

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**EXECUTIVE SUMMARY
LARGE AND MID-SIZE BUSINESS SUBGROUP REPORT**

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**LARGE AND MID-SIZE BUSINESS SUBGROUP
EXECUTIVE SUMMARY**

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INTRODUCTION/EXECUTIVE SUMMARY

LMSB Commissioner Frank Ng asked the Internal Revenue Service Advisory Council (IRSAC), LMSB Subgroup (Subgroup) to focus its efforts this year on (a) improving identification and management of tax compliance risks, and (b) improving transparency through the development of an enhanced relationship between LMSB and taxpayers.

Through a Risk Management Task Force (RMTF), the Subgroup examined LMSB's current programs to identify and respond to key taxpayer compliance risks, and has suggested and provided an illustrative process for better managing tax compliance risks.

Through a Transparency Task Force (TTF), the Subgroup examined ways in which LMSB might achieve greater voluntary (as opposed to mandated) transparency from taxpayers, and has suggested some ways to enhance the relationship between LMSB and taxpayers.

A copy of the Subgroup's Report ("Report") is attached as an "Appendix" to this IRSAC Briefing Book and serves as the basis for this Executive Summary. Hereafter, the term Appendix is used to reference the Report.

Issues and Recommendations - - Risk Management

ISSUE ONE: COMPLIANCE RISK MANAGEMENT PROCESS

Background

LMSB continues to make good progress towards identifying tax compliance risks both within LMSB and its constituent base. For example, to focus on tax compliance risks within its constituent base, it has developed a new Selection and Workload Classification system that will better integrate data and permit improved collaboration between subject matter experts. LMSB continues to refresh their primary corporate risk scoring model and has implemented specialized

models to reduce the “no change” rate and evaluate risks on loss returns. In addition, LMSB has developed and is using a fairly extensive set of risk identification rules for international, financial products, and pass-through return issues. They are analyzing published financial data, including FIN 48 disclosures, and they incorporate this information into front-end risk assessment. LMSB is using feedback from CAP team compliance reviews to help in identifying emerging issues. In general, agents are being provided with more information to assist in the risk assessment phase of their examination. Further, the Compliance Strategy Council and the Operations Committee regularly address compliance risk matters and set the direction and policy for LMSB compliance activities.

LMSB has not undertaken and documented, however, a detailed assessment of key tax compliance risks (KTCRs) as we describe in the Appendix, and could do a better job of testing the effectiveness of existing tax compliance strategies and mechanisms. Using a KTCR process could assist LMSB in identifying potential gaps in its current approach to assessing their overall compliance risk management process.

Recommendation

The Subgroup recommends that LMSB develop a more intensive and comprehensive process to evaluate performance against an agreed upon list of KTCRs and use the outcomes of this process to set strategic direction, as well as focus tactical improvements. The inherent risk analysis process undertaken by the RMTEF, as discussed in issue two below, provides a suggested model for ongoing LMSB efforts for compliance risk management.

ISSUE TWO: IMPROVE AND MONITOR PLANS

Background

The current overall strategic focus of LMSB is “Anchoring Change,” which basically involves institutionalizing and implementing improvements on programs and processes created in recent years, rather than developing new compliance strategies. These strategies include, among others, the “Industry Issue Resolution” (IIR) Program; the Compliance Assurance Program (CAP); the Limited Issue Focus Examination Program (LIFE); the Fast Track Settlement (FTS) Strategy; the Pre-Filing Agreement (PFA) Strategy; and the “Industry Issue Focus” (IIF) Initiative. Under the IIF Initiative, select issues are triaged by placing them in one of three tiers based on their prevalence across industry lines and the degree of compliance risk they present. It is because of this tiering process that the IIF initiative has become more commonly known and referred to by practitioners as the Tiered Issue Focus (TIF) Strategy. Hereafter, the IIF Initiative will be referred to as the TIF Strategy.

Recommendation

Over the past several years, LMSB has done a good job developing strategies to address KTCRs. Accordingly, the Subgroup agrees that, for the near future, LMSB should continue to focus on improving and monitoring its current compliance strategies, only creating new ones as needed to address newly discovered significant risks to tax administration. The Subgroup recommends that each existing strategy should undergo an Improve and Monitor Plan (IMP) Analysis, similar to the IMP process that was employed by the RMTF in its illustrative review of the TIF Strategy. Based on these IMPs, recommended areas of improvement should be implemented as quickly as feasible, including such reallocation of LMSB resources as may be necessary and achievable.

