

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

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

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I. INTRODUCTION

The Large & Mid Size Business Subgroup (hereinafter the "LMSB Subgroup") consists of professionals who represent large and mid-sized businesses and in-house tax counsel from large multinational firms and associations. The members of the LMSB Subgroup come to the task without personal agendas. Rather, the overriding LMSB Subgroup agenda is to provide assistance to the IRS generally and LMSB specifically for the purpose of insuring efficient and fair tax administration and the development of equitable tax policy.

The Subgroup has been busy since January 2003; with five separate multi-day meetings conducted in Washington D.C. and several conference calls with LMSB personnel and executives. In addition, many LMSB Subgroup members participated in the Nationwide Taxpayer Program, partnering with Information Reporting Program Advisory Committee (hereinafter the "IRPAC") members, to conduct focus groups (hereinafter "Focus Groups") in Atlantic City, Atlanta, San Antonio, and Las Vegas. The LMSB Subgroup is most grateful for the time devoted by the executives and personnel of the Large & Mid Size Business Operating Division and the staff of the National Public Liaison. Without their time and assistance, the year would have been less meaningful.

We have structured this Report around the three goals outlined by Commissioner Everson at our August 14, 2003 meeting. Although not exhaustive, the list of issues that follows identifies the primary issues and recommendations taken up this year by the LMSB Subgroup:

II. ISSUES AND RECOMMENDATIONS

A. REFOCUS ON ENFORCEMENT

1. EXAM CYCLE TIME AND AUDIT COVERAGE

DISCUSSION: In spite of the fact that the Large & Mid Size Business Operating Division utilized information gained from a 2001 strategic assessment to re-deploy its workforce in accordance with the determination of "top tier" taxpayers, doubled partnership entity audit coverage during fiscal year 2002, and projected an increased audit coverage in fiscal year 2003 of two and three-tenths percent, actual results thus far in 2003 reflect reduced audit coverage and no cycle time improvement. In fact, it continues to take an average of 60 months to complete an examination and the number of current cases has not improved significantly.

The LMSB Subgroup believes that the Large & Mid Size Business Operating Division (hereinafter "LMSB") should make increasing audit coverage (particularly for mid size businesses) and reducing the exam cycle time its top priorities. First, the LMSB Subgroup remains concerned with the low audit coverage of non-large case taxpayers, which we believe encourages non-compliance among mid-size businesses. Large & Mid Size Business's continued focus on the largest taxpayers is clearly preventing even minimum coverage for the remaining LMSB taxpayer community. The Large & Mid Size Business Operating Division reports that there has been considerable work on "enterprise risk assessment" for flow-through entities, Forms 1065 and 1120S. As such, close to sixty percent of the pass-through entity filing population involves a "tiering" paradigm such that the entity itself is either a member/partner/shareholder in/of a higher level entity, or it has members/partners/shareholders that are flow-through entities themselves. We realize that mandatory workload requirements for tax shelters, joint committee cases, and claim cases account for twenty five percent of LMSB's resources, and that CIC front end loaded staffing by industry components accounts for another fifty percent, leaving a mere twenty five percent to address discretionary high risk workload in the IC program. However, the LMSB Subgroup believes that this may not be maximizing resource allocation.

Second, the LMSB Subgroup believes that LMSB must instill a sense of urgency in the audit process. Although the various design teams, including new Breakthrough teams, feel the urgency to produce results, field agents continue to examine taxpayers using the same slow processes of the past. As the various design teams develop better tools for risk assessment and issue development, these tools must be implemented in the field without delay. Use of the Limited Issue Focus Exam process, or at least the tools inherent in the process, must be mandatory rather than optional to bring examinations current and reallocate resources appropriately. The LMSB Subgroup is highly encouraged by LMSB's establishment of the Breakthrough teams and their preliminary plans for improving currency. Success in the currency initiative should allow LMSB to re-deploy resources and improve audit coverage of mid sized businesses.

