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# **33<sup>rd</sup> Annual Managing Tax Audits and Appeals Seminar**

**September 12-13, 2019**



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## **Audits Part One: Selection to Resolution**

David Blair  
Carina Federico

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## Before an Audit Begins

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### Self-evaluation during return preparation

- Identify risk areas
- If significant risk areas are identified, collect and/or create documents to support those positions
- Retain relevant transactional documents and research

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## Notification of Selection for Audit

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### Recommended First Steps for Taxpayers

- After receiving first communication from IRS by mail, determine who at the company will be on exam support team
  - Identify a single point of contact (POC) to handle all communications and documents between the IRS and the company
  - Can be a company employee or outside representative
- Alert other individuals in the company that an audit is being conducted
  - Notify employees that they may need to provide information to POC
  - No conversations or meetings without approval of, and attendance by, POC
- Determine documents in taxpayer's possession that may be relevant to examination
- Hypothesize potential IRS questions and company's answers

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## LB&I Campaigns

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- LB&I moving towards issue-based examinations and compliance campaign process
- Identified through data analysis, suggestions from IRS employees, and feedback from tax community
- Goal is to improve return selection, identify issues representing a risk of non-compliance, and make the greatest use of limited resources
- Currently, there are 52 active campaigns; six campaigns have been retired
- Campaigns include issues such as micro-captive insurance, sale of partnership interest, and virtual currency, and includes a number of international issues, such as repatriation
- Campaigns are assigned a practice area and lead contact person at the IRS
- Information about each campaign is available on the IRS's website

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## Large Corporate Compliance Program

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- Use of data analytics to determine which large and complex corporate taxpayers to audit
- Use of pointing criteria factors to determine whether a case belongs in the LCC program:
  - Gross assets
  - Gross receipts
  - Operating entities
  - Multiple industry status
  - Total foreign assets
  - Total related transactions
  - Foreign tax
- If total point criteria for each factor is 15 or more points, case will qualify as LCC case

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## Overview of the LB&I Examination Process

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### LB&I Examination Process

- Planning Phase
- Execution Phase
- Resolution Phase

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## Planning Phase

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### Determine the Audit's Scope

- After return is selected for audit, LB&I:
  - Conducts preliminary risk analysis
  - Determines issues for examination
- Opening Conference
  - Taxpayers provided with copy of agenda and preliminary risk analysis prior to meeting
  - Taxpayers may add additional items to agenda
  - Share input on issues
  - Establish communication strategy
  - Identify key members of IRS audit team
- Develop examination plan
  - Issues identified
  - Audit steps
  - Timeline(s)
  - Communication agreements
  - Initial IDRs- Taxpayers should work to shape IDR requests

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## Planning Phase

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### Sample Agenda Items for Opening Conference

- LB&I Examination Team and Responsibilities
- Taxpayer or Their Representatives Roles and Responsibilities
- Expectations with Respect to Claims
- Communication
- Issue Team Approach
- Examination Plan
- Issue Development Process
- Written Acknowledgment of the Facts for Unagreed Issues
- Information Document Request (IDR) Process
- Issue Resolution
- Exit Strategy

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## Planning Phase

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### Potential Areas of Inquiry to Determine Scope of Audit

- Internal controls of company
- Taxpayer's financial and accounting policies
- Business activities and structure of operations
- How books and records are maintained
- Any foreign activities of taxpayer
- Review of certified and audited financial statements and other regulatory reviews
- Explanation of potential tax issues identified for examination including large, unusual or questionable items on the tax return
- Review of significant transactions

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## Planning Phase

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### Roles and Responsibilities

- Case Manager
  - Responsible for overall management of the case
  - Collaborates with issue managers
  - May serve as issue manager for some or all issues
- Issue Manager
  - Responsible for planning, executing, and resolving assigned issues
  - Coordinates formation of issue team
  - Coordinates with Division Counsel, subject matter experts, Competent Authority, and/or Appeals when appropriate

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## Planning Phase

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### Roles and Responsibilities (continued)

- Subject Matter Experts (SMEs)
  - Diverse team of agents, specialist, and counsel
  - Assist revenue agents and other personnel by providing relevant law and application of the law to the facts
  - Collaborate on responses to case specific technical questions submitted from the field
  - Provide technical assistance to industry and headquarters functions
  - Develop training, technical guidance, and audit tools
  - Assist in decision making and issue elevation
  - Examples include engineers, computer audit specialists, financial products specialists, economists, international specialists, foreign payments practice specialists, or employment tax specialists
- Practice Network
  - Team of technical specialists and subject matter experts in one or more issue areas
  - Provides assistance to agents

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## Execution Phase

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### Developing the Issues

- Discussions with the IRS
- IRS issue team may consult Counsel or subject matter experts
- Attempt to resolve factual differences

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## Execution Phase

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### Use of Information Document Request (IDR) process to develop facts

- IRS and Taxpayer will establish timeframes for responses
- Incomplete or late responses will result in initiation of standard enforcement procedures:
  - Delinquency Notice
  - Pre-Summons Letter
  - Summons
- Initial Transfer Pricing Documentation IDR

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## Execution Phase

### Tips for responding to IDRs

- Always ask for IDRs in draft form, review and provide feedback to Agent
- Limit response to questions posed in the IDR
- Be strategic about producing additional facts or documents; do not produce non-responsive documents on an ad hoc basis
- Produce copies instead of originals
- Responses should be consistent throughout audit, Appeals, and litigation
- When to push back on requests
  - Overly broad “any and all” document requests
  - Can request separate, issue specific IDRs

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## Execution Phase

### Tips for responding to IDRs (continued)

- Confirm that the audit team shares your interpretation of request, including resolving any ambiguities in terms
- Establish reasonable due dates
  - Consider year-end closing periods, availability of key personnel, and time required to locate and review voluminous records
- Keep organized records of communications with audit team
- Other Considerations
  - Privilege issues
  - Work Product Doctrine
  - Duty to Prevent Spoliation

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## Execution Phase

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### Third-Party Contacts

- Stricter Procedural Requirements under the Taxpayer First Act
- Auditor can no longer send a generic notice at the beginning of the audit
- The auditor must:
  - Notify taxpayer of intent to contact third parties
  - Actually intend to contact the third parties
  - Notify taxpayer at least 45 day before contact
  - Tell taxpayer the time period in which he or she intends to make the contact
- IRS keeps a record of persons contacted and will provide the taxpayer with list upon request

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## Execution Phase

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### Tips for Witness Interviews

- Prepare for testimony through mock examination
- If question is unclear, ask for IRS to rephrase question
- Give direct answers to questions asked
- Directly address bad facts
- Control the pace—take a pause before answering
- Don't guess, interrupt, or volunteer information

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## Execution Phase

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### Facility Tours

- IRS may visit taxpayer's place of business to establish facts that can only be established by a direct visit
- Visit generally will take place during normal IRS hours
- Should not disrupt business operations
- Tips for the taxpayer:
  - Seek Agent's agreement on timing, topics and sites to cover, questions that will be asked, and who from company will answer
  - Consider preparing a briefing for Agent prior to tour
  - Representative should accompany the Agent; discuss whether someone from the company should also be present
  - No one on tour should volunteer unsolicited information
  - Do a dry run first

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## Execution Phase

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### Written Acknowledgment of the Facts for Unagreed Issues

- Also known as AOF IDR
- Replaces long-standing existing process where LB&I agents would draft a Notice of Proposed Adjustment when adjustment was being considered
- For potentially unagreed issues, issue team managers are supposed to:
  - Seek taxpayer's acknowledgment on the facts
  - Resolve factual differences
  - Document factual disputes
- If case is closed to Appeals, and taxpayer then provides new information that requires investigation or additional analysis, Appeals will return to Exam for consideration

