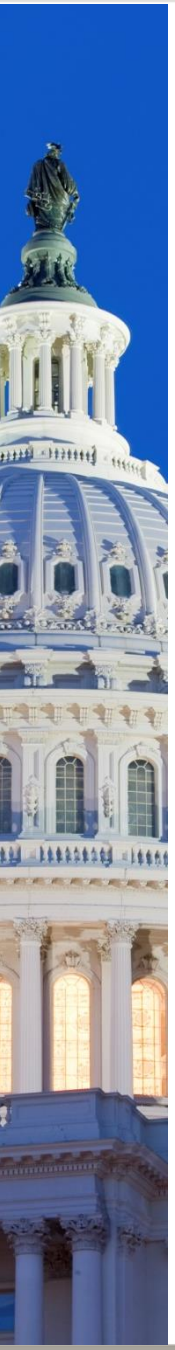
Parallel Audits





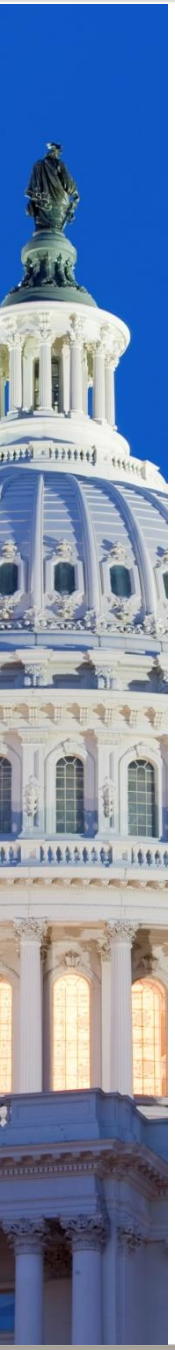
Parallel Audits

- IRS may conduct multiple types of audits concurrently
  - Corporate income tax
  - Employment tax
  - Individual income tax for select executives
  - Information returns



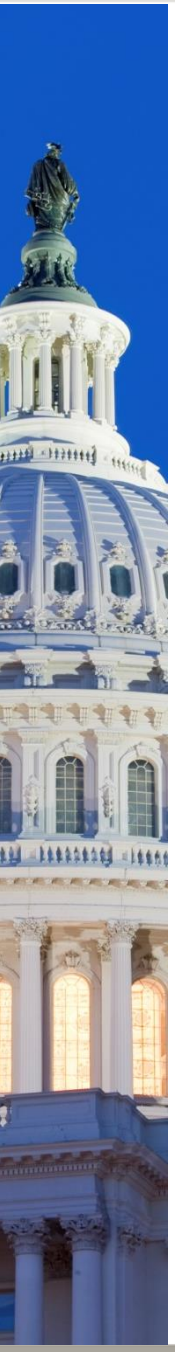
Parallel Audits

- Agent may request returns related to a return under examination
- Returns are related if
  - Adjustments to one return require corresponding adjustments to other return for consistency, or
  - Returns are for entities taxpayer controls and can be manipulated to divert funds or camouflage financial transactions



Parallel Audits

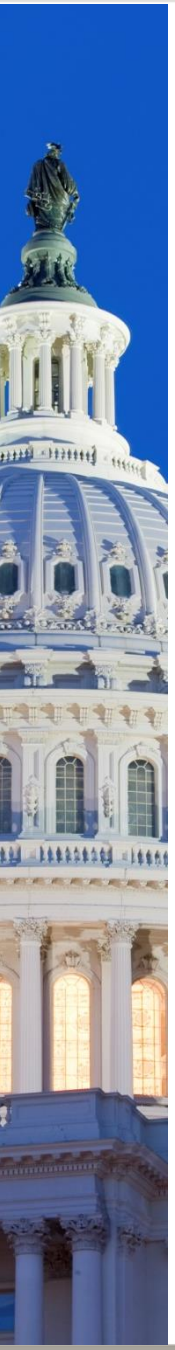
- Analysis of related returns includes
  - Identifying related returns within taxpayer's sphere
  - Determining whether transactions between related parties were correctly accounted for
  - Evaluating any large, unusual, questionable items for audit potential
- If examiner determines there is audit potential, audit will be expanded



Parallel Executive Compensation Audits

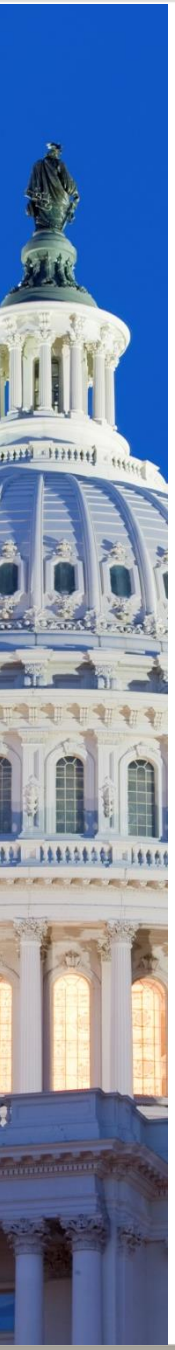
- Since 2003, audit initiative that focuses on executive compensation, especially
  - Corporate air travel, housing & other fringe benefits
  - Stock-based compensation
  - Nonqualified deferred compensation plans
  - Corporate loans to executives
  - Retirement programs
  - Sec. 162(m) compliance

- Executive compensation issues have become part of standard audit procedures for many taxpayers



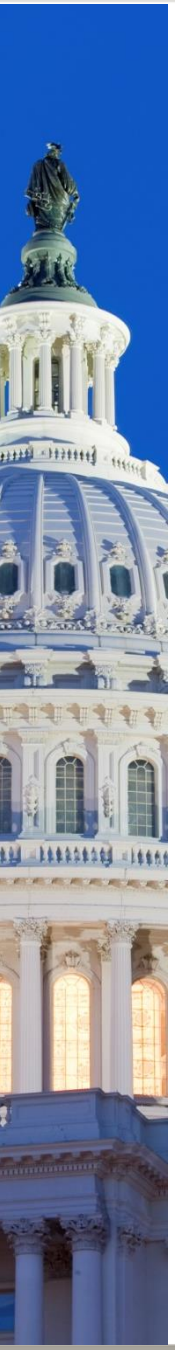
Parallel Executive Compensation Audits

- Best Practices
  - Conduct internal compliance reviews to identify & address outstanding compensation issues
  - Inform senior executives of potential for individual audit at outset of corporate audit
  - Advise executives to communicate with personal tax representative
    - May want to file protective claims for refund



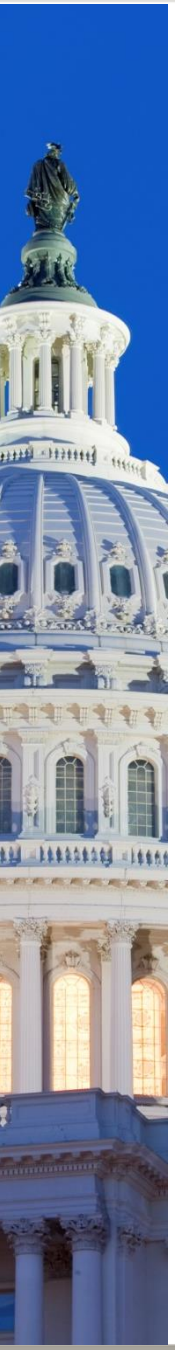
Parallel Employment Tax Audits

- Employment tax returns will be considered when income tax return is examined
- Employment tax issues include
  - FICA, FUTA, RRTA
  - Federal withholding
  - Back-up withholding
  - Withholding on income paid to foreign persons
  - Withholding by buyer or other transferee when U.S. real property interest disposed by foreign person (Sec. 1445)
- Potential worker classification examination

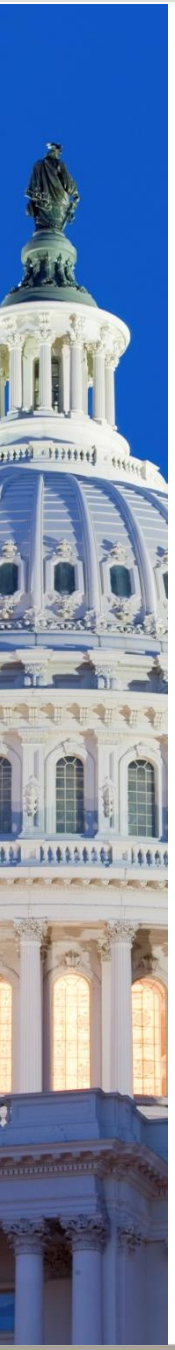


Parallel Audits & Appeals

- "Interrelated cases" forwarded to Appeals together
  - Issue in one audit has direct tax effect on another
- "Other related cases" generally not advanced together
  - Consistency in settlement of common or similar issues but no direct tax effect
- But, IRS has discretion to consider cases together

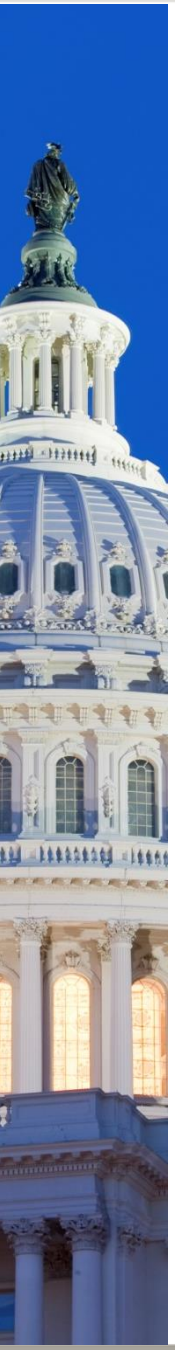


Reopening Audits



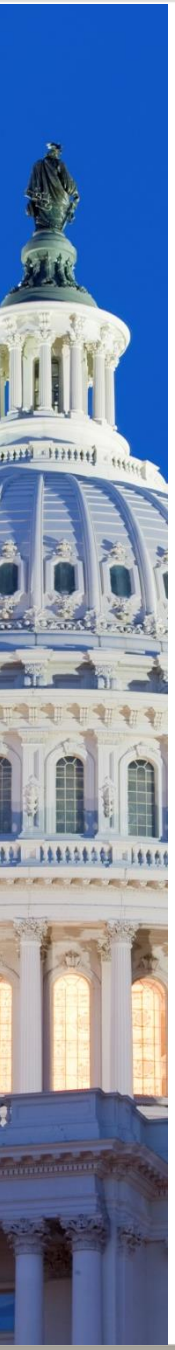
Reopening Audits

- IRS has policy against reopening closed cases unless strong reason to justify reopening
- Section 7605(b):
  - "No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary."



