INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

LARGE & MID-SIZE BUSINESS
SUBGROUP REPORT

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LARGE & MID-SIZE BUSINESS
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INTRODUCTION/EXECUTIVE SUMMARY

The Large & Mid-Size Business Subgroup (hereafter "LMSB Subgroup") consists of volunteers. These volunteers are professionals who represent large and mid-sized businesses, accounting and legal professionals, and large multinational firms. The members of the LMSB Subgroup come to IRSAC and commit to leaving their personal agendas behind. The LMSB Subgroup role is to provide advice and insight to the IRS and particularly 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 tax administration, develop equitable tax policy, increase taxpayer confidence and improve voluntary compliance.

The LMSB Subgroup has been busy since January 2006 with five meetings conducted in Washington D.C. and several specific issue conference calls. Each meeting was a collaborative session with LMSB that resulted in genuine and frank discussions of relevant issues.

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 Subgroup would have been unable to accomplish its mission of being, as Commissioner Mark Everson said in January 2004, the IRS's "boots on the ground."

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 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.

The LMSB Subgroup recognizes that closing the tax gap is a major concern of Commissioner Everson, the Congress, IRS personnel and all good faith taxpayers. Compliant taxpayers, according to the IRS Oversight Board's 2005 Taxpayer Attitude Survey, constitute an overwhelming percentage of our population. This survey stated that 88% of the population believed that it was "not at all acceptable" to cheat on their income taxes. This represents a 7% increase from 81% just two years earlier. Similarly, the survey found that another 7% of taxpayers felt that it is acceptable to cheat "a little here and there." This was a decrease of almost 50% from two years earlier. We believe that this is true of the LMSB business community as well. Taxpayers who are voluntary compliers represent natural allies to the Service in closing the tax gap. This is particularly true in the LMSB community where the taxpayers are less numerous and are business competitors with each other. It is obvious that a business which underpays its taxes has a significant advantage over a compliant business in that it has more cash for equipment upgrade, product development, advertising, distribution and other business activities.

We commend LMSB for its impressive list of initiatives and successes in recent years. These initiatives have encouraged voluntary compliance through a combination of service to compliant taxpayers and greater enforcement toward non-compliant taxpayers. LMSB's many successful currency initiatives, such as, but not limited to, Schedule M-3, E-filing, Limited Focus Examination, Compliance Assurance Program, Pre-Filing Agreements and FAST Track Appeals, increases currency (reduces taxpayer burden) and increases early identification of issues (a key enforcement tool). Other LMSB taxpayer service initiatives, such as US Residency Certification Requests, the new FIN 48 expedited examination program, and taxpayer education efforts such as the highly successful annual Financial Services Industry Conference (with over two-hundred taxpayers and advisors from around the world), enhance voluntary compliance and create win-win situations for the IRS, the taxpayers and our tax system as a whole.

We also wish to thank and commend the LMSB leadership for the effective use of the taxpayer volunteers on the IRSAC Committee. LMSB's pre-decision involvement of the Committee on a number of issues helped LMSB achieve its goals of reduced taxpayer burden and increased effectiveness of enforcement assets.

Notwithstanding all of these impressive successes, there is always room for improvement and the environment is always changing.

We have structured this report to recognize these elements and to begin to address large and mid-size business compliance issues as addressed by Commissioner Everson in his testimony on June 13, 2006, to the Senate Finance Committee.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: MODERNIZED E-FILE AND FOLLOW-UP USES

Executive Summary

In January 2005, the IRS and the Department of Treasury issued regulations that require corporations with assets of $50 million or more and that file at least 250 or more returns per year (including income tax, excise and employment tax, as well as information returns such as Forms W-2's and 1099's) to file electronically their Forms 1120 and 1120S beginning with tax periods ending on or after December 31, 2005. Mandatory e-file is considered a success by the IRS and should assist IRS in achieving goals of currency and burden reduction. This is in the best interest of both the IRS and compliant taxpayers. However, attention must be given by the IRS to the data received. This data must be utilized by the IRS in a manner to support the currency and burden reduction initiatives and not just stored on a shelf or added to an exam team inventory without being thoroughly screened. Mandatory e-file should be expanded to touch more taxpayers, and the IRS should continue to allocate resources to this effort.