RECOMMENDATIONS: The LMSB Subgroup recommends that LMSB: (i) re-deploy resources to improve audit coverage of mid size businesses; (ii) instill a sense of urgency in field agents and managers regarding completion of examinations; (iii) make use of Limited Issue Focus Exam (hereinafter "LIFE"), or at least the processes of LIFE, mandatory for all audits with but a few limited exceptions; (iv) use whatever means necessary to move away from the examination practices and processes of past years and close old cycles to examine current tax years; and (v) continue to refine risk assessment tools to enable agents to identify significant and key issues in each tax return examined.

2. POST-FILING PROCESSES

The Large & Mid Size Business Operating Division has initiated a number of new and revised procedures to make the post filing process more efficient. These include: LIFE, a redesigned claims process, and a myriad of tools that have been tested previously in pilot programs, including Pre-filing Agreements, Fast Track Appeals and Mediation, Industry Issue Resolution, and Comprehensive Case Resolution (hereinafter the "Tested Processes"). In addition, LMSB has

Breakthrough teams developing, among other things, a plan for improved cycle time and improvement in the number of current cases in exam years.

a. LIMITED ISSUE FOCUS EXAMINATION

DISCUSSION: Limited Issue Focus Examination rolled out in the fall of 2002 and is a process focused on specific issues and the concept of materiality. Using established guidelines as regards issues and materiality, a Team Manager may agree to an audit plan for each participating taxpayer, pursuant to which the IRS agrees to audit only certain issues based on a materiality threshold, in return for which the taxpayer agrees to refrain from filing a claim below the threshold. The agreement is documented in a Memorandum of Understanding (hereinafter “MOU”) and the audit is scheduled for completion within a shortened and specified time frame.

The LMSB Subgroup strongly recommends LIFE because it: (i) focuses exams on material issues; (ii) enables (and we recommend) the “freed-up” resources to be re-allocated to less cooperative taxpayers and to groups of LMSB taxpayers for which the IRS has not had traditionally high audit coverage (e.g., mid size taxpayers); and (iii) acknowledges that certain cooperative taxpayers generate a lower audit risk.

During 2003 changes were made to the LIFE process: (i) the materiality threshold was clarified; (ii) the MOU was modified; (iii) and instructions for rollover and recurring issues were clarified. In addition the LIFE Design Team developed a bullet point list of “The Facts of LIFE” and written responses to frequently asked questions. The LMSB Subgroup is in general agreement with these changes. After we expressed our concern that “The Facts of LIFE” began with a bullet point that took emphasis away from using LIFE, the Team revised the bullet point to emphasize that LIFE should be considered for all LMSB exams including the largest CIC cases.

The LMSB Subgroup continues to believe that use of the LIFE process must be the default procedure rather than optional, with a few limited exceptions, if examinations are to be brought current and resources are to be reallocated appropriately. Unfortunately, we understand that preliminary numbers reflect that of the cases opened since January 2003, only about ten percent are LIFE.

RECOMMENDATIONS: The LMSB Subgroup recommends that LMSB: (i) make LIFE, or the processes of LIFE, the standard procedure with few limited exceptions; (ii) insure that all written material places strong emphasis on utilizing any and all tools available to close old cases to increase the proportion of current cases; and (iii) insure that the Team Manager using LIFE is empowered to resolve and settle cases.

b. CLAIMS REDESIGN

DISCUSSION: The Large & Mid Size Business Operating Division's redesign of the claims process remains on-going, and the LMSB Subgroup understands there may be a pilot project rather than a full-blown roll out of the new process. The Large & Mid Size Business Operating Division's initial inclination is to have "two paths" for claims, allowing taxpayers to make informal claims with the audit team as opposed to making a formal claim on an amended return. The "first path" is for claims raised within six months of the beginning of the audit. The "second path" is for claims made after expiration of the "first path" time period. Claims made pursuant to the "first path" would be audited and resolved by the audit team. Claims made pursuant to the "second path" would be handled on a parallel track and be reviewed outside the audit time frame on a resource available basis.

