Tax controversy and risk management review

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Post-audit actions and opportunities
by Lindsay Liu, Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

The conclusion of an IRS exam is a milestone in the tax life cycle, calling for important actions as well as a review of planning opportunities.

The closing of an IRS examination is usually a cause for taxpayer celebration and relief. However, it also marks a critical time for further procedural matters and time-sensitive planning. In particular, there are two very important situations that require attention:

1. If the examination results in an overpayment, taxpayers need to confirm that the correct amount of refund and applicable interest is received or properly credited to the taxpayer’s account(s).

2. If the examination ends in a deficiency, taxpayers need to make sure that the IRS calculates the correct amount of tax and interest to be paid.

In this article we discuss these two situations and other key actions and opportunities for taxpayers to consider at this milestone in the tax life cycle.

Post-closing “musts”

Securing refunds, remitting payments and verifying interest

Whether a taxpayer’s IRS audit concludes with a determination of a deficiency or an overpayment, both the taxpayer and the IRS must follow numerous procedures and rules in processing the assessments or refunds and the applicable interest attached to each. With a clear understanding of the examination closing process, taxpayers can confirm the timely, efficient handling of assessments for tax deficiencies without the taxpayer incurring additional interest expense.

Equally important is making sure that refunds are processed in the most expeditious manner via the taxpayer’s preferred method, without forfeiture due to applicable statutes prescribing time limits and processes for obtaining such refunds. The IRS sometimes incorrectly applies or fails to consistently apply the many complex rules and procedures that pertain to the computation of interest.

Finally, the process of remitting tax payments is subject to its own rules – procedures that can often cause the unwary taxpayer problems in getting credit in the correct account and in a timely manner. Taxpayers who are new to this process may benefit from the involvement of a tax professional who knows what the correct interest should be, has experience working with the IRS to arrive at the correct amount of interest on an assessment or refund, and knows how to confirm the correct amount.

Amending state tax returns

The closing of an IRS examination triggers the need for taxpayers to report federal adjustments to the appropriate states by filing amended returns for jurisdictions in which they have filing requirements. IRS examinations typically affect multiple years and the effort to gather data and prepare the amended state returns can strain a taxpayer’s internal resources. With statutory filing deadlines occurring as little as 30 days after completion of the federal audit, it is critical to have a plan ready for execution as soon as the federal examination ends. Such preparation is essential for the taxpayer to avoid any interest and/or penalties that may result from delays and/or non-compliance with state filing requirements.

Addressing tax and financial accounting matters

Following the close of an IRS examination, companies may need to evaluate how the results affect their financial accounting, i.e., a change in unrecognized tax benefits for tax, interest and penalties. Companies may also need to address, in the tax footnote of their financial statements, the appropriate reporting of the settlement in the tabular roll-forward of unrecognized tax benefits or other disclosures.
ASC 740 requires a tax position to be recognized if it is effectively settled through examination, negotiation, or litigation. Effectively settled through examination is deemed to have occurred when the taxing authority has completed all its required or expected examination procedures, the entity does not intend to appeal or litigate any aspect of the tax position, and it is considered “remote” that the taxing authority would reexamine the tax position based on a full knowledge of all relevant information related to the tax position.

Assessing whether or not the completion of an audit by the taxing authority should affect recognition (i.e., determining whether a tax position is effectively settled by examination) begins with an assessment of the taxing authority’s ability to reopen the applicable years and reach a conclusion that is unfavorable to the taxpayer related to the tax position.

Upon conclusion of an audit, companies may determine that prior uncertain tax matters are “effectively settled” within the financial accounting guidance. If a tax position (that was previously considered an uncertain tax position (UTP)) is effectively settled by virtue of the closing of an examination the taxpayer may have a resulting benefit to record for a previously unrecognized tax position.

The determination of whether an issue is effectively settled requires careful consideration of all facts. In making their determination related to positions for which a benefit was not previously recorded because it was deemed to be uncertain, taxpayers may benefit from consulting with tax controversy specialists to understand the implications of audit settlements of specific matters. Additionally, taxpayers may need help in identifying and addressing the tax accounting considerations for interim financial reporting purposes in the quarter in which an audit closes. Finally, companies may need help computing the interest and penalties related to audit settlements and resulting changes for previously unrecognized tax benefits.

Other important post-closing actions

Performing an IRS account analysis

The IRS keeps its records on taxpayers’ accounts by tax year. All items involving actions by the taxpayer, e.g., payments and credits, and actions by the IRS, e.g., assessments and examinations are noted in the account with coded entries for each. The result of an examination may involve multiple adjustments to the tax year(s) involved, and are noted in a taxpayer’s IRS account(s) for those tax year(s). In reviewing how these adjustments relate to a taxpayer’s overall tax posture, the taxpayer may identify opportunities to reduce interest or penalties. Understanding what accounts are needed for review and obtaining those relevant accounts is critical to this analysis. Companies should seek advice and assistance from a tax professional in obtaining transcripts of its accounts from the IRS. Once obtained, a thorough review of the transcripts of these IRS accounts by a trained tax professional can frequently reveal errors, such as miscalculated interest and penalties or misapplied payments. The result of this analysis may yield significant refunds of interest, penalties and/or having misapplied payments applied to the correct taxpayer account.

Implementing accounting method changes

The end of an examination cycle presents the ideal opportunity to assess accounting method exposures and opportunities. Pursuant to section 6.03 of Rev. Proc. 2011-14, a taxpayer under examination has very limited ability to file accounting method changes to correct improper accounting methods. Even changing from a proper to a more advantageous method has to be approved by the exam team. However, during the 120 days following the conclusion of the taxpayer exam (the “120-day window”), regardless of whether a subsequent examination has commenced, a taxpayer may file an application to change a method of accounting without the consent of the examining agent.

Changing from an impermissible to a permissible method of accounting during the 120-day window eliminates exposure
to IRS adjustments for those particular items, prevents an IRS agent from forcing an accounting method change in the next cycle, and unwinds or mitigates the adjustments the IRS may have made on the cycle that was just examined and closed. In addition, opportunities to change from permissible to more advantageous accounting methods can often be used to offset or soften the adverse impact of method or non-method IRS exam adjustments.

Enhancing IRS relations
Taxpayers generally should, whenever possible, be looking to improve their experience and relationship with the IRS. The conclusion of an IRS examination, while the experience is still fresh in mind, presents the optimal time to reflect on what has just transpired. A taxpayer should evaluate its relationship with the Service, assessing the efficiency and effectiveness of the recent examination, as well as areas that need improvement to discuss with the exam team. Such an evaluation can also provide valuable information on how better to prepare for the next examination. To formally facilitate this process, the IRS offers a Post-Examination Critique; tax professionals can assist taxpayers to fully leverage this opportunity for positive change.

Conducting a state look-back review
When amending previously filed state tax returns to reflect the IRS audit adjustments from the examination, taxpayers again have the opportunity to review those returns for beneficial changes. A state look-back review may lead to the identification of refunds and prospective favorable filing methodologies, which in turn, can result in effective tax rate (ETR) reductions, improved cash flow and effective risk management. In addition, tax professionals can assist taxpayers in identifying tax risks associated with these returns and recommend the most effective methods of managing the identified risks.

Assessing international tax implications
At the conclusion of an IRS exam, a taxpayer should assess its global compliance with respect to the need for restructuring, international information returns, necessary actions regarding its foreign tax credits and use of the competent authority process.

- **Restructuring.** If the IRS made adjustments to issues that continue in the future (e.g., cross-border interest expense), in order to limit exposure the taxpayer should consider whether restructuring could eliminate the issue going forward.

- **International information returns.** If the exam caused changes to a taxpayer’s information returns, subsequent year changes may need to be made to the beginning and ending balances of Forms 5471, 5472, 8858 or 8865, including earnings and profit (E&P) pools.

