

Internal Revenue Service Advisory Council

Annual Report

November 2008





**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL
PUBLIC MEETING**

**NOVEMBER 19, 2008
1111 CONSTITUTION AVENUE NW
WASHINGTON, DC**

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**2008 PUBLIC MEETING
BRIEFING BOOK**

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**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

GENERAL REPORT

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NOVEMBER 19, 2008

**GENERAL REPORT
OF THE
INTERNAL REVENUE SERVICE ADVISORY COUNCIL**

The primary purpose of the Internal Revenue Service Advisory Council (hereafter “IRSAC or “the Council”) is to provide an organized public forum for discussion of relevant tax administration issues between Internal Revenue Service (hereafter “IRS”) officials and representatives of the public. The Council is a successor to the Commissioner’s Advisory Group established in 1953.

IRSAC was originally organized into three subgroups corresponding to three of the four IRS operating divisions: the Large & Mid-Size Business Subgroup (hereafter “LMSB Subgroup”), the Small Business/Self-Employed Subgroup (hereafter “SB/SE Subgroup”), and the Wage & Investment Subgroup (hereafter “W&I Subgroup”). The Tax Exempt and Government Entities division works with a separate advisory committee.

The Tax Gap Analysis Subgroup (hereafter “Tax Gap Subgroup”) was requested by the Director of IRS Research, Analysis, and Statistics in response to a 2006 recommendation by the Treasury Inspector General for Tax Administration. This fourth subgroup, composed primarily of academicians, was created to consult with IRS Research regarding measurement of the tax gap.

A distinct characteristic of IRSAC is the fact that it brings together dedicated individuals from diverse backgrounds in one unified body. Our members are accountants, lawyers, enrolled agents, payroll professionals, and members of academia. They represent large and small firms from a wide range of urban and rural settings in all regions of the United States. This diversity ensures that issues are considered from varying viewpoints and perspectives. We believe this collective body of experts can

assist the IRS in fulfilling their mission 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.”

We acknowledge the many challenges that the IRS has experienced in the past year such as the administration of processing stimulus checks to an estimated 130 million Americans, as well as providing assistance to victims of hurricanes Gustav and Ike. Knowing the demands of the IRS executives and operating division representatives, we sincerely appreciate the time and effort extended to the Council during the year.

Issues selected for inclusion in the annual report represent those to which IRSAC members have devoted particular attention during four working sessions and numerous conference calls throughout the year. Many are the result of specific requests for assistance by IRS personnel. Others are the result of Council member concerns. Nearly all involve extensive research efforts.

The recent economic situation has also been a focus of concern for the IRS, Congress, Council members, as well as all Americans. Commissioner Shulman has asked for our input on how the IRS can be proactive in assisting taxpayers during the current economic downturn with consideration to the IRS’ legal and regulatory authority.

The Council recommends that the IRS focus their efforts in three areas; communication, relief, and assistance. First, IRS should establish avenues of communication that will allow for a quick response to issues faced by American taxpayers as a result of the downturn. Second, IRS should explore and communicate all avenues of relief that may be available to taxpayers who may be negatively affected by

the downtown. Finally, the IRS should emphasize assistance that is available to taxpayers in need.

Specific areas for consideration relating to communication are:

1. Use the IRS Web site as a tool for timely communication on current economic issues affecting taxpayers. Historically, the IRS has responded to current events in a surprisingly short timeframe, but we think the IRS should consider establishing a dedicated URL, such as www.irs.gov/whatif, to address current issues with timely and pertinent information. Based on the fact that the IRS has received almost 2 billion “hits” on their Web site in the first three quarters of 2008 (compared to 1.3 billion in all of 2007), and continues to break records on the number of visits each year, this seems to be a optimum venue for getting information to the taxpayer. Marketing efforts by the IRS and federal agencies could promote this Web site as a source for information regarding current topics such as: “What if I file bankruptcy?”, “What if I lose my job?”, “What if my home is destroyed by a hurricane?”, “What if my home is foreclosed?”, or “What is cancellation of debt income?” This section of www.irs.gov could also address other questions, such as “What if I go back to college?” or “What if I take money out of my retirement account before age 59 1/2?”
2. We recommend that this section of the Web site also serve as a portal to answer common and important taxation questions, as well as provide links to other government agencies that may be able to provide assistance. The IRS Web site currently offers valuable assistance for business owners that could be

used as a guideline for taxpayers (who do not file as self-employed) who are experiencing economic difficulties.

3. Educate taxpayers generally on all relief provisions in the Code without necessarily advocating their use. Examples of such relief provisions include the bankruptcy tax provisions, rules regarding cancellation of debt and foreclosure relief, net operating loss carry backs, amended returns, and losses on worthless stock.

Some consideration could be made for relief in the areas of:

1. Establishing a program through EFTPS to refund penalties paid for the underpayment of estimated tax payments from prior years, but only if the taxpayer uses EFTPS for the current year's estimated tax payments. This is similar to the program that existed for paying Form 941 tax payments through EFTPS.
2. Allowing the waiver of prior-assessed penalty paid if a taxpayer fully pays off a current installment agreement.
3. Promoting the Advance Earned Income Tax Credit as a way to increase take home pay for eligible low income workers. This advance payment of the Earned Income Credit can mean as much as \$1,750 to a qualified family experiencing hardship.
4. Allowing refunds to be deposited into health savings accounts.
5. Educating employers on various ways to give an employee a raise through employee benefits, such as health savings accounts, telecommuting, or flexible work weeks.

6. Promoting savings by allowing taxpayers to allocate their income tax refund to U.S. Savings Bonds. The IRS can assist both individual taxpayers, particularly lower-income taxpayers, and the economy in general by allowing direct purchase of savings bonds. The IRS should include an option on Form 1040, *U.S. Individual Tax Return*, using the relatively new Form 8888, *Direct Deposit of Refund to More than One Account*, to allow taxpayers to use the split refund process to purchase savings bonds. The IRS should work with Treasury to develop an automated transfer data process to facilitate Treasury's portion of the purchase effort.

The IRS could provide assistance by:

1. Raising or eliminating the maximum income level on the Free File Program, allowing more taxpayers to take advantage of this program.
2. Allowing Volunteer Income Tax Assistance (VITA) sites to prepare Schedules C & E returns for low income taxpayers, conditioned on appropriate training and certification. Many elderly taxpayers with limited income may be working as independent contractors or leasing rooms for additional income, which creates a more complicated tax return, making them ineligible to use a VITA site for assistance.
3. Fully implementing the refund process through Customer Account Data Engine (CADE). Not all refunds are currently processed through CADE, which significantly expedites the refund process.
4. Directing the IRS to position itself (institutionally) as a tool to promote economic development and establish programs to educate taxpayers on the impact of taxes

on a new business. The IRS should establish itself as the best source for information for individuals and businesses through resources that will support taxpayers and tax preparers. The IRS should include this as a goal in the 2010-2015 strategic plan.

The IRSAC subgroups worked throughout the year on specific issues associated with each operating division, but the Council also worked on an issue that we felt was common to the group as a whole: the identification of paid preparers.

Paid preparers annually assist over 80 million taxpayers to meet their federal income tax obligation. The IRS does not have a single database or other information source to identify the paid preparer community. The IRS should develop such a system and conduct research on how to use it effectively. It is expected that these measures should lead to more accurately prepared tax returns and would enable the IRS to provide focused resources for outreach and education efforts.

Paid preparers include both licensed and unlicensed persons. Licensed persons prepare tax returns and also are authorized to practice before the IRS. These include state licensed professionals such as lawyers and certified public accountants, and federally licensed enrolled agents. Unlicensed persons can only prepare tax returns and do not represent taxpayers before the IRS.

There have been recent government and private industry studies that have concluded that part of the “tax gap” is the result of paid preparer error. For example, a current Treasury Inspector General for Tax Administration report issued on September 3, 2008 [2008-40-171] found 61 percent of a limited sample of tax returns prepared by unlicensed persons contained errors resulting in a significant net understatement of tax.

Television stations and reporters across the nation often note similar experiences and report them in news stories each tax season.

Only licensed preparers are regulated by Circular 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service.*

Some commentators have proposed licensing, training and testing for all paid preparers.

There are also various proposals that have been introduced in Congress to license and register the paid preparer community. Licensing is beyond the scope of this recommendation.

Recommendations:

1. The IRS should develop a system to identify all paid preparers through the use of a unique identification number.
2. The IRS should conduct research to effectuate a better process to monitor and control paid preparers utilizing these unique identification numbers.

The members of IRSAC wish to express their appreciation to the IRS personnel for their time and commitment to the work of the Council over the course of the year. I speak for all members of the Council in saying that it has been an honor and privilege to serve in our capacity on the Council and respectfully submit our report for 2008.

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**WAGE & INVESTMENT
SUBGROUP REPORT**

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NOVEMBER 19, 2008

**WAGE & INVESTMENT
SUBGROUP REPORT**

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INTRODUCTION/EXECUTIVE SUMMARY

The IRSAC Wage & Investment Subgroup (“Subgroup”) is comprised of a diverse group of tax professionals, including three certified public accountants, an attorney, and a national tax director of a large retired person organization. This group brings a broad range of experience and perspective from both tax preparers’ and taxpayers’ views, and includes unique experience in the issues faced by many W&I taxpayers. We have been honored to serve on the IRS Advisory Council and appreciate the opportunity to submit this report.

Since January 2008, the Subgroup has had the privilege of working with the professionals within the W&I Division of the IRS and found them to be extremely helpful in providing the information, resources, and IRS personnel necessary to develop our report. The Subgroup has researched and is reporting on the following three issues.

1. **Refund Inquiry Communications Strategy** - IRSAC was asked to provide input and feedback to assist in the IRS’ development of a comprehensive refund inquiry communications strategy designed to educate specific taxpayer groups about the availability of the Web-based “Where’s My Refund?” application. In FY 2007, the IRS received 29.8 million telephone calls and completed 32.1 million Web requests from taxpayers checking the status of their refund. Refund inquiry contacts account for the largest volume category of contacts the IRS receives each year. The overwhelming majority of these contacts provides the taxpayer with the timeframe for receipt of his or her refund and do not require further contact with the IRS. The IRS promotes “Where’s My Refund?” through www.irs.gov, telephone scripts, and the IRS Nationwide Tax Forums. The Subgroup reviewed a wide variety of information in formulating its recommendations. This research included a review of the refund portion of websites of 41 states. Our recommendations generally are intended to make the refund section of

irs.gov far more easy to use and more accessible, as well as to make the availability of refund information more widely known to the professional tax preparer and general public. The Subgroup applauds the IRS' efforts to upgrade its website with many of our recommendations.

