IRS tax controversy update

Engineering and Construction Workshop
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Speakers

► Susan Bennett – Ernst & Young LLP Engineering and Construction Industry Tax Leader
► Steven Diamond – Principal, Ernst & Young LLP Southwest Region Tax Controversy Leader
► Rob Hanson – Partner, Ernst & Young LLP Global Tax Controversy Leader
Agenda

- IRS Large Business and International (LB&I) Reorganization and Transfer Pricing Practice
- LB&I Natural Resources and Construction Industry Group
- LB&I information document request (IDR) directive and enforcement policy
- Change in role and mission of IRS Appeals
- IRS Appeals Rapid Appeals Process
- R&D credit update
- Section 199 update
IRS Large Business & International (LB&I) Reorganization and Transfer Pricing Practice
IRS administration of transfer pricing

► Historical
  ► Focus by international examiners/economists on transfer pricing issues; use of outside experts in some large cases
  ► Mandatory transfer pricing documentation IDR and increased focus on transfer pricing penalties
  ► Transfer pricing technical specialists and tier-coordinated issues
  ► Disclosure/transparency – Schedule UTP and Forms 5471/5472
  ► Advance Pricing and Mutual Agreement Program
  ► Simultaneous audits
  ► Treaty information exchanges

► Recent developments
  ► Reorganization of Large and Mid-Size Business (LMSB) division into LB&I
  ► IRS Transfer Pricing Practice
  ► International Practice Networks – transfer pricing inbound and transfer pricing outbound
  ► Joint audits
Transfer pricing operations

Michael Danilack
Competent Authority
Deputy Commissioner, International

Sam Maruca
Director, Transfer Pricing Operations (TPO)

- International Practice Networks (IPNs)
- Transfer Pricing Practice (TPP)
- Advanced Pricing and Mutual Agreement (APMA) Program

Douglas O'Donnell
Asst. Deputy Commissioner, International

- Treaty Assistance & Interpretation Team (TAIT)
Transfer pricing operations

Director
Transfer Pricing Operations
Sam Maruca

Executive Assistant
Technical

IPN Manager
John Kaffenberg

Senior Tax Advisor
Howard Berger

Senior Economic Advisor
Bill Morgan

Special Projects
Deputy
Eli Hoory

TPP West
Nancy Bronson

TPP Central
Tom Ralph

TPP East
Matt Hartman

Director, APMA
Dick McAlonan

Executive Assistant
Operations
New LB&I International Practice Networks (IPNs)

- Outgrowth of end of issue tiering
- Will operate differently from domestic issue practice groups
- Steering committee — facilitating function, not authoritative
  - Connection with expertise of international specialists
  - Not for advice
  - Training tool
  - Open to international examiners (IEs)/economists but eventually open to all agents
- Currently, 18 IPNs — aligned to key business drivers (not code sections)
  - 9 — international business compliance
  - 6 — international individual compliance
  - 2 — transfer pricing inbound and outbound
  - Treaty — under Assistant Deputy Commissioner (International)
IRS transfer pricing enforcement trends

► Mandatory contemporaneous document requests and transfer pricing penalty consideration
► Use of international information reporting to identify transfer pricing issues
  ► Reviews of 5471/5472/1042 for related-party transactions together with taxpayer’s transfer pricing documentation
  ► Schedule UTP
► Increase in taxpayer personnel interviews/site tours
► Treaty/tax information exchange agreement (TEIA) information exchanges
► Increase in use of authorization of agent requests for foreign-owned corporations
► Joint audits
LB&I Natural Resources & Construction (NR&C) Industry Group
LB&I NR&C Industry Group

► Kathy Robbins, Industry Director
► Denise Jennings, Construction Sub-Industry Territory Manager
► National responsibilities:
  ► Industry issue resolution
  ► Industry directives/guidance
► Focus issues
► IRS Engineers Program
LB&I IDR directive and enforcement policy
LB&I IDR directive and enforcement policy

► IRS directive on IDRs (June 18, 2013):
  ► IDRs must be issue focused.
  ► They must be discussed with the taxpayer.
  ► The agent and taxpayer must discuss appropriate response date.

