23rd Annual Health Sciences Tax Conference

IRS audit hot topics

December 11, 2013
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Large Business & International (LB&I) Division organizational changes and impact
lb&i division realignment

- Internal Revenue Service (IRS) — LB&I continues to seek greater operating efficiencies.
- On October 1, 2012, LB&I realigned its industry groups into contiguous geographical boundaries, with two distinct management lines — domestic and international.
- Field specialists (Engineers, Financial Products Specialists, Computer Audit Specialists) were separated and aligned into one of the industry groups.
- Employment Tax Specialists became part of the Small Business/Self-Employed Division (SBSE).
- Note: The LB&I reorganization has resulted in new chains of command (executives/managers) responsible for your examinations, thus altering the rules of engagement.
LB&I domestic realignment

Deputy Commissioner (Domestic)
Paul DeNard

Global high wealth
Tamera Ripperda

Retailers, food, transportation and health care (CAS)
Lori Nichols (A)

Communications, technology and media
Cheryl Claybough

Natural resources and construction (Eng)
Kathy Robbins

Financial services (FS)
Rosemary Sereti

Heavy manufacturing and pharmaceuticals
Laura Prendergast
Communications, technology and media
Retailers, food, transportation and health care
Financial services
Natural resources and construction
Heavy manufacturing and pharmaceuticals

IRS audit hot topics
LB&I organizational changes

► In 2010, the IRS renamed the division the LB&I Division to highlight IRS focus on international tax administration and enforcement.
  ► Previously, it was the Large and Mid-Size Business (LMSB) Division.

► It established four new international directorships:
  ► Director, International Business Compliance (IBC)
  ► Director, International Individual Compliance (IIC)
  ► Director, Competent Authority & International Coordination
  ► Director, Transfer Pricing

► Merger of advance pricing and mutual agreement process (APMA) — competent authority — and staffed with transfer pricing subject-matter experts (SMEs).
LB&I international program — strategic realignment

- **Integrated International Program**
  - International matrix is a framework for international strategy, training, networks and data management.
  - It organizes all international issues into four areas: business outbound, business inbound, individual outbound and individual inbound.
  - There are four cross-over issues: Foreign Currency, Information Gathering, Corporate Organizations/Transactions and Treaties.

- **International Practice Networks (IPNs) aligned with the matrix strategy**
  - Most international matrix issue areas are represented by an IPN.
  - IPNs are led by a Steering Committee — technical specialist staff, an international manager sponsor, LB&I, small business/self-employed (SB/SE) and Associate Chief Counsel (International) (ACCI) attorneys.
  - IPNs are intended to allow international personnel organization-wide and counsel to share and collaborate on strategic international issues.
New IPNs

- IPNs will focus on international issues and will replace the tiered issue process.
- The IPNs will report to Mike Danilack, Deputy Commissioner, LB&I (International).

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<th>International business compliance inbound</th>
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International enforcement priorities

- Continued emphasis on offshore bank account compliance
- Increased audit coverage of international and cross-border issues, particularly in the transfer pricing area
- Chapter 3 withholding agents (both financial intermediaries and non-financial multinational enterprises (MNEs))
- Foreign-controlled corporations
- Form 1120F filers and non-filers
- International partnerships (Internal Revenue Code (IRC) Section 1446)
- Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) withholding agents
LB&I Rules of Engagement, Internal Revenue Manual (IRM) 4.51.1, are intended to …

- Clarify individual roles, responsibilities and lines of authority
- Facilitate getting the right answer for a particular case or issues
- Promote consistent tax treatment between similarly situated taxpayers or cases
- Reinforce the integrity and ethical behavior in all case-related decision making
LB&I criteria and protocols for elevating case interactions

- Criteria include: questions regarding the availability of resources and competing demands, ability of the team to handle or resolve a particular issue or situation, disputes within teams, taxpayer requests elevation, lack of published guidance, emerging issues, need for cross-industry interaction