Background

E-file is not a new concept as e-file for individuals has been around since 1986. Over the years, the IRS has been able to utilize data obtained from e-filed returns to review taxpayer data, process returns quicker, determine if errors are made, and generally process refunds quicker. E-file for individuals has greatly increased from 64,554,000 returns for filing season 2004 to 75,997,000 returns for filing season 2006.

E-file for corporations is a relatively new development available since 2004 on a voluntary basis. E-file for corporations took a giant step forward in 2006 because of the requirement that certain entities be under a mandate to e-file returns for return periods ending on or after December 31, 2005. Initially, only corporations with assets in excess of $50 million and who file more than 250 returns were required to e-file. In addition, tax-exempt organizations with $100 million in assets that file at least 250 returns a year are subject to mandatory e-file. For tax years ending on or after December 31, 2006, the use of mandatory e-file will be expanded to include those corporations and tax-exempt entities with assets in excess of $10 million and who file 250 returns for the year. In addition, private foundations and charitable trusts will be required to e-file Form 990-PF, regardless of their asset size, if they file 250 or more returns a year.

The main emphasis behind e-file is three-fold:

- to allow the IRS to obtain information from a taxpayer quicker and in a format that lends itself to faster processing (Currency)
- to reduce processing, storage costs and other costs (Burden Reduction)
- to assist the IRS in identifying those returns that have the greatest potential for change upon examination (Compliance).

Each goal is very important for the future success of the IRS.

While the goals of e-file are noble and worthy, the IRS should be conscious of using the data received and not just storing the data. We point specifically to the recent filings made on tax shelters and Form 8886 “Reportable Transaction Disclosure Statement.” Taxpayers were required to file these forms with the IRS Office of Tax Shelter Analysis (“OTSA”) by the due date of their 2004 tax return (with substantial penalties for failure to file the forms or provide required information). Based upon meetings with LMSB officials, IRSAC members did not initially get to a comfort level that anything had been done with these forms by OTSA on a timely basis. At first we were told that these filings were stacked in an office in Ogden waiting to be processed. Several months ago, we learned that the forms had finally been processed. We have now been informed that some of those forms have now reached the examination group. Many taxpayers had to rush to complete these forms on a timely basis. However, the IRS was unable to do much with them on a timely basis. We are hopeful that the e-filed tax return information will be utilized more quickly.

<u>Recommendations</u>

1. It is imperative that e-filed information is utilized by the IRS on a timely basis to assist in their currency initiatives. Taxpayers have incurred substantial expenditures of dollars and time and must see some benefit from their actions (in reduced cycle time and identification of significant issues). Once the IRS has received the e-filed returns, they should act rapidly to utilize the data in a manner that assists them in processing returns quicker, expediting refunds, preparing issues for examination, assisting in meeting the goals of currency and burden reduction, and reducing the tax gap. IRSAC would like to be periodically updated on what is happening with the data received and how e-file is assisting.
2. The IRS has slowly expanded mandatory e-file for certain entities over the last several years. The IRS has done this systematically by adding more and more returns, types of forms, and taxpayers. IRS should expand mandatory e-file to all corporations, partnerships, trusts and tax exempt entities. The IRS should provide significant amounts of time for taxpayers and tax preparers to be ready for mandatory e-file. The IRS should also continue to work with outside software

vendors to ensure that products are available to transition to mandatory e-file as smoothly as possible.

3. Mandatory e-file is an important tool of the IRS and LMSB. However, mandatory e-file and the expansion of the program is only possible if adequate funding and resources are made available. IRS should seek the appropriate funding and allocate resources for this project in a timely manner. Funding should include software development or purchase of software that will aid in the identification of substantive issues that can lead to reduced cycle time.
4. The IRS has published guidance on waivers for those corporations unable to meet the e-file requirements –see Notice 2005-88. The IRS should continue to issue clear and concise guidance on waivers for taxpayers that are subject to mandatory e-file increases. Guidance issued on this issue should be done on a timely basis so that impacted taxpayers can plan accordingly.
5. IRSAC strongly commends the LMSB for its outreach and cooperation with taxpayers and service providers in accomplishing a task that many believed was almost impossible. We strongly recommend that the level of cooperation and resources should be continued and expanded to ensure that the next group of corporations (those with assets between $10 million and $50 million) can also accomplish the goal of e-filing in the next tax year.
6. The requirements on international tax forms should be reviewed by the IRS to facilitate the e-filing of these forms for the current tax year.