Reopening Audits – Two recent cases

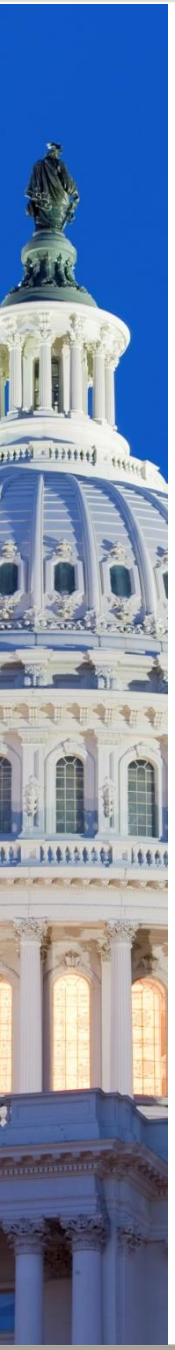
- *TBL Licensing LLC v. Commissioner*, T.C. No. 21146-15 (filed Aug. 7, 2015)
  - First NOPA involved a refund
  - Audit transferred to new exam team
  - Second NOPA issued with $500 million deficiency
- CCA 201321018 – second NOPA with additional deficiency



Reopening Audits

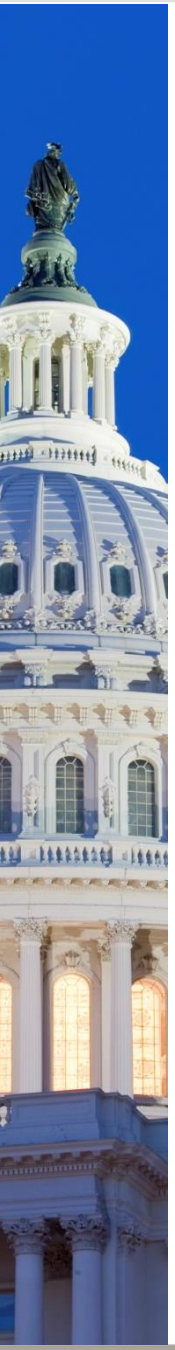
- Service will not to reopen closed case to make unfavorable adjustment unless:
  - 1. Evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact
  - 2. Prior closing involved clearly defined substantial error
  - 3. Failure to reopen would be a serious administrative omission

Treas. Reg. Sec. 601.105(j); Rev. Proc. 2005-32



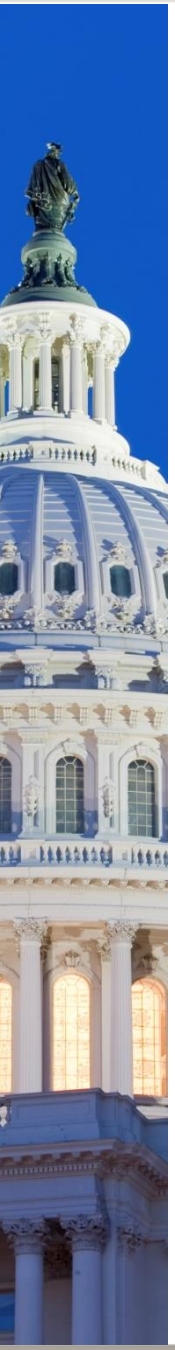
Reopening Audits

- Closed?
  - Agreed cases = taxpayer notified in writing of final proposal of adjustments or acceptance of return as filed
  - Unagreed cases = time for filing Tax Court petition has passed
- Reopening must be approved by territory manager



Reopening Audits

- Items not considered reopening include:
  - Narrow, limited contacts without inspection
  - Voluntary programs for selective issue resolution
  - Reconsiderations arising from items or transactions in different tax period or by related taxpayer
  - Information gathered from taxpayer or third party that is relevant to a different purpose, tax, or period



IDR Enforcement and Summonses

LMSB Control No.4-0508-028

Form **4564** (Rev. September 2006)	Department of the Treasury — Internal Revenue Service **Information Document Request**	Request Number

To: *(Name of Taxpayer and Company Division or Branch)*

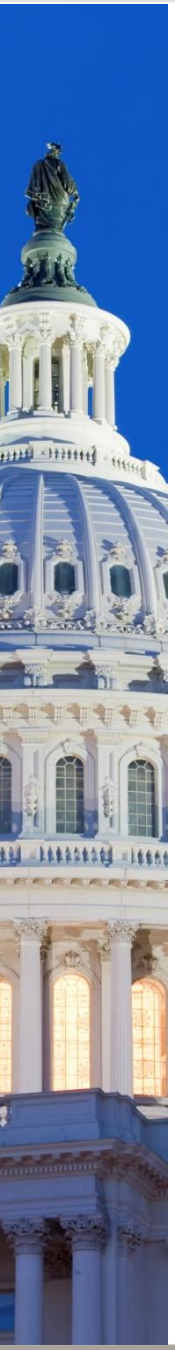
Subject
Cost Sharing - Stock-based Compensation

SAIN number	Submitted to:

Dates of Previous Requests *(mm/dd/yyyy)*

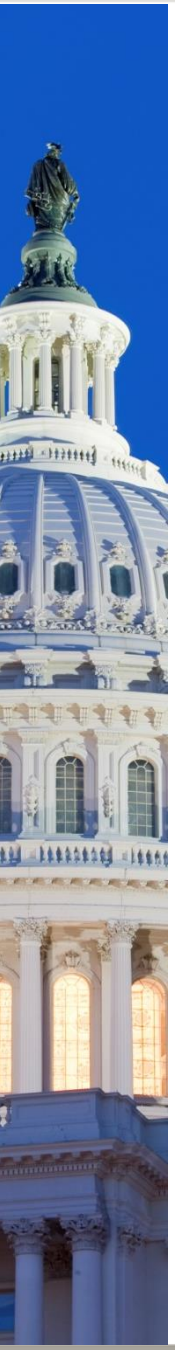
Please return Part 2 with listed documents to requester identified below

Description of documents requested



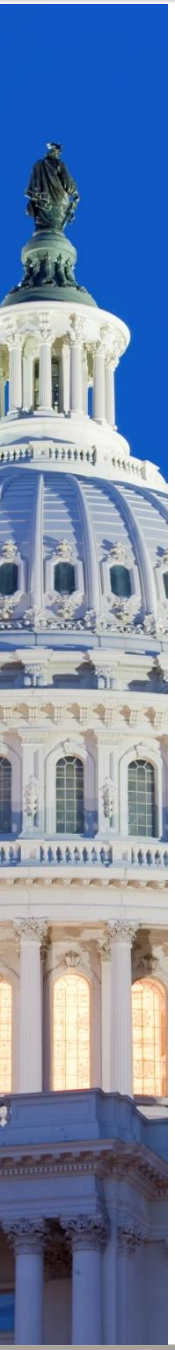
IDR Enforcement

- In Feb. 2014 LB&I Directive established new IDR procedures and IDR enforcement process
- Objectives:
  - Less examiner discretion
  - More automatic
  - More communication at each enforcement stage
  - Involvement of management & Chief Counsel as enforcement proceeds towards summons
- Bottom line: taxpayer responsibilities + **rights**



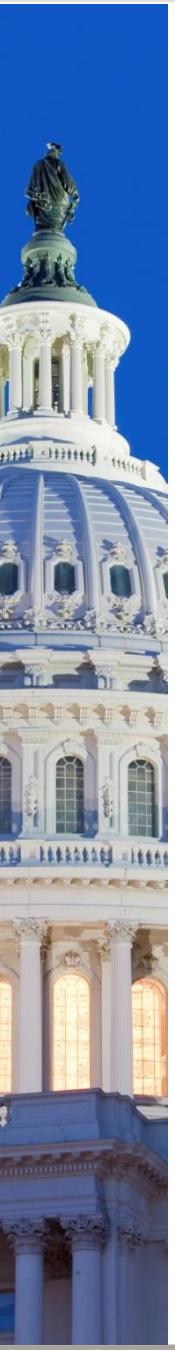
IDR Enforcement: Issue Specific IDRs

- One IDR per issue
- Must clearly state issue
- Requested information must be relevant
- No boilerplate language
  - EXCEPT if issued at beginning of examination, e.g. for basic books and records, general information about taxpayer's business



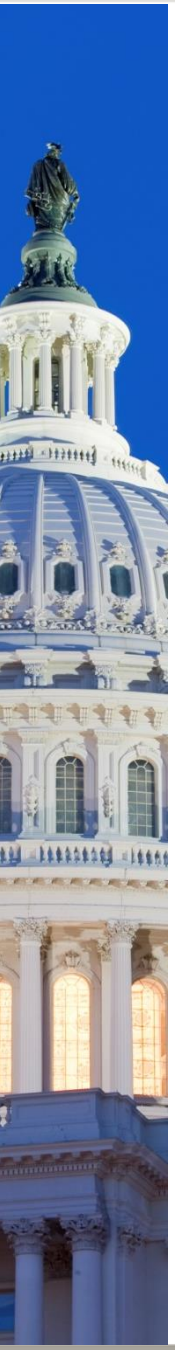
IDR Enforcement: Required IDR Procedures

- Discuss issue with taxpayer before issuing
- Provide draft IDR to taxpayer
- Discuss reasonable response date
  - Examiner will set response date if no agreement
  - Response time not changed once agreed to
  - Process is now automatic
- Examiner must commit to date by which it will review response