ISSUE THREE: TIERED ISSUE FOCUS STRATEGY

Background

Consistent with its increasing focus on industry issues, LMSB relies on various issue management strategies to more uniformly and efficiently manage key tax compliance risks. Among the newest of these issue management strategies is the TIF Strategy. The expressed goals of the TIF Strategy are to (1) promote consistent tax treatment between similarly situated taxpayers; and (2) facilitate issue resolution.

Under the TIF Strategy, key compliance issues are identified from a variety of internal and external sources. With input from the field, technical advisors, specialists and Counsel analyze potential issues in order to rank them into one of three tiers based on their current and/or potential non-compliance risks.

Tier I issues are of high strategic importance to LMSB and have significant impact on more than one industry. Some, but not all, may be “listed transactions” or otherwise viewed as overly aggressive or potentially abusive tax positions. Tier II issues reflect areas of potential high non-compliance and/or significant compliance risk to LMSB or an industry. Tier III issues generally are industry-related and have been earmarked for consideration by LMSB audit teams.

Implementation of the TIF Strategy has not in all cases proceeded as smoothly as LMSB had anticipated. Taxpayers and their advisors have reported being confused as to the scope and operational aspects of the TIF Strategy. Moreover, it has been reported that implementation of the TIF Strategy has been, in some instances, confusing to examining revenue agents, and has potentially impacted the timeliness of their examinations. LMSB has made significant progress in alleviating most of the concerns raised during the implementation phase of the TIF Strategy - communicating and clarifying through the use of its public Web site the distribution of detailed

tri-fold handouts, panel discussions at stakeholder events, as well as other internal and external speaking engagements. However, some lack of clarity around the TIF Strategy still exists.

Recommendation

LMSB should continue to initiate and reinforce strong measures already taken to further improve the operation of the TIF Strategy. Moreover, as discussed in greater detail in Attachment A to the Appendix, the Subgroup urges LMSB to continue to work more closely with its external stakeholders in framing issue-specific strategies that will allow it to achieve its objectives of substantial compliance, consistency and efficiency, while at the same time aiding taxpayers in better managing their own compliance risks.

ISSUE FOUR: BEST PRACTICES: LESSONS FROM OTHER TAXING AUTHORITIES

Background

Tax administrators in other taxing jurisdictions are also very interested in developing new compliance risk management strategies. For example, in the United Kingdom, the Large Business Service (“LBS”) of HM Revenue & Customs (“HMRC”) recently implemented a novel and fairly bold approach (the “LBS Initiative”) to managing taxpayer compliance risk for that country’s very largest business taxpayers (which collectively account for more than 50 percent of HMRC business tax revenues).

The cornerstone of the LBS Initiative is an intensive, comprehensive and collaborative compliance risk review of each affected taxpayer, resulting in the assignment of a “low risk” or “high risk” profile. A low risk designation generally required full transparency and cooperation by the taxpayer, but can result in the elimination of most, and possibly all, future audit activity. Correspondingly, HMRC benefits by gaining opportunities to shift personnel and other

compliance resources to higher risk taxpayers. Currently, LMSB representatives engage with many multi-national collaborative tax administration groups in order to exchange ideas, and to expand their understanding of the various innovative programs. Examples of such groups include: Organization for Economic Cooperation and Development's (OECD) – Forum on Tax Administration's Large Business Task Group; Seven Country Tax Haven Working Group (7C); the Tax Administration for Large Companies (TALC) research group; and the Joint International Tax Shelter Information Centre (JITSIC).

Recommendation

To aid in its identification and use of emerging best practices, and as outlined in more detail in Attachment B of the Appendix, LMSB should continue to monitor compliance risk strategies under development in other taxing jurisdictions and participate in the type of groups mentioned above. In that regard, the Subgroup believes that LMSB management should monitor closely the progress and results of the LBS Initiative -- with a view towards considering whether at least certain elements of that program might be useful to LMSB. Such consideration would be particularly germane to LMSB's continuing evaluation and modification of its CAP and LIFE programs, both of which similarly seek to ease the burden of tax audits as the result of enhanced cooperative relationships with participating taxpayers.

Issues and Recommendations - - Transparency

ISSUE ONE: TAX ACCRUAL WORKPAPERS: POLICY OF RESTRAINT

Background

Under current policy, the IRS does not request a taxpayer's tax accrual workpapers as part of its audit unless "listed transactions" are present in the return(s) being examined. Such forbearance is referred to as the "Policy of Restraint."