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## Execution Phase

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### Strategies for responding to Written Acknowledgment of the Facts (AOF) IDR

- Approach may depend of case strategy and tactics
  - Treat it like a request for admission?
  - Provide additional facts?
  - Agree with IRS's facts or write your own?
  - Decline to respond

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## Execution Phase

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### Notices of Proposed Adjustment

- May be provided throughout the execution phase
- Notice is prepared on, and is sometimes referred to as, a Form 5701
- Serves as building block for revenue agent's report (RAR)
- Can be used as a draft for discussion purposes to improve communication between agent and taxpayer

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## Execution Phase

### Continuous Risk Analysis

- IRS will determine which issues will continue to be examined or modified in scope
- New issues may be added to examination plan
- Timeline may be modified when appropriate
- Counsel and other technical experts should be consulted throughout
- IRS will risk-assess each issue on a continuous basis as new information is received (i.e. through responses to IDRs)
- Issue team will timely inform taxpayer when an issue is added, continued, expanded, narrowed, or dropped
- Mid-Cycle risk analysis provides opportunity for discussion with Exam about direction of audit

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## Resolution Phase

### Goal is to reach agreement on tax treatment of each issue

- Revenue agents do not have authority to settle legal issues based on a hazards of litigation assessment
- Revenue agents can raise or not raise issues depending on legal and factual interpretations, which in practice allows some room to “settle” issues
- Tools for issue resolution:
  - Technical Advice Memorandums (TAM)
  - Delegation Orders
  - Accelerated Issue Resolution (AIR)
  - Early Referral to Appeals
  - Fast Track Settlement (FTS)
  - Rapid Appeals Process
  - Industry Issue Resolution
  - Closing Agreements
- See I.R.M. 4.46.5

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## Resolution Phase

### Issuance of 30-Day Letter and Revenue Agent's Report (RAR)

- Agents will issue a 30-day letter, which transmits a Revenue Agent's Report (RAR) containing their proposed adjustments
- RAR contains:
  - All proposed adjustments (usually including Notices of Proposed Adjustments (NOPAs))
  - Recomputation of tax liability showing a proposed deficiency or overassessment
- Letter transmitting RAR called a 30-day letter because the taxpayer has 30 days to submit a protest
- Issuance of 30-day letter triggers (or notice of deficiency) triggers the running of "hot interest" on large corporate underpayments

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## Resolution Phase

### Issuance of Statutory Notice of Deficiency

- If IRS determines there is deficiency in tax, IRS is authorized to issue a statutory notice of deficiency
- This is also known as a statutory notice, stat notice, or 90-day letter
- IRS generally is prevented from making an assessment until after it has issued a statutory notice
- Not typically the end of examination process, but Exam may end exam by issuing a statutory notice if the taxpayer refuses to extend the statute of limitations on assessment

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## Compliance Assurance Process (CAP)

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- IRS agrees to examine taxpayer's transactions and material items prior to the filing of the tax return
- Material items can be resolved before return is filed
- If issues are agreed, memorialized in closing/issue resolution agreement
- Fast track settlement is available to resolve issues
- Three phases:
  - Pre-CAP audit of filed tax returns
  - CAP audit prior to filing the current return
  - Compliance and maintenance in accordance with a CAP Memorandum of Understanding (MOU)

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## Resources

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### Taxpayers should consult IRS guidance and other resources

- Relevant Revenue Rulings and Procedures
- Publication 5125 - Examination Process
- Audit Technique Guides
- LB&I Directives
- LB&I Issue Campaigns
- Internal Revenue Manual

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## **Audits Part Two: Recent Developments in LB&I**

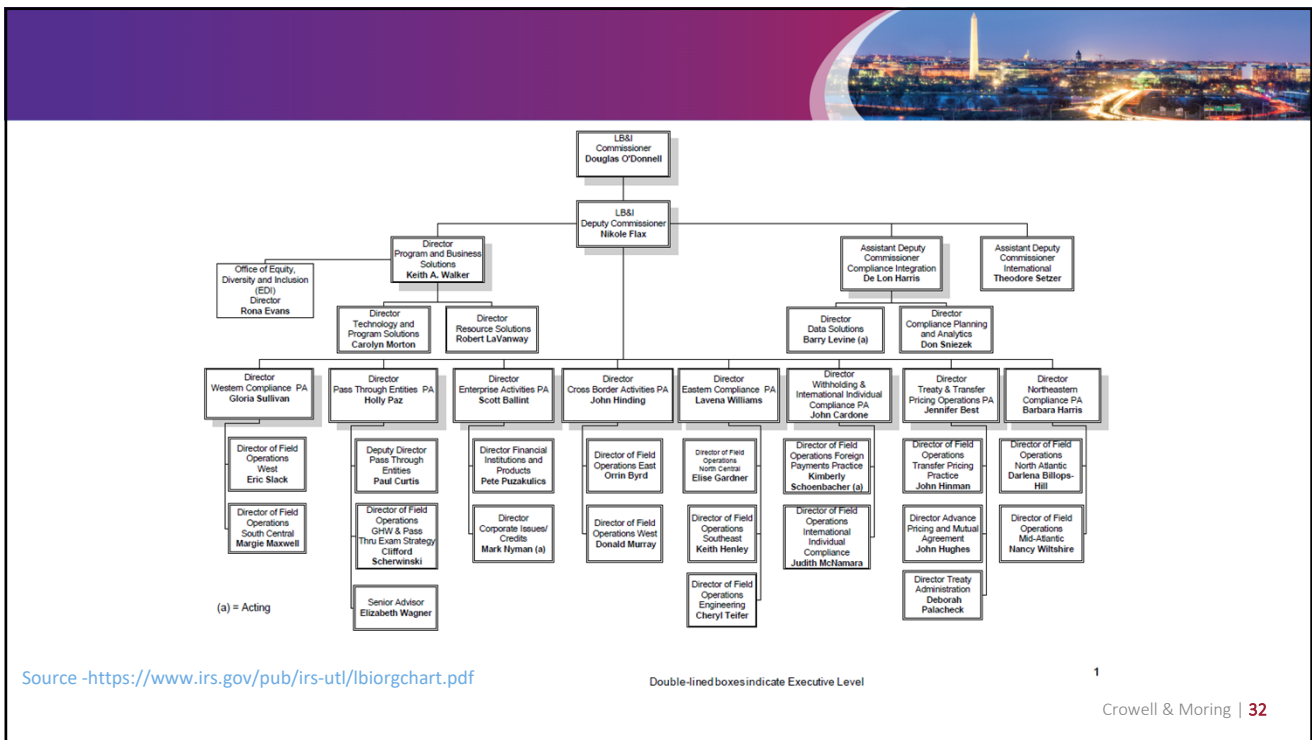
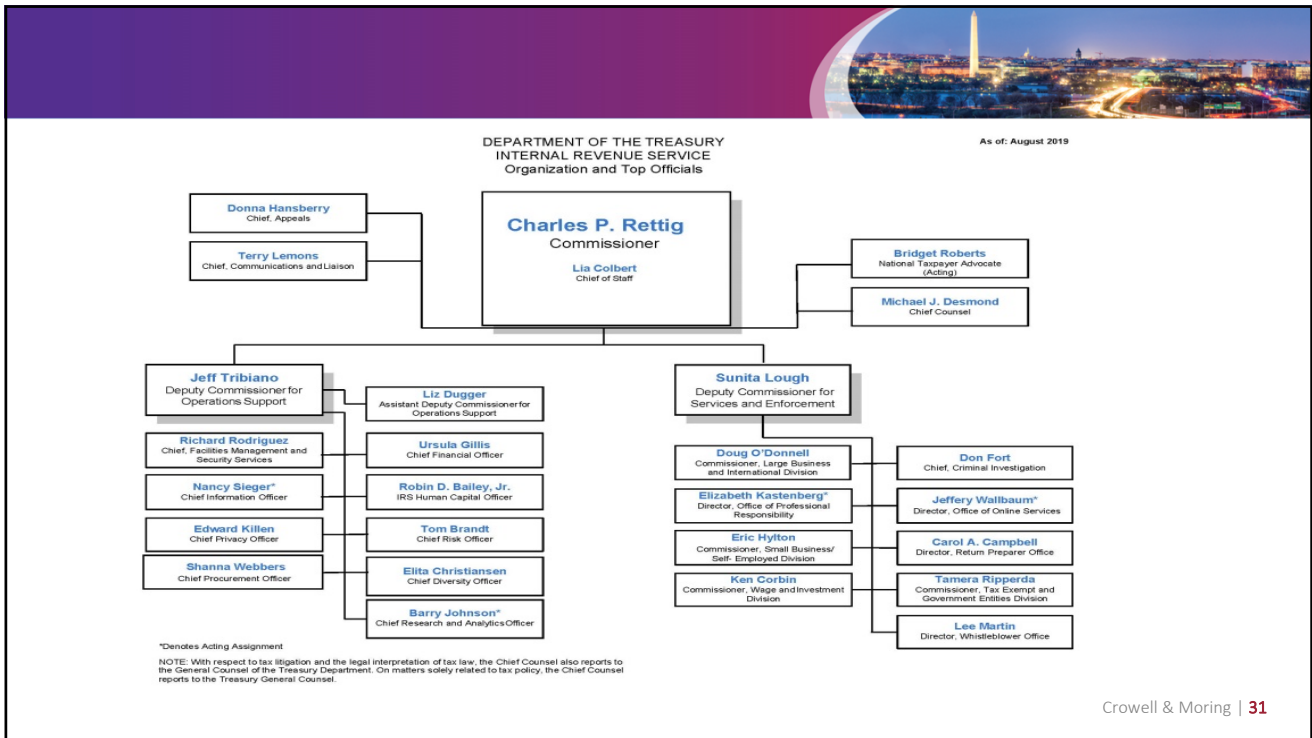
**Nikole Flax, Deputy Commissioner, LB&I  
Elizabeth Askey, Deputy Division Counsel  
(International), LB&I**



