

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**LARGE & MID-SIZE BUSINESS
SUBGROUP REPORT**

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I. INTRODUCTION

The LMSB Subgroup, consisting of professionals who represent large and mid-sized businesses and in-house tax counsel at large multinational corporations and an association, has been busy since April, 2002 participating in three separate multi-day meetings in Washington D.C. and several conference calls with Large & Mid Size Business (hereinafter "LMSB") Operating Division executives and personnel. In addition, as discussed in the General Report, many subgroup members have participated in Nationwide Tax Forum focus groups across the country. The members are most grateful for the time devoted by the executives and personnel of LMSB and the staff of the Office of National Public Liaison. Without their time and assistance, the subgroup would not have had as meaningful a year. While not exhaustive, the following identifies the primary issues reviewed and associated recommendations made by the LMSB Subgroup this past year.

II. Issues and Recommendations

A. LMSB Operations

1. Workload Realignment/Compliance Risk Assessment

ISSUE: During fiscal year 2001, the Large & Mid-Size Business Operating Division conducted a strategic assessment of its taxpayers to determine how best to deploy its workforce, prioritize its resources, track issues, and measure compliance. This initial assessment utilized a compliance risk scoring method to establish the "top tier" taxpayers that present the largest compliance risks. Among other things, the assessment validated anecdotal evidence of a large increase in pass-through entities. Using the information gained from the assessment, LMSB has been re-deploying its workforce in accordance with the "top tier" determination. Pursuant to the 2001 study, LMSB doubled partnership entity audit coverage during fiscal year 2002 and has projected an increase in audit coverage for fiscal year 2003 of two and three-tenths percent. LMSB's audit

coverage of non-large cases, including corporations, Form 1120S corporations, and non-coordinated Industry cases, improved to fourteen and six-tenths percent.

RECOMMENDATION: The LMSB Subgroup continues to be concerned with the low audit coverage of non-large case taxpayers, which we believe encourages non-compliance among mid-size businesses. However, we are highly encouraged by LMSB's use of the strategic assessment to assist in determining for the first time in years its actual audit coverage. We are also encouraged that LMSB appears initially to have used the results of the assessment to determine personnel needs and audit issues, provide immediate pass-through entity training, and shift newly trained auditors from large-case to pass-through entities. This should help LMSB improve its audit coverage of mid-sized businesses. The LMSB Subgroup believes that this type of assessment should be ongoing, and encourages LMSB to continue to utilize such assessments in the future. Moreover, we encourage LMSB's involvement and participation in future National Research Program iterations as applicable to businesses and to utilize NRP results for purposes of refining its assessments.

2. Post-Filing Processes

LMSB has initiated a number of processes to facilitate efficiency in the post-filing process. These processes include Limited Issue Focus Exam (hereinafter "LIFE"), a redesigned claims process, and a myriad of items that previously were tested in pilot programs, including Pre-filing Agreements, LMSB Fast Track Resolution (hereinafter "Fast Track"), Industry Issue Resolution, and Comprehensive Case Resolution (hereinafter the "Tested Processes"). In addition, until earlier this fiscal year, LMSB engaged teams to discuss and redesign the entire post-filing process.

A. LIFE

ISSUE: LIFE, currently under design in LMSB, is a new process, centered around the concept and issues of materiality, which would be available to certain taxpayers that have been

cooperative with the IRS in the past and whose tax returns reflect only a limited number of material and potential issues. Using guidelines established by LMSB regarding issues and materiality, a Team Manager, with respect to each taxpayer participating, would: (i) agree to an audit plan in which the IRS would audit only certain material issues based on a materiality threshold; (ii) with the taxpayer, agree not to file any claim below the threshold; and (iii) complete the audit within a shortened and specified time-frame. However, as part of implementing a LIFE audit plan, we understand that the Team Manager may require exceptions to the agreed upon materiality threshold.