IRS requests for tax accrual workpapers can result in controversy over attorney-client or work-product privilege. Moreover, it is believed that a change in the IRS policy would produce a change in taxpayer behavior and likely result in more litigation over technical issues. Hence, while a recent OECD Study focuses on increasing transparency through an enhanced relationship, a significant change in the Policy of Restraint would have an exact opposite effect, damaging the audit relationship.

Recommendation

The current IRS Policy of Restraint with respect to tax accrual workpapers under Announcement 2002-63 should be continued. However, the IRS should offer incentives to taxpayers that disclose uncertain positions taken in filed tax returns for which tax reserves have been established such as limited-scope audits, a streamlined Form 1120 process, or immunity from penalties and hot interest.

ISSUE TWO: LIMITED WAIVERS OF PRIVILEGE

Background

As a general matter, the attorney-client privilege is waived with respect to communications that are disclosed to third parties. A "subject matter" waiver of privilege allows an adversary access to all privileged communications regarding a particular subject after one privileged communication on that subject has been disclosed. In essence, a taxpayer cannot pick and choose among the privileged communications that it discloses.

Tax opinions, that provide a recitation of relevant facts and a legal analysis, are generally privileged documents. Reviewing a tax opinion would be useful to the IRS in terms of understanding an issue promptly which, presumably, would lead to a more efficient audit. Most

taxpayers, however, are hesitant to disclose tax opinions and risk a subject matter waiver of privilege.

Recommendation

The IRS should consider employing limited waivers of privilege with respect to certain documents for the purpose of encouraging taxpayers to allow IRS to review tax opinions or other transaction-specific documents, without causing complete subject matter waiver.

ISSUE THREE: JOINT AUDIT PLANNING PROCESS

Background

The Joint Audit Planning Process was developed by LMSB in partnership with the Tax Executives Institute in 2003. Although LMSB management has strongly encouraged its agents to employ the process, the TTF's research indicates inconsistent use and application. The research also suggests a high degree of correlation between the use of the process and the openness of the audit relationship.

The Joint Audit Planning Process is now five years old and significant experience relative to the process has been gained by both LMSB and taxpayers. A revised process incorporating these teachings could further develop understandings of best practices currently used in open and collaborative audits.

Recommendation

The Joint Audit Planning Process should be updated to specifically list the expectations of both LMSB and taxpayers, incorporate best practices and be further marketed to both the LMSB and taxpayer communities.

ISSUE FOUR: EXPANSION OF LIFE AND CAP PROGRAMS

Background

The Limited Issue Focus Examination (“LIFE”) process is a means by which LMSB audits can be performed in a shorter time frame without compromising the quality of results. LIFE involves many aspects of the Joint Audit Planning Process, but also uses materiality thresholds to avoid inefficient use of resources on relatively minor issues and is documented in a Memorandum of Understanding. Research indicates that usage of the LIFE process positively impacts the level of openness and collaboration of audits.

The Compliance Assurance Program (“CAP”) is an audit methodology that involves continuous real-time dialogue between LMSB and the taxpayer whereby issues are reviewed as they develop in a taxpayer’s business. Just under 100 large corporate taxpayers are now in the CAP program, and LMSB and taxpayer feedback generally indicates satisfaction with the process and a high degree of correlation between its use and the openness of the audit relationship.

Recommendation

The IRS should continue to expand the CAP process and promote more vigorously the use of the LIFE process in Coordinated Industry Case (“CIC”) cases.

ISSUE FIVE: DIRECT COMMUNICATION WITH IRS ISSUE EXPERTS

Background

CIC and certain Industry Case (IC) audits involve the use of specialists such as international examiners, engineers, financial products examiners, and Counsel’s office in the development of issues. Often the individuals participating in the development of an issue on

behalf of LMSB are not specifically identified to the taxpayer, and the taxpayer may not have an opportunity to directly dialogue with those individuals.

Recommendation

LMSB should continue to be more explicit with taxpayers about how to use its published Rules of Engagement when issues need to be elevated. Though it is understandable that direct dialogue between the issue expert and the taxpayer during the development of an issue may not always be possible, the Subgroup recommends that LMSB adopt a policy that encourages issue experts to be directly involved in the dialogue, where appropriate, and serve as the keystone to resolving issues.

ISSUE SIX: PRE-FILING PROGRAMS: FEES AND TIMING

Background

LMSB has consistently asked for more taxpayer transparency through voluntary disclosure of potentially contentious issues. Pre-filing processes such as Advance Pricing Agreements (APAs) and Pre-Filing Agreements (PFAs) are examples of existing programs where taxpayers may request the use of special processes and make voluntary disclosures of issues and relevant information in order to achieve certainty prior to filing the return. Use of these programs should be encouraged, but usage levels are low, perhaps due to high application fees and delays that taxpayers have experienced in the program.