## **Agenda**

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- Current Workforce – staffing and hiring
- Compliance Programs – overall portfolio
- Implementation of Major Priorities
- Key Compliance Issues
- Tax Certainty and Risk Assessment
- Focus for FY 2020
- Role of LB&I Counsel

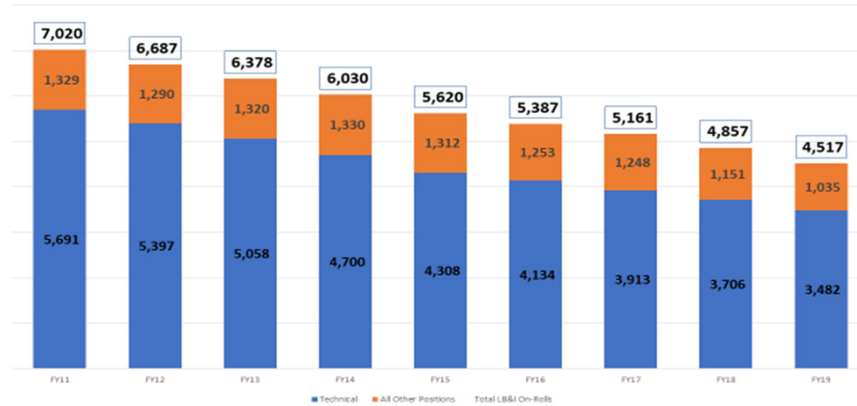




## Current Workforce - Staffing and Hiring

LB&I STAFFING YEAR-OVER-YEAR

BEGINNING OF YEAR ON-ROLLS



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## Practice Areas and Knowledge Management

- Practice Network structure
- Knowledge management network is designed to provide exam teams with technical resources needed to manage their cases efficiently, consistently, and with a high degree of technical proficiency.

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## Compliance Programs – Overall Portfolio

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- Practice Areas and Knowledge Management
- Large Corporate Compliance Program (LCC)
- LB&I Campaigns
- Compliance Assurance Process (CAP)
- Global High Wealth and Flow-Throughs
- Other Workstreams

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## Large Corporate Compliance Program

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- Use of data analytics in audit decisions
  - Factors used to determine whether a return is selected for audit
  - Consideration not just of dollar amounts reported on return, but also surrounding context
- More efficient use of resources

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## Transition to Issue Focused Campaigns

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- Slowly transitioning to issue focused campaigns
- Percentage of audits based on campaign issues will continue to increase
- Will not completely replace “traditional audits”

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## Compliance Assurance Process (CAP)

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- CAP Recalibration Memo
  - Expected to accept new applications for 2020 CAP year
  - New applicants must be publicly held C-corps.
- CAP Frequently Asked Questions
- Tools used by the IRS
- Role of Industry Issue Resolution Program process (i.e., Research Credits)
- Deselection on certain issues
- Current limitations with the CAP program
- Additional information, guidance coming before next application period

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## Global High Wealth and Flow-through Work

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- The Global High-Wealth group was organized in 2009 to examine high net worth individuals
- Audits extend beyond the individual income tax return to include examining the entities that these taxpayers control
- LB&I aims to increase its presence in this area

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## Implementation Priorities for LB&I

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- Bipartisan Budget Act (2015, effective 2018)
  - Procedural guidance in place
  - Plans to increase audit coverage for large partnerships
- Tax Cuts and Jobs Act (2017)
  - Technical guidance continues
  - Identifying areas of potential non-compliance

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## Key Compliance Issues

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- Syndicated conservation easements
- Microcaptive insurance
- Virtual currency
- Fraud referrals

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## Tax certainty and risk assessment

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- ICAP
- Research Credit
- Transfer Pricing
- Other opportunities

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## Role of LB&I Division Counsel

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- Support of LB&I programs
- Field Advice
- Litigation
- Coordination with Associate Chief Counsel Offices

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## Role of Practice Networks

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- Obtain Feedback from Field on Campaigns, enforcement priorities
- Role of subject matter experts in Exam
- Subject matter Practice Networks
- Practice Network calls
- Role of Chief Counsel attorneys in Practice Networks

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## Options for Resolution of Issues at Exam

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- Exam does not have settlement authority
- Resolutions are often different depending upon the issue
- When to get Counsel involved
- Counsel's role in resolving issues
- Elevating issues within LB&I and Counsel

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## Focus for FY 2020

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- TCJA compliance
- Use data analytics and other tools to improve case selection
- Training
- Communication/Engagement
- Improved internal operations

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### Advance Pricing Agreements (APAs) and Mutual Agreement Procedure (MAP) cases