2. **Irs.gov EITC Enhancements** - IRSAC was asked to look at ways the IRS can enhance its Web site to increase usage of the Earned Income Tax Credit (EITC) resources of the site, as well as to reduce errors. The EITC is a federal tax credit for individuals who work but do not earn high incomes. Taxpayers who qualify and claim the credit normally pay less tax, pay no tax, or even get a tax refund. More than 23 million low-income workers received EITC each year, with a high participation rate among eligible filers of 75-80 percent. Accordingly, 20-25 percent of eligible taxpayers do not receive the EITC. However, the complexity of EITC can be difficult for taxpayers and tax preparers. EITC has a high erroneous payment rate, estimated at 23-28 percent or \$10-12 billion in lost tax revenue. Since the irs.gov EITC website is a key EITC communication tool, enhancements that result in better communication and increased usage could have a positive effect on both increasing participation and reducing error.

We have included a series of recommendations that include: provide more formal user testing for word usage and site design; add training components for EITC similar to Link N Learn used by volunteers; move more of eitcforpaidpreparers.com ("EITC.com") back onto irs.gov to reduce user confusion and keep users on irs.gov; reduce heavy text and use more graphics; add a left side box with important EITC links; and use IRS' existing knowledge about preparer preferences and needs to promote usage of the EITC portion of irs.gov. Specific and additional recommendations for changes to the EITC portion of the IRS website are also included.

3. Communications Strategy – Changes to Regulations 301.7216 – Disclosure and Use of Tax Return Data by Tax Return Preparers. IRSAC was asked to assist in

creating the communication strategy regarding the changes to Regulations 301.7216 – Disclosure and Use of Tax Return Data by Tax Return Preparers. The request encompasses recommendations to assist IRS’ development of a comprehensive communications strategy as it relates to identifying and engaging impacted e-file providers and stakeholders. The new regulations are effective January 1, 2009.

The regulations strengthen taxpayers’ ability to control their tax return information, confirms that the taxpayer has the right to exert better control over the use and disclosure of their own tax information, and generally prohibits “tax preparers” from using or disclosing tax return information they obtain from their clients for any purpose other than preparing a tax return without specific written consent. Because these regulations reinforce a criminal statute, IRSAC believes the IRS has an obligation to inform all who may be subject to the revised regulations of their reach and implications.

The Subgroup’s recommendations include use of electronic means (Internet), development of a “use and disclosure” form, outreach to the many segments of the preparer community affected, publicity in IRS publications, and messages on IRS toll-free telephone numbers.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: REFUND INQUIRY COMMUNICATION STRATEGY

Executive Summary

IRSAC was asked to provide input and feedback to assist in the IRS' development of a comprehensive refund inquiry communications strategy designed to educate specific taxpayer groups about the availability of the Web-based "Where's My Refund?" application.

We reviewed refund information available at www.irs.gov, in various IRS publications, provided by e-file providers, and on state taxing agency Web sites. We identified several areas that could enhance the use of "Where's My Refund?".

Background

In FY 2007, the IRS received 29.8 million telephone calls and completed 32.1 million Web requests from taxpayers checking the status of their refund. Refund inquiry contacts account for the largest volume category of contacts the IRS receives each year. The overwhelming majority of these contacts provides the taxpayer with the timeframe for receipt of his or her refund and do not require further contact with the IRS.

According to W&I, the IRS promotes "Where's My Refund?" through www.irs.gov, telephone scripts, and the IRS Nationwide Tax Forums.

Taxpayers seeking refund information can call the Refund Hotline (1-800-829-1954), or TeleTax (1-800-829-4477), which includes pre-recorded Tax Topics as well as refund information. TeleTax differs from the Refund Hotline in that it contains more than just refund information, and callers cannot route out to a live assistor from this line.

A 2007 study by W&I entitled “Knowing the Where’s My Refund? User” found that taxpayers who use only “Where’s My Refund?” are different from taxpayers who use only the Refund Hotline or TeleTax. Those who use the Web site are more educated, younger, have a higher income, less likely to use a paid preparer, and less likely to have errors on their returns than taxpayers who use the telephone options. Two-thirds of them file electronically.

In contrast, users of telephone refund inquiry lines have lower income, are more likely to claim EITC, are older, are less likely to file electronically, and are more likely to use a paid preparer.

The study contained, among others, the following recommendations: Encourage Volunteer Income Tax Assistance (VITA), Tax Counseling for the Elderly (TCE), and IRS Taxpayer Assistance Centers (TAC) sites to offer taxpayers the option of visiting or returning to use their computers to check the taxpayers’ refund status. IRSAC endorses most of the recommendations.

The location of the “Where’s My Refund?” link at www.irs.gov varies based on other demands of the tax season. Visitors to “Where’s My Refund?” cannot immediately enter their identifier information. They first go to a page of text that discusses (among other things) phishing, what information is needed to use the link, refund tracing, and browser requirements. They then click on “Where’s My Refund?” a second time to enter their information.

We reviewed information available at www.irs.gov and in several publications and found differences in statements regarding when refund information is available. Refund information is available within seven days for an e-filed return according to information at www.irs.gov; however, several publications and tax form instructions stated three weeks. The instructions for

Forms 1040, 1040A, and 1040EZ provided an additional time frame for returns filed with Form 8379, *Injured Spouse Allocation*.

We reviewed information regarding checking on a refund provided to e-filers using two well-known commercial services. One directed the user to “Where’s My Refund?” The other directed the filer to IRS Publication 2043, *IRS E-File Refund Cycle Chart*. Publication 2043 in turn directs the user to wait at least three weeks and then call TeleTax at 1-800-829-4477 or go to www.irs.gov, and click on “Where’s My Refund?”

Several of the Free File Alliance home pages listed www.irs.gov as a secondary reference for refund information or referred to IRS Publication 2043, and several organizations provided no information about refund inquiries on their home pages. We note that the members might have provided other information to actual users of the software.

Callers to TeleTax but not the Refund Hotline are provided information about www.irs.gov up front before entering their identifying information. Callers to the Refund Hotline are provided this information as a courtesy disconnect message if they are unsuccessful in entering their identifying information.

Our review of the Web sites of 41 state taxing authorities (those with a general state income tax) revealed the following observations:

- Most state taxing agencies use the term “Check Refund Status”, “Where’s My Refund?”, or variations.
- Most state agencies get the user to the point of entry of SSN information by going to only one or two additional pages after reaching the home page.
- Seven states offer refund information for prior years.

Recommendations

1. Make the “Where’s My Refund?” feature easily recognizable on www.irs.gov. It should be as distinctive as possible, consistent with other priorities of the tax season, perhaps highlighted with a distinctive color.
2. Revise the “Where’s My Refund?” information so that a user can enter the information to obtain refund status on the first page after the home page. Engineer the site so that a user only has to click on “Where’s My Refund?” one time.
3. Make prior year refund information available through www.irs.gov.
4. Revise IRS Publication 2043 to list “Where’s My Refund?” at www.irs.gov as the first source for refund information.
5. Make information about when to check for a refund realistic and consistent in terms of current processing times among www.irs.gov and publications.
6. Callers to both telephone numbers established for refund information should be provided with information about www.irs.gov up front, as they are with the 1-800-829-4477 number,
7. E-file providers should be encouraged to list “Where’s My Refund?” at www.irs.gov as the primary tool for checking refund status.
8. We support the recommendations in the W&I Research Study that emphasize use of www.irs.gov, except for the recommendation that directs taxpayers to return to VITA and TCE sites to check on their refund. That could negatively impact the ability of the sites to serve new taxpayers seeking return preparation.
9. We recommend that the IRS consider alternate ways for identification when accessing “Where’s My Refund?” A taxpayer using a computer in a public place such as a library might have legitimate concerns about entering their complete social security number in a computer that could be compromised by others.

ISSUE TWO: IRS.GOV EITC ENHANCEMENTS

Executive Summary

IRSAC was asked to look at ways the IRS can enhance its website to increase usage of the Earned Income Tax Credit (EITC) resources available on the site, as well as to reduce errors. We have included a series of recommendations that include: more formal user testing for word usage and site design; add training components for EITC similar to Link N Learn used by volunteers; move more of eitcforpaidpreparers.com (“EITC.com”) back onto irs.gov to reduce user confusion and keep users on irs.gov; reduce heavy text and use more graphics; add a left side box with important EITC links; and, use IRS’ existing knowledge about preparer preferences and needs to promote usage of the EITC portion of irs.gov. Specific and additional recommendations including more detail are provided below.

Background

The EITC is a federal tax credit for individuals who work but do not earn high incomes. Taxpayers who qualify and claim the credit normally pay less tax, pay no tax, or even get a tax refund. More than 23 million low-income workers receive EITC each year, with a participation rate of 75-80 percent among eligible filers. Accordingly, 20-25 percent of eligible filers do not receive EITC. However, the complexity of EITC can be difficult for taxpayers and tax preparers. EITC has a high erroneous payment rate, estimated at 23-28 percent or \$10-12 billion in lost tax revenue. Since the irs.gov EITC Web site is a key EITC communication tool, enhancements that result in better communication and increased usage could have a positive effect on both increasing participation and reducing error.

The IRS conducted two EITC-centered focus groups in January 2007, but the general nature of the feedback and recommendations from these groups suggest that a more specific

process for EITC information on irs.gov at this time could provide substantially more helpful comments and suggestions for EITC on irs.gov and EITC.com redesign. This targeted focus is consistent with the IRS' desire to increase usage of the site and thereby improve accuracy in this error-prone EITC area. Through comments to this IRSAC's Wage and Investment Subgroup, the IRS' W&I Division has acknowledged that most of the results from focus groups and surveys were actually part of wider research efforts, not simply efforts focused on EITC on irs.gov. The questions and requests for comment in the May 2008 PowerPoint handout to this IRSAC W&I subgroup is an excellent, more detailed starting point for future surveys and focus groups.

Generally, we believe the layout and design for the EITC information on irs.gov is too static, heavy with text in the center of the page, and even confusing at times. For example, it would seem puzzling, and certainly inefficient, to a tax preparer to have significant EITC recourses on both the EITC page within irs.gov (EITC on irs.gov) and on EITC.com as well. Due to the volume of resources on both sites and no obvious correlation of the two, a preparer or taxpayer can be left to wonder what he or she will miss if only using one site. There seems to be significant duplication which could easily cause user frustration, potentially driving users away from the Web site.

Recommendations

General Recommendations:

1. Invest in more user testing and surveys to gather more thorough feedback on user preferences and likes/dislikes for both taxpayers and preparers. This includes word usage, site design, etc. We suggest holding focus groups at IRS Nationwide Tax Forums to obtain additional feedback from a much larger group. Kiosks could be utilized at the forums for user surveys and individual preparer feedback as a compliment to focus groups there.