ISSUE TWO: TAX SHELTER FOLLOW-UP ISSUES

Executive Summary

The LMSB Subgroup has continually and consistently supported the IRS in its attack on abusive tax shelters and tax shelter promoters. Abusive tax shelters are destructive to the underlying fabric of the tax system and increase perceptions that the tax system is "unfair." Strong and timely administrative action is appropriate in response to abusive tax shelter activity. This is particularly true with regard to tax shelter promoters. Simultaneously, it is important for the IRS to continue to educate its personnel on the distinction between legitimate tax planning and abusive tax shelters.

Background

During the past two years, the IRS also has made a number of "global settlement offers" in an attempt to resolve a significant portion of the outstanding tax shelter disputes. These settlement offers have been both fair and tough, and penalties have been required in many situations. There has been a high acceptance rate for these offers. Again, we commend the IRS on this approach, which we believe appropriately balanced administrative necessity (by avoiding time-consuming audits and trials) and the systemic requirement that tax shelter investors not be rewarded for their actions. These global settlements have been an important aspect of the IRS' attack on shelters, and we believe that this approach has been well designed and implemented.

We note that 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 if and when they are caught. The threat of penalties is a significant deterrent. Commendably, the global settlements have adopted this approach.

Another important aspect of the response to abusive tax shelters has been "sunshine." In legislation adopted in 2004, Congress required reporting by participants in reportable transactions under Section 6011 of the Code, and material advisors with respect to certain transactions were also required to file returns with respect to those transactions under Section 6111.

The IRS has made several important steps in this regard. First, the IRS eliminated transactions with book/tax differences from the definition of reportable transactions. The LMSB group applauds this action which was appropriate because of the significant number of non-abusive transactions which generate book/tax differences. The utilization of the new Form M-3 is an appropriate means to identify abusive transactions, and the removal of transactions with a book/tax difference from the definition of reportable transactions is a welcome step.

The IRS also should be commended for continuing to review the scope of listed transactions. The penalties that are imposed for failure to disclose any listed transaction are extremely onerous, so that a "listed transaction" designation should be limited to those transactions which the IRS believes have a significant potential for abusive tax avoidance. The IRS should continue to review whether each transaction that is "listed" should remain so, while also attempting to ferret out other potentially abusive transactions that deserve to be "listed." On the other hand, it is inefficient to define any listed transaction so broadly that the IRS receives numerous unwanted disclosures. "Over-disclosure" is a continuing problem that the IRS must address, but the IRS must also recognize that taxpayers have a strong incentive under current law to err on the side of over-disclosure. This problem arose during the past year with respect to listed transactions involving property subject to offsetting position, resulting in tens of thousands of unnecessary disclosures. The IRS must remain vigilant in reviewing, and narrowing or broadening when necessary, the scope of each listed transaction.

The IRS has not been as successful in implementing these reporting requirements as we believe appropriate. The IRS did not propose a new form for making the disclosures required under Section 6111 but, rather, attempted to adapt an existing form for this purpose. The existing form is not well suited for the disclosures which are required, in that it does not provide sufficient information to the IRS and also is very difficult to complete. We urge the IRS to work with IRSAC to design and to issue new forms for the reporting required under Section 6111 as quickly as practicable. At the present time, the forms being used by the IRS are limiting the amount of "sunshine" which otherwise would be cast on potentially abusive transactions.

