

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**LARGE & MIDSIZE BUSINESS
SUBGROUP REPORT**

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**Internal Revenue Service
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, accounting and legal professionals, and large multinational firms. The members of the LMSB Subgroup come to the task force without personal agendas. Rather, the overriding LMSB Subgroup role is to provide assistance to the Internal Revenue Service (“IRS” or “the Service”) and more specifically the Large and Mid-Size Business Operating Division (LMSB). The guiding principles of the LMSB subgroup are to assist IRS and LMSB to ensure efficient and fair tax administration and the development of equitable tax policy.

The LMSB Subgroup has been busy since January 2005 with five separate multi-day meetings conducted in Washington D.C. Each meeting was a collaborative session with LMSB personnel, Counsel, and Appeals that resulted in genuine and frank discussions of relevant issues between LMSB and the LMSB taxpayers.

The LMSB Subgroup is most grateful for the time devoted by the executives and personnel of LMSB 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 four issues of primary importance to the LMSB Subgroup and LMSB that were identified throughout the year. Although not exhaustive, the list of issues helped us to focus on areas where we could be the most effective in providing assistance to LMSB. The report identifies the issues and recommendations that were developed by the LMSB Subgroup during this year.

II. ISSUES AND RECOMMENDATIONS

A. Modernized e-File

Discussion

Beginning in 2006, IRS will require Corporations with assets of \$50 million or more or that file at least 250 returns per year to file their Form 1120 and/or 1120S electronically for tax years ending on or after December 31, 2005. In 2007 this requirement will be extended to apply to Corporations who have assets of \$10 million or more for tax years ending on after December 31, 2006.

Unlike current IRS antiquated technology, Modernized e-File will use XML technology and IRS will process corporate tax returns as received versus in batches. Taxpayers, who utilize Modernized e-File, will receive a prompt electronic acknowledgement receipt once their information is received by the IRS.

IRS believes Modernized e-File will increase organizational capacity to enable full engagements and maximum productivity of LMSB employees. In addition, the IRS will modernize information systems to improve service and enforcement, modernize business processes and align the infrastructure to maximize resources devoted to frontline operations. The LMSB Subgroup recognizes the importance of the Initiative and believes it is moving in the right direction.

1. Software limitations, system capacity and 3rd party vendors

LMSB has been in discussion with software vendors who will play an integral role in assisting LMSB taxpayers to comply with the IRS mandated E-Filing requirements. LMSB in a

presentation to the LMSB Subgroup communicated that the IRS Product Assurance group has performed tests on approximately 14,000 test cases.

The LMSB taxpayers currently use multiple nonintegrated software packages, spreadsheets, and/or other internally developed programs to produce Forms 1120 and 1120S tax returns. Several LMSB taxpayers have expressed concerns regarding issues such as firewall restrictions, technology capabilities, integration of software, and information security. The LMSB Subgroup believes that mandating Modernized e-Filing in 2006 will create an additional burden to LMSB taxpayers who are already overly extended implementing legislative requirements under Sarbanes-Oxley, and Schedule M-3 requirements into their tax processes as well as state electronic filing requirements.

2. Communication

The IRS issued proposed and temporary regulations on January 11, 2005. Since that time LMSB has actively solicited feedback from industry groups that represent the interests of LMSB taxpayers. IRS has created a link to Corporate e-File FAQ on their website. In addition, the IRS plans to host a Tax Talk Today session on the subject of Corporate E-Filing on November 8, 2005.

The LMSB Subgroup commends IRS for its diligent effort to inform taxpayers about the 2006 Modernized e-Filing requirements. Although much information has been published, we believe that LMSB taxpayers currently do not have enough information to adequately plan for the resources (people, money, technology, and time) needed to meet the 2006 e-Filing requirement. LMSB Subgroup is also unaware of any 3rd party software vendor who has

formally communicated to LMSB taxpayers about the additional costs or resource requirements

LMSB has communicated that further guidance will be issued by late October or November. The LMSB Subgroup is concerned that this does not provide taxpayers or tax software developer's adequate time to fully develop, implement and test Modernized e-Filing software or internal system capabilities.