2. Consider user feedback from individuals and preparers on an on-going basis within the Web site.
3. Develop a more formal training component on EITC for professionals on irs.gov. In particular, consider building an interactive Link-N-Learn type training on EITC irs.gov (or EITC.com, if it cannot be housed on EITC on irs.gov). Consider using TaxTalk Today to promote EITC irs.gov and particularly training for EITC through EITC on irs.gov to drive site usage. Review working with necessary affiliation groups to give Circular 230, or other credentialed preparers, CPE credits as an incentive to use resources on EITC irs.gov. Market EITC training on irg.gov to professionals out of tax season, when they have more time for this type of activity.
4. Eliminate redundant information on EITC.com. Provide links within EITC pages on irs.gov only to the specific item required to be on EITC.com due to irs.gov Web design restrictions. Returning as much text as possible to irs.gov should be done with the necessary approval and clearance to make the site more visually interesting. This would also make the text less wordy on any given page (more in line with EITC.com currently) and with ultimate intention to bring all EITC recourses onto irs.gov, including the EITC Assistant.
5. Enhance the individual section of the EITC on irs.gov to make it more visually interesting and text-streamlined as well. The IRS can use this EITC on irs.gov upgrade, with more pictures and interactive portions, as a model to help evolve other parts of irs.gov into an Internet presence more in line with sophisticated and graphic commercial sites that have recently evolved on the Internet. This said, we applaud the IRS on the depth and breadth of the valuable information on its site and suggest that making the information more visually appealing and less wordy may improve interest and increase usage. One good example on irs.gov of less wordy text, although not quite yet visually

interesting, is the “Avoid Common EITC Errors” page. It has minimal word usage, is able to be read without scrolling, and has useful links to more information, especially on specific IRS meaning for terms like “qualifying child.”

Specific recommendations for the Web site:

6. Highlight the recommended link on IRS search engine when typing “EITC” or “EIC” that now sends users to EITC Overview. It will stand out more and be harder to miss (example, Google does this for sponsored sites).
7. Allow for searches within areas on irs.gov and specifically within the Internet pages designated for EITC. For example, allow for a search within EITC for “child” or “qualifying child” that addresses those terms as they relate to EITC, without getting a list of press releases. Enable a search within an area in Forms, Pubs, Press Releases, etc. For example, when looking for EITC forms one could search within the Form section of irs.gov and not be directed to EITC on irs.gov, but would instead obtain only information on forms related to EITC. This is offered as another strategy to deal with the voluminous amount of helpful, but a bit daunting, information in irs.gov.
8. Use first set of blue (left side) boxes on irs.gov about EITC, then “IRS Resources,” and consider skipping “Individual Topics” on this page. At this point, there is too much information and the “Individual Topics” are not significantly relevant. This left tool bar for the Web site is a prime location and is often used by other Web sites to highlight key links for the topic at hand, in this case, EITC. It is a prominent place for important EITC information and breaks up the too-long text down the center of the page. Consider listing EITC Assistant first in this left blue section with text similar to “Are you or your client eligible for EITC? Use the EITC Assistant to find out,” then have new blue section with

dividing line linking “EITC Information for

- [Individuals](#)
- [Tax Professionals](#)
- [Employers](#)
- [Partners](#)

- Next, consider having the search within the EITC area as described in (6) above as a third area in the left side of EITC on irs.gov for EITC. Consider providing a link for a site map for EITC and, finally, list other “IRS Resources” in a last blue box on the left.
9. Add a topic in the Tax Professionals section, near the top of the first page - “Are you new to EITC or need a refresher?” With a click on a link, take tax professionals to an area for interactive training for EITC on irs.gov (or EITC.com). See (2) above.
 10. Add Free File to the list of Helpful Tools in the section for individuals. Since the taxpayers are already on the Internet, they would seem to be good candidates to use Free File.
 11. Consider interactive and creative ways to provide information, such as using a picture of a house with possibilities of members of a household. Let users drag icons of household members into the house from a list on the left, with titles such as mother, son, boyfriend, aunt/uncle, grandmother, etc. Once icons are in the house, an IRS Web tool could help taxpayers or preparers with filing status and “qualifying child” determinations, using more real world and complicated situations, thereby increasing EITC return accuracy.
 12. Keep EITC on the home page during tax season. Consider a diagonal split box on the irs.gov home page with a family in half and a single person in the other half. This would regularly demonstrate that the EITC is also for single persons, especially since this is the group with the lower participation rate.
 13. As possible, reduce use of technical terms like “qualifying child” or link such terms to definitions. (Again, use surveys to identify more of these types of terms and better

- replacements and/or contract with professionals with experience in determining these types of words.)
14. Provide the ability to print the questions asked, answers provided and results from using the EITC Assistant. Allow this print out to comply with due diligence requirements.
 15. Revise EITC Assistant or Due Diligence form so that questions are in the same order on both for preparer ease.
 16. Determine whether there is a possibility of providing information for preparers on prior denials, similar to the features of “Where’s my Refund.”
 17. Add “EITC Assistant” in each of the tax year links in the EITC assistance page to reduce confusion as to where the link leads. On the same page, move “Additional Resources” link under the EITC Assistant links to avoid inadvertently clicking off the page without getting to the EITC Assistant.
 18. Move the EITC Assistant link to a place of prominence on EITC.com as a short-term solution until .com and .gov can be merged. It is currently listed last under “Tools.”

Recommendations regarding more effective marketing of the site:

19. Add a question such as “Did you use the EITC Assistant on irs.gov?” on the Schedule EIC, Form 8867 *Paid Preparer's Earned Income Credit Checklist*, and Form 8862 *Information To Claim Earned Income Credit After Disallowance*. This will promote the tool to all EITC preparers. Consider some type of lesser penalty for an EITC error if the preparer can document using the EITC Assistant.
20. Send post cards to EITC taxpayers who have no preparer listed on the Form 1040, advising them of the resources about EITC that are available on irs.gov.
21. Make marketing of EITC Assistant a major focus of EITC outreach to partners who could use it to help taxpayers. IRS Stakeholder Partnership Education and Communications (SPEC) provides excellent general EITC awareness outreach to this group of non-

- preparer partners with access to potentially EITC eligible taxpayers. SPEC's goodwill with this group is likely especially high following the Stimulus outreach in 2008 and their regular contact with key national partners who have EITC clientele. Focus effort in 2009 on EITC on irs.gov and particularly the EITC Assistant.
22. Market EITC on irs.gov to both Circular 230 and other preparers by highlighting the reasons cited by the focus groups as to what made EITC attractive. Those reasons included verifying commercial tax software's determination of EITC eligibility or amount, finding out what is new this year for EITC (listing date of change), learning about EITC fraud and top reasons for denial, and finding helpful questions and answers. Since many focus group preparers state that the tax software is their first source for EITC calculation, ask software providers to provide a link in their commercial software to EITC irs.gov.
 23. Consider updating Form 8633 *Application to Participate in IRS e-file Program* to ask what types of returns the preparer will e-file, from a dropdown list including EITC. If EITC is noted, send a link in an email to ERO's advising about EITC on irs.gov resources.
 24. Recognizing a first time e-file transmission of an EITC return, generate an automatic email to the preparer advising him or her of the resources for EITC on irs.gov.

ISSUE THREE: COMMUNICATION STRATEGY – CHANGES TO REGULATIONS 301.7216 – DISCLOSURE AND USE OF TAX RETURN DATA BY TAX RETURN PREPARERS

Executive Summary

IRSAC was asked to assist in creating the communication strategy regarding the changes to Regulations 301.7216 – Disclosure and Use of Tax Return Data by Tax Return Preparers. The request includes recommendations to assist IRS’ development of a comprehensive communications strategy as it relates to identifying and engaging impacted e-file providers and trading partners.

The regulations reinforce the concept that taxpayers should be able to establish and exert better control over the use and disclosure of their own tax information, and generally prohibits “tax preparers” from using or disclosing tax return information they obtain from their clients for any purpose other than preparing a tax return without specific written consent.

Because these regulations reinforce a criminal statute, IRSAC believes the IRS has an **obligation** to inform all who may be subject to the revised regulations of their reach and implications. The definition of “tax return preparer” in the regulations goes well beyond the traditional definitions under Sections 6694 or 7701. The definition includes administrative support personnel, information technology personnel, and personnel who process tax return data.

Background

The Revenue Act of 1971 enacted IRC Section 7216, which provide the rules governing the disclosure and use of taxpayer data by preparers, and the related criminal penalties for unauthorized disclosure or use of information furnished to preparers in connection with the preparation of an income tax return. The related regulations were issued in 1974 and have remained essentially unchanged since that time. The 1974 regulations did not address the issues

raised by electronic filing of tax returns and were silent on need for taxpayers' consent to the disclosure and use of tax return information in an electronic environment.

The new regulations, effective January 1, 2009, update the 1974 regulations and give taxpayers greater protection and control over their tax return information held by tax return preparers. They provide the specific consent requirements that must be followed before a tax preparer can disclose a taxpayer's tax return information.

The regulations define a "tax return preparer" as follows:

(i) *In general.* The term *tax return preparer* means:

(A) Any person who is engaged in the business of preparing or assisting in preparing tax returns;

(B) Any person who is engaged in the business of providing auxiliary services in connection with the preparation of tax returns, including a person who develops software that is used to prepare or file a tax return and any Authorized IRS *e-file* Provider;

(C) Any person who is otherwise compensated for preparing, or assisting in preparing, a tax return for any other person; or

(D) Any individual who, as part of their duties of employment with any person described above which performs services that assist in the preparation of, or assist in providing auxiliary services in connection with the preparation of, a tax return.

ii) *Business of preparing returns.* A person is engaged in the business of preparing tax returns if, in the course of the person's business, the person holds himself out to tax return preparers or to taxpayers as a person who prepares tax returns or assists in preparing tax returns, whether or not tax return preparation is the person's sole business activity and whether or not the person charges a fee for tax return preparation services.

(iii) *Providing auxiliary services.* A person is engaged in the business of providing auxiliary services in connection with the preparation of tax returns as described above if, in the course of the person's business, the person holds himself out to tax return preparers or to taxpayers as a person who performs auxiliary services, whether or not providing the auxiliary services is the person's sole business activity and whether or not the person charges a fee for the auxiliary services. Likewise, a person is engaged in the business of providing

auxiliary services if, in the course of the person's business, the person receives a taxpayer's tax return information from another tax return preparer.

(iv) *Otherwise compensated.* A tax return preparer includes any person who—

(A) Is compensated for preparing a tax return for another person, but not in the course of a business; or

(B) Is compensated for helping, on a casual basis, a relative, friend, or other acquaintance to prepare their tax return.

(v) *Exclusions.* A person is not a tax return preparer merely because he leases office space to a tax return preparer, furnishes credit to a taxpayer whose tax return is prepared by a tax return preparer, furnishes information to a tax return preparer at the taxpayer's request, furnishes access (free or otherwise) to a separate person's tax return preparation website through a hyperlink on his own website, or otherwise performs some service that only incidentally relates to the preparation of tax returns.

(vi) *Application of section 7701(a)(36).* If a person is an income tax return preparer for purposes of section 7701(a)(36), the person is subject to the provisions of section 7216 and is a tax return preparer for purposes of these regulations. The fact that a person is not an income tax return preparer for purposes of section 7701(a)(36), however, is not determinative of whether the person is a tax return preparer for purposes of this section.