The LMSB Subgroup is sympathetic and agrees with LMSB's early stage design. However, as LMSB continues the redesign, care must be taken such that final design

requirements function as an excuse for audit teams to limit audit claims to a resource-available basis only. As such, the design would effectively defer and/or preclude resolution, and negatively impact the beginning of the following exam cycle. The LMSB Subgroup also notes that the recently issued Treasury Inspector General for Tax Administration (“TIGTA”) report determined that the proposed revenue procedure for LMSB’s CIC case claims processing could “significantly” increase the interest the IRS is required to pay on claims. In addition, the LMSB Subgroup believes it important that LMSB and the IRS institutionalize the claims of non-large case taxpayers under audit, so that: (i) such claims are subject to the “two path” process; (ii) such claims must be submitted to the auditor; and (iii) a Service Center is prevented from processing a claim or granting a refund without the approval of the audit Team Manager.

RECOMMENDATIONS: The LMSB Subgroup believes that LMSB should insure that the final claims process is not a potential method for deferring and/or precluding the resolution of issues. Ensure the final claims process applies to all taxpayers both large and small.

c. THE TESTED PROCESSES

DISCUSSION: As stated above, LMSB has instituted a myriad of Tested Processes. The Industry Issue Resolution (hereinafter “IIR”) program was made permanent by Notice 2000-20 and resolves issues that impact numerous taxpayers in particular industries. The program procedures were revised and incorporated in Revenue Procedure 2003-36. To date, published guidance recommended by ten IIR teams have been released. In addition, nine other IIR teams are currently resolving issues.

The Pre-filing Agreement (hereinafter “PFA”) program permits taxpayers, before filing a return, to resolve issues that would likely be disputed in a post-filing examination. The PFA program is intended to produce agreement on factual issues and apply

settled legal principles to those facts. A PFA is a specific matter closing agreement and as such resolves the subject of the PFA for a tax period or periods (We understand that originally the PFA was to apply to only one tax year and we strongly encouraged LMSB to allow the PFA to apply to multiple years going forward.). Execution of a PFA is intended to resolve issues prior to filing, thus reducing costs, burdens, and delays often incident to post-filing examination disputes. Since the PFA program was made permanent, LMSB has accepted seventy one of the 102 applications received. For cases closed in calendar year 2002 only, it has taken on an average, 183 days to evaluate an application, and 235 days to complete a PFA. The process has required more time than originally anticipated, has resulted re-deployment of resources from basic audits, and has produced relatively few agreements.

The Comprehensive Case Resolution (“CCR”) pilot to date has resulted in the resolution of one case in two years. As a result, the program has been replaced indirectly with Fast Track. The Fast Track process was found to successfully handle cases having a prior cycle in Appeals, and has effectively accomplished the intended purpose of CCR for those cases.

Lastly, the Fast Track Appeals program has been highly praised and has resulted in resolution of cases in seventy three days, on the average. To our knowledge, the Fast Track Mediation program has not been utilized.

The Subgroup believes that IIR has been the most successful of the Tested Processes and strongly encourages LMSB and the IRS to continue using this useful program. Further, the LMSB Subgroup believes that the PFA program has not been successful, largely because the program is resource intensive as regards both the IRS and the taxpayer for a resolution that applies to one tax year only. The LMSB Subgroup has serious concerns regarding: (i) the

program's applicability to non-large case taxpayers; and (ii) the potential costs to both the IRS and the taxpayer as regards revisiting the same PFA issues in the future. This results from a closing agreement procedure that is applicable to a particular tax period or periods only. However, the LMSB Subgroup encourages LMSB to examine a possible redesign of the PFA program for purposes of addressing these issues. The Fast Track Appeals program should be emphasized and continued, and, for the time being, the LMSB Subgroup encourages LMSB to continue marketing the Fast Track Mediation program. Lastly, as noted last year, the LMSB Subgroup continues to believe that existing processes, such as Delegation Orders 236 and 246, and the Accelerated Issue Resolution, should be given new life, emphasized in equal proportion as the new processes, and measured to determine their effectiveness. The results of these measurements should be publicly reported.