#### Panel Members

John C. C. Hughes, Director, Advance Pricing and Mutual Agreement Program, IRS

Brad Anwyll, Senior Counsel, Crowell & Moring LLP, Washington, DC

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## Agenda

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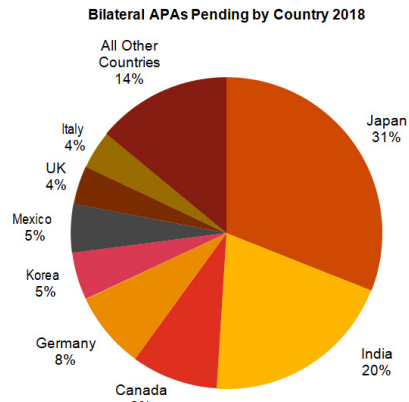
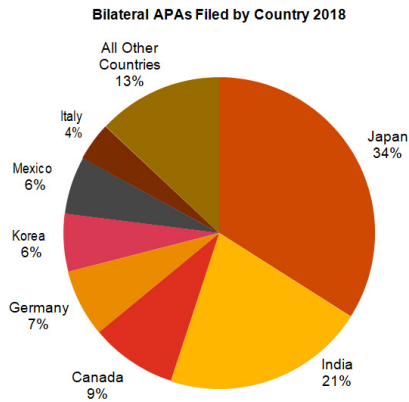
1. Recently published APMA statistics for APAs and MAP cases
2. Best practices for APAs and MAP cases
3. How APMA develops and resolves APAs and MAP cases
4. APMA's Interaction with Exam
5. Recent Developments at APMA: Functional Cost Diagnostic Model, Internal Reorganization, Increased APA Fees, Reference Sets
6. External Influencers on APMA: BEPS, BEAT, Tariffs, Arbitration

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## Recently published APMA statistics for APAs and MAP cases

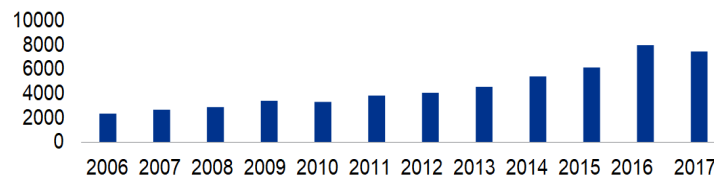
### IRS APA Annual Report for 2018



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## Recently published APMA statistics for APAs and MAP cases

### Global Inventories of MAP Cases



- MAP inventory has increased from 2,352 in 2006 to 7,500 in 2017 (The inventory was 8,002 cases reported for 2016. This decrease in the overall number of cases in MAP inventory is reportedly due to a different counting methodology used for cases received since 2016.)
- In 2017, Germany (1,241), the United States (983), France (882) and India (763) had the largest ending inventories of MAP cases.

Source: OECD Website, Dispute resolution, <http://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm>

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## Best Practices for APAs and MAP Cases

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- Know the Treaty Provisions
  - Filing requirements
  - Protective claims
- Be Prepared
  - Own the facts
  - Know the endgame
  - Respond to requests quickly and completely
- Rethink the presentation – not a documentation report
- Effective structuring of team
  - Connected advisors
  - Taxpayer's participation
- Contact with tax authorities – early and often
- Patience and perseverance are key
- Attitude adjustment
  - Common goal, not an audit
  - Be neutral
  - Be helpful
  - Be a good listener

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## How APMA Resolves Bilateral APAs and MAP Cases

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- APMA will prepare a memorandum supporting its negotiating position
- APMA and the treaty country often will exchange position papers
- APMA and the treaty country will schedule the case for negotiations
- Negotiation discussions can be face-to-face, over the phone, or by email
- Once a case is agreed, the countries exchange letters confirming their agreement
- APMA has different working relationships with different countries: logistics, the way business is conducted, etc.
- OECD – MAP Forum

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## APMA's Interaction with Exam

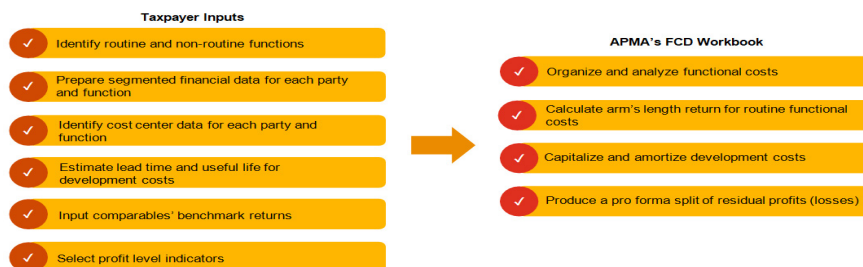
- On February 19, 2019, LB&I issued a memorandum requiring issue teams to consult with APMA on transfer pricing transactions that may generate adjustments for which a taxpayer may request competent authority assistance
  - Consultation must occur early in issue development so that risks may be properly assessed/further consultation may occur as needed as case development progresses
  - Will provide perspective on the history APMA may have with the type of case being pursued (and whether, in some similar situations, an adjustment has been withdrawn, in whole or in part, before or after negotiations have begun)
  - APMA also gives feedback on the country relationship, the types of arguments the other country is likely to make, and the types of data that are likely to be persuasive
  - Issue teams are ultimately responsible for the selection and development of all examination issues and an appropriate degree of independence is maintained from the competent authority process

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## Recent Developments at APMA

### Functional Cost Diagnostic Workbook

- In February 2019, APMA announced that it had developed a functional cost diagnostic (FCD) model
- The model is an Excel spreadsheet structured as a residual profit-split method analysis with empty cells for taxpayer costs. The model requires that taxpayers distinguish between routine costs and non-routine costs that could entitle a party to a share of residual profit



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## Recent Developments at APMA

### Functional Cost Diagnostic Workbook

- Purpose is to ensure that the U.S. is not going to be “pinched or squeezed” within a larger system given the various flows of intercompany pricing coming into the U.S.
- APMA may require taxpayers to complete the FCD workbook in certain cases, in which two or more controlled taxpayers may make material, non-benchmarkable contributions to their intercompany arrangement
- APMA is discussing the model and its intended use with U.S. treaty partners and is working on an updated version that may be released later this year
- Asking taxpayers to complete the model does not imply that APMA believes the profit-split method is the best method, but it does indicate that it has not been rejected
- APMA will use the FCD workbook only in especially complex cases
- The IRS may use the FCD model outside of APMA

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## Recent Developments at APMA

### Internal Reorganization

- In September 2018, APMA underwent a restructuring with the goal of improving the way it analyzes and develops its cases, as well as how it negotiates and resolves disputes (e.g., facilitating similar decisions in similar situations)
- Features of the reorganization:
  - The merging of economists and non-economists into the same groups. Economists were previously lumped together in separate groups from the non-economists. APMA believes this integration will foster collaboration among APMA team members and optimize economist involvement in case analysis, development, and negotiation
  - The creation of three groups, each led by an assistant director and each assigned cases for specific countries
  - Each group is then divided into two teams, each led by a team manager. The assistant director and the team managers of the group decide how to allocate the economists between the two teams

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## Recent Developments at APMA

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### Increased APA Fees

- Before July 1, 2018, the filing fee for a new APA was \$60,000. Between July 1 – December 31, 2018, it was \$86,760. Beginning January 1, 2019, the filing fee is now \$113,500
- The number of APA applications more than doubled in 2018 to 203 from 101 in 2017
- Did increase in filing fee cause this surge? Other potential factors: tax reform, audit activities in other countries, uncertainty in the international environment
- How many APA applications are expected for 2019?

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## Recent Developments at APMA

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### Reference Sets

- Reference sets are intended to be used as a starting point in certain types of common benchmarking cases, derived using very standard search and selection criteria, largely quantitatively based and with minimal qualitative/subjective filtering
- These reference sets are then modified, as needed, based on economically significant features specific to the tested party
- Reference sets are a tool designed to achieve efficiency and some degree of predictability in a given benchmarking case
- How and when does APMA use reference sets?