This language sweeps within its meaning many people involved in the return preparation process, in addition to those who actually prepare tax returns. Tax preparation firms' administrative, clerical and secretarial support staffs are included for the first time. Therefore, it is critical that there be notification to all tax preparation firms.

Recommendations

The IRS should:

1. Develop an informational CD to be sent to all tax preparers and tax firms that can be identified from tax return filings.
2. Develop a publication with the specific language that must be included in the disclosure, and in a "use and disclosure" form that would be retained by the tax

preparer. Make the disclosure and use form (as developed by Stakeholder Partnership Education and Communication) available on the Internet.

3. Include the Section 7216 regulations as a topic in all local practitioner liaison group agendas, Tax Talk Today programs, and IRS phone forums, as well as an item in “e-news for Tax Professionals”.
4. Utilize the IRS’ relationship with the tax preparation software community, including the free-file partners, as the primary way to notify the tax preparer community of the new regulations, since most tax returns are now prepared using software, whether e-filed or not.
5. Utilize the following means to reach tax preparers: Web sites that provide tax related information (including commercial sites), accounting and tax publications, and companies that sell supplies to businesses that provide accounting and tax services.
6. Develop press releases for issue to general circulation newspapers and all IRS partners and stakeholders, including accounting, law and tax professional organizations, about the new regulations.
7. Notify businesses that indicate they are in the tax preparation business, or any other business type that will be included in the new definition of tax preparer, based on the Standard Industry Codes used on the tax return for their business.
8. Include a message, alerting listeners to the new regulations, during wait time on the Practitioner Priority Service telephone line.
9. Include a message on all IRS “800” – type telephone numbers advising taxpayers of their right to restrict the use and disclosure of their tax return data and directing them to irs.gov for more information.

10. Request the assistance of the State Department in advising American embassy staff members who assist U.S. taxpayers about the new regulations.
11. Include training on the new regulations for all VITA, TCE and other volunteer tax preparers.
12. Develop Frequently Asked Questions on [irs.gov](https://www.irs.gov) to be updated as new issues arise (similar to the process used for the Economic Stimulus payment updates).

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

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

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NOVEMBER 19, 2008

**LARGE AND MID-SIZE BUSINESS SUBGROUP
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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.

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**SMALL BUSINESS/SELF-EMPLOYED
SUBGROUP REPORT**

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NOVEMBER 19, 2008

**SMALL BUSINESS/SELF-EMPLOYED
SUBGROUP REPORT**

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INTRODUCTION/EXECUTIVE SUMMARY

The IRSAC Small Business/Self-Employed Subgroup (hereafter “Subgroup”) is made up of seven tax professionals. The members of the Subgroup offer the IRS Advisory Council a variety of experiences, ranging from the representation of individuals and small businesses to large corporations. The Subgroup is honored to use this depth and breadth of knowledge to assist the SB/SE Division of the IRS (hereafter “SB/SE”) in any way possible.

The Subgroup enjoys a close working relationship with the professionals within SB/SE. This relationship has granted the Subgroup the opportunity to consult with SB/SE on many issues outside of the regularly scheduled meetings. The Subgroup and SB/SE consulted both formally and informally on the issues contained in this report. The Subgroup respectfully recommends the following:

1. Extended Due Date of Partnerships, Real Estate Mortgage Investment Conduits (REMICS) and Certain Trusts that File Fiduciary Tax Returns. Pursuant to recently Proposed Regulations issued July 1, 2008, Proposed Regulations under 1.6081-2 and -6 etc., the partnership and trust extended due date has been reduced from the current six months to five months generally effective for years beginning in 2008. Moving the extended due date from October 15 to September 15 will help many recipients file accurate and timely tax returns, should enhance the efficiency of the tax system, and reduce overall taxpayer burden. These regulations should be supported and made final.

2. Mail Procedures in the AUR/CP2000 Correspondence Cycle. The Automated Under Reporter and Computer Paragraph 2000 (AUR/CP2000) Program is a vital part of the IRS’s

efforts to ensure accurate income reporting compliance and a valuable tool in helping to reduce the tax gap. However, more effective mail procedures are needed to avoid unnecessary correspondence with taxpayers. We recommend that upon receipt of taxpayer's response, the IRS should promptly notify the taxpayer that no further action will be taken until the response is processed. Concurrent with the sending of an acknowledgement letter a "hold" should be placed on the taxpayer's correspondence cycle ensuring that no further escalating letters will be sent until the "case is worked" by an examiner. Finally, since taxpayers have the option of responding to an AUR/CP2000 notice by either mail or fax, guidance needs to be given as to what constitutes a timely response in order to satisfy the requirement for the two previous recommendations. A fax is received by the Service on the transmission date. A mailed response may be timely based on the postmark date but will arrive at some time after that date. IRS procedures need to consider whether the language in an AUR/CP2000 notice needs to be modified in the section "you need to respond by ..." to reflect the differences in dates of receipt given the two modes of possible response by the taxpayer.

3. Improve Employment Tax Reporting and Worker Classification Compliance.

Currently, there is no definitive test to distinguish whether a worker is an employee or an independent contractor. The tests used to determine whether a worker is an independent contractor or an employee are complex and subjectively applied. Significant tax consequences result from the classification of a worker as an employee or independent contractor. The IRS has developed the Worker Classification Settlement Program (CSP) as equitable remedy to this situation. This program, however, is not widely publicized and thus few companies know about it and thus don't utilize it. We recommend that the IRS publicize the availability of the CSP to service recipients, whether under examination or not, allowing them to voluntarily apply for the

CSP even in the absence of an employment tax related examination. Additionally, the IRS should consider creating an informal voluntary disclosure program emphasizing employment tax and worker classification issues. IRS should also consider sending letters to service recipients in industries having a history of noncompliance offering a way to avoid penalties through the employment tax voluntary disclosure filing of amended returns and payment of the taxes and interest due. Finally, the IRS should accelerate the matching process for federal tax deposits and Forms 941 so that the Trust Fund Recovery Penalty (TFRP) Investigations can be started whenever there are employment tax delinquencies for two consecutive calendar quarters.

4. Seasonal Employees and Employees Working Limited Hours. There is no de minimis number of hours or minimum compensation which exempt an employer from the requirement to withhold income taxes and to pay and withhold employment taxes. IRS publications related to the employment taxes and employment classification have limited guidance on this topic. A possible solution would be to more prominently feature and more clearly state in plain language in all relevant publications and materials that there is no de minimis hours worked nor dollar amount earned threshold for employment tax status.

5. Requiring Appraisers to Include Their Social Security Number on Written Appraisal Reports and on IRS Form 8283. Treasury Regulation 1.170A-13(c) (3) (E) requires qualified appraisals to include "The name, address, and identifying number (i.e. social security number) of the qualified appraiser. Additionally, an appraiser's SSN is required to be entered on Form 8283 in Part III, "Declaration of Appraiser." These requirements invite identity theft. In order to remedy this situation we recommend that the IRS take immediate action to eliminate all existing requirements that appraisers include their SSNs on written appraisal reports, on IRS Form 8283 and on any other documents that could expose them to the threat of identity theft. Additionally,

the IRS should permit appraisers to apply for an expanded Preparer Tax Identification Number (“PTIN”) or for an equivalent discreet number that will permit the service to identify their work without exposing them to the possibility of ID Theft. Should the above or its equivalent not be adopted the proposed regulations (REG-140029-07) need to be adopted permanently and be publicized.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: EXTENDED DUE DATE OF PARTNERSHIPS, REAL ESTATE MORTGAGE INVESTMENT CONDUITS (REMICs) AND CERTAIN TRUSTS THAT FILE FIDUCIARY TAX RETURNS

Executive Summary:

Pursuant to recently Proposed Regulations issued July 1, 2008, Proposed Regulations under 1.6081-2 and -6 etc., the partnership and trust extended due date has been reduced from the current six months to five months generally effective for years beginning in 2008. Moving the extended due date from October 15 to September 15 will help many recipients file accurate and timely tax returns, should enhance the efficiency of the tax system and reduce overall taxpayer burden. These regulations should be supported and made final.

Background:

Pursuant to temporary regulations previously effective for tax returns due for tax year 2005 and later, the IRS allowed partnerships, real estate mortgage investment conduits (REMICs) and certain trusts that file fiduciary tax returns to file an automatic six-month extension of time to file their tax return on one application, Form 7004, *Application for Automatic 6-Month Extension of Time to File Certain Business Income Tax, Information, and Other Returns*. [See T.D. 9229, November 7, 2005] The six-month automatic extension of time

to file set forth in the temporary regulations applies to returns of pass-through entities, e.g., Form 1065, *U.S. Return of Partnership Income*, and Form 1041, U.S. Income Tax Return for Estates and Trusts, filed by most trusts, beginning in 2006 (for tax years 2005 and later) for a three year period, i.e. tax years 2005, 2006 and 2007. Previously two extension requests were required to obtain a full six month extension.

When the Treasury Decision was released in late 2005 for that year's filing season it was rightly heralded for streamlining tax filing responsibilities and eliminating administrative procedures that no longer advanced the goal of efficient tax collection by eliminating the prior interim extension filing requirements. The preamble to the Treasury Decision left for another day, and cautioned the tax community about, the obvious anomaly that the filing due date for most pass-through entities coincided with the due date for their owners to file tax returns reporting the same data. It said, in relevant part, that:

The Treasury Department and the IRS recognize that because the six-month automatic extension is available for returns of pass-through entities, some taxpayers may not receive information returns from the pass-through entities that they need in order to complete their own income tax returns before those returns are due. For example, an individual income taxpayer with a six-month extension of time to October 15 to file the Form 1040 may not receive a Schedule K-1, *Beneficiary's Share of Income, Deductions, Credits, etc.*, from a partnership in which the taxpayer holds an interest until after the partnership files its Form 1065 on its extended due date of October 15. Similarly, a C-Corporation with a six-month extension to September 15 to file its Form 1120, *U.S. Corporation Income Tax Return*, may not receive a Schedule K-1 from a calendar year partnership in which it holds an interest until 30 days after its return is due if the partnership files its Form 1065 and sends out the Schedule K-1s on its extended due date of October 15. This filing anomaly existed under prior regulations when the pass-through entity received an extension of time to file to a date on or after the extended due date for the pass-through interest holder, but the automatic six-month extension in these regulations may cause this to happen with more frequency.

Because of this filing anomaly, the availability of a six-month extension of time to file for pass-through entities may result in taxpayers filing an increased number of amended income tax returns. Therefore, it may be appropriate for pass-through entities to have a shorter extension period than their partners or shareholders.

At that time, the Treasury Department and the IRS requested comments on “whether a shorter extension of time to file for pass-through entities might reduce overall taxpayer burden.” A request was also made that, “in order to minimize the burden that might be imposed as a result of this filing anomaly, the Treasury Department and the IRS encourage pass-through entities that request an extension of time to file to minimize the impact that such extension might have on their partners' or members' ability to timely file (with an extension) their own tax returns.”