- **Foreign tax credits.** If the exam results affect a taxpayer’s foreign tax credit balances for earlier years, the taxpayer may need to consider changes to carryover amounts (including any carrybacks that generate refunds and may, depending of the amount, require Joint Committee on Taxation review). Taxpayers should also monitor all foreign examinations to determine whether a request for competent authority assistance is needed to confirm that paid foreign taxes are creditable, and to avoid double taxation between the two jurisdictions.

- **Transfer pricing and Competent Authority.** If a transfer pricing issue is likely to arise in the next examination cycle, the taxpayer should consider whether pursuing an advance pricing agreement (APA) can mitigate risk. With respect to passive income flows, there may be limitation of benefits issues or situations in which the taxpayer is not being granted the appropriate treaty rate. A taxpayer may want to seek relief through the US Competent Authority if it believes that the actions of the US, another treaty country, or both, cause or will cause a tax situation not intended by the treaty between the two countries.

- **IRS account analysis.** With respect to IRS adjustments that modify carrybacks, especially with regard to foreign tax credits, taxpayers should make sure that tax and interest amounts as re-determined by the Service are accurate and that any payments or refunds are processed correctly.

Although the end of an IRS examination is cause for relief and hopefully celebration, it is also a time for the taxpayer to assess tax risks and take the opportunity to plan for better risk management. This article notes a number of items that taxpayers should be aware of and possible actions that should be considered. EY’s Account Analysis and Recovery (AAR) group is dedicated to helping taxpayers evaluate their tax situations, obtain information maintained by the IRS and strategically plan their tax futures.

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**Post-exam to do list**

The conclusion of an IRS examination, whatever the outcome, is the springboard for these timely taxpayer actions:

- Secure refunds
- Remit payments
- Verify interest
- Amend state tax returns
- Address tax accounting matters
- Perform IRS account analysis
- Implement accounting method changes
- Conduct a state lookback review
- Enhance IRS relationship
- Assess international tax implications
Seeking alternatives to the traditional exam

A number of alternative dispute resolution (ADR) vehicles other than the normal examination process are available to taxpayers. These are available at different stages of the tax life cycle. Two of them are available prior to the filing of the return: entering the Compliance Assurance Process (CAP) program or obtaining a Pre-Filing Agreement (PFA). Following the close of an examination, taxpayers may also consider the merits of either program for current tax years. Both require the consent of the IRS, but the IRS has been amenable to allowing qualifying taxpayers the benefit of participating in these programs because they are both more timely and efficient. The programs can also be more favorable to taxpayers than the customary full-blown examination.

CAP allows taxpayers to work collaboratively with an IRS team to identify and resolve potential tax issues before the return is filed each year. Through CAP, taxpayers can achieve real-time certainty and a quicker resolution on many controversial issues, such as research credit, Section 199, transfer pricing and others. The ability to achieve tax currency and issue certainty allows companies to recognize the full amount of benefits sustained on tax positions in their financial statements once resolution is achieved, and can eliminate burdensome Schedule UTP reporting.

While participation in the CAP program may not be for all taxpayers, an understanding of the program, its limitations and its benefits, can assist in weighing the options as a part of a taxpayer’s overall tax risk management strategies. In addition, the benefits can extend beyond the US, into other countries that have similar programs, or with whom the US will be considering a joint process to resolve cross-border disputes.

The IRS is now offering Pre-CAP that allows a taxpayer to prepare for entering into CAP by resolving tax issues in the taxpayer’s open tax years and once that is done, to move into CAP. Getting into the CAP program requires taxpayers to be cooperative and transparent with the IRS, but in the long run, establishing this type of relationship with the IRS has been beneficial for many taxpayers.

If taxpayers are not prepared to enter the CAP program, they may still want to seek resolution on issues before their return is filed. In that case, a PFA may be more appropriate as a strategic tax risk management tool to achieve tax certainty. A PFA enables taxpayers and the IRS to resolve, before a return is filed, the treatment of issues otherwise likely to be disputed in post-filing audits. If accepted into the PFA program a company with potentially contentious issues can achieve resolution by applying well-settled legal precedents to the taxpayer’s facts in a cooperative environment. The closing agreement evidencing the resolution is valid for the current year, and a PFA methodology agreement, if obtained, can apply for up to four future years. Taxpayers should consider the desirability of such long-range certainty in assessing and managing tax risks.
LB&I’s new summons initiative, part 2

By Alan Summers, Senior Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

We discuss available alternatives in the event the IRS issues a formal summons to compel a taxpayer or third-party to produce certain documents or be interviewed.

In the previous edition of the Tax controversy and risk management review, we discussed LB&I’s new summons initiative and how the process works when the IRS believes that the taxpayer has not properly responded to information document requests (IDRs) during an examination. In this second article of our series we discuss protections afforded taxpayers and third parties when the IRS decides to formally issue a summons to compel a taxpayer or third-party to produce documents and information or requests an interview with a representative of the taxpayer or third-party. Although we present hypothetical scenarios, the potential headaches and problems are very real.

Headache no. 1120

As Tax Director of a C corporation (Company), you provide intermittent reports to the Audit Committee on the status of the current IRS examination. Just last week, you reported to the Audit Committee that things were going smoothly. As the Company had anticipated, the IRS targeted the transfer of certain intangibles to a controlled foreign subsidiary (the Transaction). Your team has timely provided the IRS examination team with reams of information in responding to IDRs concerning the Transaction (and the related cost-sharing arrangement).

However, after conferring with your general counsel, you withheld certain documents based on attorney-client and Internal Revenue Code (IRC) Section 7525 privileges and the work product immunity, and so informed the IRS team coordinator. Following that notification, the team coordinator told you that the team would be issuing a summons requesting the documents and information. This morning, the team coordinator handed you a summons (Company summons) that requires testimony from “a corporate officer with knowledge” of the contents of the withheld documents and production of the withheld documents. The team coordinator also handed you courtesy copies of two third-party summonses: one served on your independent auditor and the other on the consulting firm that issued an opinion regarding the tax treatment of the Transaction. Both of these third-party summonses seek testimony and documents related to the Transaction.

You dutifully informed your CFO of these developments, and the CFO has charged you with providing a detailed briefing and analysis on: 1) the procedural steps/options the Company should consider with respect to each summons; 2) available objections/defenses in responding to/opposing these summonses; 3) the consequences if the Company or the third-parties produce the withheld documents; and 4) the likely outcome if judicial enforcement of the summonses is sought.

1. Procedural steps/options the Company should consider with respect to each summons

   a. Were the summonses properly completed and appropriately served, and were notice requirements complied with?

      ▶ The Company was properly identified. [correct name, employer identification number (EIN) and address]

      ▶ The team coordinator had the delegated authority to issue the summons. [see Internal Revenue Manual (IRM) 25.5.1.3.2]

      ▶ The team coordinator had the delegated authority to serve the summons. [see IRM 25.5.1.3.4]

      ▶ The summons was properly served. [see Federal Rule of Civil Procedure (Fed R. Civ. P.) 4(d)(3), IRM 25.5.3.2 (1-22-10) and case law all permitting a summons issued to a corporation to be served on a corporate officer, director, managing agent or other person authorized to accept service.]

1 Since that publication the Large Business & International (LB&I) Division issued a Directive dated 18 June 2013, (see highlight on page 9) providing more details to examining agents on the IDR process they are to follow. Although that process will hopefully alleviate the need for the IRS to use summonses, taxpayers should be aware of the potential for that formal process and prepare accordingly.
The copy of the summons handed to you did not bear an attestation.

The appearance date was proper (not less than 10 days from the date of service.) [see IRC Section 7605(a) and IRM 25.5.3.4 (1-22-10)].

Does the lack of attestation, a statutory procedural requirement under Section 7603(a), provide an opportunity to invalidate the Company summons? Probably not. Courts have not automatically invalidated a summons due to IRS non-compliance with a procedural requirement. Specifically, with respect to the lack of attestation, courts have refused to sustain taxpayer challenges to enforcement because the courts have not viewed the lack of attestation as rising to the level of a violation of a substantial right or interest.