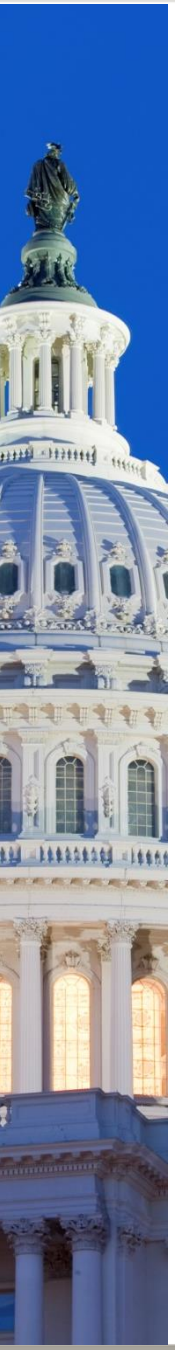
IDR Enforcement: Satisfaction of Requests

- IDR process closed at any time IDR is considered by examiner or specialist to be complete
  - Examiner must inform taxpayer once complete
- One extension of up to 15 business days
  - Taxpayer must give explanation to warrant additional time



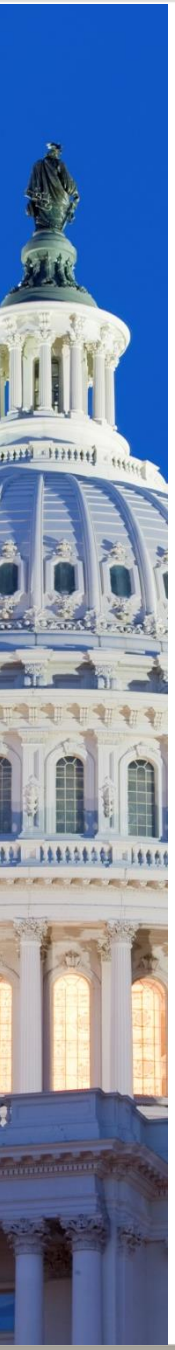
IDR Enforcement: Three Step Enforcement Process

- Step 1: Delinquency Notice
  - Issued within 10 business days of beginning of enforcement process
  - Signed by Team Manager
  - Must be discussed with taxpayer
  - Response date of no more than 10 business days
  - Chief Counsel is notified



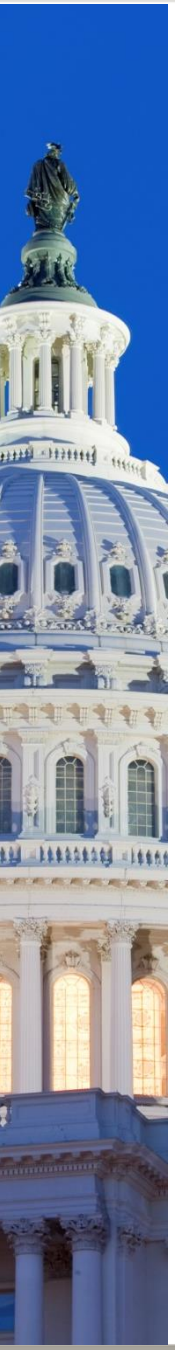
IDR Enforcement: Three Step Enforcement Process

- Step 2: Pre-Summons Letter
  - Examiner informs managers and Counsel
  - Territory Manager discusses with taxpayer
  - Letter issued within 10 business days of Notice
  - Letter addressed to higher up taxpayer official
  - Response date of no more than 10 business days
  - Chief Counsel & Director of Field Operations are notified



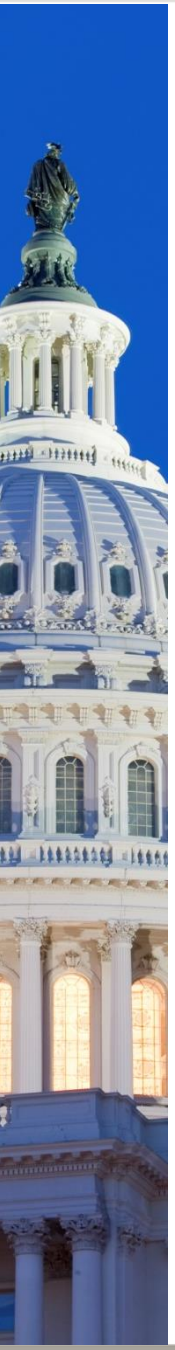
IDR Enforcement: Three Step Enforcement Process

- Step 3: Summons
  - Examiner informs mangaers, Director of Field Operations, and Counsel
  - Issuance of Summons is coordinated with assigned Counsel
- From draft IDR to Summons, can take 4 to 5 months



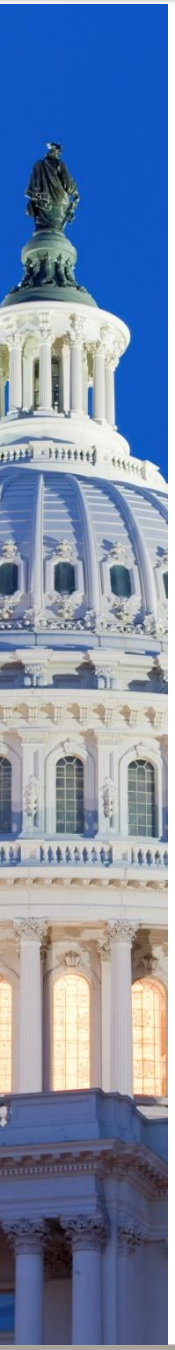
IDR Enforcement: Summons

- Before issuance, IRS must weigh importance of information against:
  - Tax liability involved
  - Time and expense of obtaining records
  - Probability of having to institute court action
  - Adverse effect on voluntary compliance by others
  - Status of case with respect to any pending criminal investigations
- IRS may try to obtain information from 3rd party



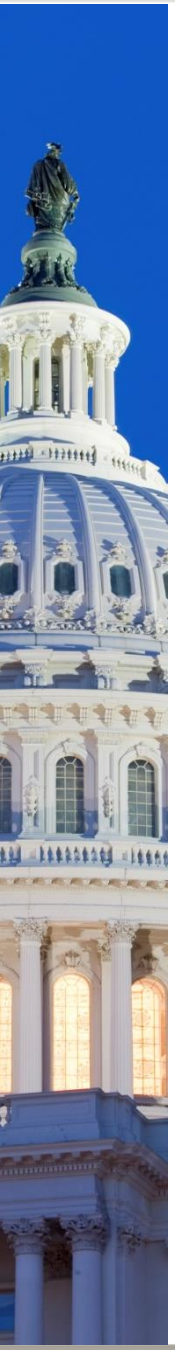
IDR Enforcement: Summons

- Summons generally issued where
  - Submitted records suspected to be incomplete
  - Taxpayer appears unwilling to provide documentation until a later stage
  - Information cannot be obtained elsewhere
- IRS has broad authority to require testimony and presentation of books and records for inspection. I.R.C. Sections 7602-7613.

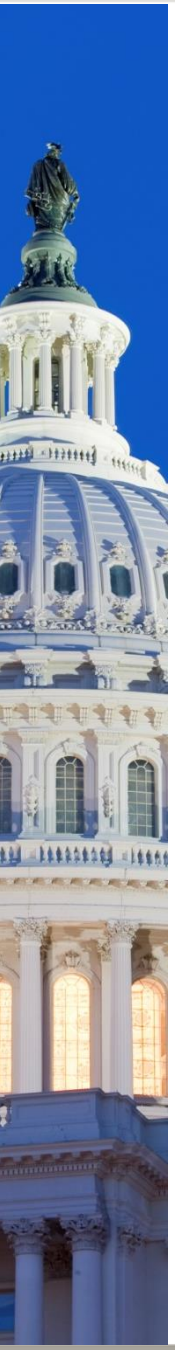


IDR Enforcement: Summons

- Requirements for valid summons from *United States v. Powell*, 379 U.S. 48 (1964):
  - Issued for legitimate purpose
  - Seeks information that may be relevant to that purpose
  - Seeks information that is not already within the IRS's possession
  - Satisfies all administrative steps required by I.R.C.

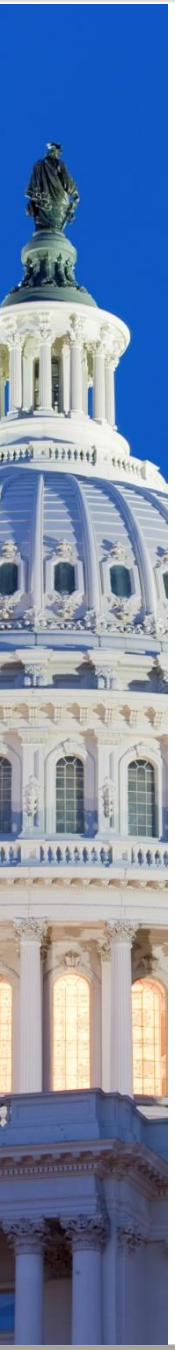


IDR Enforcement: Avoiding a Summons



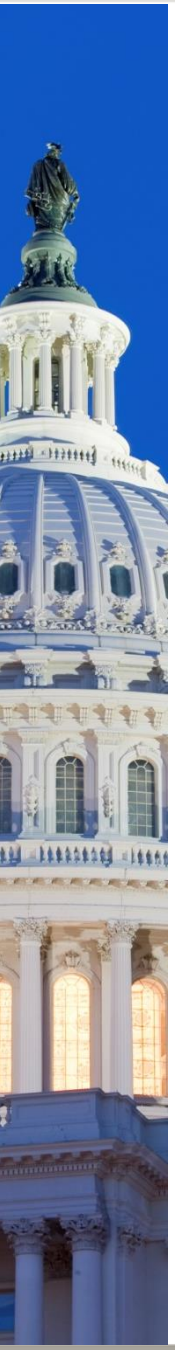
IDR Enforcement: Avoiding a Summons

- Actively participate in IDR drafting discussions
- Satisfy the IRS that the response is complete
- Establish that information can be obtained from another, less burdensome source
- Make valid privilege objections
- Begin settlement discussions to moot the issue



Summons Enforcement

- IRS must ask DOJ to pursue summons enforcement in federal district court
  - U.S. Attorneys versus Tax Division
- Examiner unlikely to seek enforcement unless believe information is necessary
- No SOL on summons enforcement
- DOJ files Petition, IRS Declaration, Order to Show Cause



Questions

Shelley Leonard

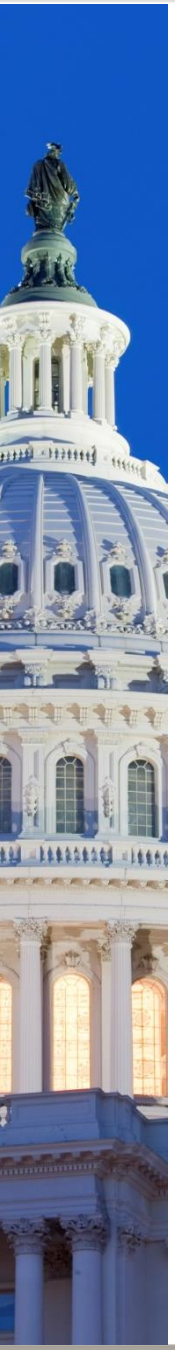
(202) 624-2783

sleonard@crowell.com

Employment Tax Updates: Free Lunch in the Tax Court?