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## External Influencers on APMA: BEPS, BEAT, Tariffs, Arbitration

### BEPS

- OECD's BEPS initiatives, changes in regulatory requirements, and increased transparency lead to greater use of profit splits
- OECD's Consultation Document "Addressing The Tax Challenges of the Digitalization of the Economy" includes "user participation" and "marketing intangibles" proposals that prescribe profit split methods
- How do these initiatives/proposals intersect with APMA's FCD model?
- OECD Initiatives/Proposals v. OECD Guidelines

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## External Influencers on APMA: BEPS, BEAT, Tariffs, Arbitration

### BEAT

- The BEAT hits a company with a 10% tax when 3% of more of the company's deductible payments are considered base-erosion payments. The BEAT is designed to stop U.S. multinationals from moving profits offshore
- The BEAT could capture certain intercompany transactions for which companies are seeking APAs
- Will APMA address questions about the BEAT? What have taxpayers already requested?
- Companies should bring to APMA's attention any questions they have about intercompany transactions included in APA applications that might be captured by the BEAT – APMA will then coordinate with other parts of the IRS to address any concerns and give the companies confidence on their questions

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## External Influencers on APMA: BEPS, BEAT, Tariffs, Arbitration

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### U.S. Tariffs

- Tariffs will result in additional revenue to the U.S. government
- Tax authorities in other countries might object to reduced tax revenues caused by the U.S. tariffs
- U.S. might have similar objections with respect to retaliatory tariffs
- Effect of tariffs may be subject to discussions in MAP negotiations or bilateral APA discussions
- What is APMA's position/thinking on tariffs in general?
- Will new tariffs trigger a violation of the critical assumption language used in APAs?

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## External Influencers on APMA: BEPS, BEAT, Tariffs, Arbitration

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### Arbitration

- Certain U.S. income tax treaties, including recent treaties, provide for mandatory binding arbitration to resolve eligible cases in which the competent authorities have undergone but are unable to reach a complete agreement
- How many arbitration cases have there been to date?
- What is the purpose of the arbitration provisions?
- Is that purpose being achieved?
- Taxpayer interaction with APMA Team about arbitration

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## **Uber Me Where! Employee or Independent Contractor?**

- **Federal and State Tax Implications**
- **Different Strokes for Different Folks**

David McFarlane

Samuel Krause

Special Guest Appearance by Glenn Grant

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## **Employee or Independent Contractor?**

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Whether or not a worker is an employee or independent contractor affects employer's tax, employee benefit and employment law obligations. Misclassifying workers as independent contractors can create significant exposure under state and federal tax and other laws.

We will cover:

- How to determine whether worker is an employee or independent contractor for tax withholding purposes
- Consequences of misclassification
- What to do upon determining that they have misclassified employees.

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## Classification Tests

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- Common Law Test
- IRS Test
- “20-Factor” Test
- Other Relevant Factors
- State Tests
- Employment Related Tests

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## 1. Common Law Test – “Right to Control”

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Generally an **employer-employee relationship** exists when the person for whom services are performed has the **right to control and direct the individual** who performs the services as to the 1) result to be accomplished, and 2) “means and methods” by which that result is accomplished.

In general, if an individual is subject to control or direction of another merely as to the result to be accomplished and not as to the “means and methods” for accomplishing the result, that person is an **independent contractor**.

Treas. Reg. §§ 31.3121(d)-1(c)(2).

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## 2. IRS Test

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- Recent IRS guidance creates a test using three categories of factors that evidence degree of control and independence:
  - Behavioral: Does the business control or have the right to control what the worker does and how the worker does his or her job?
  - Financial: Are the business aspects of the worker's job controlled by the payer? (e.g., how worker is paid, whether expenses reimbursed, who provides tools/supplies, etc.)
  - Type of Relationship: Are there written contracts or employee benefits (e.g., 401(k), healthcare, vacation pay, etc.)? Will relationship continue and is the work a key aspect of the business?

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## 3. The “20-Factor” Test

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Prior to current guidance, the IRS used the 20-factor test, established in Revenue Ruling 87-41. The 20-factor test is still a predominant method for determining a worker's status.

(Grab a ~~coffee~~ glass of wine, this could take a while....)

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## The “20-Factor” Test (Cont.)

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1. Level of Instructions
2. Mandatory training
3. Integration into business operations
4. Services rendered personally (or right to assign)
5. Hiring, supervising, and paying assistants
6. Continuing relationship
7. Flexibility of schedule

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## The “20-Factor” Test (Cont.)

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8. Full time required
9. Work on employer’s premises
10. Order or sequence of services
11. Oral or written report required
12. Method of Payment (hour, week, month)
13. Payment of business and/or traveling expenses
14. Furnishing tools and materials

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## The “20-Factor” Test (Cont.)

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15. Investment in Facilities
16. Realization of profit or loss
17. Working for more than one business at a time
18. Making services available to the general public
19. Company’s right to discharge at will
20. Individual’s right to terminate at will

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## 4. Other Relevant Factors

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The courts and the IRS have identified other relevant factors that do not clearly fall under the factors listed above. These include:

- Parties’ intent to create an employer-employee relationship and indicators of intent
- Whether the worker is required to comply with certain policies and procedures
- Special considerations for professionals (*Law Office of Gerard C. Vince LLC v. Board of Review, Department of Labor et al.*, case number A-5441-17T2, Superior Court of New Jersey, Appellate Division, September 3, 2019)

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## 5. State Tests

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- Majority of states reference the federal test or common law test for determining whether workers are employees or independent contractors for state tax purposes.
- Other states do not explicitly reference the federal tests but outline a similar test.
- Only a few states have substantially different tests, such as Ohio and Oregon.

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## 6. Employment-Related IC Tests

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Courts and state agencies tend to apply one of the following four independent contractor tests in the employment setting:

- The “Right to Control” Test
- The “Economic Realities” Test
- The “Hybrid” Test
- The ABC Test

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## The ABC Test

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- The ABC Test starts with a presumption that the worker is an employee!
- To establish independent contractor status, an employer must prove:
  - (A) The employee is free from control or direction over the performance of the work; and
  - (B) The work performed is outside the usual course of the employer's business; and
  - (C) The worker is customarily engaged in an independent trade, occupation, profession, or business.
- Each of the factors must be established; it is not a balancing test like the others.
- The ABC Test has now been adopted for wage and hour purposes in a handful of states.

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## Misclassification & What to Do

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- Risk Upon Misclassification
- Section 530 Safe Harbor
- IRS Voluntary Classification Settlement Program (VCSP)

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## Risk Upon Misclassification

### TAX/FINES

- Federal/state fines - up to 100% of employment tax due
- Federal/state income tax
- Withholdings – medicare, social security, unemployment & workers compensation
- IRS audits

### ERISA/WAGE & HOUR/OTHER

- Employee benefits – health insurance, paid leave, 401(k) (retirement plan may cover independent contractors), etc.
- Expense reimbursement
- Wage & hour claims – minimum wage, unpaid overtime, wage statement violations
- DOL audits
- Unemployment and workers compensation insurance

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## Section 530 Safe Harbor

- If a company mistakenly treated certain employees as independent contractors, relief from federal employment taxes may be available under s. 530 of the Revenue Act of 1978. Following criteria must be met:
- Taxpayer did not treat worker (or any other individual in substantially similar position) as an employee for any period.
- Taxpayer filed all federal tax returns for worker consistent with treating him/her as an independent contractor.
- Taxpayer had reasonable basis for treating worker as an independent contractor. This can be shown by reliance on:
  - Judicial precedent or published rulings
  - Past IRS audit of taxpayer
  - Long-standing industry practice of significant segment of industry in which worker was engaged
  - Contemporaneous reliance on prospective professional advice

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## Voluntary Classification Settlement Program

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Employers can also seek partial relief through the Voluntary Classification Settlement Program (VCSP). A taxpayer participating in the VCSP prospectively treats the workers as employees for future tax periods in exchange for paying 10% of employment tax liability that would have been due on compensation paid to the workers for most recent tax year. Employer is not liable for any interest or penalties on the amount and cannot be subject to an IRS employment tax audit with respect to the worker classification for prior years.