After reviewing the procedural requirements regarding the interview process, you conclude that a Company officer, accompanied by Company counsel, should appear at the date, time and place indicated in the summons. To the extent that any of the withheld documents could be considered to meet the IRS’s definition of “tax accrual workpapers,” (see IRM 4.10.20.2), Company counsel should so state on the record and state the objection that the summons requests for these items are improper as the Transaction to which the requests relate is not a listed transaction nor are there any “unusual circumstances” that would justify an exception to the IRS’s stated policy that it will not seek enforced production of tax accrual workpapers absent these conditions.

For the tax accrual workpapers and other responsive documents for which claims of privilege or work product immunity could apply (see below), in light of court rulings relating to summons enforcement actions, a privilege log consistent with the requirements of Federal Rule of Civil Procedure (Fed. R. Civ. P.) 26(b)(5) should be prepared and presented. The Company should produce any responsive non-tax accrual documents not protected by privilege or work product immunity.

b. To determine whether the third-party summonses were properly completed and served, confirm the following requirements were met.

In addition to the general requirements for issuing summonses, that were applicable to the Company summons, Section 7609 provides special procedures for third-party summonses. After reviewing the above checklist to determine if the two third-party summonses were properly completed and served, you conclude that further consultation may be needed.

It is critical that the Company, as the “Noticee” for purposes of Section 7609, take timely action to exercise its rights. Your options include intervening in any enforcement proceeding brought on behalf of the IRS against the third-parties or taking the initiative to bring a proceeding to quash these summonses. Consultation with the summoned third-parties will dictate the course of action. If the third-party chooses to decline to produce the summoned documents, then the Company, as the Noticee, will have the right to intervene in any enforcement action brought by the IRS against the third-party. See Section 7609(b)(1).

On the other hand, if, absent any other action, the third-party intends to produce the responsive documents on the appearance date, and the Company believes that there is a basis for objecting to the third-party providing the documents, the Company must file a timely petition to quash. The timely filing of such petition will relieve the third-party of any obligation to produce responsive documents until ordered to do so by the court. See Section 7609(d)(2).

Section 7609(b)(2) provides that a proceeding to quash must be brought within 20 days after notice is given and that, no later than the close of this 20-day period, the Noticee must mail copies of such petition to quash by certified or registered mail to the person summoned (the third-party) and to the IRS. This 20-day period runs from the

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3 Announcement 2010-76, 2010-1 C.B. 767.
earlier of the date of mailing by the IRS to the Noticee of the notice required under Section 7609(a) or the date the Noticee actually receives such notice. Thus, the Company needs to start the 20-day clock beginning the day after it receives the courtesy copies of these third-party summonses.

In contrast to the leniency the courts have shown to IRS foot faults concerning Section 7609 notice and service requirements, the Section 7609 procedural requirements imposed on the Noticee are viewed by the courts as jurisdictional. Failure to perform those requirements within the 20-day time period has resulted in dismissals of petitions to quash.5

Note that if a taxpayer intervenes in an enforcement proceeding involving third-party summonses or brings a proceeding to quash those summonses, there can be a suspension of the statute of limitations on assessment under Section 7609(e)(1). But, even absent intervention or the institution of a proceeding to quash, the period of limitations on assessment will be suspended if there is no final resolution of the third-party’s response within six months after service of the summonses. Final resolution is reached when the summons is fully complied with, and all appeals are concluded or the time has passed to take an appeal. Section 7609(e)(2).

2. Available objections/defenses in responding to/opposing these summonses: attorney-client and federally authorized tax practitioner privileges and work product immunity

In 1991, the US Supreme Court held that a summoned party is entitled to raise claims of privilege when the Government seeks to enforce a summons [Upjohn Co. v. U.S., 449 U.S. 383 (1991)]. In the ensuing decades, putting aside claims that the requests contained in a summons are overbroad or unduly burdensome, the cases dealing with whether taxpayers must provide the requested information/documents involved the assertion of privileges (e.g., the common law attorney-client privilege, the Section 7525 federally authorized tax practitioner privilege and work product immunity).

The common law attorney-client privilege protects confidential communications to and from attorneys and their clients created for the purpose of securing legal advice and which communications have not been disclosed to any third-party. The protection afforded by the attorney-client privilege, if applicable and not subject to an exception, is absolute. Section 7525, codified in 1998, extends with certain limitations, that same absolute protection to confidential communications between federally authorized tax practitioners and their clients.

Work product immunity, as codified in Fed. R. Civ. P. 26(b)(3), is not absolute and attaches when a party or her agents prepares materials in anticipation of litigation. Courts have treated work product material as falling into one of two classes. In the higher class, opinion work product that includes mental impressions, conclusions, opinions and legal theories of the attorney, are immune from disclosure except in the rarest circumstances.

3. Consequences of voluntary disclosure

Disclosing certain information or documents that could be withheld under one of the privileges or work product immunity could have far-reaching consequences. Most importantly, the intentional disclosure to a third-party (e.g., the IRS) of a communication protected by the attorney-client privilege generally results in a waiver of protection not only for that communication, but for other undisclosed communications concerning the same subject matter (subject matter waiver).

The protection afforded by the attorney-client privilege, if applicable and not subject to an exception, is absolute.

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4Courts have not held the IRS to strict compliance with the notice and service requirements of Section 7609, but rather have balanced the seriousness of the violation against the government’s good faith and the likely harm resulting from the violation. Kellog v. Rossotti, 2003-1 USTC ¶ 50,463 (S.D. Cal. 2003); Shisler v. U.S., 199 F.3d 848 (6th Cir. 1999).

5Treas. Reg. §301.7609-3(b); Miller v. U.S., 94-2 USTC ¶50,383 (N.D. Ind. 1994); Beam v. U.S., 90-2 USTC ¶ 50,595 (D. Ore. 1990), aff’d 951 F.2d 358 (9th Cir. 1991); Faber v. U.S., 921 F.2d 1118 (10th Cir. 1990); Stringer v. U.S., 776 F.2d 274 (11th Cir. 1985).
The same holds true for the Section 7525 privilege. In the case of work product, disclosure dissolves the immunity only if the disclosure is to an adversary or potential adversary or the disclosure facilitates or enables an adversary or potential adversary to gain access to the materials. Thus, the waiver of work product protection may be more difficult for the IRS to prove, but the potential for waiver is still present if the purportedly protected documents are given to the IRS.

Since normally the documents requested are voluminous, there is a chance that a privileged document will be given to the IRS by mistake. Over the years courts ruled differently on how such an inadvertent disclosure affected privileges that could be asserted regarding those documents. In 2008, Congress added Federal Rule of Evidence 502. This rule limits subject matter waivers of the attorney-client privilege and work product immunity through inadvertent disclosures of privileged communications or information in a federal proceeding or to a federal office or agency.

The IRS Chief Counsel’s Office in Notice CC-2009-023 and the Department of Justice in its Tax Resource Manual, have acknowledged that Rule 502 applies to inadvertent disclosures made to the IRS and in response to a summons. Under Rule 502, disclosure of a privileged communication results in subject matter waiver only if the disclosure was intentional and, in fairness, the disclosed and undisclosed information should be considered together.

Because the potential effects of voluntary disclosure are far-reaching, documents should only be disclosed voluntarily if there is no arguable basis for claiming privilege or work product protection.

4. Assess the likely outcome: will the privileges/work product claims preclude enforcement of the Company and third-party summonses?

There have been mixed results in the way courts have dealt with the enforcement of summonses. If the third-party summonses were issued to non-attorneys, the resistance to enforcement of those summonses will likely rest on a claim of work-product protection; for example, where the tax opinion obtained from one of the taxpayer’s advisors was disclosed to another advisor, the Company’s independent auditor. In the context of voluntary disclosures and transparency resulting from the requirement that certain entities reveal their UTP, the IRS announced that it will not assert during an examination that privilege has been waived because a document was provided to an independent auditor as part of an audit of the taxpayer’s financial statement.