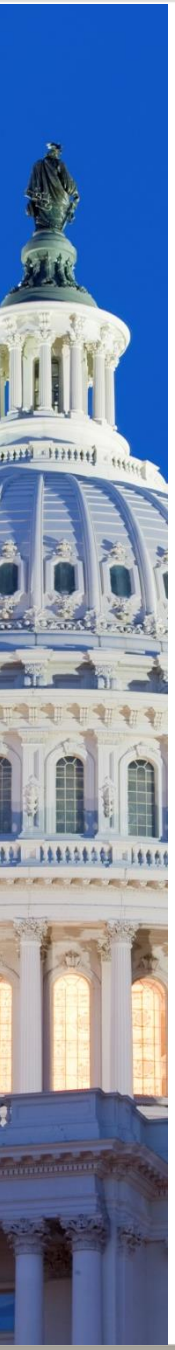
Jennifer Ray

October 2, 2015



IRS focus on employee meals

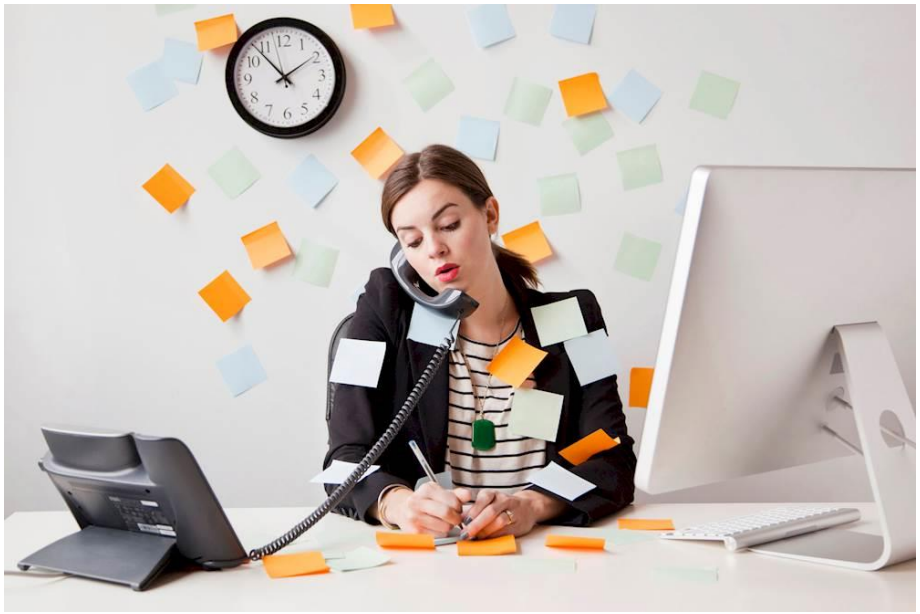
- Two tax issues
  - Does the employee have income
  - Does the employer get a 100% deduction
- 2015-2016 Priority Guidance Plan includes regulations under sections 119 and 132
- Recent expansion of Tax Court jurisdiction



Employee meals: income

- Employee cafeteria
- Consequences if taxable fringe benefit
  - Withholding
  - Reporting
- Provided for the convenience of the employer?
  - Employees on call for emergencies
  - Workers in remote locations

Emergency call and remote locations

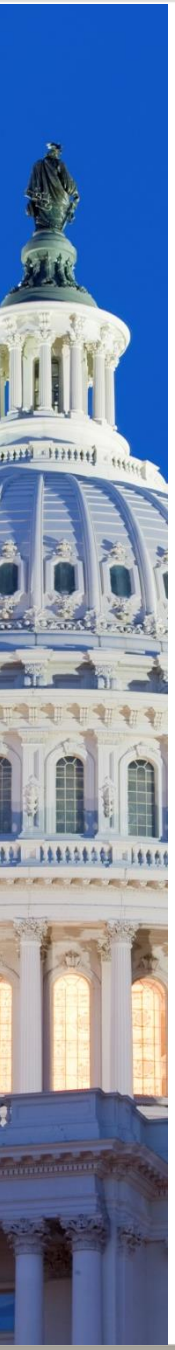


Convenience of the employer?

“Insanely Awesome”

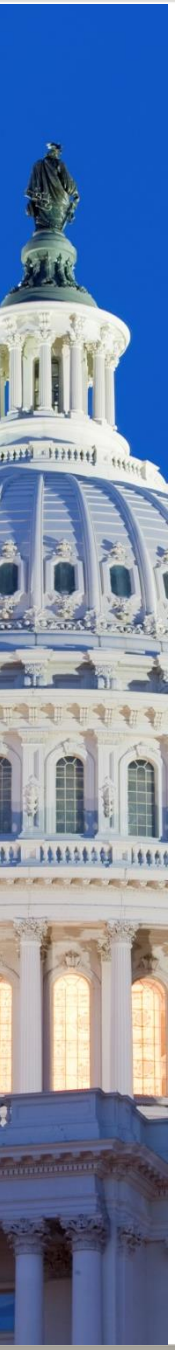
“Gorgeous and Exclusive New Cafeteria”

“High-End Meal Perks”



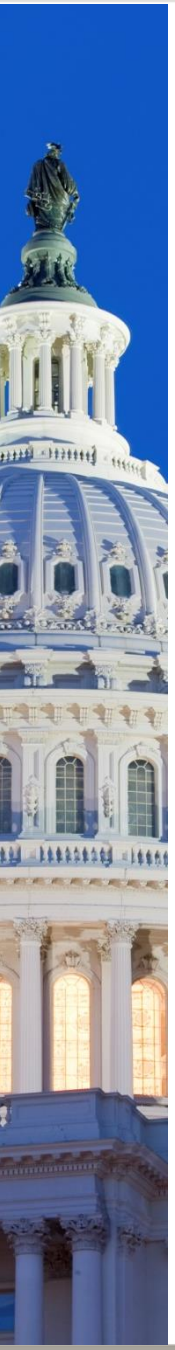
Employee meals: deduction

- Deduction for food expenses
  - Often limited to 50%
  - Exception for de minimis fringe benefits
- Employee cafeteria
  - Employer operated eating facility
  - Located on or near the employee's business premises
  - Operated at or above cost (or section 119 applies)



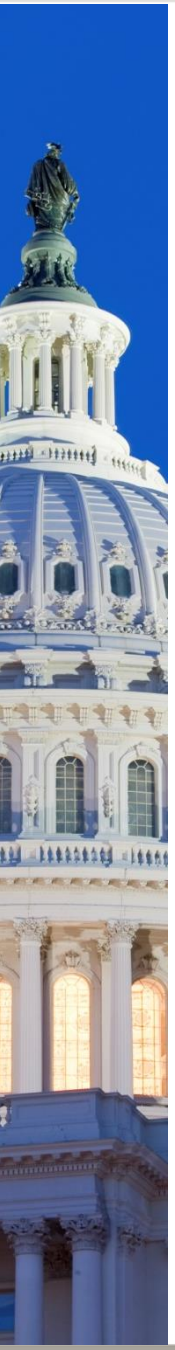
Potential IRS arguments

- Benefit is taxable to employees
  - Section 119?
  - De minimis fringe benefit?
  - Working condition fringe?
- Employer's deduction is limited to 50%
  - De minimis fringe benefit?
    - Employer operated eating facility AND operated at cost or section 119 applies
  - Treated as compensation to employees?



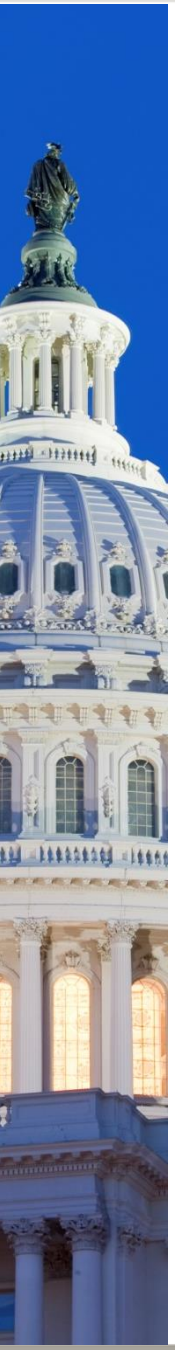
Tax Court jurisdiction

- Limited jurisdiction.
- Jurisdiction to review notice of deficiency involving subtitle A taxes (income taxes). Section 6213(a).
- Limited jurisdiction to review determinations involving subtitle C taxes (withholding and employment taxes). Section 7436.