To qualify, an employer must:

1. Have been consistently treating workers as independent contractors,
2. Filed all required Forms 1099 over past three years, and
3. Not be under an IRS employment tax audit or any DOL/state audit concerning worker classification.

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## CONCLUSION

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### Best Practices

- Undertake review using appropriate test to determine if employee or independent contractor
- Review independent contractor agreements
- Avoid having independent contractors do exact same work as employees
- Require staffing agencies to provide proof of benefits/insurance
- Have independent contractors sign release stating that they are not entitled to employee benefits
- Avoid handing out job description, SPD, employee handbook etc.

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Labor & Employment  
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# WASHINGTON OUTLOOK

Rick Grafmeyer  
Capitol Tax Partners©

## 2019 Legislative Outlook

### Unfinished Business

- Extenders
  - 26 items expired end of 2017'
  - Others expire at the end of 2018 and 2019 -- itemized medical deductions and black lung trust fund (2018); suspended ACA taxes reinstated (2019)
- Tax administration reforms
- Retirement Enhancement and Savings Act
- Technical corrections & other fixes to TCJA
  - Chairman Neal wants to hold hearings first
- Multiemployer pension plan relief
- Disaster relief
- Trump tax returns

### Other Possibilities

- Infrastructure
- EITC and middle income rate cuts



## Significant Calendar Events

- Final Treasury regulations – need to be issued by mid-June 2019 to be fully retroactive to enactment date of TCJA
- Govt. funding bills and Defense Auth. expire Sept. 30 / Overall spending caps – Agreed to / Reset for Oct. 1
- ACA taxes – reinstated Dec. 31, 2019
  - Medical device tax and the health insurance tax
  - The medical device tax and the health insurance tax repeal have bipartisan support
  - Cost is about \$20B per year to continue moratorium, potential PAYGO issue
- Black lung excise taxes on coal expired Dec. 31, 2018 (last renewed 10 years ago)
  - Trust fund already over \$4B in debt
- Treasury approves benefit cuts to multiemployer pension plan – summer or fall?

## Key technical and fixes to glitches to tax reform?

### **Technical fixes to errors in the 2017 tax law, including:**

- Increase in time for restaurants and retailers to write off renovations, other improvements
- Use of net operating loss carrybacks for certain corporations
- Inability of sexual harassment victims to deduct legal costs
- Taxation of parking benefits provided by tax exempt organizations (i.e., churches)
  - Why is it a big deal?
- Gold Star families benefits / lower income student room and board financial aid
- Countless other items – Democrats still examining....

## Regulatory Actions / Issues

- OMB review – is it slowing guidance or not?
  - Four to six weeks on average for reviews
- Effective dates – 7805(b)
  - (1) Retro only to period ending after Prop. Reg was been filed (BEAT)
  - (2) Retro if filed within 18 months of DOE (GILTI)
- March 5 Policy Statement limiting Notices and Temp. Regs
- Current regulation issues / Reg. plan

### Specific Audit Issue:

#### Income Tax Accounting

Dwight Mersereau

## Specific Audit Issue: Income Tax Accounting

### Agenda:

- What is “income tax accounting”?
- How are accounting methods adopted?
- What is a change in method of accounting?
- What authority does the IRS have to change a taxpayer’s accounting method?
  - What is Examination’s authority?
  - What is Appeals’ authority?
- What are some strategic considerations to resolve change in method issues?

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## Specific Audit Issue: Income Tax Accounting

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“The word ‘audit’ comes from ‘auditory’ which means ‘to hear bad news coming’.”

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## Specific Audit Issue: Income Tax Accounting

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### What is “income tax accounting”?

- Tax accounting rules determine when a taxpayer takes into account an item of income or deduction.
  - Overall cash or accrual method of accounting.
  - Special methods of accounting for specific items (e.g., advance payments).
- It is not “accounting for income taxes.”
- It is not “bookkeeping.”

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## Specific Audit Issue: Income Tax Accounting

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### How are accounting methods adopted?

- A taxpayer adopts a proper accounting method by using it on the first tax return that includes the method.
- A taxpayer adopts (or changes to) an improper accounting method by using it on two consecutive returns.

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## Specific Audit Issue: Income Tax Accounting

### What is a change in method of accounting?

- A change in method of accounting includes a change in the overall method of accounting or a change in treatment of a material item.
  - What is the item?
- The correction of an error is not a change in method of accounting, and does not require the consent of the Commissioner.
- A change in facts is not a change in method of accounting; the taxpayer simply applies the new facts to its existing method

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## Specific Audit Issue: Income Tax Accounting

### What authority does the IRS have to change a taxpayer's accounting method?

- The IRS can change a taxpayer's accounting method if, but only if, it does not clearly reflect income.
  - The IRS cannot change a taxpayer from one proper method to another proper method.
  - Is an accounting method improper simply because the taxpayer changed to it without consent?
- Once the IRS determines the taxpayer's accounting method does not clearly reflect income, the IRS can change a taxpayer to any accounting method that, in the IRS's opinion, does clearly reflect income.
  - Can the IRS can change the taxpayer to a method that the taxpayer could not have adopted?
  - What if the IRS changes the method for the year in which the taxpayer adopted the method?

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## Specific Audit Issue: Income Tax Accounting



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## Specific Audit Issue: Income Tax Accounting

### What is Examination's authority?

- If it determines a taxpayer's accounting method is improper, Examination:
  - Must change the taxpayer to a proper accounting method.
    - In the case of a prior improper change, change the taxpayer to its prior method.
  - Must change the taxpayer in the earliest year under examination (if possible).
  - Must impose a § 481(a) adjustment in the year of change (if possible).

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## Specific Audit Issue: Income Tax Accounting

### What is Appeal's authority?

- Appeals has much greater authority than Examination.
- Appeals may change the taxpayer's accounting method.
- Appeals may resolve the issue without changing the taxpayer's accounting method.
  - Alternative-Timing Resolution.
  - Time-Value-of-Money Resolution.
  - Any other appropriate resolution.

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## Specific Audit Issue: Income Tax Accounting

### What is Appeal's authority?

- If it changes the taxpayer's accounting method, Appeals:
  - Must change the taxpayer to a proper accounting method.
  - May defer the year of change.
    - Ordinarily not later than the most recent year under examination.
    - In no case, not later than the current taxable year.
  - May impose a § 481(a) adjustment or use a cut-off method.
    - May compromise the amount of the § 481(a) adjustment.
    - May spread the § 481(a) adjustment over any number of years.

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## Specific Audit Issue: Income Tax Accounting

### What is Appeal's authority?

- Alternative-Timing Resolution:
  - In lieu of changing taxpayer's accounting method.
  - Can apply to all of some of the items arising during, or prior to and during, the years before Appeals.
  - Does not affect any items not covered by the resolution.