- Protocols include: facilitate continued team involvement and decision making at a level closest to the facts, verify that other leaders closest to the facts have been engaged, support consistent treatment of industry issues, interact in a collaborative manner, add value and build trust
Transfer Pricing Practice — impact on examinations
LB&I transfer pricing operations
High priority on international tax enforcement and cooperation
Promoting corporate governance to drive accountability
Focus on tax return information reporting and withholding, transparency and disclosure
Improving audit process through risk assessment, development and resolution of issues
Strategic focus on enforcement and increased audit coverage
Voluntary compliance initiatives
Compliance Assurance Process
More aggressive guidance
Steps in the exam process — transfer pricing

- Initial request for transfer pricing (TP) documentation
- Supplemental information document request (IDRs)
- Requests for interviews
- Taxpayer responds to request for information and interviews
- Development of IRS positions
- IRS to draft proposed adjustments
- Issuance of economist report
- Formal notification of proposed adjustment — IRS will issue a 30-day letter providing notification of the adjustment
- Within 60 days of a taxpayer’s failure to protest the 30-day letter, or failure to pay any deficiency, the IRS issues a notice of deficiency (90-day letter)
Information exchange in TP audits, other than IDR

- Prior IRS exam and IRS appeals reports
- TP documentation for purposes of Section 6662(e)
- Forms 5471 and 5472
- Securities and Exchange Commission (SEC) Forms 10-K and 20-F, annual reports and financial statements
- Corporate meeting minutes
- US and foreign customs import/export duty pricing information
- Internal audit reports
- Intercompany agreements
- List of corporate policy and procedure manuals, including intercompany pricing policies
- Sales catalogs, brochures and pamphlets
- Newspapers, journals, periodicals and reference materials
- Company websites — US and foreign companies
Developing a TP defense strategy

▶ Rank your goals
  ▶ Certainty, freedom from adjustment and/or penalty, simplicity, relationship with governments, impact on ETR, cost

▶ Identify the issues
  ▶ Losses, earnings differ from industry norm, TP methodology not acceptable, insufficient documentation

▶ Agree on what is in vs what is out
  ▶ Set the stage for the controversy discussion
  ▶ Try to clear immediately resolvable issues upfront
Developing a TP defense strategy

- TP issues differ from other tax issues
  - Subjective application of the rules
  - Potentially large adjustments and penalties
  - Procedural options
  - Government differences
  - Double taxation likely
- Consider substantive arguments
- Consider your procedural options (Appeals, alternative dispute resolution (ADR), advance pricing agreement (APA), competent authority (CA))
- Develop your overall substantive and procedural strategy
**TP dispute procedural flowchart**

**File return**
- T/P return selected for examination
- IRS issues either initial contact letter or initial telephone contact
- Pre-opening or opening conference: start of examination
- IRS starts detailed TP examination

**IRS issues Form 4564 (IDR)**
- If CIC* Audit, are there any issues that should be sent to Appeals? "Early Referral to Appeals" (Pursuant to Rev. Proc. 99-28)
- IRS issues Form 5701, Notice of Proposed Adjustments. Does T/P agree?

**IRS issues 30-day letter Preliminary Notice of Deficiency, Form 4665, Publication 5, Pub. 586A**
- IRS and/or T/P should consider if any issue requires Field Service Advice or Technical Advice:
  - Consider CA**/SAP*** pursuant to Rev. Proc. 2006-54
  - Consider whether IRS Examination may resolve open issues, pursuant to Del. Ord. 236 (Rev. 3)
- IRS issues Form 5701 as agreed and proceed to close examination

**Do T/P want to settle issue in Appeals?**
- Does T/P consider mediation, pursuant to Rev. Proc. 2002-44 or arbitration under Rev. Proc. 2006-44; agreement reached?
- Appeals issue 90-day letter agreement reached?
- T/P and IRS agree to a resolution in Appeals?