A related concern involves the IRS' response to the disclosures that have been filed. Anecdotal evidence indicates that taxpayers who have made disclosures have either had no follow-up contacts with the IRS or, alternatively, have simply received a "tax shelter identification number" to include on their returns. We believe that the IRS needs to implement procedures under which:

1. All filings made under Section 6011 and 6111 are reviewed promptly upon receipt.
2. Each listed transaction that is disclosed by a taxpayer and/or a material advisor should be reviewed to determine whether the transaction is abusive. If it is, the

taxpayer and/or the material advisor should be contacted promptly and an examination of the transaction should be commenced.

3. Each reportable transaction (other than a listed transaction) disclosed by a taxpayer should, at a minimum, be reviewed in order to determine whether there may be additional transactions that should be listed. In appropriate circumstances, taxpayers and/or material advisors who make disclosures of reportable transactions (other than listed transactions) should be contacted in order to review these transactions.

4. The returns filed by taxpayers under Section 6011 and the returns filed by material advisors under Section 6111 should be "matched" to verify that all required returns have been filed.

Another area in which there has not been as much activity as anticipated involves enforcement actions against the promoters who participated in tax shelter activity. With the exception of the well-publicized criminal indictments of individuals associated with KPMG, there has been virtually no visible action taken by the IRS in response to the numerous tax shelters that were sold in the first half of this decade. We are completely mindful of, and support, the need for confidentiality in disciplinary proceedings under Circular 230. We also do not believe that such proceedings should be publicly disclosed unless and until a determination has been made that a practitioner has violated the rules of practice. On the other hand, we strongly support public disclosure of Circular 230 violations if and when a determination that such a violation has occurred is made by an independent reviewer.

We also believe that monetary penalties should be asserted, to the extent provided in the Code, against individuals or firms engaged in the promotion of abusive tax shelters. We encourage the IRS and the Justice Department to widen their use of Code section 6700 (the penalty for promoting abusive tax shelters), Code section 6701 (the penalty for aiding and abetting understatements of liability) and Code section 7408 (actions to enjoin specified conduct related to tax shelters and reportable transactions). Also, in appropriate circumstances, the IRS also should pursue criminal sanctions against the individuals involved in the promotion of abusive tax shelters. The imposition of these penalties, together with appropriate publicity indicating that penalties have been imposed, will provide an important disincentive with respect to future abusive tax shelters.

While we are fully supportive of the IRS' attack on abusive tax shelters, we also believe that it is important for the IRS to distinguish between "abusive" transactions and transactions that reduce a taxpayer's liability through appropriate tax planning. We are aware of situations in which revenue agents have used terms like "lack of economic substance" or "abusive tax shelter" to attack transactions that are appropriately structured to reduce tax liability and which are neither listed nor non-listed reportable. It will be counter-productive in the long term if the IRS does not recognize the distinction between legitimate tax planning and abusive tax shelters. We urge the IRS to continue to educate its personnel concerning the differences between such transactions.

In this regard, we note that the IRS has had several significant recent victories in attacking transactions that lacked economic substance, particularly the recent <u>Coltec</u> and <u>Black & Decker</u> cases. The courts concluded that the IRS had appropriately challenged the economic substance of those transactions. However, the courts also rejected all of the "technical" or "legal" arguments raised by the IRS in those cases as lacking merit and without any basis in the Code. While we strongly support the IRS' challenge to transactions which lack economic substance, the IRS needs to be mindful that it is not appropriate to raise "strained" or "aggressive" legal arguments. The IRS rightfully attacks taxpayers and their advisors who adopt "aggressive" legal positions, but it appears that in some instances the positions being taken by the IRS are equally "aggressive." We are concerned that, if the IRS does not apply the law rigorously, taxpayers or their advisors may also believe that they are not required to apply the law as Congress has enacted it. The long-term interests of the tax system are best served if both the IRS and taxpayers are encouraged to apply the tax laws as enacted, with neither the IRS nor taxpayers taking positions which are contrary to the Code and Congressional intent.

Recommendations

1. The IRS should continue to pursue abusive tax shelters as a top priority, with particular emphasis on promoters.
2. Significant penalties should be imposed on taxpayers and particularly on promoters who engage in abusive tax shelters.
3. The IRS needs to revise the forms used for disclosure of listed and non-listed reportable transactions by taxpayers and material advisors.
4. The IRS should continue to utilize global settlements to resolve disputes involving abusive tax shelters if and when they are identified.
5. The IRS needs to promptly review all disclosures that it receives with respect to listed transactions and to contact the affected taxpayers and material advisors with respect to any transactions that the IRS believes are potentially abusive.