RECOMMENDATION: The LMSB Subgroup strongly favors LIFE because:

(i) the program acknowledges the past cooperation of certain taxpayers and their resulting lower audit risk; (ii) enables (and we recommend) the “freed-up” resources to be allocated to non-cooperative taxpayers and to groups of taxpayers for which the IRS has not had traditionally high audit coverage (e.g., mid-size taxpayers); and (iii) focuses exams on material issues. The subgroup strongly encourages LMSB to make no exceptions to the agreed upon materiality standard in a LIFE audit because such exceptions would dilute the program's above-described benefits and accordingly, reduce a taxpayer's willingness to participate. Moreover, similar to our recommendation below, we recommend that a Team Manager engaged in a LIFE audit be empowered to resolve and settle cases.

B. CLAIMS REDESIGN

ISSUE: Although LMSB's redesign of the claims process is in the early stages, the Operating Division's initial reaction is to create “two paths” for claims, while continuing to permit taxpayers informally to make claims with the audit team, rather than formally on an amended return. The first path would be for those claims raised within six months of the beginning of the audit, and the second path for claims made after expiration of the time period applicable to the first path. Claims under the first path would be audited and resolved by the audit team. Claims under the second path would be handled on a parallel track and reviewed outside the audit plan time frames on a resource available basis.

RECOMMENDATION: The LMSB Subgroup agrees with LMSB's early stage design. However, as LMSB continues the redesign process, care should be taken not to allow final design requirements to be an excuse for an audit team to audit claims only on a resource available basis. Such a practice would potentially defer, even preclude resolution, or negatively impact the beginning of the next exam cycle. In addition, the subgroup believes it is important for LMSB and the IRS to institutionalize the claims of non-large case taxpayers under audit so that such claims: (i) also are subject to the "two path" process; (ii) must be submitted to the auditor; and (iii) are prevented from being processed - or a refund granted - at a Service Center without the approval of the Team Manager.

C. THE TESTED PROCESSES

ISSUE: As discussed above, LMSB has instituted a myriad of Tested Processes. In the Industry Issue Resolution pilot program, LMSB selected seven issues for consideration, and the IRS published guidance on six of the seven issues selected. By all accounts, the program has been very successful and was made permanent in Notice 2000-20. For the year 2001-2002, LMSB has selected seven issues for Industry Issue Resolution.

The Pre-filing Agreement Program is designed to permit taxpayers, before filing a return, to resolve the treatment of an issue that would otherwise be likely to give rise to dispute in a post-filing examination. The Pre-Filing Agreement Program is intended to produce agreement on factual issues and apply settled legal principles to those facts. A Pre-filing Agreement is a specific matter closing agreement and, as such, resolves the subject of the Pre-filing Agreement for a tax period or periods. Execution of a Pre-filing Agreement is intended to resolve issues prior to filing, thus permitting taxpayers to avoid a portion of the costs, burdens, and delays that are frequently incident to post-filing examination disputes. In its Pre-filing Agreement pilot, LMSB accepted twelve applications of nineteen received, and entered into ten Pre-filing Agreements. LMSB spent thirty-seven and two-tenths days, on average, reviewing

the six Pre-filing Agreements entered into the first year of the pilot and an average of 166-1/10 days to complete each of the six agreements. An average of forty-four and one-half days was spent reviewing the four Pre-Filing Agreements entered into the second year of the pilot and an average of 482-3/4 days to complete each Pre-filing Agreement. The above statistics do not include time spent reviewing unaccepted or withdrawn applications. The process has required a great deal more time than anticipated, has resulted in redirecting resources away from basic audits, and has produced relatively few agreements. However, both taxpayers who entered into Pre-filing Agreements and LMSB generally believe the program is promising and provides benefits. The Pre-filing Agreement Program has now been made permanent.

To date, after two years, the Comprehensive Case Resolution pilot has resulted in but one case having been addressed and resolved. Lastly, the Fast Track Program has an Appeals option and a mediation option. The Appeals option has been praised highly and has resulted resolution of cases in seventy-one days on average. To date, no taxpayer has applied to use the mediation option, although the IRS and taxpayers have used mediation processes in the past successfully. The Fast Track Program is in the process of being made permanent by the IRS.