Recommendation

The IRS should continue to improve the APA and PFA taxpayer-initiated programs by eliminating barriers to entry and enhancing the speed of the process. While it is recognized that LMSB does not control the level of the user fees for APAs and PFAs, LMSB should make the case with the fee setters that fee levels should be reviewed, particularly with respect to non-CIC

taxpayers. It is also recommended that a targeted timeline should be agreed upon at the beginning of each new case. Though pre-filing and other Alternative Dispute Resolution (ADR) processes have been heavily marketed by LMSB in the past, perhaps such efforts should now be re-invigorated through stakeholder organizations and their in-house news publications.

ISSUE SEVEN: CONTINUED IMPROVEMENT OF GUIDANCE PROCESS

Background

Several TEI members responding to a request for comments as to how the large taxpayer compliance and audit processes could be improved cited (i) the need for more published guidance; and (ii) more intensive involvement of the appropriate IRS specialist in formulating technical advice memoranda and other “private” taxpayer guidance.

This 2008 taxpayer request for more guidance is consistent with a 2007 recommendation of this Subgroup that called for more intense outside stakeholder group involvement at the front end of the guidance process, consistent with the Chief Counsel pilot project along these lines announced in Notice 2007-17. That Notice, concerning securitized commercial mortgage loans held by Real Estate Mortgage Investment Conduits (REMICs), requests policy and technical input on specific aspects of contemplated guidance, as well as procedures for the timing and content of written submissions and ongoing involvement in the project through meetings and other interaction between stakeholder group representatives and the responsible IRS and Treasury attorneys.

Recommendation

Within reason, the Task Force believes that it is always better to have more published guidance. Accordingly, the Task Force recommends an increased and more expansive focus on the Revenue Ruling and Revenue Procedure process as a means to provide greater clarity to

problematic issues and enhance the audit process. Further, in compliance with a process designed to protect disclosure of taxpayer identifying information, the Task Force recommends the use of topic-specific guidance review panels comprised of outside specialists to review proposed Technical Advice Memorandums (TAMs) and, as appropriate, other types of private Chief Counsel advice prior to issuance.

To the extent a designated review panel disagrees with proposed guidance, it should provide feedback to the IRS to consider before final issuance of that guidance. The feedback from the designated review panel should outline in sufficient detail what it considers problematic along with proposed recommendations.

To alleviate concerns that designated review panels will only provide slanted information designed to achieve more favorable tax treatment, the IRS should make clear that topic-specific guidance review panels are not being invited to enter into negotiations or to participate in the decision-making process. Moreover, the IRS should adopt whatever further safeguards it deems necessary and prudent to allow greater up-front input from outside stakeholders.

Permitting more expansive front-end input in a systematic and transparent manner should help to assure the proper targeting and high technical quality of future guidance; and, among other things, improve the compliance and audit processes. As confidence in this approach builds, the IRS and Treasury should be able to generate more items of useful guidance, to do so more quickly, and to free up resources for other important work.

ISSUE EIGHT: ENHANCEMENT OF IRS COMMERCIAL AWARENESS

Background

It would be mutually beneficial to both the IRS and taxpayers if the IRS acquired a greater "commercial awareness." If the IRS became more "connected" to the businesses it

examines, it would gain a better understanding of matters from both a commercial and a tax perspective. This would provide the IRS with the knowledge and insight to efficiently enforce the tax laws with limited resources, and taxpayers would receive the benefit of expediting the resolution of tax controversies.

A business-provided education or training program is an appropriate way to acquire such commercial awareness.

Recommendation

The IRS should engage various taxpayer industry groups and other external stakeholders in order to establish educational programs to further develop commercial awareness and enhance industry-specific technical tax skills within LMSB.

ISSUE NINE: TAXPAYER TRANSACTION APPROVALS

Background

Taxpayers have various policies and controls in place to mitigate financial and franchise exposure to any risks. Management committees are often used to monitor compliance with policies and to approve transactions, although this practice varies by industry and from company to company. Reviewing the risk management policies, and the minutes from related management committee meetings, would be very useful to the IRS and would keep it abreast of current corporate decisions and transactions.

Recommendation

The IRS should expand their review of taxpayer minutes or other written materials reflecting approvals of transactions that may be of interest to examining agents.