3. Waivers and PDF Forms

IRS has acknowledged that some taxpayers will not be able to meet Modernized e-Filing requirements in the first year. Taxpayers can apply for a waiver of the e-Filing requirements in the 1st year according to procedures to be issued. During the 1st year of the mandate, LMSB taxpayers, who file electronically, will have the option to submit certain tax forms that do not affect financial calculations in PDF format. The LMSB communicated in a presentation to the Subgroup that under the PDF rules, no single file can be larger than 500 pages and total pages cannot exceed 5,000 pages.

We believe this option will be well received by taxpayers and reflects the IRS's conscientious effort to address taxpayer's concerns.

Recommendations:

In order to ensure the effectiveness in complying with this Initiative, the LMSB Subgroup has the following recommendations:

1. Defer the "mandatory" requirement of Modernized e-Filing Corporate Forms 1120 and 1120S for one year.

2. Reduce the corporate e Filing mandate in the 1st applicable year to pages 1 through 4 of the Forms 1120/1120s and Schedule M-3.
3. Widely communicate the IRS test site by the 1st quarter in 2006. Note that such site can be used by taxpayers to test transmission of data for those LMSB taxpayers who will not use 3rd party providers.
4. Publish future communication related to Modernized e-Filing in publications commonly used by taxpayers. (BNA, Tax Notes, CCH, IRS Website, etc.)
5. Test Modernized e-Filing in the 1st year with a few taxpayers who voluntarily chose to participate in Modernized e-File in 2006.
6. Provide an infrastructure plan showing how the data transmitted will be handled and housed within the Service. For example, what do you plan to do with the information, how will it be used within the scope of an examination, and who is given responsibility for managing the data?

B. LMSB/Appeals Initiatives

Appeals, LMSB, and General IRS Objectives

Discussion

The operational objectives of the IRS and its Appeals and LMSB divisions are consistent and call for the resolution and/or settlement of tax matters on a fair and impartial basis at the lowest level possible with the ultimate goal of determining a taxpayer's correct

tax liability. These goals are embodied in the mission statements of the IRS and the Appeals and LMSB functions.

The mission of Appeals is:

To resolve controversies, without litigation, on a basis which is fair and impartial to both the Government and the Taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.

The LMSB Vision Statement includes “applying innovative approaches to customer service and compliance” and applying “the tax laws with integrity and fairness.”

The mission of the IRS is to:

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Emphasis on Timely Case Closings

While perhaps sometimes overlooked, a fundamental component of achieving these objectives includes doing so in an efficient and timely manner that is consistent for similarly situated taxpayers. Reducing overall cycle time maximizes utilization of the parties' resources, reduces “hot interest” costs where applicable, and achieves certainty for financial reporting purposes. The LMSB Subgroup believes the Service's emphasis on timely case closings is a commendable objective if quality of case handling is not impugned in the process.

Appeals and the LMSB Examination function are currently working together on a process initiative (“the Initiative”) to reduce the post-filing 30-day letter/appellate process

time. The Initiative focuses on what is best for the IRS and the Taxpayers rather than what is best for Appeals or LMSB. In order to reduce cycle time, the Service is considering viewing the entire time a case spends in compliance and Appeals as a whole rather than designing processes that are “inwardly focused.” The Service’s consideration of the total time a case spends in both Exam and Appeals as an organic whole may eliminate any incentive either division would otherwise have to reduce time the case spends in its own function without an eye towards the larger picture of utilization of IRS resources. Based upon briefing sessions provided to IRSAC, we understand that LMSB cases currently spend about five years in the Examination division (“Exam”) and about two years in the Appeals division. The goal of the Initiative is to decrease the total time from 86 months to less than 48 months for cases worked by both LMSB Exam and Appeals. The focus of the Initiative is eliminating areas of duplication (*e.g.*, both Appeals and LMSB doing tax computations) and smoothing out the process of transferring information between Exam and Appeals.

Focus on Reducing/Eliminating Premature Appeals

One of the areas targeted by the Initiative is the elimination of cases, that are not ready for conference, being forwarded from Exam to Appeals. This is not a new area of focus, but rather an ongoing, significant issue. Reduction of premature Appeals should make the process more cost and resource effective. Our understanding is that twenty percent of the cases sent to Appeals are initially rejected for consideration since they are not

adequately developed, *i.e.* the facts are not appropriately developed, the legal framework not adequately researched, etc. Many of these cases return to Appeals after further development by Exam. This situation is likely a product of Exam not being fully knowledgeable about the scorecard Appeals uses to determine whether a case is sufficiently developed for its consideration.