RECOMMENDATION: We believe that Industry Issue Resolution has been the most successful of the Tested Processes and strongly encourage LMSB and the IRS to continue using this useful program. Further, the subgroup believes that the Pre-filing Agreement Program has not been successful, largely because the program requires an intensive use of resources by the IRS and the taxpayer. We also have concerns regarding the program's applicability to non-large case taxpayers, and the potential costs to both taxpayers and the IRS associated with revisiting issues already addressed in a Pre-filing Agreement due to a closing agreement procedure that is applicable only to a particular tax period or periods. However, we encourage LMSB to review whether the Pre-filing Agreement Program can be redesigned to address these issues. The Fast Track Appeals Program should be emphasized and continued. For the time being, we encourage LMSB to continue marketing the Fast Track Mediation Program. However, if this

mediation program is not utilized soon, the subgroup encourages LMSB to end the program. The Comprehensive Case Resolution Program should be dropped due to its lack of success. Lastly, as we indicated last year, we believe that existing processes, such as Delegation Orders 236 and 246 and the Accelerated Issue Resolution, should be given new life, stressed to the same extent as the new processes, and measured to determine their effectiveness. The results of these measurements should be publicly reported.

D. REDESIGN OF ENTIRE POST-FILING PROCESS

ISSUE: Until earlier this fiscal year, LSMB had engaged a team and an outside facilitator to review and redesign the entire post-filing process. However, due to funding shortfalls, LMSB is no longer engaging the facilitator and the team has been disbanded.

RECOMMENDATION: The subgroup strongly encourages LMSB to recommence its post-filing process redesign efforts notwithstanding current budget constraints, and urges LMSB to seek assistance from its stakeholder groups and the IRSAC in redesigning the process. As part of this redesign, we encourage LMSB to consider formulating the redesigned process around “issues” and the “concept of materiality” (i.e., concepts that LMSB is addressing in LIFE) to streamline the post-filing process and “free-up” additional resources. A redesigned post-filing process is critical to assisting the IRS with limited resource allocations. With respect to non-large case taxpayers, the subgroup strongly encourages LMSB to institute procedures mandating that the agent establish a written audit plan with an estimated completion date prior to commencement of an audit.

3. LMSB BUDGET

ISSUE: Based on actuarial data, LMSB estimates that it will lose between 150 and 200 agents, and a total of 250 in fiscal year 2003. LMSB also estimates that it will continue to lose a substantial number of agents and employees across the next nine years. However, LMSB has the funding to replace less than thirty percent of those agents in fiscal year 2003, and its current budgetary situation makes it unlikely the Operating Division will be able to replace the substantial number of departing agents and

employees in future years. The subgroup believes that a compliance crisis will arise without these agents, particularly with respect to mid-size taxpayers.

RECOMMENDATION: LMSB has developed a multitude of processes to reduce the personnel needed for audits. (*See* II.B. above). However, given the significant number of projected agent and employee losses, these processes will provide a mere band-aid for the problem. Congress should fund LMSB adequately for personnel needs and the development of training programs for new and existing employees.

4. TRAINING AND PROFESSIONAL DEVELOPMENT

ISSUE: LMSB's goal is to become "a World Class Organization by promoting a culture of continuous learning." As part of the program in support of this goal for fiscal year 2002, LMSB has offered many training and educational programs on pass-through entities and tax shelters. We note that as part of this training, LMSB conducted forty-five Centra sessions (a web based software that runs on the Internet), twenty interactive video sessions, and many traditional classes around the country.

RECOMMENDATION: The LMSB Subgroup is gratified that the LMSB Operating Division adopted the recommendation made by the IRSAC in its 2001 Public Report that more technology be utilized in training, including the use of Centra. While LMSB has made progress in its training and development programs, we believe that it should continue to stress education, including training through technologies that will enhance distance learning. Further, the LMSB Subgroup recommends that LMSB establish educational programs that are mission-focused, customer-driven, and future-oriented (i.e., utilize the Compliance Risk Assessment to determine what and where to train). Lastly, the LMSB Subgroup encourages the LMSB Operating Division to provide achievement-based incentives for training and development programs.