This policy is somewhat qualified when the information relates to listed transactions, as was the case in Wells Fargo wherein the US District Court in Minnesota partially upheld the taxpayer’s assertion of attorney-client privilege and work product protection. Although the IRS is selective on when to pursue summonses on these matters, the Department of Justice appears to have parted ways, arguing in several summonses enforcement actions that the independent auditor was a “potential adversary.” As a result, the disclosure resulted in a waiver of work product protection. The majority of the courts that have addressed this question have rejected this argument and ruled that the disclosure to the independent auditor did not result in a waiver of work product protection.

Final thoughts

The IRS issued a recent Directive telling its examining agents how to request documents and information in the context of an audit. The IDRs must be issue-focused, the examiners must discuss the reason for the IDR and must come to an agreement with the taxpayer on a reasonable time period in which the taxpayer has to respond to the IDR. After that agreed-upon time has run its course and the IDR is not fully responded to, the examiner is instructed to begin the formal summons process.

6 Announcement 2010-76, 2010-1 C.B. 767.
7 See, “Court holds that Wells Fargo’s tax accrual workpapers are partially protected” in this issue.

6 Announcement 2010-76, 2010-1 C.B. 767.
7 See, “Court holds that Wells Fargo’s tax accrual workpapers are partially protected” in this issue.
Transfer pricing enforcement trends

The Tax Court holds that it has jurisdiction to review cancellation of advance pricing agreements under an abuse of discretion standard

By Steven C. Wrappe, Global EY Organization Americas Director of Advanced Pricing Agreement Services, Ernst & Young LLP and Kenneth P. Christman, Jr., Executive Director, Transfer Pricing Tax Services, Ernst & Young LLP

Advance pricing agreements (APAs) have been a viable alternative dispute resolution (ADR) vehicle since the IRS started using them in 1991. They allow taxpayers with transfer pricing issues to gain needed certainty for extended periods. APAs take frequently contentious issues off the table in IRS examinations. One of the recent criticisms of the APA program has been how long it takes to reach an agreement. With the combining of the APA and mutual agreement (MAP) programs into the single Advanced Pricing and Mutual Agreement (APMA) program, there is hope for better and quicker issue resolution.

Recently, taxpayers have become concerned about the IRS cancellation of certain existing APAs. This significant development was revealed when a taxpayer, Eaton Corporation, filed a petition in US Tax Court seeking a redetermination of deficiencies asserted by the IRS resulting from the cancellation of its APAs. In its petition, Eaton asserts that the IRS inappropriately cancelled an original and a renewal APA.

Eaton is contesting the resulting deficiencies in the Tax Court. Initially, there was a question as to whether the Tax Court has jurisdiction to rule on the APA cancellations. In the Court's opinion issued on 26 June 2013, the Tax Court ruled that its deficiency jurisdiction extended to reviewing the cancellation of an original and a renewal APA because “they constitute administrative determinations necessary to resolve the merits of a deficiency determination.” The Court also ruled that the burden was on the taxpayer/petitioner to show that the IRS “abused its discretion” in executing the cancellations, i.e., the “cancellations were arbitrary, capricious or without sound basis in fact.”

Background

In the Eaton case, the taxpayer and the IRS entered into the original APA for years 2001-2005, which was later renewed for years 2006-2010 (the renewal APA). In 2011 the IRS cancelled both, claiming that the taxpayer had not complied with the APAs’ terms. The IRS later issued a deficiency notice for years 2005 (the last year covered by the original APA) and 2006 (the first year covered by the renewal APA). In its petition to the Tax Court and in a motion for partial summary judgment, the taxpayer challenged the IRS’s deficiency determinations, in part, by contending that APAs are enforceable contracts and therefore the deficiency determinations based on the APAs’ cancellations could not be upheld unless “the party exercising a contractual cancellation provision” (the IRS) could “demonstrate that a factual predicate exists to cancel the contract.”

The Tax Court found that it had jurisdiction to review the cancellation of the APAs.

At issue is whether it was necessary for the IRS to demonstrate that the APA cancellations were appropriate under contract law before the Court could properly exercise its deficiency jurisdiction. The Tax Court concluded that it was not necessary.

Both parties agreed that the Court had jurisdiction to review the IRS’s deficiency notice as part of the Court’s deficiency jurisdiction. The taxpayer argued, however, that before exercising its deficiency jurisdiction, because the APAs were enforceable contracts, the IRS would first have to demonstrate that the cancellations were appropriate under contract law. In opposing the Taxpayer’s motion for partial summary judgment and in support of its own such motion, the IRS contended that contract law was not relevant and that the Court “may review the cancellations under [the Court’s] deficiency jurisdiction for abuse of discretion because the cancellations were administrative determinations that are necessary to determine the merits of the deficiency determination.”
The Court found that “the terms and conditions in the APA” (which incorporated by reference Revenue Procedure 96-53\(^9\) in the case of taxpayer’s original APA and Revenue Procedure 2004-40\(^{10}\) in the case of taxpayer’s renewal APA) provided the IRS with the authority to revoke or cancel an APA and therefore the cancellations were administrative procedures. In general, and consistent with decisions involving other administrative actions by the IRS, the Court held that an act of administrative procedure is subject to the Court’s judicial review under an abuse of discretion standard. Consequently, the taxpayer’s challenge to the propriety of the cancellations was governed by the abuse of discretion standard, which placed on the taxpayer the burden to show that the IRS abused its discretion and acted in an arbitrary or capricious manner or without a sound basis in fact.

**Taxpayers should pay careful attention to the critical assumptions used in reaching an APA.**

Revenue Procedure 2006-09\(^{11}\), section 11, paragraph 06 lists the conditions under which the IRS may cancel or revoke an APA. In light of the Tax Court’s finding that the IRS standard “boilerplate language” providing that an APA’s legal effect and administration is governed by the applicable APA revenue procedure making general contract law inapplicable to APAs, taxpayers entering into an APA should pay special attention to the APA critical assumptions. Per the APA revenue procedure, a critical assumption is any fact the “continued existence of which is material to the taxpayer’s proposed transfer pricing method, whether related to the taxpayer, a third party, an industry or business and economic conditions.”\(^{12}\) Because an (alleged) failure of a critical assumption could constitute grounds for the IRS to cancel or revoke an APA, the negotiations around what critical assumptions are stated in the APA merit heightened scrutiny. The outcome of this case in the Tax Court should provide significant guidance as to how the courts will view APAs and the cancellation process. The initial view is that taxpayers should continue to use the relief provided by the APMA program to resolve transfer pricing issues.

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11. 2006-1 C.B. 278.
12. See Revenue Procedure 2006-9, Section 4, ¶ 05.
Court holds that Wells Fargo’s tax accrual workpapers are partially protected

By Alan Summers, Senior Manager, Tax Controversy and Risk Management Services, Ernst & Young LLP

Based on the ruling discussed in this article, taxpayers should be cautious in relying on the IRS’s self-imposed policy of restraint to defeat a summons that a court finds was issued with a legitimate purpose.

In a long-anticipated decision, the US District Court for the District of Minnesota addressed the question of whether the IRS can compel taxpayers to produce tax accrual workpapers (TAWs). In this decision, the court took up consolidated cases concerning IRS summonses issued to Wells Fargo & Company (Wells Fargo). The summonses requested TAWs as well as testimony about the preparation and content of the TAWs and the processes for identifying and measuring the amount of Wells Fargo’s uncertain tax positions (UTPs) for the years under IRS examination.

Previously, the IRS had publicly announced a “policy of restraint,” wherein the Agency would only seek TAWs under limited circumstances. In Wells Fargo, the IRS deviated from this self-imposed policy. The court, however, found that regardless of the policy of restraint, a legitimate purpose existed for requesting the documents and stated: “The Court is not persuaded that the IRS must abide by the policy of restraint in order to have a legitimate purpose to request TAWs.” The Court declined to quash the summonses under the facts of the case. The court held that the taxpayer and its audit firm had to disclose its UTPs, the taxpayer’s process for identifying UTPs and other factual information regarding its UTPs. The court held, however, that information reflecting the taxpayer’s recognition and measurement analysis of the UTP was protected in this case by the work product doctrine.