Comments were received and many of them recommended shortening the extension period to five months. Proposed Regulations modifying Treasury Decision 9229 to shorten the due date to September 15 were issued effective July 1, 2008. See IRS News Release 2008-84, June 30, 2008.

The anomaly presaged by Treasury Decision 9229 has become a self-fulfilling prophecy that is raising increasing concern among a growing group of owner/partner/members (and their representatives) of pass-through entities. Commercial pressures have not provided sufficient motivation. Too many partnerships, REMICs and trusts that have been granted automatic extensions to October 15 have not been mindful of the impact of utilizing the full extension period on the recipients of the K-1's having an October 15 filing date. There are several factors that have been identified as causing a significant number of K-1s to be released at the “last minute” in the final week or two before owners must also file their tax returns. These include:

- Underlying transactions are difficult and complex--- it is only human nature to put off difficult decisions to the last minute;

- “Tiered” partnerships or trusts have created information “bottlenecks.” For example, a trust may be awaiting a partnership K-1 before it may issue K-1s to its beneficiaries, while the partnership awaits a K-1 from several alternative investments;
- Many entities are more mindful of their own responsibility to the tax system than they are to the needs of their owners, particularly in later life businesses that no longer are actively involved with many of their original investors;
- Extraneous issues such as foreign tax credits, passive activities and multistate tax jurisdiction issues further complicate calculations and require time to gather data;
- Tax treatment of particular items is sometimes difficult to determine, and only the pressure of a filing deadline motivates the decision makers to act;
- The significant proliferation of the use of pass-through entities involves many more taxpayers now than were involved five and ten years ago.

Today, as a result, too many K-1s are often not available until shortly before or on the October 15 deadline.

The change to the partnership and trust extended due dates in the Temporary Regulation would reduce overall taxpayer burden. It would smooth out the workflow and improve the accuracy, efficiency and reliability of the administration of our tax laws. Having said this, we recognize the need to balance the requirements of the pass-through entities that need sufficient time to prepare their tax returns with the same needs of owners who desire to accurately comply with their filing obligations in a timely fashion. The new, Temporary Regulation balances those needs.

This change will induce partnerships and trusts to complete their work within 8 ½ months after the end of their year ... September 15 for calendar year entities...which will give most individuals at least a month to complete their tax filings by October 15.

This should not be a hardship to the pass-through entities, and will simply hold partnerships and trusts to the same timetable as most similarly situated businesses conducted in corporate form. At the same time, this revision will resolve the anomaly that has arisen by giving pass-through entities as much time as possible to report their activity.

By changing the extended due date one month earlier, the filing system would be enhanced in several ways:

- Better, more accurate returns may be prepared in a timely manner;
- Fewer compliance issues might arise;
- Processing work flow will be streamlined for taxpayers, practitioners and the government;
- Simpler, less complex practices will be possible, reducing the current need to estimate and then amend tax filings.

More specifically, the IRS may anticipate the following improvements to the reporting and tax compliance system, should it enact this proposal:

1. Tax reporting would be improved because the tax preparer community would have completed the entity returns by September 15, thus allowing substantially more time to be devoted to the accurate preparation of individual returns due October 15.

2. Unarguably, the proposed change would be revenue positive because personal returns would be completed sooner (as many balances due from taxpayers would be paid weeks before October 15 rather than exactly on October 15).
3. More tax returns may be filed before October 15 thereby saving the IRS the extra costs incurred by the late “rush” of filings.
4. Taxpayers would be spared the cost of preparing amended tax returns that resulted from not receiving their K-1s early enough to be included in their tax returns. (Traditionally when this situation occurs, taxpayers estimated the amounts anticipated on their K-1s, and tax preparers were engaged to prepare amended returns well after October 15.)
5. The vast majority of corporate partners will receive K-1’s on a timely basis in advance of the filing of the partner’s corporate tax return and the situation where K-1’s arrive after the Form 1120 was required to be filed should become rare.

Recommendation

The new, Temporary Regulation should be supported and made final.

ISSUE TWO: MAIL PROCEDURES IN THE AUR/CP2000 CORRESPONDENCE CYCLE

Executive Summary:

The Automated UnderReporter and Computer Paragraph 2000 (AUR/CP2000) Program is a vital part of the IRS’s efforts to ensure accurate income reporting compliance. The program is a valuable tool in helping to reduce the tax gap but more effective mail procedures are needed to avoid unnecessary and often, escalating correspondence with taxpayers. It is important that the IRS allow sufficient time to process taxpayer correspondence and equally important that the

taxpayer know that the IRS has received the response. When the taxpayer response is received, they should be promptly notified by the IRS that no further action will be taken until the response is processed. It should be noted that similar problems can exist with campus examination letters 566, *Initial Contact Letter*, and all references to AUR/CP2000 problems should be construed to include the 566 letter process as applicable.

Background:

AUR/CP2000 notices are sent to taxpayers when “income and payment information that the IRS has on file does not match entries” that the taxpayer has submitted via a filed Form 1040 return, *U.S. Individual Income Tax Return*. These notices typically give taxpayers a 30-day period in which to respond with documentation to support their entries on the filed Form 1040 or, in the event of a taxpayer omission or error, the opportunity to agree with the proposed adjustment in AUR/CP2000 notice. This process is reasonable and appropriate given the IRS’s mission to collect the correct amount of tax from each taxpayer. But, the next steps in the mail procedures are often frustrating and counter-productive to both taxpayers and tax practitioners assisting the taxpayers. The AUR notice stream is a CP2000 followed by a Statutory Notice of Deficiency Letter 3219 (For Campus Examination, the notice stream begins with letter 566, followed by letter 525 and lastly letter 3219). Far too frequently, a 90-day letter (letter 3219, Statutory Notice of Deficiency) is mailed to the taxpayer before any documentation submitted within the original 30-day response period provided by the AUR/CP2000 can “be worked by the Service”. Certainly, taxpayers may be left wondering – is anyone acting on my correspondence?

To be fair, many of these issues do get resolved before the end of the 90-day period in which a taxpayer can file a petition with the Tax Court but that begs the question. Current

procedures in the IRS mail cycle response process are creating unnecessary anxiety and often duplicative efforts for both taxpayers and tax practitioners. During this intervening time period the taxpayer and the practitioner are forced to begin preparation of the petition and may actually prepare and file the petition with the Tax Court in order to not lose the ability to resolve the issue through the prepayment process afforded by the Tax Court procedures. The potential costs and efforts create an unnecessary burden on taxpayers who complied in a timely manner with the IRS request.

If the IRS research indicates that a case involving an AUR/CP2000 notice requires “x” days to be worked after a taxpayer submits a response and/or the requested documentation, it is absolutely foolish to send further escalating notices to the taxpayer anytime prior to the expiration of “x” days. If a taxpayer has responded in a timely manner to an IRS request, then the concept of good customer service requires that the IRS evaluate the response and the accompanying information before any further escalating correspondence is sent.

Recommendations:

1. Upon receipt of a taxpayer’s timely response to an AUR/CP2000 notice, the Service should send an acknowledgement letter to the taxpayer indicating the correspondence has been received and stating that the taxpayer’s next notice will not be sent until after the response and/or documentation has been reviewed.
2. Concurrent with the sending of an acknowledgement letter, a “hold” should be placed on the taxpayer’s correspondence cycle ensuring that no further escalating letters will be sent until the “case is worked” by an examiner.

3. Since taxpayers have the option of responding to an AUR/CP2000 notice by either mail or fax, guidance needs to be given as to what constitutes a timely response in order to satisfy the requirement for the two previous recommendations. A fax is received by the Service on the transmission date. A mailed response may be timely based on the postmark date but will arrive at some time after that date. IRS procedures need to consider whether the language in an AUR/CP2000 notice needs to be modified in the section “you need to respond by ...“ to reflect the differences in dates of receipt given the two modes of possible response by the taxpayer.

ISSUE THREE: IMPROVE EMPLOYMENT TAX REPORTING AND WORKER CLASSIFICATION COMPLIANCE

Executive Summary:

IRS procedures should be reviewed to increase the awareness of various programs and initiatives designed to enhance compliance. Worker classification is dependent upon a complex, difficult factual analysis. A reclassification as a result of an examination for prior tax years often results in a liability that effectively renders the employer/service recipient insolvent. Compliance may be enhanced by providing reclassification incentives to employers.

Background:

No definitive test exists to distinguish whether a worker is an employee or an independent contractor. The tests used to determine whether a worker is an independent contractor or an employee are complex and subjectively applied. Significant tax consequences result from the classification of a worker as an employee or independent contractor.

Under the Worker Classification Settlement Program (CSP), the examiner must first determine whether the employer is entitled to relief under the guidelines for determining the employment status of a

worker as set forth in Section 530 (a) of the 1978 Act, as amended by Section 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982 (“Section 530”). Section 530 generally allows a service recipient to treat a worker as not being an employee for employment tax purposes, regardless of the worker’s actual status under the common-law test, unless the service recipient has no reasonable basis for such treatment or fails to meet certain requirements. Section 530 was permanently extended by the Tax Equity and Fiscal Responsibility Act of 1982.

If the service recipient is entitled to Section 530 relief, under CSP there is no assessment and the service recipient can continue to treat the workers in question as independent contractors. If the service recipient desires to begin treating the workers as employees, it can agree to do so in the future (no later than the beginning of the next year) without giving up its claim to Section 530 relief for earlier periods.

If the examiner determines that the service recipient is erroneously treating employees as independent contractors, a series of two graduated CSP settlement offers can occur. If the service recipient has met the reporting consistency requirement of Section 530 but clearly has no reasonable basis for its treatment of the workers as independent contractors or has been inconsistent in its treatment of the workers, the offer will be a full employment tax assessment under IRC §3509 for one taxable year (with the employer agreeing to reclassify the workers as employees on a prospective basis, ensuring future compliance). If the service recipient has met the reporting consistency requirement and can reasonably argue that it met the reasonable basis and consistency of treatment tests, the offer will be an assessment of 25% of the employment tax liability for the audit year under IRC §3509 (with the employer agreeing to reclassify the workers as employees on a prospective basis, ensuring future compliance).

In the event of a recharacterization of workers as employees from independent contractors under CSP or otherwise, no interest will be due on the additional liability arising as a result of the recharacterization if: (i) the employer agrees to the recharacterization with either the Examination Division or the Appellate Division of the IRS (following a timely Protest), and (ii) the additional FICA

tax is paid in full before the date the current Form 941 would be due for the quarter within which there is an agreement with the IRS as to the recharacterization. See Revenue Ruling 75-464 and IRC § 6205. The foregoing represents a significant economic incentive for the employer to promptly agree to the recharacterization and satisfy the resulting liability.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test that seeks to determine whether the worker is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed.

Before a service recipient can know how to treat payments made to workers for services, they must first know the business relationship that exists between the service recipient and the person performing the services. The person performing the services may be: (a) A common-law employee, (b) A statutory employee, (c) A statutory nonemployee, or (d) An independent contractor.