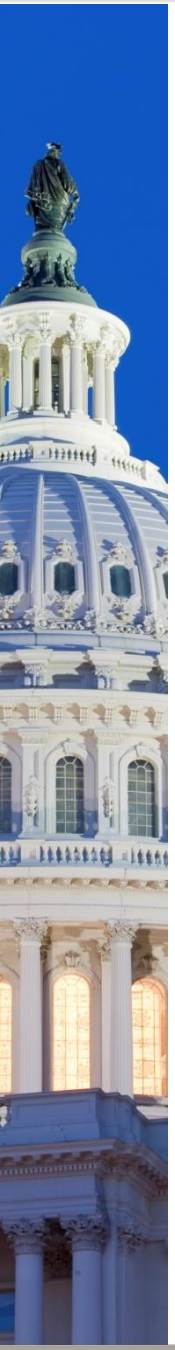
Section 7436

- Jurisdiction over subtitle C taxes requires:
  - "Actual controversy"
  - Involving a "determination" by the IRS as part of an "examination"
  - Involving employment status or section 530 relief
  - Filing of appropriate pleading
  - If IRS sends "notice" of its determination by registered or certified mail, the pleading must be filed within 90 days after the notice is mailed



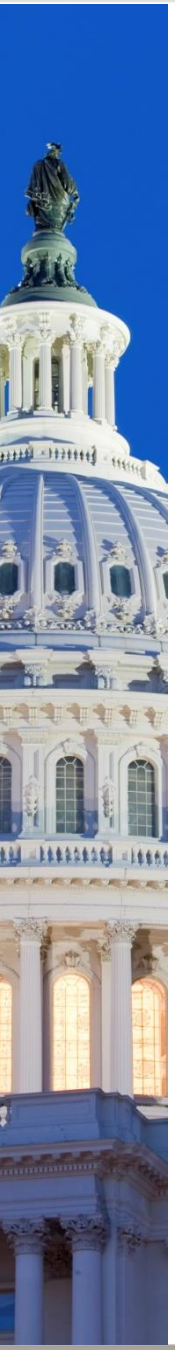
IRS cafeteria arguments

- If the IRS raises alternative arguments:
  - Notice of deficiency → Tax Court jurisdiction for the deduction
  - Assessment → refund jurisdiction for the withholding and employment taxes
- Incentive to raise worker classification or section 530 issues to create jurisdiction?

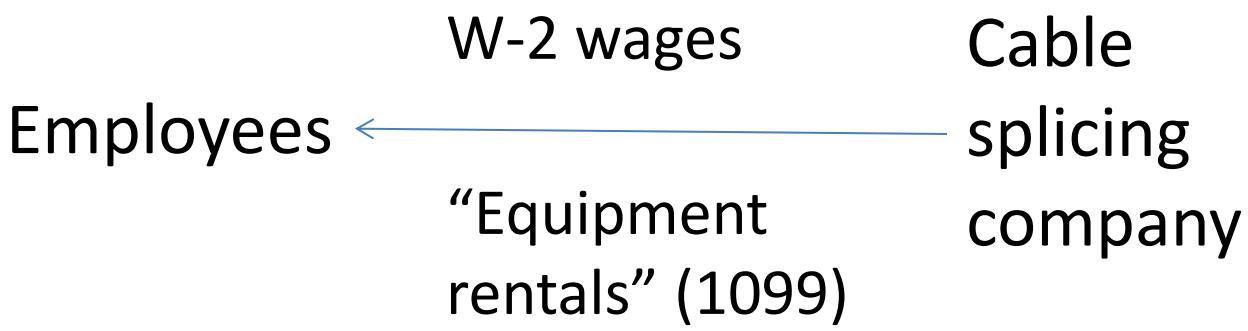


Notice 2002-5

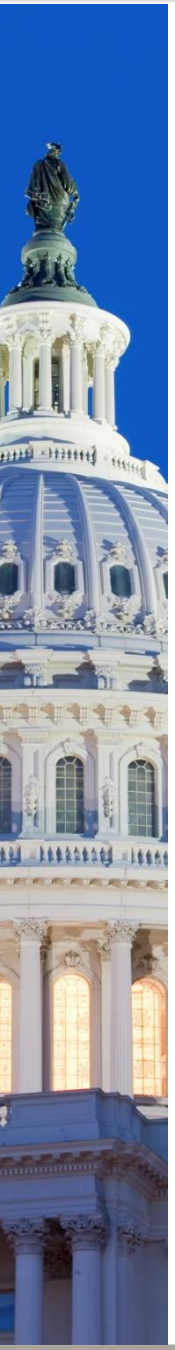
- Section 7436: "If, in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination"
- IRS position:
  - Actual controversy: doesn't exist if Forms W-2 issued
  - Determination: Notice of Determination of Worker Classification
  - Examination: must be an audit (e.g., Form SS-8 does not confer jurisdiction)



SECC Corp. v. Commissioner, 142 T.C. 12 (2014)

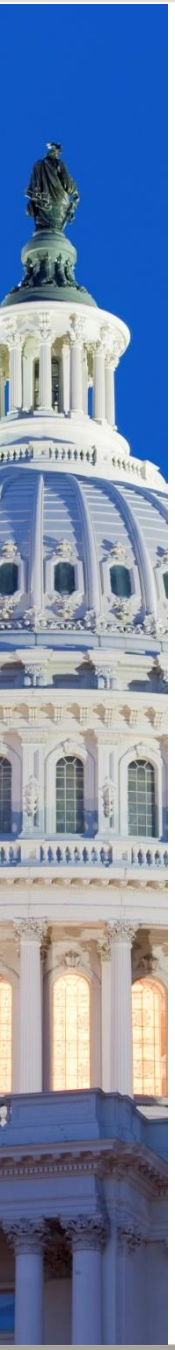


- IRS reclassified the equipment rentals as taxable wages because accountable plan rules not met



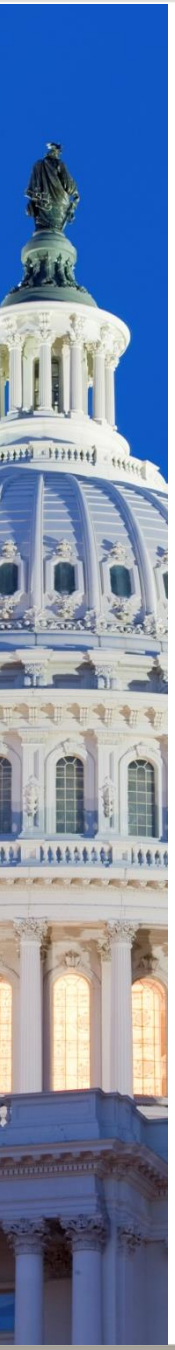
SECC Corp.

- SECC argued in its protest that workers were independent contractors with respect to wages and the equipment rentals.
- IRS sent a 30-day letter, not a NDWC.
  - "These changes to your employment taxes are not based on a worker classification determination."
- Exam's responses to questions from Appeals:
  - "There is no evidence to support taxpayer's position that the workers were in business for themselves."
  - "There is no evidence to support taxpayer's argument that the workers worked under a dual capacity."



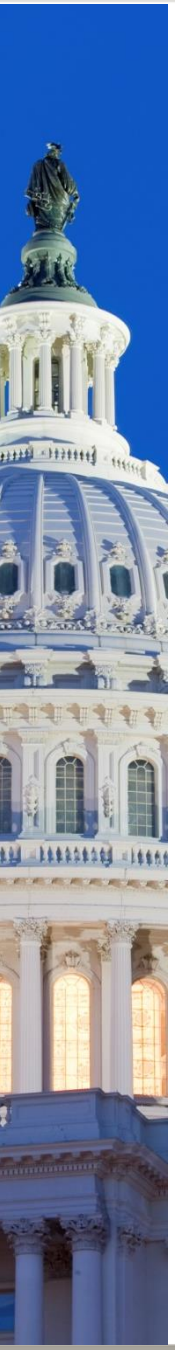
SECC Corp.

- Appeals Closing Letter
  - "Unfortunately, we were unable to reach an agreement on your case. The employment tax liability, as determined by Appeals, will be assessed . . . ."
  - "If you would like to challenge our determination in court, you may file a complaint in the United States District Court or the United States Court of Federal Claims."
- No notice sent by certified or registered mail



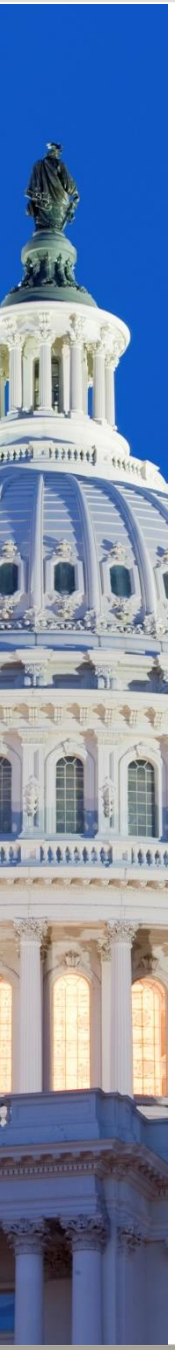
SECC Corp.

- 10 months later, SECC filed a petition in Tax Court
- SECC and IRS both filed motions to dismiss for lack of jurisdiction
  - IRS argued no NDWC so no jurisdiction
  - SECC argued employment tax assessment was invalid because no NDWC



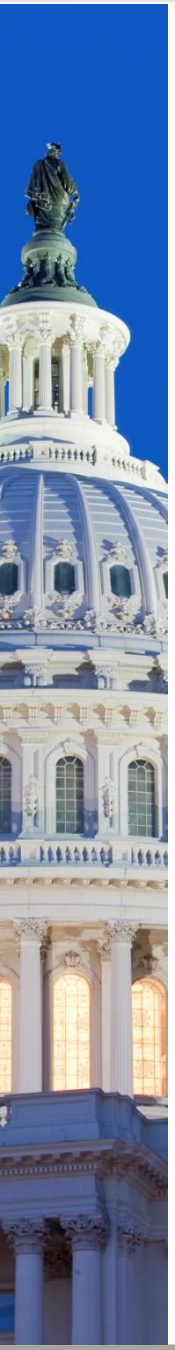
SECC Corp.

- Tax Court held that no "particular title or format" is necessary for a "determination"
- Appeals Closing Letter was evidence of a "determination" in connection with an "actual controversy"
- Administrative record showed that worker classification was at issue
- No 90-day filing period



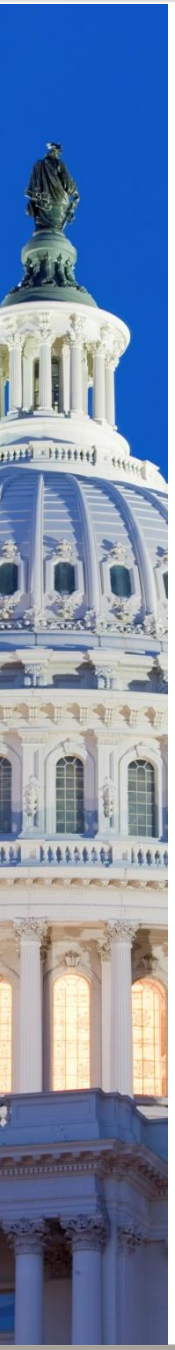
SECC Corp.