Background on the summonses

During an IRS examination of Wells Fargo’s 2007 and 2008 tax years, the IRS issued three summonses on 12 August 2010, for the years under exam. The first summons directed Wells Fargo to produce its TAWs and documents pertaining to the preparation of the TAWs that were created by Wells Fargo, an accountant for Wells Fargo, or Wells Fargo’s independent auditor. The first summons directed Wells Fargo to produce testimony concerning the preparation of its TAWs and documents pertaining to the preparation of the TAWs that were created by Wells Fargo, an accountant for Wells Fargo, or Wells Fargo’s independent auditor. The second summons directed Wells Fargo to provide testimony concerning the preparation of its TAWs and documents pertaining to the preparation of the TAWs that were created by Wells Fargo, an accountant for Wells Fargo, or Wells Fargo’s independent auditor. The second summons directed Wells Fargo to provide testimony concerning the preparation of its 2007 and 2008 TAWs and the processes for identifying and measuring the amount of its UTPs. The third summons directed KPMG, Wells Fargo’s independent financial auditor, to provide testimony and produce TAWs related to Wells Fargo’s 2007 and 2008 financial statements. (Note that the years under examination predated the IRS requirement to file a UTP disclosure form.)

In response to the IRS requests and summonses, Wells Fargo produced approximately 750 pages of documents and testimony regarding the manner in which Wells Fargo prepared its financial statement disclosures and the aggregate amount of the reserves Wells Fargo created due to its UTPs. Wells Fargo withheld, on the basis of privilege, documents reflecting its identification and analysis of its UTPs and declined to answer questions about specific UTPs. Similarly, KPMG withheld documents reflecting its review of Wells Fargo’s UTPs on the basis that the documents were privileged.

Under Section 7609(b)(2), a taxpayer may file a petition to quash a summons issued to a third party in connection with the taxpayer’s examination. Seeking to protect its rights to assert privilege, Wells Fargo filed a petition to quash the KPMG summonses. The government filed a counter-petition to enforce the KPMG summonses and a separate case to enforce the two Wells Fargo summonses. The cases were consolidated and an evidentiary hearing was held on 25 July 2011. The withheld TAWs were submitted for a private review (“in camera”) by the court, and nearly two years later, on 4 June 2013, the court issued its decision.

The TAWs at issue included narratives summarizing Wells Fargo’s FIN 48 (as now codified in ASC 740, but referred to herein as FIN 48) analysis and included a brief...
description of a UTP, the relevant jurisdiction and tax year, the unit of account, the gross tax benefit, whether the more-likely-than-not recognition threshold was met (recognition), and the amount of benefit that was more likely than not to be achieved through litigation or settlement (measurement). Some narratives included assessments of potential litigation results, including evaluations of strengths of IRS possible counter-arguments.

The Court partially ruled in favor of Wells Fargo

The summons was not prohibited by the IRS’s policy of restraint

The court held that the IRS had a legitimate purpose when it issued the summonses in that the IRS established that it sought the TAWs, at least in part, to verify the accuracy of Wells Fargo’s returns. The court noted that even if the IRS examining agents were also motivated by a desire to “punish” Wells Fargo for entering into transactions that the IRS disliked, that motivation did not negate the legitimate purpose of the IRS to verify the accuracy of Well Fargo’s returns.

The court was similarly not persuaded by Wells Fargo’s argument that the summonses violated the IRS’s own policy of restraint, because under that self-imposed policy the IRS would only request the TAWs when a taxpayer had claimed the benefits of a listed transaction on its return. The court noted that: 1) the policy of restraint established boundaries stricter than those required under the US Supreme Court’s holding in US v. Arthur Young & Co, 465 US 805 (1984), 2) the IRS had changed its policy over time, and 3) Wells Fargo had claimed benefits from listed transactions (the relevant fact under the IRS’s policy of restraint) in earlier years and had engaged in other questionable tax practices in the past.

Partial protection by the work product doctrine

Identification of UTP not protected

The court rejected Wells Fargo’s argument that the identification of UTPs was protected by the work product doctrine. The court stated that the work product doctrine applicable to this case protects the work product from discovery by the opposing party’s attorney if the document reflects the attorney’s mental impressions, opinions or thinking about an individual case, including estimates of anticipated settlement values. However, the doctrine does not protect factual data that does not reveal an attorney’s thinking.

During the court hearing, Wells Fargo testified that its tax accountants determined UTPs in conjunction with formulating transactions aimed at tax benefits, before beginning their financial reporting analysis, and requested the assistance of Wells Fargo’s attorneys to further analyze the tax positions and structure the transactions. The court found that Wells Fargo’s identification of UTPs was not a task prepared in anticipation of litigation, but rather for the purpose of helping structure business transactions associated with tax positions and occurring in the ordinary course of business. The court found Wells Fargo’s statement that it anticipated and prepared for litigation every time that it entered into a transaction potentially controversial with the IRS was inconsistent with Wells Fargo’s statement that it would not enter into a transaction related to a UTP unless it had at least a 70% likelihood that the tax effects would be upheld by a court. The court therefore declined to find that Wells Fargo anticipated litigation every time it identified a UTP, and because Wells Fargo did not address individual UTPs, the court was unable to determine whether Wells Fargo anticipated litigation at the time that any specific UTP was identified.

The court rejected Wells Fargo’s argument that the identification of UTPs was protected by the work product doctrine.
Recognition and measurement of UTPs was protected from disclosure

The court held, however, that the work product doctrine protected from production the recognition and measurement analysis reflected in the TAWs. Relying on its private review of the TAWs at issue in the case, the court found that the recognition and measurement analysis did reflect the legal analysis conducted by Wells Fargo’s attorneys in preparation for litigation. In differentiating the recognition and measurement analyses from the identification of the UTPs, the court noted that Wells Fargo was actively participating in litigation or IRS Appeals on many of the UTPs.

The court also noted that for other UTPs, litigation appeared likely, and the analyses appear to have been pre-existing and not merely created for the FIN 48 analysis in the conduct of the audit. The court held that TAWs related to the recognition and measurement of the FIN 48 positions which were prepared by Wells Fargo’s independent auditor, KPMG, were closely tied to the analysis of Wells Fargo’s attorneys and were also protected from production by the work product doctrine. The court also held that the privilege was not waived when Wells Fargo intentionally disclosed its FIN 48 analysis to KPMG because KPMG was not an adversary, and evidence showed nothing more than a remote possibility that KPMG may be required to disclose the TAWs to Wells Fargo’s adversary.

In holding that the recognition and measurement analysis in the TAWs was privileged, the court cautioned that its ruling was limited to Wells Fargo’s unique circumstances. In particular, the court noted the substantially limited number of tax positions that Wells Fargo subjected to FIN 48 analysis and the objective facts that evidenced Wells Fargo’s anticipation of litigation with respect to each UTP at the time the TAWs were created. The court specifically rejected the argument that, because FIN 48 requires a taxpayer to assume that positions will be litigated, TAWs by their very nature are created “because of” litigation and thus satisfy the anticipation of litigation criterion applied in the Eighth Circuit.

In holding that the recognition and measurement analysis in the TAWs was privileged, the court cautioned that its ruling was limited to Wells Fargo’s unique circumstances.

Court found emails protected under attorney-client privilege

In a very brief discussion the Court also held that eight of Wells Fargo’s emails were protected by attorney-client privilege and that the IRS had not articulated a prima facie case for relevance of the information contained in Wells Fargo’s state and local tax UTPs and the TAWs of Wachovia, which Wells Fargo had acquired on 31 December 2008.

Implications

The Court’s rulings appear to put Wells Fargo in a similar position as if it had been required to file Schedule UTP during these years and disclose the identification of its UTPs, but not the amounts involved or the analyses of
potential outcomes/settlements/hazards. In arriving at this result, the Court addressed issues and arguments addressed in other cases involving claims of work product privilege to shield TAWs. These included the scope of the exception for documents prepared in the ordinary course of business, whether an independent auditor is an actual or potential adversary or a conduit to a potential adversary, whether material developed in anticipation of litigation can be incorporated into a document produced during an audit without ceasing to be work product, and whether the FIN 48 analysis, by its very nature, creates an “anticipation of litigation.” The Court’s rulings on these matters generally are consistent with existing case law precedents.