6. Return matching should be utilized to verify that all taxpayers and material advisors are making the disclosures that Congress has mandated.

7. Promoters of abusive tax shelters should, after a determination has been made that fully protects their rights to privacy until final determination, be subjected to disciplinary sanctions under Circular 230 and, in appropriate circumstances, civil or criminal penalties.

8. The IRS needs to avoid adopting "aggressive" or "strained" interpretations of the law in attacking potentially abusive transactions.

9. The IRS should implement measures to reduce over-disclosure of transactions that are not reportable transactions.

<u>ISSUE THREE</u>: TAX GAP - INTERNATIONAL COMPLIANCE ISSUES

<u>Executive Summary</u>

International tax issues are among the most complex areas of US tax law for both compliant taxpayers and the IRS examination teams. It is also an area that has been marked with abusive transactions by non-compliant taxpayers.

<u>Background</u>

In his Written Testimony of June 13, 2006, Commissioner Everson discussed several significant international issues. These included Transfer of Intangibles Offshore/Cost Sharing, Abusive Foreign Tax Credit Transactions, Abusive Hybrid Institution Transactions and Transfer Pricing, particularly with regard to Section 936 taxpayers.

The 2006 IRSAC did not address Section 936 termination issues since we did not have expertise in that area. We also did not address Abusive Hybrid Instrument Transactions because information on these is still being developed.

We did discuss with LMSB several tax administration topics in the international arena. These topics include: (1) the Service's emphasis on transactions involving company exploitation of intellectual property via cross-licensing agreements and cost sharing arrangements; (2) potential simplification in the compliance process; and (3) foreign tax credit planning techniques utilized to either artificially generate creditable foreign tax credits ("FTC"), or more materially, reallocate/redistribute credit and income items to facilitate greater foreign tax credit utilization.

We generally agree that it would be beneficial from a tax compliance and examination perspective to simplify the current information reporting system, including a possible overhaul of Form 5471 and other related information returns. This would facilitate e-filing, enhance more current issue selection and reduce taxpayer burden. Ideally, we believe that such modifications most appropriately go hand-in-hand with overall international tax reform - a topic beyond the scope of this report and probably several years into the future. In the current period, it would be an effective use of resources for the Service to internally delineate for the benefit of the Examination function the areas in international tax that constitute low-risk for which period compliance checks would be a more suitable alternative than comprehensive examinations. To the extent there is a desire to simplify current reporting processes, that type of issue control list may be utilized to facilitate the proposal of alternative formats for information reporting.

We agree that focusing on foreign tax credit generation or splitting transactions that lack a bona fide business purpose and economic substance and which are not compliant with the law is an appropriate area of focus. Tax credit products that may be technically correct, but are inconsistent with the intent of the law, should be identified, and, if necessary, legislative changes should be recommended. We caution that IRS reliance on "the intent of the law" agreements can be a two-edged sword. It is, of course, critical at the same time that the government accord sufficient care to the manner in which the net is cast to close abusive transactions so that legitimate business transactions are not inadvertently swept up by any such initiative.

The business community is keenly aware of the Service's increased interest and focus regarding the manner in which intellectual property is exploited and sometimes abused by companies. Cross-licensing agreements ("CLAs") and similar intellectual property ("IP") sharing arrangements have been a mainstay of numerous industry sectors and have been operationally employed for several decades. These agreements generally function as the cornerstone for the generation of fluid information sharing which is a material driver to technological advancement and the creation of commercial product. These agreements are often created to manage risk from a legal liability perspective, share information, of course, and manage costs. There has been material commentary in this area and we encourage the study of this topic so that clear administrative guidance can be promulgated to reduce existing or potential controversy. As part of such guidance, the Service should confirm that merely entering into a CLA does not constitute a realization and recognition event such that income is generated. This notion is consistent with the existing guidance and case law.