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## Specific Audit Issue: Income Tax Accounting

### What is Appeal's authority?

- Time-Value-of-Money Resolution:
  - In lieu of changing taxpayer's accounting method.
  - Taxpayer pays amount that reflects the time-value-of-money benefit taxpayer received by using its method compared to method preferred by the IRS.
    - Amount can be reduced to reflect hazards of litigation.
    - Amount is not deductible, but the computation can be tax affected to approximate a deduction.
  - IRS provides a sample computation.

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## Specific Audit Issue: Income Tax Accounting

### What is Appeal's authority?

- If Appeals resolves the issue on a non-accounting-method-change basis:
  - A closing agreement is required.
  - The taxpayer is required to file amended returns to make adjustments to affected subsequent years.
  - The taxpayer must continue to use its current accounting method, unless the taxpayer receives consent to change it.
  - If the IRS imposes an accounting method change in a subsequent year, the § 481(a) adjustment is computed such that there is no duplicate adjustment.

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## Specific Audit Issue: Income Tax Accounting

### What are some strategic considerations to resolve change in method issues?

- While appeals has the authority to resolve accounting method issues using alternative resolutions, many appeals officers are reluctant to do so because they are unfamiliar with them, so persistence and patience are necessary.
- Alternative resolutions are often optimal because, if the IRS changes your method, you will need the consent of the IRS to change from that new, less favorable method.
  - Example: you are using a favorable method for an item. Another taxpayer is litigating the propriety of that method. IRS Examination proposes changing you from that method. It is optimal to resolve the issue using an alternative resolution because, if the other taxpayer later wins its case, the IRS likely will not consent to your request to change back to the favorable method.

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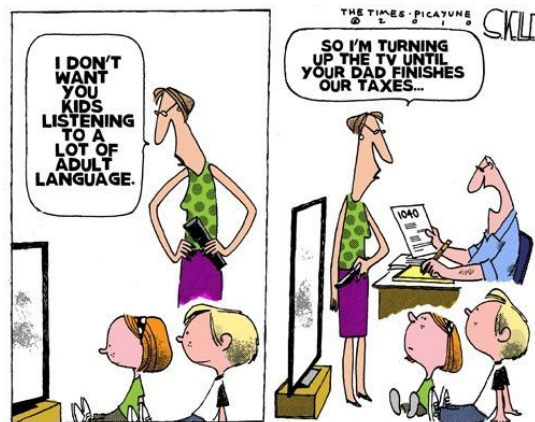
## Specific Audit Issue: Income Tax Accounting

### What are some strategic considerations to resolve change in method issues?

- Because Examination has limited authority to resolve accounting method issues, it may be necessary to go to Appeals to achieve an optimal resolution.
  - If you must resolve an accounting method issue at Examination, press factual issues because Examination has the discretion to determine facts.
  - Example: Examination proposes changing your inventory method to include numerous additional costs in inventory. Examination has authority to negotiate a resolution to not include some of the costs in inventory because Examination has discretion to determine which costs are incurred by reason of the production of inventory, a factual question.

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## Specific Audit Issue: Income Tax Accounting



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## Defenses to Penalties

**Teresa Abney**  
**Carina Federico**



## Types of Penalties

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## Types of Penalties

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- **Delinquency (§6651)**
  - Non-fraudulent failure to file: 5% of net tax due per month, up to 25%
  - Fraudulent failure to file: 15% of net tax due per month, up to 75%
  - Failure to pay: 0.5% of net tax due per month, up to 25%
- **Accuracy-Related (§6662): 20% of underpayment attributable to the following:**
  - Negligence or disregard of rules or regulations
  - Substantial understatement of income tax
  - Noneconomic substance transactions

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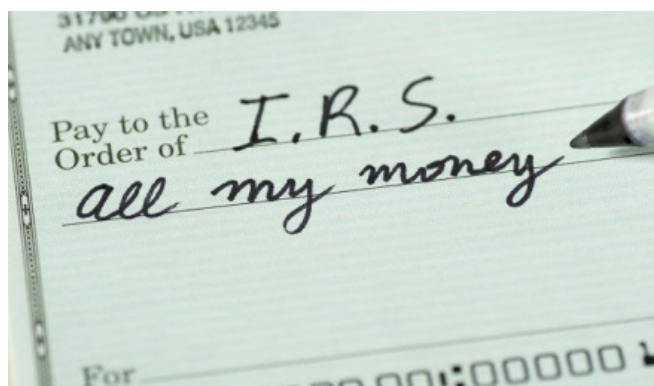
## Types of Penalties

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- **Reportable Transaction Understatement (§6662A): 30% of understatement of tax resulting from undisclosed reportable transaction**
- **Civil fraud (§6663): 75% of any portion of an underpayment attributable to fraud**
- **Foreign-related penalties**
  - FinCEN Form 114: Report of foreign bank and financial accounts
  - Form 5471: Information Return of U.S. Persons with Respect to Certain Foreign Corporations
  - Form 5472: Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

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## Defenses to Penalties



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## Defenses to Penalties

- **Administrative waiver:** IRS may provide administrative relief from penalties, for example, in the event of delay by the IRS in preparing forms or publishing guidance
  - First Time Abatement: IRS may provide administrative relief the first time a taxpayer is subject to penalties for failure to file, failure to pay, and failure to deposit
- **Disclosure:** Certain accuracy penalties do not apply if the taxpayer's position contrary to a rule or regulation has a reasonable basis in law and is disclosed on the return

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## Defenses to Penalties

- **Statute of Limitations Defense**
- **Proper calculation of penalty amount**
- **Constitutional Defenses**
  - 8th Amendment
  - 5th Amendment
- **Strict liability penalties**
  - Failure to disclose reportable transactions (§6707A)
  - Noneconomic substance transaction penalty (§§6662(b)(6); 7701(o))

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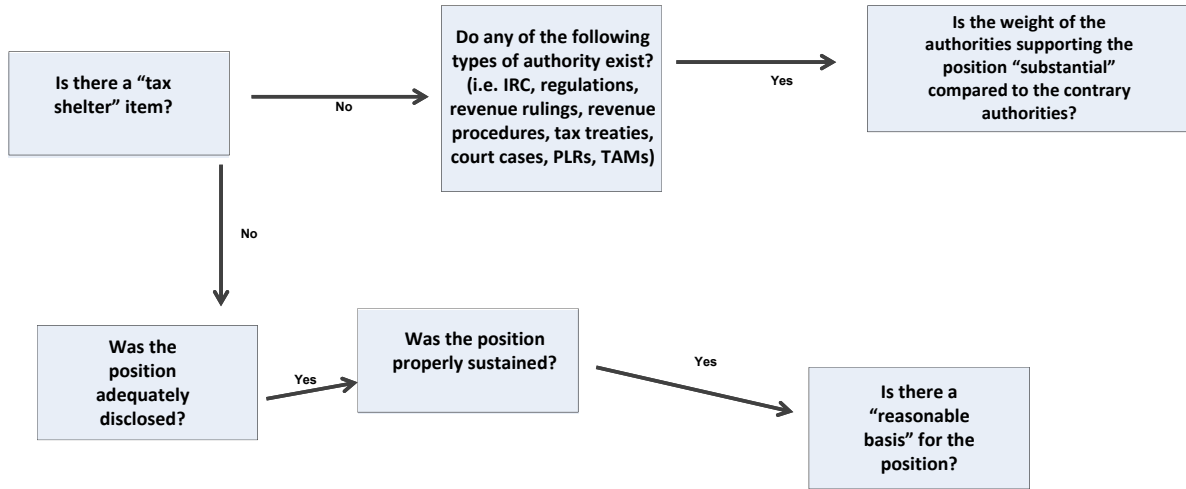
## Defenses to Penalties