The court cautioned that the protection granted to the recognition and measurement steps of the FIN 48 analysis was limited to Wells Fargo’s unique circumstances, including its ability to prove its anticipation of litigation at the time it created its TAWs. The court also relied on the absence of contrary evidence when ruling that KPMG would not be regarded as a conduit to an adversary.

Based on the ruling of this court, taxpayers should be cautious in relying on the IRS’s self-imposed policy of restraint to defeat a summons that a court finds was issued with a legitimate purpose. Taxpayers must continue to take care in creating, documenting and preserving facts that can support claims of work product protection and confidentiality.
Legislative, regulatory and other guidance

Treasury and IRS issue final and re-proposed tangible property regulations that will broadly impact taxpayers across industries

By Susan Grais, Executive Director, Quantitative Services, Ernst & Young LLP

The US Treasury Department and the IRS have issued final (T.D. 9636) and re-proposed (REG-110732-13) tangible property regulations under provisions that include Sections 162, 263(a) and 168. The final regulations generally are intended to simplify, clarify and make more administrable the 2011 temporary and proposed regulations and broadly apply to amounts to acquire, produce or improve tangible property, as well as dispositions of such property.

These final and re-proposed regulations generally are effective for tax years beginning on or after 1 January 2014. However, certain rules apply only to amounts paid or incurred in tax years beginning in 2014. Taxpayers also will be allowed to rely on, and early adopt, for tax years beginning in 2012 (or for amounts paid or incurred in such year(s), as appropriate), both the final provisions and the proposed disposition rules to facilitate implementation efforts. Transition guidance providing the procedural rules to comply with such regulations is anticipated to be released within the next several weeks. The forthcoming transition rules generally will require, for certain identified method changes, a Section 481(a) adjustment (and, correlatively, the filing of Form(s) 3115, Application for Change in Accounting Method), presumably with a waiver of method change eligibility/scope provisions applicable to taxpayers under IRS examination. Also, if they choose, taxpayers continue to have the option of applying the 2011 temporary regulations to tax years beginning on or after 1 January 2012, and before the applicability date of the final regulations (and, for certain expenditures, amounts paid or incurred within this timeframe).

Additional EY Tax Alerts will be issued elaborating further on this significant regulation package and related forthcoming guidance. A comparison chart summarizing significant changes in the new final and re-proposed regulations follows on the next page.

EY hosted part one of a two-part webcast on the regulations on Monday, 23 September 2013. Scott Mackay of the Office of Tax Policy, Department of Treasury, joined a panel of EY professionals and discussed the new rules and shared insights for this first public webcast regarding the new rules. For a replay of the archived webcast, please visit the following link – http://www.ey.com/GL/en/issues/webcast_2013-09-17-1700_tangible-property-regulations-all-systems-go.
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This summary chart is for educational purposes only and is not intended, and should not be relied upon, as accounting advice.

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Section 199 deduction: LB&I issues directive on determining benefits and burdens of ownership for contract manufacturing arrangements

By Catherine Brandt, Senior Manager, Federal Tax Services, Ernst & Young LLP, Scott Garrison, Manager, Federal Tax Services, Ernst & Young LLP and Tim Powell, Manager, Federal Tax Services, Ernst & Young LLP

Recent developments offer insight into the IRS’s examination of Section 199

On 24 July 2013, the IRS Large Business & International (LB&I) Division issued a directive (Directive #2) (LB&I-4-0713-006)15 to aid LB&I examiners in determining whether a taxpayer has the benefits and burdens of ownership under a contract manufacturing arrangement for purposes of Treas. Reg. Section 1.199-3(f)(1).16 Directive #2 was issued because a previous directive (LB&I-4-0112-001) issued on 1 February 2012 (Directive #1)17 was apparently not having the desired results.

After a slow start, Section 199 gains momentum

In 2004, Section 199 was the centerpiece of the American Jobs Creation Act, providing a domestic manufacturing deduction (Section 199 deduction) equal to 3% of qualified production activities income.18 At the time, taxpayer response to the new legislation was underwhelming and many companies opted not to pursue the deduction. Fully phased in at a 9% rate, the Section 199 deduction is gaining momentum across several industries, providing a permanent tax savings that positively affects a company’s earnings per share, stock price and effective tax rate.

In general, Section 199 provides that a taxpayer with domestic production activities is eligible for a deduction equal to a percentage19 of the lesser of: (1) the qualified production activities income of the taxpayer for the tax year, or (2) the taxable income (without regard to Section 199) for the tax year.20 The amount of the deduction for any tax year is generally limited to 50% of the W-2 wages of the employer for the tax year.21 The Section 199 deduction provides a permanent tax savings that positively affects a company’s earnings per share, stock price and effective tax rate.

The Section 199 deduction provides a permanent tax savings that positively affects a company’s earnings per share, stock price and effective tax rate.

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16 LB&I uses directives to provide administrative guidance to LB&I examiners to confirm consistent tax administration and on matters relating to internal operations. These directives do not establish the Service position on legal issues and are not legal guidance but are used as an aid to examiners.
19 The applicable percentage is 3% for taxable years beginning in 2005 or 2006, and 6% for taxable years beginning in 2007, 2008 or 2009. The deduction is fully phased in at 9% for tax years beginning in or after 2010. There are further limitations applicable to taxpayers with oil-related qualified production activities.
20 Section 199(a)(1)(A).
21 Section 199(a)(1)(B). For individuals, “taxable income” is “adjusted gross income.” Section 199(d)(2).
22 Section 199(b)(1). Note also that under Section 199(b)(2)(B) for tax years beginning after 17 May, 2006, W-2 wages includes only amounts properly allocable to domestic production gross receipts.
23 Section 199(c)(1).
24 Section 199(c)(4).
derived from any lease, rental, license, sale, exchange or other disposition of qualifying production property (QPP)\textsuperscript{23}, that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States.

Historically, there has been very little guidance related to Section 199. Taxpayers seeking a framework for claiming the deduction could only look to the interpretation of the statutory and regulatory rules. In recent months, however, emerging issues and guidance have provided insight into the IRS's examination of Section 199 in the area of contract manufacturing.

Under the infamous “coffee footnote”\textsuperscript{24} (Treas. Reg. Section 1.199-3(o)(3)), there is a potential tax planning opportunity for companies that manufacture their own private label brands and produce products off-site. For example, a grocer may qualify for the deduction based on production of various private label brands and/or bakery items that are manufactured at separate locations. When third-party manufacturing is involved, the benefits and burdens of ownership determine Section 199 eligibility, not necessarily hands-on involvement in the manufacturing.

**Benefits and burdens issue is source of controversy**

Section 199 provides that only one taxpayer may claim the deduction with respect to any qualifying activity performed in connection with the property being produced.\textsuperscript{25} In the case of a contract manufacturing arrangement, only the taxpayer that has the benefits and burdens of ownership of the property during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity.\textsuperscript{26} The determination as to which party has the benefits and burdens of ownership is based on all the facts and circumstances.\textsuperscript{27} Indeed, one large area of controversy for the IRS is the determination, in many contract manufacturing arrangements, as to which party has the benefits and burdens of ownership. This is not a simple determination.