With respect to the topic of cost sharing rules and "buy-ins" (the method by which external contributions of property are valued), we understand there is a desire by the Service to increase its attention and focus in this area. We agree that some taxpayers have abused this area. In general, these issues are largely valuation ones. Valuation inherently lacks scientific precision; and, in this context, we are aware that the determination of taxable income regarding the transfer of intellectual property can present challenges for both the IRS and taxpayers. The 2006 IRSAC did not have time to discuss with LMSB the rules set forth in Treas. Reg. section 1.482-4 and the apparent conflict with the administrative rules set forth in the -7 regulations. It is hoped that the 2007 IRSAC will be able to address with LMSB the -7 regulations and its possible intrusion into the manner in which companies conduct their business and apparent lack of conformity with the OECD cost contribution guidelines. The legislative history of the 1986 Tax Reform Act regarding Section 482 is clear in that there was no intention to prevent the use of bona fide cost-sharing arrangements as long as they are in accordance with the purpose of the provision and "reasonably reflect the actual economic activity undertaken by each." Accordingly, we believe sound tax administration would be best served by risk assessing and focusing on the transactions at the extremes of the spectrum, so that no harm is done to domestic growth. Objective evaluation of whether transactions reasonably reflect the economics of the relationships (as opposed to hair splitting that will only propagate unnecessary controversy) should be encouraged so that enforcement assets can be focused on abusive transactions. In this regard, IRSAC is concerned that a problem area may exist for mid-market firms with international transactions.

We agree that there are many complex transactions in the international area of tax compliance and that some of these are abusive. In that regard, we commend the IRS for the creation of the position of LMSB Deputy Commissioner, International and the appointment of Frank Ng as that Deputy Commissioner. We believe that this position is in the best interests of compliant taxpayers. It will help bring more certainty and consistency to those issues, reduce burden on compliant taxpayers and help identify and correct abusive transcations of non compliant taxpayers.

Recommendations

1. Simplify the current information reporting system for international data and determine if certain data on the forms is not needed and if certain forms can be consolidated.
2. Provide auditors with screening mechanisms to recognize possible abusive FTC transactions (e.g., require high-level disclosure for a three to four year window on information returns reflecting FTC generated per basket and FTC utilized per basket).
3. Delineate for the Examination function the areas of international tax that constitute low-risk areas for which periodic compliance checks would be suitable.
4. Issue clear adminstrative guidance confirming that merely entering into a CLA does not constitute a realization and recognition event such that income is generated.
5. Stratify the population of cost-sharing and buy-in issues and critically evaluate those that present a higher risk for the government regarding valuation issues, so that resources are appropriately and efficiently deployed.

6. Expand the number of IRS "touches" for mid-market firms with international transactions.

<u>ISSUE FOUR</u>: TAX GAP - DOMESTIC COMPLIANCE ISSUES

<u>Executive Summary</u>

The Research and Experimentation credit and the Deduction for Certain Manufacturing Activities are among the most important sections of the Internal Revenue Code enacted by Congress. Their importance is directly related to Congress's intent to create US jobs in a worldwide economy that is marked by the increasing outsourcing of US jobs to foreign locations.

<u>Background</u>

In the Written Testimony of June 13, 2006, Commissioner Everson discussed several significant domestic issues. These included Research and Experimentation (R&E) Credit Claims, Universal Service Fund, Mixed Service Costs, Deduction for Certain Manufacturing Activities (IRC Section 199), Foreign Earnings Repatriation (IRC Section 965), Executive Compensation (IRC Section 409A), Tax Shelters and Other Abusive Tax Avoidance Transactions, as well as an increase in book-tax differences.