**Sign Form 5701 as agreed and proceed to close examination**
- Consider correlative and corresponding adjustments
- Consider refund request in foreign jurisdiction

**Does T/P petition Tax Court?**
- T/P pays tax deficiency; does T/P agree?
- Proceed to close case and consider CA**

**Proceed to close case, consider CA**
- T/P files for refund; refund granted?
- No
- Yes
- Proceed to close case, consider CA**

**Proceed with Tax Court case**
- T/P accepts; proceed to close case, consider CA**
- Go to Appeals for review, consider SAP***

**Refund Appeals:** agreement reached?
- T/P files with District Court or Federal Claims Court
- Proceed to close case, consider CA**

**Docketed appeals:** may have case reviewed by Appeals Officer
- Agreement at appeals?
- Proceed to close case, consider CA**
- May request additional time to file protest in writing – generally IRS will grant an additional 30 days
- Non-docketed Appeals: (a) file written protest within 30-day period; (b) do not pay tax – consider cash bond; (c) consider SAP***
- Does T/P require additional time to prepare and file protest with IRS?

**Key**
- *CIC – Coordinated Industry and Industry Case Program**
- **CA-Competent Authority**
- *** Simultaneous Appeals/CA Procedure

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IRS audit hot topics
LB&I’s new approaches to examinations
LB&I/IRS new examination procedures are designed to strategically ...

- Improve compliance through greater transparency
- Reduce the time it takes to find issues
- Spend more time discussing the law as it applies to the facts, rather than looking for information
- Identify areas of uncertainty requiring guidance
- Prioritize the selection of issues and taxpayers for examination
LB&I requests for electronic (non-PDF) copies of bridge work papers

- Rev. Proc. 99-25 details requirements under IRC Section 6001 for taxpayers to keep and provides IRS access to electronic tax records (not return preparers).
  - Return practitioners frequently use their own return preparation software to bridge (map/link) a client’s trial balance accounts to lines on the tax return and save them in a non-PDF format.
- Historically, the IRS accepted these PDF files and converted them to a usable format through third-party software, and then input those files into their analysis software.
- Recent requests by exam teams now require bridge work papers in Excel or other generic data file format that will save them time and resources.
Shift to mid-market

- Issues will determine audit selection, assignment of resources and audit execution, rather than size of taxpayer.
- Elimination of the CIC and IC designation will impact assignment of cases and allocation of resources.
- It may impact continuous CIC case examinations in the future.
- It may encourage greater Compliance Assurance Process participation.
- It will standardize some audit procedures, resulting in less administrative burden to examiners so they can focus more time on development of issues.
- It may result in increased audit coverage across taxpayer classes.
IRS income tax audit process overview

Pre-filing ADR options
- Compliance assurance process
- Pre-filing agreement
- Industry issue resolution
- Private letter ruling
- APA

Audit process ADR options
- Accelerated issue resolution
- Early referral appeals
- Fast-track settlement
- DO 4-24

Appeals ADR options
- Mediation
- Arbitration
- Statutory Notice of Claim Disallowance
  - File refund claim
  - Pay tax
- No protest
- Statutory Notice of Deficiency – 90-Day Letter
  - No settlement
  - Settlement Form 870 AD
  - Assessment
  - Pay tax
- File protest
- Revenue agent report — 30-Day Letter Report
  - No change
  - Exam

Start
- Tax year-end
- Return filed
- Statute of limitations
- No change

US District Court or Court of Federal Claims
- Assessment
- Pay tax
- File refund claim
- Wait six months or until Statutory Notice of Claim Disallowance
- Tax court
- File petition
- No petition
- No petition
- No change
- No settlement
- Settlement Form 870 AD
- Assessment
- Pay tax
## Managing the examination process