RECOMMENDATIONS: The LMSB Subgroup recommends that LMSB: (i) make PFA's applicable to multiple tax years on a going forward basis; (ii) continue to emphasize Fast Track Appeals; (ii) re-emphasize and revitalize Delegation Orders 236 and 246, and Accelerated Issue Resolution; and (iii) develop new processes that encourage faster resolution of issues, shorter examination cycles, and increase current exams.

d. REDESIGN OF ENTIRE POST-FILING PROCESS

DISCUSSION: At one time, LMSB had engaged an outside facilitator to assist an assembled team to review and redesign the post-filing process. However, however, due to a lack of funding, LMSB was forced to terminate the facilitator and discharged the team. Subsequently, the LIFE process was developed internally and the LMSB Subgroup commends LMSB for this project.

Last year the LMSB Subgroup strongly encouraged LMSB to recommence the redesign of the post-filing process notwithstanding budget constraints, and urged LMSB to seek assistance from its stakeholder groups and the IRSAC in the redesigning process. The new Breakthrough teams are moving in the right direction and the LMSB Subgroup encourages continued support of these teams. As part of the redesign, the LMSB Subgroup encourages LMSB to consider redesigning the process around “issues” and the “concept of materiality” (i.e., concepts used in LIFE) to streamline the post-filing process and “free-up” additional resources. The LMSB Subgroup believes that requiring that the LIFE process be mandatory in all LMSB exams, subject to limited exceptions, would prove most effective. A redesigned post-filing process (whether that be mandatory use of LIFE or some other process) is critical to managing IRS’ limited resources more wisely. With respect to non-large case taxpayers, the LMSB Subgroup strongly encourages LMSB to mandate procedures such that, prior to commencement of an audit, the agent, working with the taxpayer, establishes a written plan that includes an estimated completion date.

RECOMMENDATIONS: The LMSB Subgroup recommends that LMSB: (i) make the LIFE process mandatory, with limited exceptions; (ii) require an exam agent to work with the taxpayer to develop a written exam plan with a targeted completion date prior to commencement of an audit; (iii) continue Breakthrough team work and engage outside stakeholders in the design process, particularly the IRSAC LMSB Subgroup.

3. THE LARGE & MID SIZE BUSINESS OPERATING DIVISION BUDGET

Discussion: Based on actuarial data, LMSB estimates it will lose 250 agents in fiscal year 2003 and a substantial number of agents and employees across the next nine years. However, LMSB has budgetary funding to replace less than thirty percent of these agents. Without such agents, the LMSB Subgroup believes that a severe compliance problem will develop among

LMSB taxpayers, particularly as regards mid-size taxpayers. The LMSB Subgroup is encouraged by the number of significant new hires in 2003 and LMSB's plans to hire additional staff in 2004.

LMSB has developed numerous processes by which the number of personnel necessary to conduct audits will be reduced. However, given the extent of employee losses, these processes will operate as a mere band-aid for the problem. The IRS should fund LMSB adequately to meet its personnel needs, and it must develop training programs for new and remaining employees.