We did not look at the Universal Service Fund and Mixed Service Cost issues because they are industry specific, and we did not have expertise in these areas. Our Committee did discuss the Section 965 and Section 409A issues. These issues are under compliance review by their respective Issue Management Teams to determine if they are tax issues. Hence, they are not ready for recommendation by IRSAC this year, but the subcommittee looks forward to being of assistance in future years if tax issues are determined to exist. We commented on our opposition to abusive tax shelters earlier in this Annual Report and in past Annual Reports. There is no need to report them other than to re-emphasize the importance of early detection and the opportunity for the IRS to develop alliances with compliant taxpayers to bring abusive taxpayers into compliance. Regarding book-tax differences, we agree with the need to examine these in greater depth to fully understand their impact on compliance. We recognize that some industries, such as publishing, are adversely affected by book-tax differences while other industries benefit from them. We believe that early data from Schedule M-3 analysis indicates that the largest book-tax difference is depreciation. We also recognize that more complete reporting of data on Schedule M-3 and the analysis of it will help identify areas of abuse by non-compliant taxpayers.

The remaining two issues, the R&E Credit and the Manufacturing Deduction, are issues that we wish to comment on. These two issues are similar in Congressional intent and appear to be mirror images in compliance difficulties.

The Congress recognizes that the United States has one of the highest statutory and effective tax rates among our major trading partners. They also recognize that capital flows easily across borders and with that flow goes jobs. Congress enacted both of these sections to help create or protect US jobs.

The R&E Credit has been the subject of much controversy. Some taxpayers have filed abusive claims. Other taxpayers feel that the IRS undetermined the intent of Congress by being unnecessarily restrictive and burdensome on requested credits. An atmosphere of distrust developed to the extent that some non-abusive taxpayers believed that the opportunity cost and burden required to sustain the credit was less than the value of the credit. These taxpayers essentially stopped claiming the credit on their tax returns or in their return on investment calculations, thereby defeating Congress's intent.

The IRS examiners were, and still are, trying to determine the correct credit. In doing so, a large amount of IRS examination resources are being expended.

Similarly, the Section 199 manufacturing deduction is intended to create US jobs, but it is very complex and can become very burdensome. However, the IRS is working to get in front of this issue.

LMSB recognizes that Section 199 is a very challenging area for the taxpayers and the IRS. LMSB is proactively trying to identify and address problems to avoid bigger problems in the future. They are hoping to avoid marketing claims in this area such as happened in the R&E area. They have substantial taxpayer involvement, have at least seven guidance projects in progress, have developed a five-point Field Readiness Action Plan and have developed internal and external web sites to strengthen communications. We commend LMSB for its initiatives and efforts to help protect US jobs and accomplish the intent of Congress.

As background, Section 199 was enacted as part of the American Jobs Creation Act of 2004. Congress, in conjunction with the repeal of the extraterritorial income ("ETI") regime, enacted a complex deduction for taxpayers for domestic production activities. Many taxpayers are perplexed by the complexity and ambiguity inherent in applying its requirements. However, it must be remembered that Congress enacted this deduction as a benefit for taxpayers and as an incentive to increase global competitiveness. Taxpayers and the Service must now work together to implement the intent of Congress and protect US jobs.

The statute enacting Section 199 is one of the most complex provisions in the Internal Revenue Code. Congress left many areas open for interpretation by Treasury and the IRS. Complexity makes it more difficult and costly for taxpayers, who want to comply, to do so and for the IRS to explain and enforce the tax laws. Thus, in order to decrease the costs of both tax administration and tax compliance, the tax law needs to be simplified. The issue is fundamentally simple: the IRS must enforce the law and taxpayers must comply with the law. Therefore, it is important that both know what the law is.

We commend the IRS for creating guidance on Section 199 in a timely manner. However, guidance issued thus far on Section 199 is cumbersome, can be overwhelming and runs over 270 pages. The computations are complex and require that even knowledgeable and seasoned practitioners review and re-learn rules and concepts once thought to be familiar. These lengthy and complex rules are even more convoluted for intercompany transactions, consolidated groups and a new grouping called the expanded affiliated group. Other areas of complexity include cost allocations (including the use of the Section 861 allocation rules), issues related to embedded services, and classification of assets as realty or tangible personal property.

The regulations contain complex terminology and confusing acronyms. Although the guidance is designed to (1) ensure compliance with the intent and purpose of Section 199 and (2) provide clear administrable rules that minimize the administrative burden on taxpayers and the IRS, this purpose has not been accomplished to the extent that this is needed in practice. Congress recently enacted changes to Section 199, which will require even further guidance.