One way to decrease the number of premature Appeals is to provide the Exam team that worked an issue ultimately settled at Appeals with a copy of the Appeals Closing Memorandum (ACM) via a formal post-Appeal conference with the Taxpayer. This information may be helpful to Revenue Agents in planning examinations and understanding the manner in which issues are evaluated and considered at Appeals, including how the facts are applied to the relevant legal precedent and how uncertainties regarding the law and proof of fact are addressed. While closing conferences have long been a part of the procedural tapestry on paper, in practice they are often not conducted at all or address only skeletal content.¹ Exposure of the process to the maximum degree of sunlight will provide all parties to the process with greater clarity regarding the roles played and nature of issue evaluation. This clarity, which inures to the benefit of all, will aid in the efficient handling of future matters and remove any perceived mystery in the process.²

¹ Of course, such sharing of information does not vest, nor should it entice, Exam to engage in future discussions of issue settlement regarding other matters whereby hazards of litigation are taken into account.

² The same copy of the ACM would have to be furnished to the taxpayer to avoid *ex parte* issues.

Streamlined ACMs

Another suggestion to reduce use of Appeals' resources and expedite case handling is to eliminate the drafting of extensive draft ACM's prior to conferencing of the case and/or after settlement of a matter. To the extent a reasoned summary of the facts and settlement can be memorialized in a form that is useful for the government, we believe this may alleviate burden on the Service and move cases more rapidly, thereby serving the interests of taxpayers as well.

Minimization of Continued Dialogue with Exam Once An Issue is Ripe for Consideration by Appeals

Another means of reducing overall cycle time proposed in the Initiative is to increase the involvement of the examination function during the Appeals process. The LMSB Subgroup believes Exam input is appropriate if the taxpayer raises new issues or new facts in the protest. Excess involvement, however, has the potential to frustrate the function of Appeals and may engender unnecessary independence concerns regarding the role of Appeals. Such a practice is also likely to increase taxpayer requests that Appeals objectively demonstrate satisfaction of the *ex parte* rules. Appeals is an institution of the highest integrity. Taxpayers and tax practitioners recognize and respect its objective evaluation of issues. Inserting Exam into the Appeals process beyond traditional involvement jeopardizes one of the cornerstones that has made the Appellate process reliable and successful. Appeals has gained this respect because of its actual and perceived, independence. Therefore, any change that would cause concern regarding independence should be

approached with the utmost care and sensitivity. It is difficult to separate perception from reality; and, once the wave of perception is in motion, it is difficult to reverse.

The LMSB Subgroup also notes that such a practice may have the impact of unduly prolonging the process via the creation of new case theories and arguments from Exam while the case is at Appeals, which may carry a potential toll-charge of additional “hot interest” to the taxpayer.

The contemplated process of involving Exam in the traditional Appellate hearing to address substantive matters is appropriate for Fast Track Mediation or Settlement, in which the taxpayer and Exam function are both parties to the process and apply for participation in it. One of the reasons the Appeals process is so successful is that it provides the Service and taxpayers a means of reviewing issues through new lines of communication. Sometimes the mere fact that different individuals are driving the process leads to a better understanding of relative merits of positions and/or increased or meaningful dialogue. Inserting another participant, e.g. Exam, into the traditional Appellate process may likely frustrate the process.

Finally, the LMSB Subgroup understands that an additional means of reducing cycle time is to materially limit the granting of extensions of time for protest. We propose that taxpayers and Exam be held to the same 30 day window for protest rebuttal and forwarding to Appeals so long as no new issues or facts were presented in the protest. The LMSB subgroup is aware of no rational basis for differentiation. The normal restrictions on raising new issues would continue to apply to protest rebuttals. This appears to be a practical and

simple means of reducing overall cycle time and is consistent with the principles of fairness embodied in typical administrative and litigation proceedings.