Under common-law rules, a worker may generally be subject to classification as an employee if the service recipient can control what will be done and how it will be done. An individual is generally treated as an independent contractor if the person for whom the services are performed has the right to control or direct only the result of the work and not the means and methods of accomplishing the result. In Rev. Rul. 87-41, the IRS developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. In 1996, the IRS published a training manual for examiners, entitled “Independent Contractor or Employee? Training Materials” which grouped the common factors in three categories: (1) behavioral control; (2) financial control, and (3) relationship of the parties.

On May 7, 2007, the U.S. Joint Committee on Taxation (JCT) released a report, entitled “The Report”, describing the present law and background relating to worker classification for federal tax

purposes.¹ The Report analyzed alternative methods of classifying workers, including: (1) adopting a “check-the-box” approach whereby the parties decide by contract whether the worker is to be treated for all federal tax purposes as an employee or independent contractor; (2) limiting the number of relevant factors to be considered either by way of an additional safe harbor or by replacing the present-law rules; or (3) providing similar treatment of workers for all federal tax purposes with the result that worker classification would become irrelevant. We reference the JCT Report without comment on its recommendations.

Recommendations:

1. Increased Application and Awareness of the CSP. Under the CSP, the IRS allows examiners and employers to resolve worker classification cases as early in the enforcement process as possible. IRS should publicize the availability of the CSP to service recipients, whether under examination or not, allowing them to voluntarily apply for the CSP even in the absence of an employment tax related examination.

2. Employment Tax Voluntary Disclosure Program. IRS should consider creating an informal voluntary disclosure program emphasizing employment tax and worker classification issues. The employment tax / worker classification voluntary disclosure program could provide for graduated CSP treatment for employers who voluntarily contact the IRS before:

A. The IRS has initiated an examination or investigation of the service recipient, or has notified the service recipient that it intends to commence such an examination or investigation;

B. The IRS has received information from a third party (e.g., informant, other governmental agency, or the media) alerting the IRS to the specific service recipient’s potential noncompliance;

or

¹ Joint Committee on Taxation, “Present Law and Background Relating to Worker Classification for Federal Tax Purposes” (JCX-26-07), May 7, 2007). For the text of the report, see <http://www.house.gov/jct/x-26-07.pdf>.

C. The IRS has initiated a civil examination or investigation that is directly related to the specific liability of the service recipient.

3. **Provide Incentives to Improve Compliance.** IRS should consider sending letters to service recipients in industries having a history of noncompliance offering a way to avoid penalties through the employment tax voluntary disclosure filing of amended returns and payment of the taxes and interest due. Service recipients may self-comply if they receive educational information regarding worker status and an opportunity to correct any filing errors rather than be subjected to a traditional examination.

4. **Publish “Top 10” Employment Tax Audit Priorities.** IRS should increase the publication and clarification of worker status and employment tax priorities with meaningful examples setting forth potential liabilities for taxes and penalties. Examples could include seasonal (such as retail help at holidays) and long-term substitutes (such a person who answers phone only one day a week) being subject to employee status.

5. **Improve IRS Oversight and Enforcement.** In employee concentrated industries such as professional employer organizations (PEOs), manufacturing, etc. IRS should improve oversight such that it can promptly intercede following the first significant quarterly liability. Often, quarterly liabilities are several quarters delinquent before IRS first contacts the employer. Pyramiding of employment tax liabilities frequently makes it difficult for both the IRS and the employer to achieve any realistic resolution in a timely manner.

A. **Accelerate Trust Fund Recovery Penalty (TFRP) Investigations.** IRC §6672 authorizes the imposition of the TFRP against the individual responsible persons within a corporate entity who fail to take appropriate steps to assure payment of certain employment tax related amounts to the government. The amount of the penalty is equal to the unpaid balance of the trust fund tax and is based on the unpaid income taxes withheld, plus the employee's portion of the withheld FICA taxes. IRS should accelerate investigation of TFRPs by maintaining an

informal policy providing for the commencement of the TFRP investigation whenever there are employment tax delinquencies for two consecutive calendar quarters.

B. Federal Tax Deposits. IRS should review the required timing for federal tax deposits to determine if deposits should be accelerated in certain types of situations of historically noncompliant industries.

C. Employment Tax NRP. IRS should commence a National Research Program (NRP) focused on employment tax and independent contractor issues. Historical data seems to be out of date with the current Internet economy. The employment tax NRP would increase the ability of the IRS to focus limited resources within employment tax compliance challenged industries.

D. Form SS-4, *Application for Employer Identification Number, Revisions.* IRS should add employment tax /worker classification information to the Form SS-4, which would provide an additional tool since taxpayers could not realistically assert that they lack sufficient knowledge of the relevant withholding obligations and determination of worker status as an independent contractor. For example, provide links to relevant publications and sites on www.irs.gov.

E. Employment Tax Web Site. We applaud the launch of the employment tax site on www.irs.gov. We would recommend that a search of “employee” or “contractor” be linked to the employment tax site. The site should continue to be highly publicized through www.irs.gov, business associations and professional organizations.

ISSUE FOUR: SEASONAL EMPLOYEES AND EMPLOYEES WORKING LIMITED HOURS

Executive Summary:

There is no de minimis number of hours or minimum compensation which exempt an employer from the requirement to withhold income taxes and to pay and withhold employment taxes. IRS publications related to the employment taxes and employment classification have limited guidance on this

topic. Our recommendation would be to more prominently feature and more clearly state in plain language in all relevant publications and materials that there is no de minimis hours worked nor dollar amount earned threshold for employment tax status.

Background:

Some businesses believe that an individual can be considered an independent contractor based solely on the number of hours worked or the short period of time that the individual is performing services. The number of hours worked may be a factor in the determination of whether the individual is an independent contractor or employee, however, an individual can be an employee even if only one hour is worked.

IRS Publications related to the employment taxes and employment classification have limited guidance on this topic.

IRS Publication 15, *Employer's Tax Guide*, has two references to this issue:

1) In Section 2, "Who Are Employees?" there is the following paragraph:

"If an employer-employee relationship exists, it does not matter what it is called. The employee may be called an agent or independent contractor. It also does not matter how payments are measured or paid, what they are called, or if the employee works full or part time."

2) Section 9 has a paragraph entitled "Part-Time Workers," which states:

"For federal income tax withholding and social security, Medicare and federal unemployment (FUTA) tax purposes, there are no differences between full-time employees, part-time employees and employees hired for short periods."

Regarding classification as employees or independent contractors, Publication 15-A, *Employer's Supplemental Tax Guide*, in a paragraph entitled "Common-Law Employees," it states:

"If you have an employer-employee relationship it makes no difference how it labeled. The substance of the relationship, not the label, governs the worker's status. Nor does it matter whether the individual is employed full-time or part-time."

There is one publication that has a clear statement. Fact sheet FS-2007-27, December 2007,

“Employment Taxes and Classifying Workers” states:

“It is a common misconception that someone working part time or earnings less than \$600 per year should be classified as an independent contractor. But in fact, part time status and the number of hours worked are generally not factors that determine whether a worker is an employee or independent contractor.”

Recommendation:

1. More prominently feature and clearly state in plain language in all relevant publications and materials that there is no de minimis hours worked nor dollar amount earned threshold for employment tax status. This can be included in Web site materials as well as publications (e.g. , Publication 15, *Employer’s Tax Guide*; Publication 15-A, *Employer’s Supplemental Tax Guide*; Publication 334, *Tax Guide for Small Businesses*), Industry-Specific Audit Technique Guides; Section 7 of the Businesses with Employees area on the IRS web site; etc).

The statement in the fact sheet is one option. An alternative example is: “For federal income tax withholding, social security, Medicare, and federal unemployment (FUTA) tax purposes, neither the number of hours worked nor amount earned alone determines the status of an individual as independent contractor or employee. For example, an individual can be an employee even though the individual works one hour a week or one day a year.”

ISSUE FIVE: REQUIRING APPRAISERS TO INCLUDE THEIR SOCIAL SECURITY NUMBER ON WRITTEN APPRAISAL REPORTS AND ON IRS FORM 8283

Executive Summary:

Treasury Regulation 1.170A-13(c) (3) (E) requires that, in order for an appraisal report to be considered a “qualified appraisal”, it must include "The name, address, and... the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership [or] an employee of any person (whether an individual, corporation, or

partnerships)... the name, address and taxpayer identification number...of the partnership or the person who employs or engages the qualified appraiser."

This has been interpreted by taxpayers and/or their agents to require the appraiser's signature and Social Security Number (SSN) on their appraisal reports in order for those reports to be considered as "qualified appraisals". Additionally, an appraiser's SSN is required to be entered on Form 8283 in Part III, "Declaration of Appraiser". These requirements invite identity theft.

Background:

It has been interpreted by many taxpayers and/or their agents that current IRS Regulations(Treasury Regulation 1.170A-13(c)(3)(E) require that, in order for an appraisal for any tax purpose to be considered a "qualified" appraisal, the appraisers must include his or her signature and Social Security Number on the appraisal reports. IRS is aware of the tax-related identity theft issues and, in fact, recently took action to address this issue for tax practitioners, but not for appraisers preparing reports to be used in connection with tax returns. This is an issue of great concern to many appraisers who work for companies offering appraisal services. Unlike sole practitioners, appraisers employed by others have not been eligible for a separate Tax ID Number. Accordingly, to meet service requirements for a "qualified appraisal", they are being asked to include their personal social security Number on written appraisal reports.

The IRS has recently attempted to remedy this problem. A provision in regulations (REG-140029-07) on "Substantiation and Reporting Requirements for Cash and Non-Cash Charitable Contribution Deductions" states "if an appraiser is employed by a firm, the firm's employer identification number should be used", thereby eliminating the need for an appraiser performing the work to include his or her personal social security number. The proposed rules also clarify that appraisers who are sole practitioners may obtain an employer identification (EIN) even if they do not have any employees.

Unfortunately this solution carries with it a host of different problems. The purpose for including the "identifying number of the Qualified Appraiser" is to identify the person responsible for the appraisal, not his or her employer. While the proposed provisions may solve the immediate identity theft problem it may create an identification problem. Appraiser

employees who use their firm's employer identification number may not be identifiable once they leave the firm, and a single appraiser who works for several firms could be submitting appraisals under several different identification numbers.

In lieu of using their firm's Employer Identification Number, appraiser/employees might avail themselves of the ability to apply for their own EIN. Appraiser employees who have their own (EIN) blur the distinction between employee and independent contractor. This could encourage a bad business practice.

Recommendations:

1. IRS should take immediate action to eliminate all existing requirements that appraisers include their social security numbers on written appraisal reports, on IRS Form 8283, and on any other documents that could expose them to the threat of identity theft.
2. IRS should permit appraisers to apply for an expanded Preparer Tax Identification Number ("PTIN") or for an equivalent discreet number that will permit the service to identify their work without exposing them to the possibility of identity theft.
3. The proposed regulations (REG-140029-07) should be modified to include providing an expanded PTIN or an equivalent discreet number to identify appraisers, and then be adopted.