As noted, LB&I issued two directives for use in determining whether a taxpayer has the benefits and burdens of ownership under contract manufacturing agreements related to Section 199. The Directives were intended to simplify and streamline examination of the issue.\textsuperscript{28} The first, Directive #1, issued in February 2012, set forth a three-step process focusing on the contract terms, production activities and economic risks of a transaction.\textsuperscript{29} The second, Directive #2, issued in July 2013, supersedes Directive #1 and allows taxpayers to provide a certified statement, signed by both the taxpayer and the counterparty, stating that the taxpayer has the benefits and burdens of ownership over the qualifying property during production.\textsuperscript{30} Directive #2 also requires the counterparty to the contract manufacturing arrangement to sign a certification statement attesting that it did not claim, and will not claim, the Section 199 deduction for any tax year covered by the contract under which the

\begin{itemize}
\item \textsuperscript{23}Section 199(c)(5)
\item \textsuperscript{24}H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 272 n. 27 (2004) (indicating a component may be treated as qualifying property in the case of food and beverages). Footnote 27 of the Conf. Rep. explains that, in the context of food and beverages prepared at a retail establishment, although a cup of coffee prepared at a retail establishment does not qualify under Section 199(c), a portion of the cup of coffee, that is, the coffee beans (roasted at a facility separate from the retail establishment) that meet the requirements under Section 199(c), does qualify under Section 199. See, e.g., REG-105847-05, IRB 2005-47, Notice of Proposed Rulemaking and Notice of Public Hearing Income Attributable to Domestic Production Activities (21 November 2005).
\item \textsuperscript{25}Section 199(d)(10); Treas. Reg. Section 1.199-3(f)(1).
\item \textsuperscript{26}Treas. Reg. Section 1.199-3(f)(1).
\item \textsuperscript{27}Supra footnote 17.
\item \textsuperscript{28}Supra footnote 15 and 17.
\item \textsuperscript{29}Supra footnote 17.
\item \textsuperscript{30}Supra footnote 15.
\end{itemize}
same qualifying activities were performed.\textsuperscript{31} The specific requirements under the Directives, specifically Directive #2, are discussed in more detail below.

The directives

Directive #1\textsuperscript{32} drove taxpayers to deploy facts and circumstances test

Directive #1 provided a three-step process for examiners to use in determining whether a taxpayer has the benefits and burdens of ownership over the qualifying property while the production activity takes place. The steps related to contract terms, production activities, and economic risks. Each step required examiners to ask three questions. If the answer to at least two of the questions was “yes,” the step was completed and the examiner moved on to the next step. If two of the three steps were completed, the taxpayer had the benefits and burdens of ownership.

If the taxpayer could not satisfy at least two of the three steps, Directive #1 instructed examiners to use a facts and circumstances test to determine whether the taxpayer had the benefits and burdens of ownership. Directive #1 explicitly instructed examiners to not rely solely on the nine questions contained in Directive #1 when examining facts and circumstances. Instead, examiners were instructed to consider all relevant factors.

Although LB&I may have thought that Directive #1 provided an objective set of questions to determine if a taxpayer had the benefits and burdens of ownership for purposes of Section 199, its requirements proved very difficult for most taxpayers to satisfy. Both parties to a contract manufacturing arrangement often have some indication of benefits and burdens over the qualifying activities. Thus, taxpayers and examiners were once again forced to rely on the facts and circumstances test, expending extensive resources in order to determine which party in a contract manufacturing arrangement had the benefits and burdens of ownership under Treas. Reg. Section 1.199-3(f)(1).

Directive #2\textsuperscript{33} sets forth objective criteria for satisfying the benefits and burdens test

LB&I reconsidered the approach used in Directive #1 and issued Directive #2, superseding Directive #1 and instructing examiners to request the following documents from the taxpayer when deciding whether to challenge the taxpayer’s position that it had the benefits and burdens of ownership under a contract manufacturing arrangement with a counterparty:

1. A statement explaining the basis for the taxpayer’s position that it had the benefits and burdens of ownership in the year or years under examination.

2. A certification statement signed by the taxpayer (using the form attached as Appendix 1 of Directive #2).

3. A certification statement signed by the counterparty (using the form attached as Appendix 2 of Directive #2).

For Directive #2 to apply, the taxpayer and the counterparty must complete all sections of the applicable certification statements included in Appendices 1 and 2. The taxpayer’s certification requires the taxpayer to attest to the following:

1. Taxpayer determined that it had benefits and burdens over the qualifying property when the qualifying activities were performed and filed its federal income tax return(s) consistent with this determination.

2. Taxpayer was not required to record a reserve for financial statement purposes under its accounting standard for its determination that it had benefits and burdens over the qualifying property.

3. The contract to which this certification statement applies was not governed by the rules applicable to: (1) expanded affiliated groups (EAGs) under Treas. Reg. Section 1.199-7; (2) qualifying in-kind partnerships under Treas. Reg. Sections 1.199-3(i)(7) and 1.199-9(i); (3) EAG partnerships under Treas. Reg. Sections 1.199-3(i)(7) and 1.199-9(j); and (4) government contracts under Treas. Reg. Section 1.199-3(f)(2).

\textsuperscript{31}Ibid.

\textsuperscript{32}Supra footnote 17.

\textsuperscript{33}Supra footnote 15.
4. The qualifying activities occurred in whole or in significant part within the US.

The counterparty’s certification requires the counterparty to attest that it did not claim, and will not claim, the Section 199 deduction for any tax year covered by the contract under which the same qualifying activities were performed.

Requirements for certification

The certification statements must be signed under penalty of perjury by individuals who are authorized to execute the taxpayer’s and the counterparty’s federal income tax returns. For a consolidated federal income tax return, the common parent is the sole agent for the group and an individual authorized to sign the common parent’s federal income tax returns must sign the certification statement for each member of the group.

Directive #2 will not apply if there is a change as to which party to a multi-year contract has the benefits and burdens of ownership. In that case, LB&I directs examiners to apply regular audit procedures for the year of change or any subsequent years to which the contract applies.

The taxpayer should provide the benefits and burdens statement and certification statements to the LB&I examiner within 30 days of the date that the LB&I examiner issues an information document request (IDR) to the taxpayer for a Section 199 deduction. If the benefits and burdens determination was under examination on 24 July 2013, the date Directive #2 was issued, the taxpayer must have provided the benefits and burdens statement and signed certification statements to the examiner by 22 September 2013, which may provide significant relief to taxpayers if they are able to satisfy the requirements of Directive #2.

LB&I directs examiners, if a taxpayer timely submits the benefits and burdens statement and certification statements described above, not to challenge that the taxpayer has the benefits and burdens of ownership over the qualifying property while the qualifying activity is performed under the contract manufacturing arrangement for Section 199 purposes. However, LB&I instructs examiners, if the taxpayer does not submit the statements listed above, not to presume that the taxpayer does not have the benefits and burdens of ownership. Instead, LB&I examiners should apply regular audit procedures to determine which entity has the benefits and burdens of ownership.

Limits of Directive #2

Directive #2 is limited in scope to determining which unrelated party (as defined in Treas. Reg. Section 1.199-3(b)) in a contract manufacturing arrangement may claim the Section 199 deduction because it satisfies the benefits and burdens test. In order to claim the deduction, that party must also meet all other requirements of Section 199. Directive #2 does not change the special rules in the regulations under Section 199 applicable to EAGs, qualifying in-kind partnerships, EAG partnerships or government contracts. Directive #2 also does not apply to any other provision of the Internal Revenue Code when the examiner is determining the benefits and burdens of ownership in a contract manufacturing arrangement, including Section 263A.

Impact on taxpayers

The determination of which party in a contract manufacturing arrangement has the benefits and burdens of ownership for Section 199 purposes has been a highly contentious issue. Directive #1, although intended to reduce uncertainty on the matter, resulted in additional confusion. Many taxpayers were unable to satisfy the steps in Directive #1 and, as a result, had to rely on the subjective facts and circumstances approach to support their benefits and burdens positions. As such, the issuance of Directive #2 is a favorable development for taxpayers in that it sets forth objective criteria for satisfying the benefits and burdens test. Further, there may be significant relief for taxpayers currently under examination for the benefits and burdens issue if they are able to satisfy the requirements of Directive #2.
Directive #2 is also noteworthy considering there are several cases pending before the US Tax Court. Advo, Inc.,34 involves a direct-mail marketer. That case was argued in May 2012 and briefs were filed and we are awaiting the Court’s opinion. In addition, Limited Brands, Inc. and L Brands Inc. (formerly known as Limited Brands, Inc.) also filed petitions in the US Tax Court challenging the Service’s disallowance of the Section 199 deduction related to the domestic production of personal care, beauty and home fragrance products.35

A taxpayer that otherwise satisfies the requirements under Section 199 should examine its contracts to determine if there is a basis for claiming that it has the benefits and burdens of ownership. If so, the taxpayer should contact the counterparty to the contract manufacturing arrangement and ask the counterparty if it will sign the certification statement required under Directive #2.