RECOMMENDATIONS: The LMSB Subgroup recommends that: LMSB: (i) receive adequate funding for personnel replacements; and (ii) develop state-of-the-art employee training programs

4. TAX SHELTERS

DISCUSSION: Curtailing abusive tax shelters has been a major LMSB priority. Several mechanisms have been deployed by Treasury and the IRS to identify shelter transactions, their promoters, and the taxpayers employing them. During 2002, LMSB undertook a voluntary disclosure initiative that resulted in 1,689 disclosures from 1,206 taxpayers. Across the past year, LMSB has made settlement initiatives available to close out certain common transactions. For example, the IRS conducted an initiative from October 2002 through March 2003 that allowed taxpayers engaged in certain abusive transactions to resolve the tax consequences arising from participation in such transactions. Further, the IRS has been very active in seeking to compel promoters to identify clients who have purchased tax shelters. The LMSB Subgroup commends LMSB for their success in attacking Tax Shelters and encourage the IRS to continue using appropriate means to identify abusive transactions, the taxpayers who use them, and the promoters who sell them. The LMSB Subgroup continues to believe that promoters are sources of useful

information and the key to curtailing the development and sale of abusive transactions. The LMSB Subgroup is concerned that certain promoters have refocused their efforts to market schemes to mid-size and small taxpayers, and the LMSB Subgroup recommends that the IRS seek new ways to cease the marketing of such transactions to these taxpayers.

At the same time, the LMSB Subgroup encourages LMSB to publicly recognize that many large corporate taxpayers do not engage in abusive corporate tax shelters. Such public acknowledgement would go a long way toward improving relationships between the field and taxpayers that are currently under examination. Large & Mid Size Business Operating Division representatives, including former LMSB Commissioner Langdon, have often said that they have no intention of curtailing ordinary tax planning. As a result, it would be helpful if guidance were issued defining transactions that LMSB considers ordinary tax planning transactions. The LMSB Subgroup believes that LMSB's reluctance to issue such guidance has resulted in legitimate tax planning classified as abusive transactions.

RECOMMENDATIONS: The LMSB Subgroup recommends that LMSB: (i) continue to identify abusive tax shelters and vigorously prosecute promoters; (ii) focus its attention on mid-size and smaller taxpayers to which new abusive shelters are being promoted; (iii) publicly recognize that many corporate taxpayers have not engaged in abusive tax shelters; and (iv) issue guidance regarding transactions that are considered ordinary tax planning versus those considered to be abusive tax shelters.

B. CONTINUED CUSTOMER SERVICE APPROACH

DISCUSSION: The IRS has made a much-needed move toward a "customer service approach" in the last few years. However, it is feared that enforcement has suffered in the process. Commissioner Everson has stated that he intends to refocus the Service on enforcement yet

continue to pursue a customer service approach, and LMSB has embraced this goal. The LMSB Subgroup commends this focus and believe that a proper balance must be achieved for the IRS to effectively administer the tax system. The Large & Mid Size Business Operating Division has in fact been effective in the area of enforcement and Tax Shelters, but has been unsuccessful in increasing audit coverage of non-large case taxpayers and increasing the number of current cases in the exam cycle.

RECOMMENDATION: The LMSB Subgroup recommends that LMSB continue to “take a fresh look” at all processes, and involve stakeholders and the IRSAC in all process redesign initiatives.

C. STRENGTHENED MODERNIZATION EFFORTS

DISCUSSION: The Commissioner’s third goal is to strengthen modernization efforts. Although much progress has been made toward modernization, the progress has not been sufficiently rapid to produce the intended results. The Large & Mid Size Business Operating Division has made strides in using interactive technology for training purposes, becoming part of the IRS Web site, and designing the 1120 e-file project, which is a part of modernized e-file. The LMSB Subgroup is particularly encouraged that business taxpayers will be able to file Form 1120 and attachments electronically for tax year 2003.

RECOMMENDATIONS: The LMSB Subgroup recommends that LMSB: (i) continue to press forward on the modernized e-file initiative for business returns; (ii) continue to enhance the Web site, to provide a more interactive site that can serve as a portal for (a) filing, including: Coordinated Issue Papers, pre-filing agreement procedures and forms, Forms S-4, Forms 966, S status elections, check-the-box elections, and ruling requests; (b) checking taxpayer accounts and filing status; and (iii) continue to utilize technology to enhance IRS personnel training.