Moving Closer to a “One Meeting One Issue” Rule in Practice

A fourth area targeted by the Service in the Initiative is to move towards using a “one meeting one issue concept” whereby one conference is held to settle each individual issue (with the potential to settle more than one issue per conference). Then, a joint closing conference would be held covering all issues. This has long been a stated goal. However, this may be inconsistent with sound tax administration since issues might settle at different times and some might require more time than one conference -- especially if an issue were a coordinated issue or factually and/or legally complex. Placing focus on the substantive issues, with a “one conference one issue” goal, and moving the computational aspect to a specialized function in which the computations are performed once by the most experienced personnel is a laudable means of reducing time in Appeals and overall cycle time. The LMSB Subgroup understands that there are issues for which the nature of the matter itself is computational or the settlement framework is so complex that the settlement cannot be properly memorialized in an ACM until a final computation is performed. With the exception of those cases, however, the streamlined ACM approach is practical.

The LMSB Subgroup notes that there is a growing concern amongst tax practitioners and taxpayers that Appeals is being excluded from much of the Appeals process because of the increased focus on the settlement initiatives and coordination of issues. Where issues are

coordinated formally or informally, or where particular settlement or resolution initiatives exist, it is critical that Service decision makers be identified and actively participate in the Appellate process. In addition, matters should not be accepted into the Appellate process when it is known that the Service is not in a position to settle the matter. Where the Service has formulated strict guidelines regarding range of settlement, both the existence of the guidelines as well as their terms should be clearly communicated to the taxpaying public. This method, when previously used, has worked successfully from a process and resource management perspective. These techniques reduce error in communication, provide a necessary openness to the settlement process and ensure that expectations are well articulated and managed on both sides. This effort also should have the effect of reducing cycle time since, where applicable, it places the decision makers at the table together and identifies when a decision is not possible through traditional Appeal.

Recommendations

1. LMSB and Appeals should continue to pursue significant improvements in cycle time.
2. The Initiative should be developed in such a way as to protect the independence and objectivity of Appeals as well as the perception of such.
3. The Initiative should require that Appeals timely provide Revenue Agents and Taxpayers with a copy of any Appeals Closing Memoranda to help in planning future examinations.

4. Appeals should revise its form for the Appeals Closing Memorandum in a manner useful to Exam in order to help reduce cycle time.
5. The Initiative should not increase involvement of Exam in the Appellate process.
6. Appeals should mandate a 30-day window for Exam to provide any rebuttals to taxpayer protests when the taxpayer has not raised new facts or new issues.
7. The Initiative should use test groups to develop methods of standardized tax computations.
8. The Service should continue to seek assistance from stakeholder groups in designing the post-filing process.

C. TAX SHELTER STRATEGY

TAX SHELTER SETTLEMENTS AND PENALTIES

Discussion

The LMSB Subgroup strongly supports and commends the IRS in its “crackdown” on abusive tax shelters and tax shelter promoters. Abusive tax shelters are destructive to the underlying fabric of the tax system and strong administrative action is appropriate in response to abusive tax shelter activity.

The IRS began last year to take a much harder line with taxpayers who engaged in abusive tax shelter activity, and it has maintained that approach. This approach is evidenced best by the settlement offers that were made in connection with various listed transactions. In order for a taxpayer to settle the case without trial, the IRS required the imposition of

penalties except in the case of taxpayers who had voluntarily disclosed their abusive tax shelter activities during the limited period provided in Notice 2002-2.

We strongly support the initiative taken by the Service and generally support the approach utilized. Taxpayers who engaged in abusive tax shelters should not benefit from the audit lottery and/or abusive interpretations. Claimed losses from abusive tax shelters must be disallowed. On the other hand, the Service must recognize that taxpayers can engage in planning to reduce their tax liability from legitimate transactions. Care must be exercised by the Service in drawing and recognizing this distinction.

In addition, consistent application of penalties is an important aspect of tax administration. Taxpayers who engage in abusive tax shelter activities need to know that they will have to pay significant penalties (and not just tax plus interest which in turn is tax deductible) if they are caught. The threat of penalties provides a significant deterrent to taxpayers.

In this respect, the Service should recognize the value of “divide and conquer” and the value of differentiating between abusive and non-abusive taxpayers. The Service’s limited resources are more efficiently used by developing allies. The Service should recognize that non-abusive taxpayers, who represent the backbone of our voluntary compliance tax system, also suffer both professionally and personally from the actions of abusive taxpayers. The Service should actively attempt to ally themselves with non-abusive taxpayers (possibly from settlements with less aggressive tax shelter users). By allying itself

wherever possible, the Service's resources can be utilized to identify and combat abusive tax shelter developers and users, without diluting available resources on non-abusive taxpayers.