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

**TAX GAP ANALYSIS
SUBGROUP REPORT**

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NOVEMBER 19, 2008

**TAX GAP ANALYSIS
SUBGROUP REPORT**

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INTRODUCTION/EXECUTIVE SUMMARY

The purpose of the Tax Gap Analysis Subgroup is to help the IRS improve its estimates of the tax gap. This is the report for 2008, which is year two in the three-year term of this subgroup.

In pursuing its mission the subgroup conducted three meetings with IRS staff this year -- a full-day face-to-face meeting in Washington, DC on January 31, 2008 and two telephone conference calls, on July 28, 2008 and September 12, 2008.

Most of the subgroup's deliberations during this year were centered on improving estimates of the corporate tax gap, but the subgroup also considered ways to apply new IRS estimates of underreporting by S-corporations to improve estimation of the individual income tax gap. At the January meeting, subgroup members were briefed on the history of IRS estimates of the corporate tax gap and then on a set of issues that IRS must address in estimating the tax gap, including:

- the extent to which estimates can be based on random audits or must rely on operational audits;
- the extent to which audits detect non-compliance;
- whether the measure of noncompliance should be an auditor's recommendations or the actual assessments after appeals;
- the way net operating losses are counted in the estimates; and
- the special challenge of integrating tax and fiscal year data.

A final presentation compared three alternative approaches for using operational audit data to estimate non-compliance. Later in the day, the subgroup met with staff members from the Large and Mid-Size Business Division (LMSB). Because yield curves

have not provided sufficiently accurate estimates of non-compliance for LMSB firms, division staff members solicited suggestions for improving their methodology.

The July conference call was devoted to discussing a document prepared by staff of the Office of Research Analysis and Statistics (RAS), “Estimating the Corporate Income Tax Underreporting Gap Using Examination Yield Curves.” In the absence of studies under the National Research Program (NRP) that would estimate corporate noncompliance by looking at the results for firms *randomly* selected for audit, the IRS seeks to use the results of its operational audits to impute noncompliance in the corporate population at large. The document explained the available data, described the yield curve model and presented some preliminary results.

Two additional IRS staff documents were discussed during the September conference call, “Preliminary Methodology for Estimating the TY2004 Tax Gap Associated with S-Corporations” and “Preliminary Results of the 2003/2004 National Research Program S-Corporation Underreporting Study.” The first paper presented preliminary results from the NRP S-corporation study. The second paper updated prior NRP work on the individual tax gap for TY2001 to 2004 and discussed how the results of the NRP S-corporation study might be used to adjust the estimates from TY 2001 study (projected to 2004) of reporting compliance on individual income tax returns.

The Subgroup discussions over the course of the past year culminated in the following recommendations of actions IRS might wish to take, grouped into five categories.

ISSUE ONE:

Recommendations

General

1. In place of the current structure in which the Tax Gap subgroup is a part of the Internal Revenue Service Advisory Committee (IRSAC), establish outside of IRSAC, a permanent board of outside advisors, consisting of academics and practitioners, to review how IRS estimates the tax gap. This body would meet (in person or via conference call) to review and offer suggestions on IRS Research methodology papers, and, subsequently, drafts of tax gap studies. Towards promoting an efficient and fruitful interchange, the papers would be provided to board members in advance of their meetings. On their part, members of the board would funnel the latest academic research on tax compliance to the IRS. While the new board of advisors would be separate from the IRSAC, it would provide periodic reports of its findings and recommendations to the IRSAC and invite comments from other IRSAC members.
2. The IRS should release updated tax gap estimates at the end of 2008 that reflect:
(a) new estimates of the corporate tax gap; (b) any revisions in the individual tax gap estimates that may flow from the S-corporation study (or an explanation why none were done); and (c) extrapolation of 2001 estimates to tax year 2004.
3. The IRS needs to do an updated study of employment tax compliance. The S-corporation NRP results regarding the compensation of officers could be one input into that study.

4. In the near future, the tax gap subgroup should provide suggestions for how IRS could develop better estimates of the international tax gap resulting from abusive transfer pricing transactions and other sources.

LMSB Issues

1. Until U.S.-specific data are available, the IRS should develop reasonable methods to convert the publicly-disclosed aggregate liability balances contained in FIN 48 disclosures to an annual gap related to U.S. tax uncertainty. Because FIN 48 disclosures provide information about whether the liability relates to permanent or temporary tax positions, analysis of FIN 48 data should assist the IRS in evaluating how much of the tax gap is permanent.
2. Congress should provide the IRS with summary data from the Permanent Subcommittee on Investigations' detailed analysis of approximately 40 firms' FIN48 disclosures. Specifically, knowing how much of the FIN 48 liability relates to U.S., international, or multistate tax uncertainty could inform IRS' estimates relating aggregate FIN 48 liability to the U.S. tax gap for other taxpayers.
3. The IRS Research should consider whether it is possible to report separately non-compliance from domestic and international transactions and, if not, what additional data capture from NRP audits or regular audits would be necessary to do this. Separate reporting of domestic and international based non-compliance could be done for both corporate and individual taxpayers.

Corporate Tax Gap – Yield Curves

1. The IRS should address the fundamental problem of selection bias in inferring noncompliance for the population of corporate taxpayers from that detected in corporations it selects for operational audits.
 - a. One approach to this problem would be to infer population noncompliance from audits conducted on a randomly selected sample of corporations, as in the NRP audits.
 - b. An alternative would be to introduce a correction to the operational audit estimates that explicitly models the process the IRS uses to select corporations for audit. A selection bias model would include all of the factors available on corporate returns that are associated with choosing entities for audit. A selection bias model should further account for:
 - i. Listed transactions. IRS should estimate models that predict whether a firm has a listed transaction, based on data reported on tax returns and data from financial statements. Doing so should help determine whether these firms get audited more in general, either because they are on the list or for other reasons.
 - ii. The Compliance Assurance Program (CAP). Participating firms may or may not have characteristics that make them more likely to be compliant, based on current scoring methods.
 - iii. Financial statement data. The model should include appropriate variables from financial statements to determine whether they are useful in developing compliance-scoring methods.

2. The IRS Research should more clearly articulate the consequences of excluding the effects of subsequent taxpayer claims that might be presented during an examination or in an amended return (such as carry-backs and new deductions) from tax gap estimates. To the extent that claims offset deficiencies, clear communication is necessary to avoid Congress believing the current definition of the tax gap represents easily accessible government receipts.
3. For large corporations, the IRS should model the probability that specific issues get examined during an audit. Even if there were 100 percent audit coverage for these firms, there would still be the issue of extrapolating total non-compliance because only a subset of issues get examined and the content of that subset is likely to differ across firms.
4. The IRS should include as independent variables in yield curve functions variables that are available both for audited and unaudited firms. That is, the auditors' recommended change should depend not only on items that typically arise during an operational audit but also on items that characterize all firms.

National Research Project (NRP) Individual and S-Corp Studies

1. The IRS should incorporate operational audits more comprehensively into its NRP work. To enable this to be done, IRS examiners should be encouraged to capture more data from operational audits than is currently done in a form that facilitates use in subsequent research. IRS researchers, with assistance from the new board of advisors, would then need to develop further methodologies for combining random and operational audit data in tax gap estimation. If

- operational audits were used to supplement random audits, fewer random audits could be conducted, reducing costs and/or making more frequent tax gap estimates possible.
2. There are sampling issues in the S-corporation study that deserve further attention.
 - a. The IRS should vary the sampling rates across return classes in order to ensure a fully representative sample. For example, while most S-corporations have only one or two shareholders, a small number have 75 or more. Stratifying the sample on the number of shareholders, S-corporations with many shareholders should be oversampled, relative to those with few shareholders.
 - b. The IRS should consider pooling tax years, with every S-corporation given a weight that is the inverse of the sampling likelihood.
 3. The IRS should pursue the following additional issues in the NRP program.
 - a. The self-employment aspect of S-corporations is a very common planning issue, likely to be associated with noncompliance.
 - b. Entity conversions. The IRS should look at entity conversion cases to see to what extent either the election was incorrect or the examiner converted an S-corporation to Schedule C. This could happen either if the taxpayer failed to file Form 2553 *Election by a Small Business Corporation* or if the taxpayer filed the form, but nevertheless did not meet the requirements to be a subchapter S-corporation.

- c. The IRS should display estimates of non-compliance of S-corporations for separate asset classes and then compare the observed non-compliance rate for the smallest S-corporation asset class to the observed noncompliance (excluding the adjustment for non-detection) for Schedule C income in the 2001 NRP individual taxpayer compliance study.
4. In the NRP S-corporation study, the IRS should adjust for inflation between 2003 and 2004.

Beyond Measuring the Tax Gap

1. IRS Research should think systematically about the potential returns to marginal dollars spent on alternative enforcement and service activities, with a view towards developing an evidence-based strategy for efficiently reducing the gap.

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL**

LARGE AND MID-SIZE BUSINESS SUBGROUP REPORT

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I. RISK MANAGEMENT TASK FORCE

While the perception of LMSB and the Subgroup is that LMSB has taken significant steps towards identifying and addressing tax compliance risks,¹ it was not possible for the Subgroup to test this perception given that LMSB does not have documented processes and controls around all tax compliance risks. Similarly, while LMSB and other government controlled offices, such as the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA), do periodically test the execution of strategies designed to address tax compliance, neither the IRS nor LMSB maintain a robust internal audit function aimed at tax compliance, which could enhance the effectiveness and execution of the risk management strategies and related internal controls of LMSB aimed at tax compliance.

The Subgroup believes that it is important for LMSB to continue its ongoing efforts to develop a more comprehensive and systematic program for identifying and managing the risks of taxpayer non-compliance. Toward that end, the Subgroup's Risk Management Task Force (RMTF) has focused its work this year on (i) identifying the core elements and objectives of an effective risk management program; (ii) formulating a basic methodology for determining, prioritizing and responding to specific types of tax compliance risks; (iii) suggesting possible improvements to the relatively new Industry Issue Focus (IIF) Initiative, hereafter referred to as the Tiered Issue Focus (TIF) strategy, designed to identify and provide coordinated treatment of significant audit issues (including, but not necessarily limited to, issues arising out of tax shelters or other aggressive tax-driven transactions); and (iv) examining a recent U.K. initiative to ease the tax compliance burden for cooperative "low risk" taxpayers.

A. Relevant Definitions

Before beginning its work, the RMTF discussed with LMSB definitions of "tax compliance" and "risk", and the scope of a review it would conduct to demonstrate to LMSB the design of an Improve and Monitor Plan (IMP) that RMTF would recommend be implemented. In addition, the RMTF described to LMSB various design facets of the IMP model it would demonstrate, such as the (i) methodology that would be employed in undertaking the identification of inherent risks to tax compliance; (ii) how those inherent risks would be assessed in determining which were KTCRs; and (iii) the interview process that the Subgroup could use to evaluate and inform its recommendations for an IMP with respect to select KTCRs.