- Dissent:
  - "The IRS could have reasonably concluded that the worker classification arguments were frivolous and did not justify a determination."
  - "Instead of permitting this result, the Court combs through the administrative record to discover whether the IRS should have issued a notice of determination."
  - "This approach sets a dangerous precedent that may require us to review the administrative record every time a taxpayer makes a worker classification argument and the IRS chooses not to issue a notice of determination."



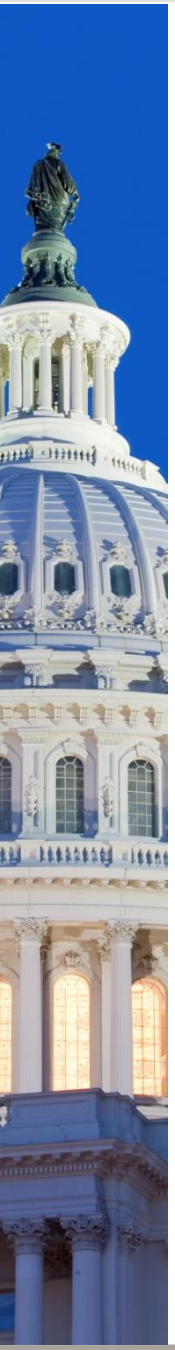
IRS response: CC Notice 2015-001

- IRS will continue to follow Notice 2002-5
  - IRS position is that section 7436 applies only when the taxpayer did not treat its worker as an employee during the applicable period
- If no NDWC is issued, IRS attorneys should file a motion to dismiss for lack of jurisdiction



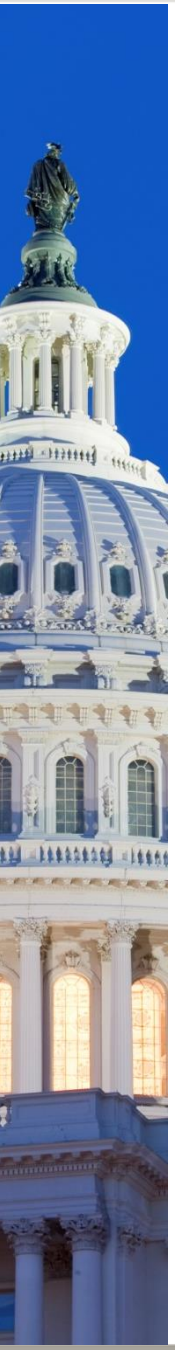
American Airlines v. Commissioner, 144 T.C. 2 (2015)

- Foreign flight attendants on routes between South America and Miami
- Airline did no U.S. tax withholding or reporting with respect to the flight attendants
- Procedural history
  - IRS granted section 530 relief in previous audit
  - Documented in Appeals Case Memorandum



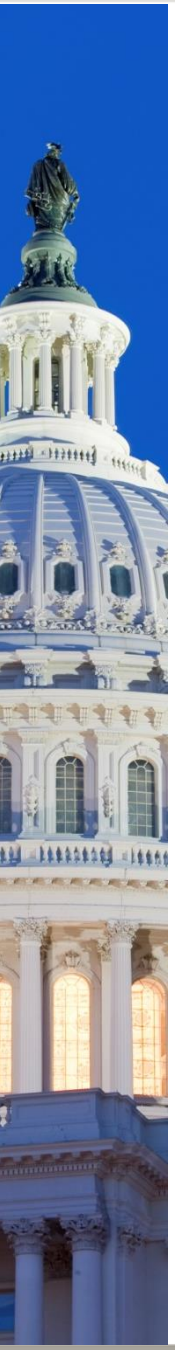
American Airlines

- IRS took position that section 530 was not properly at issue
- Appeals Case Memorandum:
  - "The classification of the NRA flight attendants (under section 530) is not relevant in this case, other than it was cited by Appeals as a basis for granting complete relief in a prior cycle. Accordingly, although Appeals has concluded that entitlement to relief under section 530 is not properly at issue, it has been addressed since it was the basis for concession when last considered."
- Taxpayer continued to claim section 530 relief



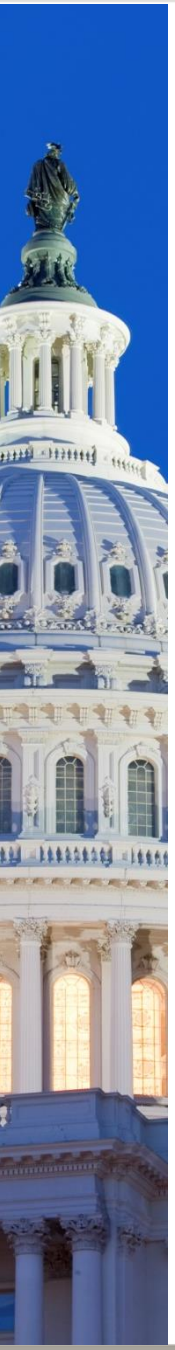
American Airlines

- IRS alternative arguments
  - Taxable U.S. wages and no section 530 relief → assessment (no NDWC issued)
  - Section 1441 withholding → notice of deficiency
- Airline petitioned Tax Court and raised both issues



American Airlines

- "Actual controversy" demonstrated by administrative records from 1992-1996 and current audits
- Section 530 at issue:
  - "disagreement between the parties"
  - "failure to agree"



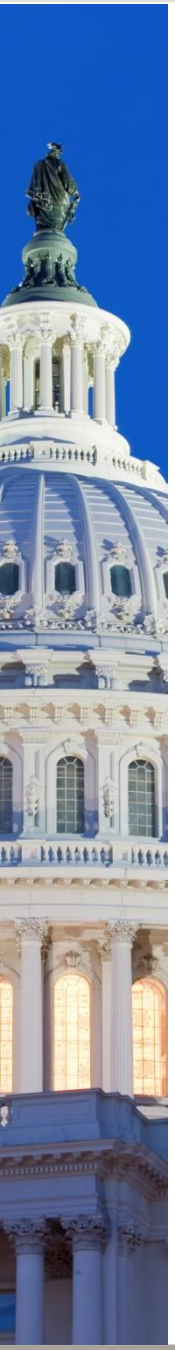
Conclusion

- When employment tax issues are raised, consider jurisdictional issues early in process

- Administrative record is important

Employee Benefits Issues

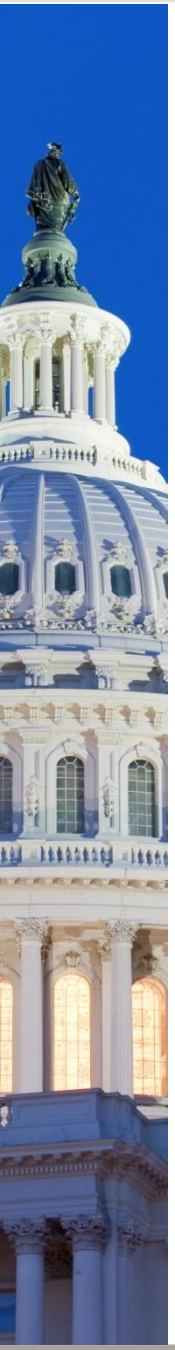
Joel Wood



Employee Benefits Issues

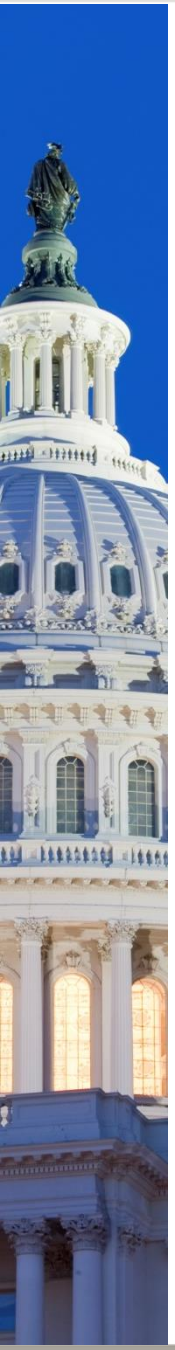
- Elimination of Determination Letter Program for qualified retirement plans

- "Cadillac Plan" Tax under Affordable Care Act



IRS Determination Letter Program

- IRS Determination Letter ("DL") program developed decades ago, process to provide some certainty as to whether a retirement plan satisfies tax-qualification requirements of Code section 401(a)
- Under Code section 7805(b), plan sponsors are generally entitled to rely on a favorable DL



IRS Determination Letter Program

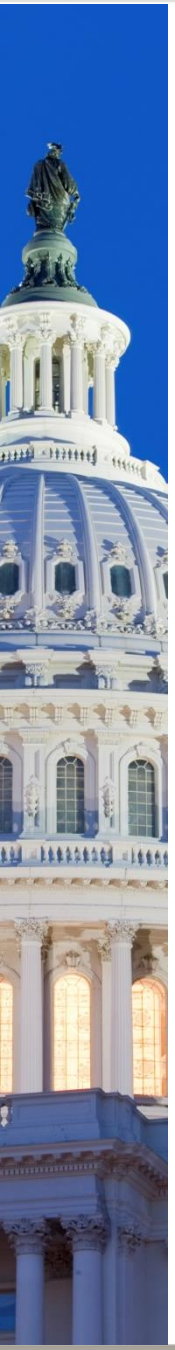
- Historically, DLs were requested when plan first established, and then periodically thereafter (including plan termination), at discretion of plan sponsor
- In mid-2000s, IRS established the "staggered" five-year DL filing cycle, based on EIN of plan sponsor
  - Five-year cycle also established remedial amendment period for plans

IRS Announcement 2015-19

- After public discussions about changes to the program, Announcement 2015-19 issued on July 21, 2015
- Per Announcement, effective January 1, 2017, 5-year staggered DL filing cycle will be eliminated
  - However, "Cycle A" plans, will be given until January 31, 2017 to file