In this sense, the Service should:

1. Actively encourage the support of non-abusive taxpayers in the abusive tax shelter examination and settlement program.
2. Actively review and clearly define abusive tax shelter activities. The Service needs to appreciate the ineffectiveness of creating so wide a net as to overload enforcement activities. The Service should exercise utmost care before any transaction is "listed."
3. Expend greater resources providing training and education in this area so that legitimate tax planning that is either not understood or for which the result is not clear is not falsely classified as an abusive tax shelter.
4. Avoid using so-called shelter initiatives or listing of transactions to gain undue leverage in attempting to force resolution of an issue or in an attempt to impose and sustain penalties.
5. Aggressively pursue methods of identifying existing and new abusive tax shelters.

The most important aspect of tax shelters is to prevent them before they happen, which occurs only if the IRS targets the promoters as well as the taxpayers involved. The only way to inhibit future tax shelter activity is to find and penalize the persons who sell

them. That appears to be the approach that the IRS is taking, and we commend it. The imposition of penalties against promoters may be just as, if not more, important in preventing a re-occurrence of the tax shelters that emerged over the last decade as any other single step that the IRS has taken. While users must be penalized, the Service must remember that a problem is best cured at its source. We also believe that the focus on mid-market compliance, as discussed below, is an integral aspect of this issue, because “touching” more taxpayers makes it more likely that abusive tax shelters will be identified before they spread. Letter inquiries are low cost alternatives and serve the same purpose. Touches inform taxpayers that they are not hidden within the tax system and forgotten about by the IRS.

We remain concerned, however, that the “hard line” that has been taken with respect to taxpayer penalties may also result in a strain on the IRS’s resources and benefit tax promoters and tax abusers, if the IRS is unable to settle a large percentage of individual and corporate tax shelter cases. Some individuals and corporations may have legitimate arguments that they are not subject to penalties because they relied upon recognized tax professionals. Whether or not these arguments will be persuasive in court is not certain, creating the potential for the IRS to eventually be subject to some unfavorable decisions. The Service needs to be sensitive to the adverse effect of the headlines associated with unfavorable decisions, which affect future settlements and the public’s confidence in the tax system. The Service should not pursue risky cases where failure may undermine the Service’s enforcement program as a whole. Settlement initiatives are generally the most

efficient and fair way to resolve the remaining disputes, and some forgiveness or reduction of penalties may be required. The Service should be aware of the advantage to the most egregious abusers of clogging the system with numerous, less abusive cases.

Recommendations

1. The Service should continue to pursue abusive tax shelters as a top priority, with particular emphasis on promoters, including the imposition of penalties.
2. The Service should prepare guidelines under which Appeals can resolve each type of abusive tax shelter, taking into account the IRS's view of the law and each taxpayer's particular circumstances.
3. The Service should continue to be diligent with regard to the tension between taxpayer rights and its right to penalize improper taxpayer behavior.
4. The Service should focus more attention and resources on individual or mid-market taxpayers. Agents should be on the lookout for abusive tax shelter activity in this segment.
5. The Service should recommend that the interest associated with abusive tax shelter assessments be non-deductible or only partially deductible.
6. The Service should encourage the support of non-abusive taxpayers in its fight against abusive tax shelters.

7. The Service should encourage settlements among less abusive tax shelter users if they agree to specific actions such as:
 - a) Forbearance of future abusive activities,
 - b) Disclosure of all past tax shelter activities, and
 - c) Disclosure of other tax shelter products of which they are aware.

8. The Service should recognize the strategic advantage accorded abusive tax shelter users and promoters when the enforcement and judicial systems are overloaded and justice is delayed for a long period of time, often until the perpetrators are retired and have had time to hide their assets.

9. The Service should recognize the vital importance of preventing future abuses. This will reduce the requirement for resource utilization to identify and attack abuses after they occur and will encourage confidence in the tax system among non-abusers. The settlement process should be used to help accomplish this goal.

10. The Service should continue to increase its active participation with state and local tax administrators in information sharing and resource coordination. This is particularly true with states that have or will implement local tax amnesty programs.