5. SERVICE CENTER TRANSITION

ISSUE: Last year, the IRS transitioned LMSB taxpayers to Service Centers located in Ogden, Utah and Cincinnati, Ohio. Specifically, taxpayers will file Forms 1120, 1120S, and Forms 1065 at

the Ogden Service Center while Forms 941 will be filed at Ogden and Cincinnati Service Centers according to geographical location. Excise Tax returns, Forms 720, will continue to be filed at the Cincinnati Service Center regardless of geographical location.

RECOMMENDATION: While the transition by all accounts has been successful, the subgroup encourages LMSB to continue to monitor for issues that may arise.

B. Tax Shelters

1. WHAT IS A LISTED TRANSACTION?

ISSUE: LMSB's strategy with respect to tax shelters has centered on disclosure and transparency, particularly with respect to transactions that the IRS has specifically identified as "abusive." In a series of notices and rulings, LMSB has identified certain transactions with respect to which disclosure is mandatory by including them on a list (i.e., a "Listed Transaction"). Moreover, taxpayers and promoters have certain disclosure obligations with respect to a transaction which the taxpayer participated in or the promoter promoted if such transaction is "substantially similar" to a Listed Transaction. We note that the disclosure initiatives have allowed the IRS to identify "promoters" of tax shelter transactions and to take steps to compel disclosure.

RECOMMENDATION: The subgroup supports LMSB's efforts to stop abusive transactions, alert taxpayers to transactions about which there are concerns, and foster transparency. We also commend LMSB for the voluntary tax shelter disclosure initiative that ended April 23 of this year. However, the subgroup is concerned that not all Listed Transactions reflect "settled law" and that disclosure rules imposed with respect to "substantially similar" transactions may act as a trap for the unwary. Thus, we recommend that the IRS proceed with caution in imposing harsh penalties on taxpayers engaged in a transaction that was not in conflict with "settled law" at the time the transaction was entered into or reported on the federal income tax return.

2. TAX ACCRUAL WORKPAPERS

ISSUE: Earlier this year, the IRS issued guidance regarding the circumstances under which the IRS can request a taxpayer's tax accrual workpapers when a listed transaction is involved. In summary, for tax returns filed after June 30, 2002, if a taxpayer fails to disclose a listed or "substantially similar" transaction, the IRS can request the taxpayer's tax accrual workpapers, subject to certain safeguard procedures. However, if the taxpayer has disclosed the listed or "substantially similar" transaction, the IRS should request the taxpayer's tax accrual workpapers only with respect to a listed or "substantially similar" transaction. For tax returns filed prior to July 1, 2002, if a taxpayer was obliged to disclose the transaction and failed to do so, the IRS would limit its request to workpapers pertaining solely to the Listed Transaction. The IRS and LMSB have been developing a question and answer Revenue Procedure to address certain outstanding issues regarding this guidance.

RECOMMENDATION: The subgroup strongly believes that additional guidance is needed with respect to acquired entities. If an acquired entity fails to disclose prior to an acquisition, we believe it inappropriate for the IRS and/or LMSB to require the Acquiror to disclose its tax accrual workpapers, unless the Acquiror is given sufficient time following the acquisition to disclose and does not do so. Further, the disclosure obligation also applies to transactions that are "substantially similar" to Listed Transactions. The subgroup believes strongly that the definition of "substantially similar" should be refined such that the rules do not operate as a trap for the unwary or as grounds for delaying resolution of audit issues.

3. RESOLUTION STRATEGY PROCESS FOR LISTED TRANSACTIONS

ISSUE: LMSB is discussing various strategies for resolving cases that involve Listed Transactions.

RECOMMENDATION: The subgroup feels strongly that any resolution should not reward taxpayers that participated in abusive transactions or failed to disclose their participation early. Further, any resolution strategy should not *de facto* penalize taxpayers that did not participate in abusive transactions (i.e., result in a favorable settlement to non-disclosing or late disclosing taxpayers). Lastly, we encourage the IRS and/or LMSB to utilize all means available to penalize promoters, including the possibility that practice before the IRS be restricted.