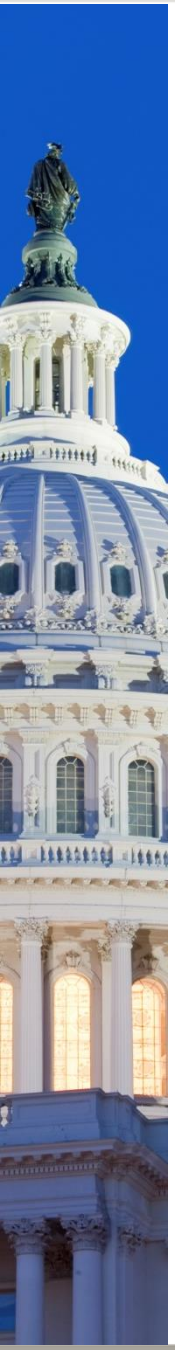
IRS Announcement 2015-19

- Effective January 1, 2017, individually designed plans can apply for a DL ***only***
  - For new plans (initial qualification)
  - For terminating plans
  - "In certain other limited circumstances that will be determined" by Treasury and IRS
- Effective July 21, 2015, no "off-cycle" DL applications will be accepted (except for new plans and terminating plans)



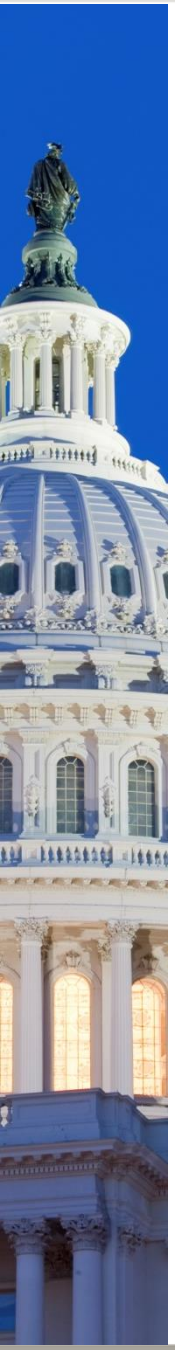
Impact of Changes to DL Program

- Era of a recent DL being an effective "short hand" for qualification is closing
- IRS audit risk and expense will increase
  - Plan sponsors may want to have detailed legal review before submission of documents to IRS auditor
- External auditors may require opinions from management/counsel that plans are 401(a) compliant and up to date



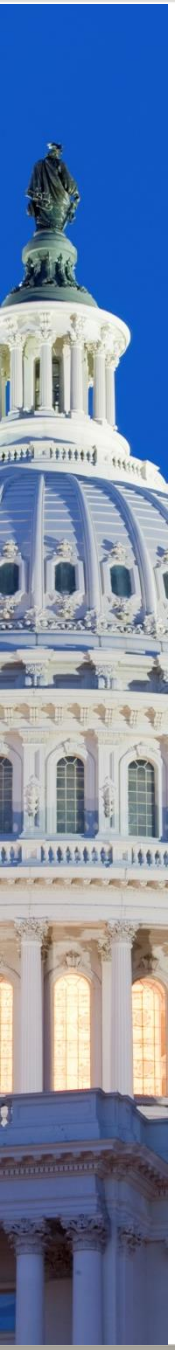
Impact of Changes to DL Program

- Investment managers who rely on SEC exemptions for "section 401(a) plans" may require management/counsel opinions
- M&A transactions will require more detailed due diligence
  - Relying on recent DL in reps & warranties will no longer be sufficient
- Other changes seem certain in EPCRS and IRS audit procedures



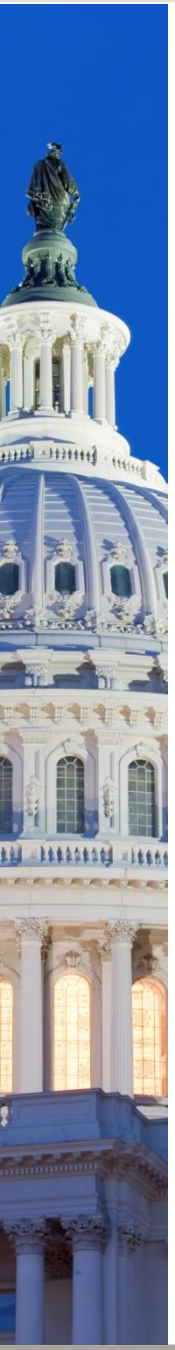
What is the Cadillac Plan Tax?

- Cadillac Plan Tax is an excise tax under Internal Revenue Code Section 4980I
- 4980I applies, beginning after December 31, 2017, to "applicable employer-sponsored coverage"
- 4980I provides that a 40% excise tax will be imposed on the aggregate value of "applicable employer-sponsored coverage" in excess of statutory thresholds (in 2018, $10,200 for self-only coverage, and $27,500 for "other than self only" coverage (e.g., family coverage, etc.))



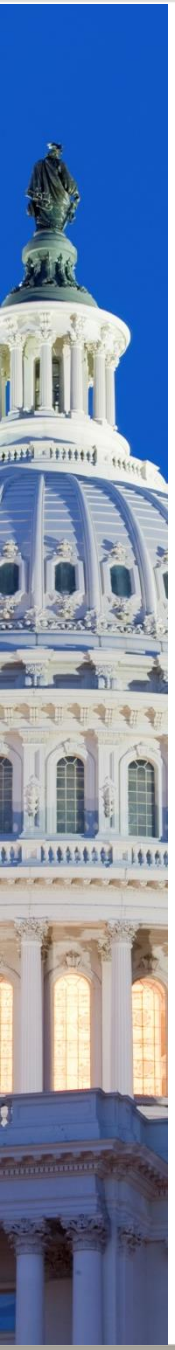
What is the Cadillac Plan Tax?

- The tax applies only to the "excess benefit," i.e., the amount by which the cost of coverage exceeds the statutory threshold
- Tax is calculated on a monthly basis (i.e., only in months in which there is an "excess benefit")
- Cost of "applicable employer-sponsored coverage" (used in calculating "excess benefit") is determined under rules similar to those used to calculate COBRA premiums



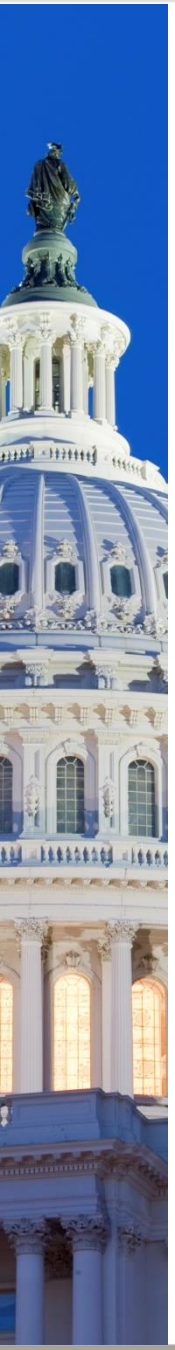
What is the Cadillac Plan Tax?

- Under 4980I, the ***employer*** is responsible for ***calculating*** the excess benefit and any excise tax . . .
- and the actual ***liability*** for the excise tax rests with
  - the insurer (in the case of insured coverage);
  - the employer (in the case of a Health Savings Account); or
  - the "person that administers the plan benefits" (in the case of other types of coverage)
- The "person that administers the plan benefits" isn't defined, statute says it can be plan sponsor if plan sponsor administers benefits



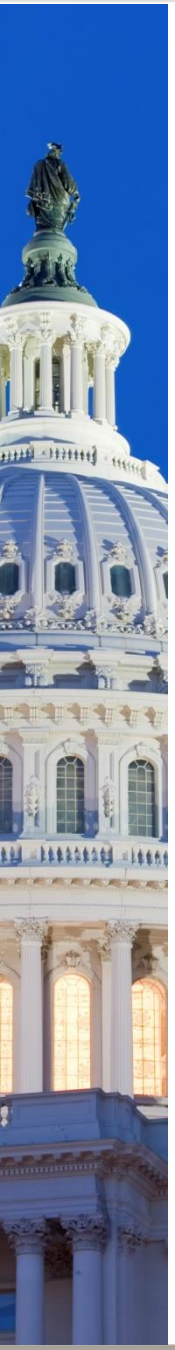
IRS Notices 2015-16 and 2015-52

- The first substantive guidance on the Cadillac Tax was IRS Notice 2015-16, issued on February 23, 2015
- This was followed by IRS Notice 2015-52, issued on July 30, 2015
- The Notices are "intended to initiate and inform the process of developing regulatory guidance" regarding 4980I
- In both Notices, IRS gives some substantive guidance, while inviting comments in other areas
- Notices indicate that IRS anticipates next issuing proposed regulations



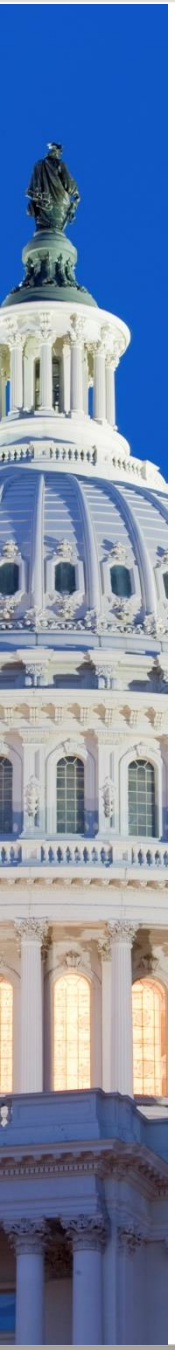
Definition of Applicable Coverage

- Notice 2015-16 addresses what constitutes "applicable coverage" to which 4980I applies
  - Notice makes clear that "applicable coverage" is determined without regard to who (i.e., employer or employee) pays for the coverage, and that IRS anticipates, in future guidance, making clear that HRAs and executive physical programs ***are*** applicable coverage subject to 4980I
  - Health Savings Accounts, HRAs, certain EAPs and the value of some on-site medical clinics (among other benefits) might be included in the value of "applicable coverage"