11. While we encourage sharing of information, the Service must recognize that many of the state disclosures were protective to avoid penalties on items that were clearly not tax

shelters. The Service should also ensure it properly educates its employees and provides internal resources that understand the nuances of the state disclosure regimes and that some of the voluntary disclosure procedures were clearly geared to raising needed revenue rather than identifying abusive transactions.

12. The Service should encourage active coordination regarding abusive transactions among LMSB, SB/SE, and W&I. The Service should analyze if there is a correlation in abusive tax shelter use between individuals and the businesses that they control or manage. It is likely that individuals who employ abusive tax shelters in their businesses also employ abusive tax shelters on their individual returns and vice-versa.

TAX SHELTER DISCLOSURES

Discussion

The Jobs Creation Act of 2004 increased the information available to the Service concerning potential tax shelters as a result of the disclosure requirements under Sections 6011 and 6111 of the Code. Under these provisions, taxpayers and their material advisors are required to make certain disclosures concerning all listed and other reportable transactions. We understand that the Service has received a significant number of disclosures under both provisions, and that the Service is establishing procedures to review and respond to these disclosures.

We believe that the Service should give special emphasis to disclosures concerning listed transactions. It is essential that taxpayers, and their advisors, understand that any filings made

with respect to listed transactions will be immediately addressed. Based on anecdotal evidence, we are concerned that the Service may not have the resources necessary to promptly contact taxpayers, or material advisors, who makes a disclosure with respect to a listed transaction. The efficacy of the new disclosure regime as a limitation on undesirable taxpayer behavior may depend upon taxpayers, and their advisors, knowing that there will be an immediate follow up on any disclosure concerning a listed transaction.

We recognize that there are different considerations regarding other reportable transactions. For example, a corporation may have entered into a completely non-abusive transaction which generates a substantial book-tax difference, or a loss may be fully allowable notwithstanding disclosure was required. We believe that the Service needs to devote the resources necessary to review the disclosures made under Sections 6011 and 6111 with respect to other reportable transactions. Again, in order to increase compliance, it is important that taxpayers know that any disclosures that are filed concerning other reportable transactions will be reviewed in order to determine whether a further examination is appropriate.

Recommendations

1. The Service should promptly contact all taxpayers and material advisors who make disclosures with respect to listed transactions under Sections 6011 and 6111, respectively.
2. The Service should implement procedures to promptly review the disclosures made with respect to other reportable transactions so that it can:
 - a) Timely determine whether further examination is appropriate.
 - b) Identify disclosures which are unnecessary and dilute resources so that such disclosures can be eliminated from future filings and reduce the compliance burden on non-abusive taxpayers.
3. The Service should continue to emphasize publicly that sufficient resources are being allocated to reviewing disclosures in a timely manner.

JOINT INTERNATIONAL TAX SHELTER INFORMATION CENTER

Recommendation

We received limited information concerning the initiative for domestic and foreign taxing authorities to share information and engage in dialogue regarding potential tax shelters where the sharing of information would not violate local disclosure rules. However, given the growth of tax shelters from a domestic to an international problem, this seems like an excellent idea to further the

goals of consistent and sound U.S. tax enforcement efforts. However, we note that tax arbitrage is a natural result of different nations employing different tax standards and definitions and should not be confused with tax shelter activity. Business transactions entered into in the ordinary course of business may be treated differently under the tax laws of different tax jurisdictions, and U.S. taxpayers may lawfully structure business transactions with these differences in mind to achieve economic benefits. The mere existence of tax arbitrage itself is not, and should not be viewed by the IRS, as nefarious. It is only when the arbitrage encroaches on the U.S. tax laws that there is a potential for questioning the soundness of the structure. These points should be clearly articulated and disseminated in training materials and published guidance related to this initiative.

D. FOCUS ON MID-MARKET TAXPAYER COMPLIANCE

Discussion

The LMSB Subgroup has continued to express concern that the mid-market taxpayer base has been under-audited for many years. The Service has dedicated significant resources to auditing the largest LMSB taxpayers on a continual basis, simply because they are the largest taxpayers. We continue to believe that this is not the best use of resources.