C. Authority Issues within LMSB/Rules of Engagement vis-a-vis Counsel/Measurement of Audit Team/Team Manager Effectiveness

ISSUE: The subgroup believes strongly that many audits are not resolved in a timely manner because it is unclear when the Team Manager has ultimate authority vis-a-vis Technical Advisors, Specialists, Chief Counsel, and others. The absence of clear management guidelines (including the guidelines outlined in the Internal Revenue Manual) has contributed to the length and uncertainty of the post-filing process. Moreover, the subgroup believes that it is critical for LMSB to establish measures regarding the effectiveness of Team Managers and auditors. To date, we are unsure whether the measures established by LMSB are effective because such measures have not yet been disclosed.

RECOMMENDATION: The subgroup believes strongly that the Internal Revenue Manual and the Regulations should be redrafted to clarify that the Team Manager has the authority to resolve and settle a case, subject to a short, written list of discrete exceptions. These exceptions should include Coordinated Issues, but only when designated and disclosed in writing to taxpayers. Further, the subgroup recommends that LMSB's measures require that a Team Manager and his/her team be evaluated regarding how he or she exercises authority and resolves cases. Moreover, the subgroup believes strongly that an empowered Team Manager is the key to a successful LMSB and the key to LIFE and any redesigned post-filing process.

D. INTERNET WEB SITE

ISSUE: LMSB is finally part of the main IRS Web site, irs.gov. The subgroup believes it important that LMSB's site be user-friendly and interactive.

RECOMMENDATION: The subgroup recommends that LMSB's portion of the IRS Web site be more user-friendly, which should include improving the "search" function and providing easier access to specific regulations and other guidance. To provide a more interactive Web site, we believe the site should be a portal: (i) for filing, including: Coordinated Issue Papers, pre-filing agreement procedures, Forms S-4, Forms 966, S status elections, check-the-box elections, pre-filing agreement forms, and ruling requests; and (ii) for checking taxpayer accounts and filing status.

E. GLOBALIZATION/INTERNATIONAL

1. COMPETENT AUTHORITY

ISSUE: The bottleneck that exists in resolving Competent Authority Process issues remains a problem. The average time required to process a competent authority case in fiscal year 2002, has been 642 days. While this continues a five-year trend reducing processing time from the high of 807 days in fiscal year 1997, the subgroup believes there is room for further improvement. Part of the challenge is that LMSB has only thirty-four people to resolve more than 500 extremely complex cases, involving numerous foreign governments.

RECOMMENDATION: To assist in resolving this bottleneck, LMSB should continue to increase its staff and utilize creative agreements, such as the November 2000 Agreement with the United Kingdom. Further, we applaud LMSB for attempting to streamline the process through the updated Competent Authority Procedure, Rev. Proc. 2002-52. Moreover, the subgroup encourages the IRS to leverage the thoughts of taxpayers contemporaneously during the process, rather than through intermittent consultation. For example, the IRS should develop a mechanism by which a taxpayer may provide factual assistance contemporaneous with IRS' discussions with another country's competent authority.

2. TRANSFER-PRICING DOCUMENTATION

ISSUE: In recent years, transfer-pricing documentation has become increasingly important under the laws of many jurisdictions. Under the laws of the United States and other countries, taxpayers may be subject to documentation-related penalties under section 6662(e) of the Internal Revenue Code. As a consequence, taxpayers often struggle to understand and satisfy differing transfer-pricing documentation requirements in each jurisdiction. To help reduce the complexity, the Pacific Association of Tax Administrators (hereinafter "PATA") has tentatively prepared a unified set of documentation requirements that meet the applicable transfer-pricing documentation requirements for each of its member countries (the U.S., Canada, Japan, and Australia), permitting taxpayers to avoid penalties in those jurisdictions.

RECOMMENDATION: While the subgroup applauds LMSB's efforts with regard to the tentative documentation package produced by PATA, we encourage LMSB to ensure that the final set of unified requirements eliminates any uneven requirements of the PATA members. Further, since the transfer-pricing regulations have been in existence for some time, LMSB should review the entire process and documentation requirements, and determine what is and what is not important. Moreover, the subgroup encourages LMSB to establish simple documentation requirements for small taxpayers, small transactions, and smaller units of larger taxpayers, based on a materiality standard.