We would suggest careful review of Section 199 computations, noting that many of the required steps are burdensome and may not be necessary. We would hope that, in determining audit selection and compliance risk criteria, the IRS keeps in mind (1) Congressional intent to provide a domestic production incentive and (2) the complexity of complying with this provision.

Section 199 and the final regulations require the evaluation of information that may not typically have been created or retained. For example, this is likely in the case of the segregation of embedded services, application of the "shrink back" rule, and identification of the US content of previously produced films.

We have been informed that the IRS is looking at sampling as a tool to reduce burden. We agree that the practical and efficient administration of Section 199 would be materially aided by the use of statistical sampling, appropriate construction of judgment sampling techniques, and other reasonable methods of quantitative analysis. We believe that it would be beneficial if Section 199 statistical sampling guidance specifies that (as with meals and entertainment under Rev. Proc. 2004-29, 2004-20 I.R.B. 918), taxpayers employing statistical sampling techniques be allowed to deviate from the lower limit and use the point-estimate in appropriate circumstances where a specified degree of comfort is achieved, i.e., 10%.

In Litigation Guideline Memorandum ("LGM"), TL-97 (September 9, 1992), the Office of Chief Counsel expressed support of taxpayer use of sampling methods. That guidance states:

> The validity of statistical sampling as a tool is a two-sided issue: both the Service and the taxpayer rely on sampling. We must be

> careful in attacking taxpayer use of sampling procedures in general; that is, as a policy, we should be supportive of sampling as a valid measurement of the impact of all similar tax records. Further to the extent that sampling promotes currency in examination, it may represent a desirable alternative to taxpayers, so long as it is soundly conducted.

Application of statistical sampling in the Section 199 context, including allowing taxpayers to use the point-estimate where certain confidence levels are achieved, is consistent with these policy objectives. Such sampling guidance should clearly state that statistical sampling is not the required method of evaluating and assessing a large population of data and that other reasonable means of evaluation are allowed. We believe that such an explicit statement will eliminate unnecessary future issues that could arise for IRS field examiners who might inappropriately conclude, from the release of statistical sampling guidance, that only statistical sampling methods specified in published guidance are allowable for evaluating large populations of information and data. The suggested simple statement should have the effect of avoiding unnecessary controversy and allowing the Service to efficiently utilize its resources.

Recommendations

1. LMSB should continue to rigorously examine abusive refund claims.
2. Refund claims should have a penalty component to discourage frivolous claims.
3. To reduce the resources utilized by the IRS and burdens on the taxpayer in examining R&E refund claims, both the taxpayer and the examiners should be reminded of basic efficient examination skills. Taxpayers should be reminded to

submit refund claims early in the examination process. Both taxpayers and examiners should be reminded of the value of jointly discussing an Information Document Request before it is actually prepared.

4. In examining R&E credits, examiners should be reminded that, while there are abusive claims, not all claims are abusive. Examiners should be aware of the dangers of thinking that all taxpayers are non-compliant. Such an attitude hinders the ability of the IRS to enlist compliant taxpayers as allies in its efforts to close the Tax Gap.
5. In examining R&E credits, examiners should be reminded that they have a dual responsibility to protect the Treasury and to implement the intent of Congress. Although it is difficult after having dealt with an abusive claim, the examiner should be reminded that the 1960's Revenue Procedure of the Rule of Reason (Rev. Proc. 64-22) is still in force.
6. R&E claims should be required to disclose whether the claim is related to a contingent fee arrangement.
7. R&E claims should be required to disclose if the claim is based on a method other than the Taxpayers Internal Project Accounting Method.
8. LMSB should continue its laudable efforts in developing and issuing guidance for Section 199 compliance.
9. LMSB should develop a set of audit selections and risk criteria that take into account the complexity of Section 199 and its related guidance.

10. The IRS should look for ways to simplify the computation of the Section 199 deduction to make it easier for taxpayers to comply and to take advantage of the incentive that Congress intended.
11. The IRS should develop sampling guidance which does not require statistical sampling as the only method for evaluating and assessing the large population of data used in computing the Section 199 deduction and which allows for other reasonable methods.