- **Qualified Amended Returns**
  - Disclosures can be made on a qualified amended return
  - Amounts of tax reported on a qualified amended return will be treated as if they had been reported on the original return for purposes of computing the amount of the tax “underpayment” unless the original return reported a fraudulent position
- **To be “qualified,” the amended return must be filed before:**
  - The date the taxpayer is first contacted concerning an IRS exam
  - In the case of a promoted transaction, the date the shelter promoter is first contacted concerning an IRS exam
  - In the case of a pass-through item, the date the pass-through entity is first contacted concerning an IRS exam
  - The date a John Doe summons is served on a third party with respect to an activity of the taxpayer for which the taxpayer claimed a tax benefit
  - The date on which the IRS announced a settlement initiative for a listed transaction

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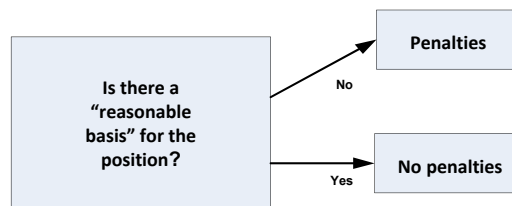
## Defenses to Substantial Understatement



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## Defense to Negligence

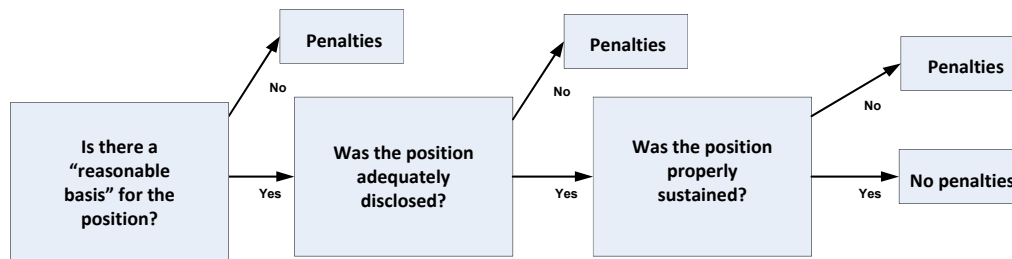
The 20% penalty for negligence can be avoided if there is a "reasonable basis" for the tax position



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## Defense to Disregard of Rules

The 20% penalty for the disregard of rules and regulations can be avoided if there is a “reasonable basis” for, and adequate disclosure of, the tax position



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## Reasonable Cause Defense

- The exercise of “reasonable cause and good faith” can be a complete defense to penalties (§6664)
- Factors considered include the extent of the taxpayer’s effort to assess the correct tax liability and taxpayer’s education, sophistication, and business experience (Reg. §1.6664-4)

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## Reasonable Cause Defense

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- But relying on the advice of counsel will most likely result in a waiver of all advice on the same subject matter – no “sword and shield”

### *What Could Be Waived?*

- Opinions (including drafts)
- Emails between advisor and client
- Advisors’ internal emails
- Emails between lawyers and economists
- In-house communications
- Communications with financial auditor

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## Ways to Make a Reasonable Cause Defense

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- Written requests
- Deficiency procedures/appeals
- Claim for refund

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## The US-China Trade War And Impacts on China Tax Policy and Practice

Dr. Zhou Ye, PRC Tax Consultant  
Jackson Pai, Counsel



## Today's Topics

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- Overview of China Tax Regime – Carrots and Sticks
- Trends in Chinese Tax Audits and Practical Strategies
- China Tax Flashpoints: Royalties & Transfer Pricing
- Balance with Foreign Investment: Export VAT Rebate Strategy



## Overview of China Tax Regime – Carrots and Sticks

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- The primary categories of tax in China include:
  - Value-added tax 增值税
  - Enterprise income tax (“EIT”) 企业所得税
  - Individual income tax (“IIT”) 个人所得税等
  
- Other categories of tax in China include:
  - Stamp duty 印花税
  - Real estate property tax 房产税
  - Land use tax 土地使用税
  - Urban maintenance and construction tax 城市维护建设税

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## Overview of China Tax Regime – Carrots and Sticks

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- VAT tax rebates and exemptions
  - For export of goods, a Chinese company can generally obtain an export tax rebate
  - For export of services, a Chinese company can generally obtain a tax exemption
  
- If a Chinese company pays royalties to a U.S. company, the Chinese company must pay VAT and withhold income tax on behalf of the U.S. company
  - Transfer pricing issues may come into play
  
- If a foreign enterprise assigns an expat employee to work at the Chinese company, beware of the application of the IIT and issues associated with permanent establishment/business nexus

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## Overview of China Tax Regime – Carrots and Sticks

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- To counter the impacts of the trade war, China began reducing its taxes:
  - The VAT tax rate for goods was reduced;
  - The tax burden for small enterprises was reduced;
  - The deduction for R&D expenses was increased to reduce the EIT tax burden of high-tech companies;
  - The IIT tax rate was reduced as a part of the IIT reform.

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## Trends in Chinese Tax Audits and Practical Strategies

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- Policy and enforcement adjustments in response to the trade war:
  - Tax authorities have been tasked to strictly implement the policy of tax reduction
  - On issues where tax laws may not be entirely clear and are subject to interpretation, such as transfer pricing, tax authorities tend to take a more conservative position
- Management of invoices (fapiao 发票) is a very important part of the strategy to manage China audits; China auditors rely heavily on invoice records
  - Many tax violation cases stem from fake invoices or real invoices that are incorrect or inaccurate

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## Trends in Chinese Tax Audits and Practical Strategies

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- Chinese tax authorities are beginning to use data analytics to assist in its audits
  - Exchanging information with securities and stock registration agencies and real estate registration agencies
  - Requesting information from industry associations and statistical reporting organizations
  - Linking the various databases to create the necessary data analytics for comparison between companies of the same industry or other companies with similar risk profile

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## China Tax Flashpoints: Royalties & Transfer Pricing

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- China's transfer pricing system which is part of the China corporate tax law is similar to those of the US
- US invested enterprises have faced a large amount of EIT as a result of transfer pricing adjustments
- Chinese companies' payment of royalties to overseas affiliates may be seen as diversion of profits overseas, which can result in adjustments in transfer pricing
  - Transfer pricing issues can result from related-party transactions in both tangible and intangible assets, including transactions involving sales of stock

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## China Tax Flashpoints: Royalties & Transfer Pricing

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- The strategy to managing transfer pricing risks is to ensure arm-length transactions and to prepare accurate and complete documentation
- Royalties are paid based on use of patents or other non-patent technologies, trademark or copyright; the use of such rights must objectively exist
- Royalties and service fees are often connected; however, it may be more beneficial to keep them separate if possible, rather than confusing the two

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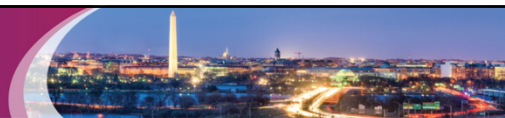
## Balance with Foreign Investment: Export VAT Rebate Strategy

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- To manage China export rebates, it is important to keep good records of the VAT invoice, especially the input VAT invoice, as the basis of export rebate claims
- The use of special customs zones can allow for early tax rebate; movement of goods to a special customs zone is considered export, even though the goods have not physically left China
- To avoid the hassle of dealing with export rebates, a company can conduct its processing in bonded zones

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## Questions?

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