As an example of this focus, for fiscal year ended 2004, LMSB was comprised of 159,320 taxpayers. Of these, 102,437 (64.3%) were either subchapter S corporations, partnerships, or limited liability companies (LLCs) -- collectively "flow-through entities." The Service audited approximately 2.9% (2,963) of these flow-through entities during the fiscal year ended 2004. On the other hand, there were 11,018 LMSB taxpayers that were subchapter C corporations with more than \$250

million of assets. The Service audited approximately 37.9% (4,181) of these taxpayers during fiscal year-ended 2004.

The LMSB Subgroup continues to believe that as a result of the Sarbanes-Oxley legislation, focusing a significant amount of resources on the largest of the LMSB taxpayers is not in the best interest of the Service. Based on the Service's own projections, the population of flow-through entities is expected to grow to over 150,000 in the year 2008. If the Service is not able to increase its 2.9% audit rate on these taxpayers, an increasing number of taxpayers will go un-audited.

With the tax gap continuing to increase and the largest component of the tax gap being under-reporting of income, failure by the Service to increase audits or "touches" of the mid-market taxpayers (LMSB taxpayers with less than \$250 million in assets and flow-through entities) promotes an attitude of under-reporting among this group of LMSB taxpayers because there is a belief amongst these taxpayers that they will never be audited. In order to be effective, audits of mid-market taxpayers need to increase in terms of number of taxpayers audited as well as percentage of taxpayers audited.

The LMSB Subgroup is also concerned about the increase in the number of "transactional" flow-through entities that have been formed in recent years. A "transactional" flow-through entity is an entity that begins a tax period with negligible assets, conducts a significant transaction during the tax period, and ends the tax period (as a result of the transaction) with negligible assets. As it stands currently, these "transactional" flow-through entities are not considered LMSB taxpayers; however, some LMSB taxpayers use these entities to conduct certain transactions. Failure to account for and audit these entities could reduce the effectiveness of increasing coverage on the overall population

of mid-market taxpayers since these entities may be used to shift the reporting of aggressive tax transactions from the mid-market taxpayer to this type of "transactional" entity.

As the population of LMSB taxpayers continues to increase (almost entirely through the increased number of flow-through entities), risk assessment in selecting taxpayers to audit will be crucial. Because of the relatively low level of assets required to qualify a taxpayer as an LMSB taxpayer (at least \$10 million), many taxpayers included in LMSB may be inherently lower in risk due to their purpose (for example an LLC that owns a commercial rental property) than others, making risk assessment critical.

There is a fiscal year 2007 resource initiative regarding enterprise risk within LMSB. This initiative will provide additional resources (approximately 153 full-time equivalent Revenue Agents) to increase examination coverage for flow-through entities. However, this initiative is still a year away and is based largely on the Service receiving substantial increases in its annual budget for 2006 and 2007. We believe this initiative will go a long way toward increasing audits of mid-market taxpayers, but also believe that LMSB should develop a contingency plan to carry out this initiative in the event that the requested budget increases are not received.

We commend LMSB on their other initiatives designed to improve currency, reduce cycle time, and shift resources away from auditing the largest of the LMSB taxpayers including Schedule M-3, mandatory electronic filing, remote examinations, and the Compliance Assurance Program ("CAP"). We believe that all of these efforts should continue to be aggressively pursued, and that they should result in the ability to reallocate resources to audit mid-market taxpayers. Re-focusing

resources to this basically untouched taxpayer base should pay dividends to the IRS by significantly increasing taxpayer compliance.

Recommendations

1. Continue to explore ways to leverage the Sarbanes-Oxley legislation in order to release more resources, currently devoted to auditing the largest of the LMSB taxpayers, to audit mid-market taxpayers.
2. Develop a contingency plan in the event that the requested level of funding under the fiscal year 2006 or 2007 budget is not received in order to carry out the current initiatives to increase audits of mid-market taxpayers.
3. Continue to develop tools and initiatives--such as remote examinations, Schedule M-3 and mandatory electronic filing--to assist with risk assessment and selection of LMSB taxpayers for audit.
4. Include "transactional" flow-through entities in the population of LMSB taxpayers and devote resources to both understanding and auditing these entities.
5. Increase training of Revenue Agents in the field of flow-through taxation including training related to TEFRA audits, subchapter S corporations, and partnership taxation.