► Delinquent IDR response enforcement policy (effective October 1, 2013)
  ► Step 1: Delinquency notice
  ► Step 2: Pre-summons letter
  ► Step 3: Summons
LB&I IDR directive and enforcement policy

Strategic considerations for dealing with the enforcement policy:

- Consider taxpayer presentations on significant issues prior to IDR issuance
  - May reduce the number of IDRs
  - Should focus the IDRs on documents necessary and readily available
- Develop agreements with Exam teams regarding IDR process
  - Discussion of significant IDRs before issuance
  - All IDRs in draft before issuance
  - Development of agreements, based on realistic discussions, regarding IDR due dates
- Push back on any IDRs that do not follow the IDR directive
  - Not focused (challenge “any and all” and kitchen-sink-type IDRs)
  - Not discussed with taxpayer prior to issuance
- Use management’s involvement in the IDR process to elevate noncompliant IDRs and other issues
Change in role and mission of IRS Appeals
Change in role and mission of IRS Appeals

Appeals’ stated mission is to resolve tax controversies:
(i) Without litigation; (ii) that is fair and impartial to government and taxpayer; and (iii) enhances voluntary compliance and public confidence.

Ex parte communications between IRS Appeals officers and other IRS employees are prohibited.

Appeals Judicial Approach and Culture (AJAC) Project:
A return to a “quasi-judicial” approach.
First phase announced July 2013:
Appeals will not raise new issues.
Alternative arguments are not considered new issues.
Factually deficient cases will generally not be returned to Exam but will include an assessment of the factual hazards of litigation.
IRS Appeals Rapid Appeals Process
Rapid Appeals Process (RAP)

- This is a new alternative dispute resolution process for appeals team case leader (ATCL) cases.
  - It is an optional process offered at ATCL’s discretion.
  - Both taxpayer and LB&I must agree to use the process.
- Pre-opening conference becomes a working conference: ATCL engages taxpayer and LB&I team, using Fast Track Settlement techniques, to focus on key areas of the controversy and inform settlement options.
  - Appeals retains settlement authority and the responsibility for evaluating the hazards of litigation.
- It reduces cycle time and shortens taxpayer's experience with Appeals by leveraging parties’ expertise and familiarity with the issues.
- If the process is unsuccessful, the traditional Appeals process is used.
Rapid Appeals Process (cont’d)

Potential benefits:

- If successful, it resolves issues in one conference and avoids the time and cost of completing the normal Appeals process.
- It provides earlier FIN 48/ASC 740 financial statement certainty.
- While Exam is “at the table,” Appeals retains settlement authority and responsibility for determining hazards of litigation.
- Taxpayer does not waive prohibition on ex parte communications unless taxpayer specifically agrees to do so.
- It promotes independence of Appeals by having Exam argue the issues on behalf of the IRS.
Rapid Appeals Process (cont’d)

Potential barriers:

- Issues must be fully developed.
- Taxpayers forgo the opportunity to receive feedback from Appeals on issues and provide additional submissions to Appeals further supporting the taxpayer’s position.
- If an agreement is not reached, the normal Appeals process may be influenced by heavy Exam participation.
R&D credit update
Research credit (Geosyntec)

- Southern District of Florida case (April 2013)
- Order on summary judgment
- Issue is whether engineering and construction (E&C) firm had requisite economic risk on client contracts to claim the credit
- Six contracts reviewed:
  - Three fixed-fee contracts were allowed.
  - Three cost-plus contracts with a cap were considered funded.
    - Two were based on full review.
    - The third contained an explicit clause that E&C firm did not guarantee results.
- No real change from legal standpoint (same as Fairchild and Lockheed)
- IRS early posture is troubling
Section 199 update
Section 199 deduction industry issues

- Shift of pre-enactment compensation expenses, increase to qualified production activities income (QPAI) equal to 90% of FAS 106, pension, option and other compensation expense attributable to pre-1/1/2005 time frame
- Examination activity around future building requirement as to environmental remediation expenditures
- Safe harbor allowing the assignment of benefits and burdens between parties