If the counterparty is amenable to signing the certification statement, the taxpayer should draft a statement in support of the position that it has the benefits and burdens of ownership and have the certification statement signed by the appropriate taxpayer representative. Alternatively, if the counterparty is not willing to sign the certification relating to past and present contracts, the taxpayer and the counterparty should discuss the treatment of this issue for contracts going forward.

Health care reform, the IRS and the employee mandate

by Mary Gorman, Senior Manager, Federal Employment Tax Controversy Group, Ernst & Young LLP

Under the Affordable Care Act, there is a significant exposure for employers in misidentifying full-time employees as part-time.

Earlier this year – even as the IRS announced a one-year extension of the employer mandate under the Affordable Care Act (ACA)36 – most large employers (more than 50 employees) should become aware of and prepare for an important part of ACA dealing with part-time and newly hired employees. In the event of an IRS audit once the employer mandate is effective, an employer could eventually be answering questions about how he can prove that the company’s part-time employees are really part-time.

If the employer has more than 50 employees, the “shared responsibility” provisions of ACA mandate that the employer offer full-time employees health coverage. If a full-time employee is not offered health care through his employer’s plan, and the employee purchases health care at a local exchange with the assistance of a premium tax credit,

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34 Advo, Inc. & Subsidiaries vs. Commissioner, US Tax Court, Docket No. 17247-10.
35 Limited Brands Inc. and Subsidiaries et al. v. Commissioner US Tax Court, Docket Nos. 17903-10 and 14667-12.
36 On 9 July 2013, the IRS issued Notice 2013-45 providing a one-year extension of the employer mandate and the associated reporting under IRC Sections 6055 and 6056.
the employer may be liable for a payment under IRC Section 4980H. Therefore, there is a significant exposure for employers, under the ACA, in misidentifying full-time employees as part-time. Generally part-time employees do not need to be offered health care. There is no liability for an employer that does not offer health care to part-time employees, even if that employer has more than 50 employees and even if the employee purchases health care at a local exchange and receives a premium tax credit. It seems likely that the IRS will be interested in whether you have correctly identified employees as part-time or full-time. The potential liability could be large, since the payment due for failure to provide health insurance to full-time employees who receive a premium tax credit is measured as $2000 times the number of all of your full-time employees. However, there is a safe harbor for employers that will prevent the imposition of liability if 95% of the employees have been treated correctly with regard to the offer of health coverage.

There is no liability for an employer that does not offer health care to part-time employees

Demonstrating compliance at the audit

Your business needs to be “audit-ready” in the event that the IRS asks you to verify that all of your part-time workers who received a premium tax credit, are actually part-time employees. To ascertain your company’s preparedness, consider the following questions

- If you have a business with “variable-hour” employees who don’t always work the same number of hours in a given pay period, how will you prove that none of these employees actually worked full-time?
- If you have new employees, how will you prove that you properly identified those employees as part-time employees?

Look-back measurement periods

The ACA statute provides that a “full-time employee” is employed an average of at least 30 hours per week. Proposed IRS regulations define optional look-back measurement periods for ongoing employees, new variable hour employees and seasonal employees, as well as re-hired employees and those whose employment status changes during the initial measurement period.

The look-back measurement methods use a standard measurement period (a defined time period of not less than three but not more than 12 consecutive calendar months, as chosen by the employer) for ongoing employees and an initial measurement period of between 3 and 12 months (as selected by the employer) for new variable-hour employees.

37 Reduced by 30 employees. Section 4980H(c)(2)(D)(i).
38 Accordingly, the proposed regulations provide that an applicable large employer member will be treated as offering coverage to its full-time employees (and their dependents) for a calendar month if, for that month, it offers coverage to all but five percent or, if greater, five of its full-time employees (provided that an employee is treated as having been offered coverage only if the employer also offered coverage to that employee’s dependents). Proposed Reg. (12/28/12) REG-138006-12; RIN 1545-BL33.
39 The employer has the flexibility to determine the months in which the standard measurement period starts and ends, provided that the determination is made on a uniform and consistent basis for all employees in the same category.
A stability period, the period of time in which a full-time employee must be offered health care, must be the greater of six months or the length of the standard measurement period. There can also be an administrative period between the end of the standard measurement period and the stability period for employers to determine which ongoing employees are eligible for coverage and to notify and enroll employees.

As a large employer, you will be able to use the optional look-back measurement method to determine which employees are required to be offered health care by you as the employer. As discussed above, the optional look-back for new or ongoing employees involves several measurements of time and attendance. You will need to document and retain the information used for these measurement periods for each employee so as to be prepared to provide the information in the event that the IRS audits you and raises this as an issue.

Scenario with a new employee

You hire new Employee A with a start date of 10 May 2016. You do not offer health insurance to part-time employees. It cannot be determined whether new Employee A is reasonably expected to be employed on average at least 30 hours per week. Your initial measurement period is 12 months and begins on the employee's start date; your administrative period is less than one month.

You measure the hours worked by Employee A during the 12-month period beginning 10 May 2016, and determine that new Employee A has an average of 28 hours of service per week during the 12-month initial measurement period. You do not offer Employee A health coverage. Employee A purchases health insurance at the state exchange and receives a premium tax credit.

The IRS has asked you to prove that Employee A worked an average of 28 hours per week during your initial measurement period (the 12-month period beginning 10 May 2016) and is therefore not a full-time employee. If the IRS determines that Employee A worked more than an average of 30 hours per week, she could be determined by the IRS to be a full-time employee. As a full-time employee, Employee A was entitled to your offer of health care to her and her dependents. Your failure to do so could make you potentially liable for the Section 4980H(a) penalty of $2000 times the total number of your full-time employees if you are not eligible for the 95% safe harbor.

To respond to the IRS, you will need to produce the following types of documents and information, at a minimum:

- The time and attendance records used to determine whether or not the employee worked on average 30 hours per week during the initial measurement period
- Documentation of the employer’s chosen initial measurement period, standard measurement period, stability period and administrative period (if any)
- Documents establishing your measurement criteria and proof that you applied the measurement criteria uniformly to the facts of Employee A’s time and attendance
- Documents and information establishing Employee A’s start date
- Documents and information establishing any break in service
- Any information given to Employee A as a new employee, including information regarding the employer’s health care plan
- Any information given to Employee A to submit to the Exchange, e.g., appendix A of the Exchange Application package

As a large employer, you will be able to use the optional look-back measurement method to determine which employees are required to be offered health care by you as the employer. As discussed above, the optional look-back for new or ongoing employees involves several measurements of time and attendance. You will need to document and retain the information used for these measurement periods for each employee so as to be prepared to provide the information in the event that the IRS audits you and raises this as an issue.

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Ernst & Young LLP adds new controversy talent

Alice Harbutte rejoinse EY to focus on partnership tax controversy and TEFRA

Alice Harbutte has returned to EY following a year of service as a tax law specialist in the transfer pricing practice of the IRS Large Business and International (LB&I) Division. Back at EY, she has assumed a leading role in expanding our capabilities to meet our clients’ growing needs for technical and procedural assistance related to the Tax Equity and Fiscal Responsibility Act (TEFRA).

Alice brings more than 25 years combined experience with the IRS and EY. Having spent 15 years as an attorney in the Office of Chief Counsel of the IRS, as the National Field Industry Specialization Counsel for TEFRA partnership issues, Alice will serve as EY’s primary national resource in the area of TEFRA partnership procedural rules. With the IRS enforcement focus on flow-through compliance and its objective to expand the audit coverage of partnership entities, Alice’s experience and competence is invaluable.
Tax Controversy and Risk Management Services: Ernst & Young LLP team leadership


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