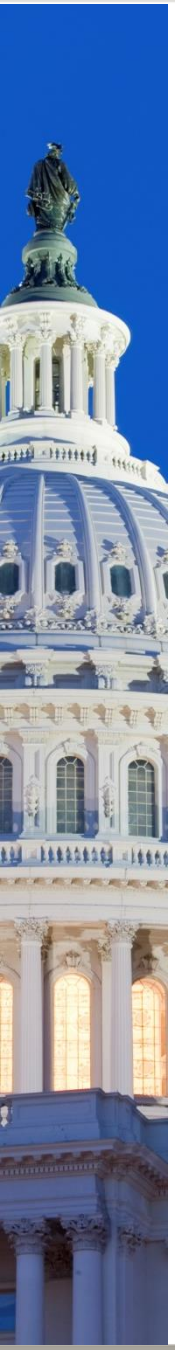
Determination of Cost of Coverage

- Notice 2015-16 also covers how to determine the cost of "applicable coverage," an important topic given that the 40% excise tax will be determined by reference to such cost (and the extent to which it exceeds statutory thresholds)
- Notice broadly states that rules provided under existing COBRA regulations for determining cost of coverage are likely to be used in this context
  - However, the Notice also raises the possibility of the calculation rules for 4980I deviating in some places from the COBRA rules



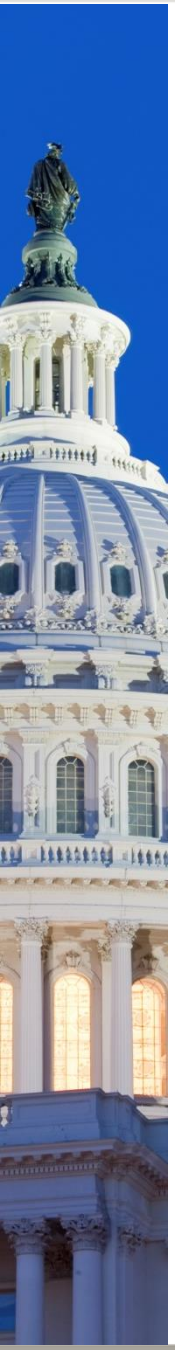
Liability for 4980I Excise Tax

- Notice 2015-52 states that IRS is considering two alternative approaches to determining identity of "the person that administers the plan benefits":
  - Person responsible for performing day-to-day administrative functions ("this person generally would be a third-party administrator for benefits that are self-insured"); ***or***
  - Person who has ultimate authority or responsibility with respect to plan administration, regardless of whether such authority is routinely exercised
    - IRS anticipates that this person would be identifiable under plan documents and would often ***not*** be person doing day-to-day administration



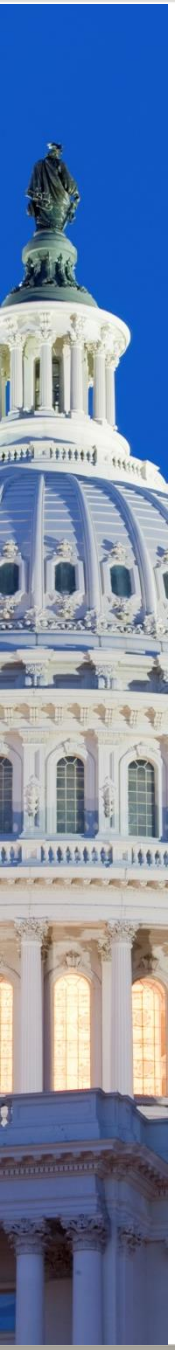
Payment of Excise Tax

- Although 4980I compliance is measured month-by-month, Notice 2015-52 indicates that IRS anticipates excise-tax payments will be made on an annual basis
- Employers will be required to calculate tax "soon after the end of the taxable year" so that providers can make timely payments
  - This presents issues for self-insured plans with run-out periods, experience-rated plans, etc.



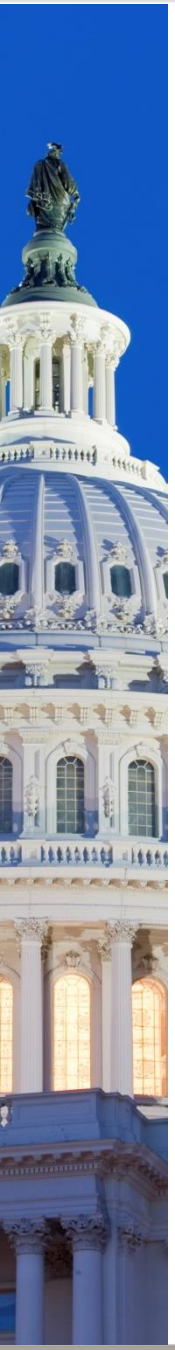
Exclusion of Excise Tax Amount

- Under statute, excise tax amount is a non-deductible expense
- In Notice 2015-52, IRS anticipates that service providers liable for excise tax will pass through to clients the cost of tax, and may also pass through liability for income tax on "passed through" reimbursement
  - IRS notes that excise-tax reimbursement should be excluded from the cost of applicable coverage, but
  - Believes that some or all of any income-tax reimbursement should be excluded only if separately billed



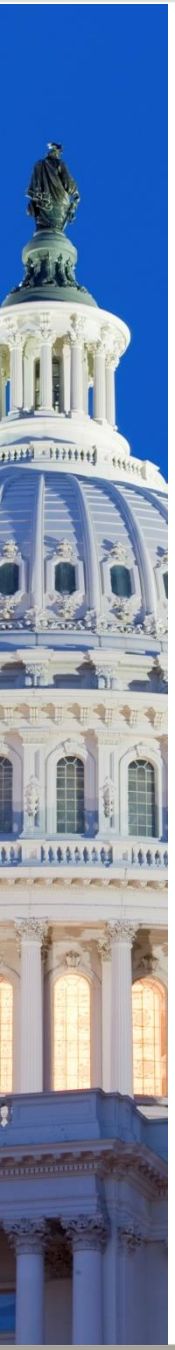
Other Issues Addressed

- Notice 2015-52 also addresses
  - Allocation of HSA, FSA, HRA and Archer MSA contributions to "applicable coverage"
    - Looking at pro-rata allocation over calendar year, even if full benefit is available immediately
    - Employer flex credits would be credited with amount actually used in excess of deferral (all of deferral counted, but flex may be limited)
  - Age and gender adjustments to baseline per-employee dollar limits
    - Employers would need to compare their age and gender banded groups to similar groups for FEHBP,
    - Dollar limits increase ***only*** if employer total is higher than FEHBP



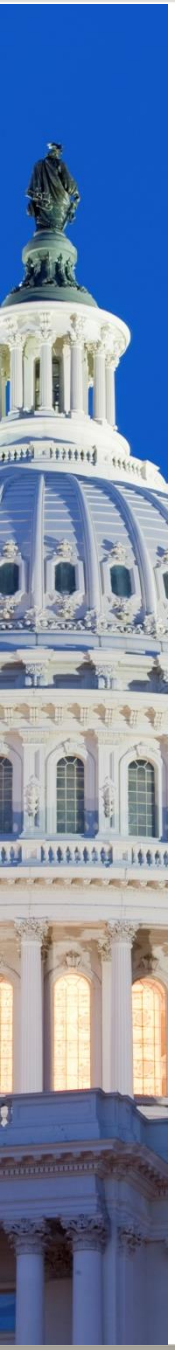
Open Issues

- The most critical open issue with regard to Cadillac Tax is who is responsible for payment of excise tax in self-funded plans (i.e., does "the person that administers the plan benefits" mean the designated Plan Administrator under ERISA (usually the plan sponsor), or could it mean TPAs, PBMs, etc.?)
  - It was anticipated that Notice 2015-52 would resolve this issue, but IRS has left it open for now



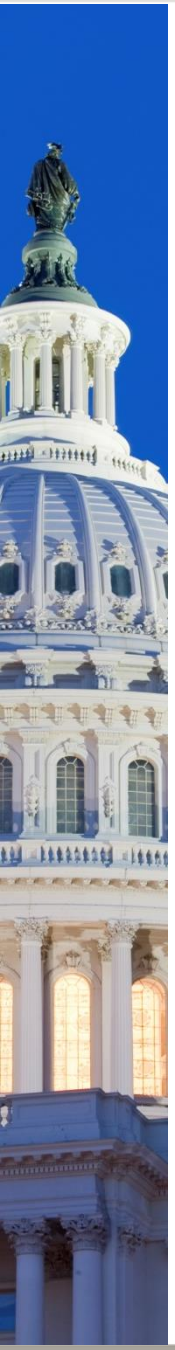
Open Issues

- Calculation and assessment obligations, under statute, are on employer
  - Calculation looks to be a very complicated administrative task
  - Hard payment due date for excise tax may complicate calculation
  - What challenges are available for service providers? Against employer? IRS? Both?



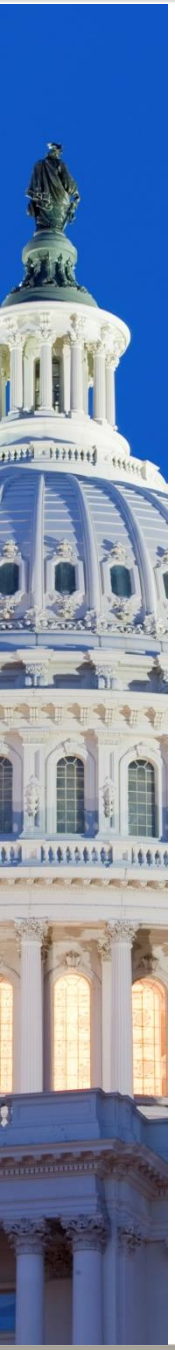
Action Items

- Employers and insurers should be looking closely at the totality of coverage available to employees
  - Don't assume that, because general group health coverage isn't "excessive," that Cadillac Tax can't be triggered – note that it's the ***aggregate*** cost of all coverage available to employee that is at issue.
  - Plans with HSAs and HRAs will need to remember to add these benefits into the cost of "applicable coverage"
  - Employers should begin planning ***now*** to comply with calculation and assessment responsibilities
- Plan documents and insurance/TPA agreements should be reviewed (to clearly spell out who is responsible for calculation, who is liable for payment, etc.)



Much Ado About Nothing?

- Bipartisan support in House and Senate to repeal Cadillac Tax
  - But no consensus on how to do so (outright, offset, etc.)
- Obama administration seems destined to veto any repeal attempts
  - How will next administration handle?
  - Can employers avoid any of administrative ramp up?



Questions

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