<table>
<thead>
<tr>
<th>Key factors for success</th>
<th>Examination strategy</th>
<th>Resolution</th>
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<tbody>
<tr>
<td>▶ Build a cooperative relationship with the exam team</td>
<td>▶ Conduct risk analysis in advance to anticipate areas of controversy</td>
<td>▶ Negotiations can take place at various levels</td>
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<td>▶ Establish ground rules for a successful engagement</td>
<td>▶ Understand the exam team, the hierarchy, personalities, professional styles and group dynamics</td>
<td>▶ Be strategic as to when and how outside advisors should interact with the exam team</td>
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<tr>
<td>▶ Ensure good communication techniques – manage, record, monitor</td>
<td>▶ Prepare personnel to understand their roles in context of the IRS exam</td>
<td>▶ If auditor negotiations begin to fail, consider involving others</td>
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<td>▶ Provide quality documentation</td>
<td>▶ Consider strategic involvement of other officials in the process</td>
<td>▶ Take action well before reassessments are issued</td>
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<tr>
<td>▶ Stay engaged throughout</td>
<td>▶ Prepare early for dispute resolution options — Appeals, CA or APA</td>
<td>▶ Consider settlement impact on Appeals and CA rights</td>
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<tr>
<td>▶ Proactively present facts</td>
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<td>▶ Reduce issues or requests</td>
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Technical issues — IRS focus
Technical issues — IRS focus

- Intellectual property (IP) migration and value creation
  - How to deal with hard to value intangibles
  - Key considerations for a robust defense
- Income method vs traditional 1.482 IP migration methods
  - Income method outside the context of cost sharing
  - Impact of income method on exams
  - Corroboration of income method against primary method
- Income method technical issues
  - Infinite life vs finite life
  - Impact of discount rate
  - Post-tax discount rate vs pretax discount rate
- Residual profit split vs profit split
  - How to defend your profit split
Technical issues — IRS focus

- Forensic accounting
  - IRS officials with domestic backgrounds
  - Focus on research and development (R&D) expenses vs R&D credits
  - Not all Phase IV expenses qualify for R&D credit
Uncertain tax positions (UTPs)

- Background
- Concise descriptions — when is enough enough?
  - Concise description of the tax position; should not exceed a few sentences
  - Description of the relevant facts affecting the tax treatment of the position
  - Information that reasonably can be expected to apprise IRS of the identity of the tax position
  - Nature of the issue
- Soft letters
  - Impact
- Penalties
Compliance Assurance Process (CAP)

Pre-CAP phase

Description
- The purpose is to close all transition years except for one open and one unfiled year, and to assist the taxpayer to qualify for CAP.
- The taxpayer must meet the CAP eligibility criteria.
- The taxpayer can apply for pre-CAP at any time.
- A joint action plan should be established to eliminate transition years with an agreed-upon time frame.

Requirements
- The taxpayer will sign a pre-CAP Memorandum of Understanding (MOU).
- The taxpayer will work in a CAP environment.
- The taxpayer will exhibit transparency and cooperation.
- The taxpayer will agree to identify issues within transactions and provide information in a timely manner to resolve the issues.
- All transition years must be closed except for one open, filed year and one unfiled year.
CAP

CAP phase
  Description
    The taxpayer will proactively provide the IRS with pertinent facts in order to develop material issues.
    Transparency and cooperation will reduce the taxpayer’s and the IRS’ use of resource needs.
    The IRS will conduct due diligence review as appropriate.
  Requirements
    The taxpayer will sign a CAP MOU.
    The taxpayer will exhibit transparency and cooperation with the IRS.
    The taxpayer will identify issues within completed business transactions.
    The taxpayer must meet the CAP eligibility criteria (see IRM).
CAP

- CAP maintenance phase
  - Description
    - Significantly reduced scope and depth
    - Varying levels of review based on history of compliance and risk
    - Enable increased optimization of resources
    - Move between compliance maintenance and the CAP
  - Requirements
    - The taxpayer completed one CAP cycle through post-file.
    - The taxpayer maintains open, honest communication.
    - Consistency in tax department personnel is required.
    - The taxpayer is transparent and cooperative and has fully disclosed all material and significant transactions.
    - The taxpayer has good internal controls.
    - Historically, the taxpayer has low-risk transactions and limited controversy.
New IDR enforcement policy

- New policy effective date — 10/1/2013
- Mandatory for all LB&I cases
- Three-step process
  - Delinquency notice
  - Pre-summons letter
  - Summons
- Game changer — no more running out the clock
- Relationship management becoming critical
- Resource strain
- Finesse in IDR wording/timing negotiation
Questions?