¹ For example, to focus on tax compliance risks within its constituent base, LMSB 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.

1. What Constitutes Tax Compliance?

It is important to define “tax compliance,” because the term can refer to differing activities when used by LMSB and publicly traded corporations. For a tax authority, the term typically is used to convey the goal of maximizing taxpayers’ overall level of compliance with the tax laws. Moreover, it is used to convey the objective of the tax authority to maximize its limited resources in the efficient targeting of compliance risks and the development of actions necessary to reduce those risks. For a public company, tax compliance carries a broader connotation. It connotes tax compliance (frequently on a global basis) with a multitude of different types of national and subnational levies and fees encased within nonuniform laws and/or interpretations. Also, it conveys the duty of a company to comply with the reporting of financial statement information imposed by differing countries and regulatory bodies.

From a tax law perspective, tax compliance represents two components that are inextricably linked. The first deals with how a return is prepared by the taxpayer; the second is how LMSB uses its resources and knowledge in contributing to a higher level of tax compliance.

The known and perceived behaviors of taxpayers in accurately self-assessing, reporting and paying their tax obligations drive how LMSB allocates its resources. Similarly, the behaviors and resource allocations of LMSB employed to assist taxpayers before and after tax returns are filed have a significant impact on how taxpayers allocate their resources and approach the self-assessment process. There is clearly a push-pull relationship between the IRS and taxpayers, with the operations of both sides ultimately impacting tax compliance.

Until a tax period and its related issues are finalized, the tax compliance process (or lack thereof) remains relevant. In other words, while tax compliance may ultimately begin with the taxpayer, it ends with the IRS or, at times, the courts. Collectively the actions and duties of the taxpayer and the taxing authority represent the tax compliance process.

Examining only the operations of taxpayers from a risk management perspective ignores the linkage of how actions of the taxing authority impact taxpayers. Ignoring either side of the tax spectrum will jeopardize tax compliance.

2. What Constitutes a “Risk”

A risk is any event, action, or inaction in tax strategy, operations, oversight reporting, or compliance that either adversely affects LMSB’s collection or business objectives, or results in an unanticipated or unacceptable level of oversight reprimands, lost appeals, diminished collections, harm to reputation, lost opportunities or reporting exposure.

B. Benefits and Objectives of a Risk Management Program

By assessing the spectrum of risks surrounding tax compliance, LMSB will be able to develop and document a list of KTCRs. Once identified, this could empower LMSB to refine its strategic plan by focusing on the component parts that collectively drive taxpayer non-compliance or produce unacceptably high compliance costs. Moreover, given that the tax gap is not attributable to a single cause, the information gathered to determine KTCRs could inform LMSB in how it can best minimize each component of the tax gap.

A risk management program may not only enhance the strategies developed by LMSB in addressing the tax gap but, of course, increase collections and improve its services to taxpayers. It could provide information of how LMSB can best respond to risk, deploy additional resources, seek legislative change, improve the audit selection processes and take actions to better manage aggressive tax behavior.

Additionally, a risk management program can light the way for LMSB to better allocate its finite resources to achieve an optimal tax compliance strategy and, thus, optimize the overall level of compliance by taxpayers with the tax laws. Further, it can empower LMSB to better manage and assure the smooth operation of its strategic responses. Without effective and efficient tax administration, taxpayer confidence in the tax system could be damaged and elevate the impact and likelihood of KTCRs.

As a management tool, a robust risk management program can aid LMSB in other positive ways. For example, it can help LMSB avoid reputational harms; provide it with objective evidence to counter false or misleading subjective criticisms; allow it to better manage risks so that stakeholder cooperation and respect is preserved and enhanced; create additional opportunities for channeling lessons learned back to management's strategic plan and objective-setting process; and, create a more proactive risk management program that will benefit taxpayers as well.

A more robust LMSB risk management program also will aid taxpayers, because LMSB may become better equipped to understand taxpayer activities that do not possess significant tax compliance risk. Further, for taxpayers embracing transparency and possessing a conservative risk appetite, a risk management program could contribute to LMSB's goals to be more cooperative and lower the compliance costs of these taxpayers. Moreover, with enhanced opportunities for real time discussions, a taxpayer may be better able to obtain early certainty and, thereby, better match the demands of CFOs and audit committees who are devoting increasing time and resources to managing tax risk.

C. Methodology Employed: A Three Step Process

1. Identify "Inherent" Risks

An inherent risk analysis focuses on risks without thought given to the related controls that may already be in place. By comparison, under a residual risk analysis, the internal controls and safeguards surrounding risks first need to be documented and analyzed before areas of significant exposure are determined and addressed. A residual risk analysis was deemed to be outside the scope of this evaluation as it would significantly increase the work that would need to be performed. Accordingly, the process employed by the RMTF began by identifying inherent risks to the tax compliance spectrum.

To aid in its identification process, inherent risks were categorized under one of three topics: (1) Strategic Risks, defined as instances of bad publicity, reputational harm, and/or a loss of trust in the self-assessment system; (2) Operational Risks, defined as excessive annual staff turnover, significant disruption to operations, a delay in regulatory or other external reporting deadlines and/or a substantial loss of credibility with external audit leading to increasing workloads; and, (3) Compliance Risks, defined as the inability to comply with regulatory and statutory requirements and/or actions resulting in excessive oversight scrutiny. While some

risks may appear in more than one of the three topics, their focus changes depending upon the topical heading to which they are assigned. Table One below lists the potential inherent risks that were identified and reviewed by the Subgroup and LMSB for the purpose of the Subgroup's demonstration of its recommended IMP design.

Note that Table One lists all the types of potential failures that were discussed and reviewed in the IMP design demonstration and that could produce one or more of the three types of potential risks described above.

So that readers will not misconstrue the import of Table One, it does not list actual failures found in the IMP demonstration to be present within LMSB.

Table One – POTENTIAL INHERENT TAX COMPLIANCE RISKS BY SELECT CATEGORY

<p>STRATEGIC RISKS – [Instances of Bad Publicity/Reputation; Loss of Trust in the Self-Assessment System]</p>	<p>OPERATIONAL RISKS – [Excessive Annual Staff Turnover; Significant Disruption to Operations or Delay in Regulatory/Other External Reporting Deadlines; Substantial Loss of Credibility With External Audit Leading to Increasing Workloads]</p>	<p>COMPLIANCE RISKS – [Inability to Comply With Regulatory and Statutory Requirements; Excessive Oversight Scrutiny]</p>
<p align="center">Potentially stem from failure to - -</p> <ul style="list-style-type: none"> ✓ Develop an audit selection system ✓ Provide an appropriate level of transparency internally and externally ✓ Seek needed law changes ✓ Catalogue compliance strategies ✓ Analyze and prioritize compliance behaviors (e.g., causes and options for treatment) ✓ Maintain taxpayer privacy ✓ Optimize collections under the law while maintaining taxpayer confidence in the tax system ✓ Maintain a robust internal audit function ✓ Be innovative ✓ Evaluate tax intermediaries’ risk appetite, e.g., the commoditization or one off selling of abusive tax shelters ✓ Monitor the external environment, e.g., public opinion, Congress, economic conditions, governmental policy ✓ Shape internal capabilities, e.g. organizational culture; organizational structure; information technology and business systems; and staff and business capabilities ✓ Segment taxpayers into related groupings, e.g., public v. private; flow-through v. non-flow-through entities; domestic v. international operations; degree of risk appetite/compliance behaviors; industry; consolidating v. non-consolidating affiliate groups; etc. ✓ Identify and remediate strategic and operational risks ✓ Maintain cost-benefit strategies ✓ Avoid requests for data already available from another source ✓ Align strategic and operational decisions to taxpayers’ and tax intermediaries’ risk appetites, i.e., risk/return trade-offs ✓ Maintain a sufficient degree of LMSB senior management’s time in risk planning ✓ Maintain a robust internal audit function ✓ Sufficient staffing ✓ Provide clear avenue for Voluntary Disclosures ✓ Integrate LMSB with other Service Operating Divisions, accounting and legal departments ✓ Evaluate taxpayer’s risk appetite by considering, for example: The degree of taxpayer’s senior management (Board, CFO, VP-Tax) in risk planning; Taxpayer’s level of aggressive tax planning outside the FIT space; If taxpayer maintains a robust internal audit function; The quality of the taxpayer’s processes and accounting systems; Whether it maintains an “enterprise risk management” (ERM) process; Issues reported on Forms 10-K and 10-Q to SEC that disclose material tax weaknesses; Tax returns prepared internally or externally; Existence of a risk assessment process within the tax department; Degree of integration between tax, accounting and legal departments; The taxpayer’s behavior and degree of cooperation in sharing information with LMSB and responding to its questions; Taxpayer compliance with tax laws and regulations in all jurisdictions in which it operates to test taxpayer’s risk appetite against LMSB’s perceptions of same; ✓ Leverage the impact of information learned through taxpayer interventions ✓ Guard against internal fraud ✓ Map major compliance risks to the relevant taxpayer population ✓ Develop of a risk management program ✓ Compare risks across the total responsibilities of LMSB to determine what not to audit ✓ Clearly communicate roles and responsibilities ✓ Cost-efficiently optimize tax collections ✓ Provide training within and without LMSB ✓ Attract and retain tax expertise ✓ Participate in IRS/Treasury business planning ✓ Maintain appropriate reporting structures ✓ Identify non-filers ✓ Identify nonreported transactions ✓ Modify organizational structure to respond to changes in business operations and/or legislation ✓ Not identify the industry(ies) that best represents the taxpayer’s business and, thus, failing to apply applicable tax laws, regulations, ruling, and judicial decisions ✓ Use best efforts to pursue an “enhanced relationship” with taxpayers as envisioned in the OECD report on tax intermediaries ✓ Identify technical issues that present greatest dangers of underpayment ✓ Track appeals and issue disagreements ✓ Develop and communicate risk appetite to staff 	<p align="center">Potentially stem from failure to - -</p> <ul style="list-style-type: none"> ✓ Provide timely adequate and sufficient administrative guidance ✓ Maintain shared values and compliance with policies and procedures ✓ Fully understand organizational objectives ✓ Receive needed (appropriated) funds ✓ Establish procedures to resolve exams when agent indicates retirement ✓ Minimize employee turnover. ✓ Undertake generational planning reflecting anticipated changes in demographic factors ✓ Treat taxpayers with similar facts and circumstances consistently and equitably ✓ Maintain commercial awareness ✓ Provide sufficient staffing ✓ Provide needed training ✓ Lack of uniform execution across all field offices and taxpayers ✓ Implement strategies consistently up and down the organization ✓ Attract tax expertise ✓ Provide access to taxpayer data ✓ Provide responsive tax resources ✓ Leverage non-tax personnel supporting tax ✓ Plan and manage tax resources ✓ Recognize and respond to external factors ✓ Assign individuals to the audit with relevant tax law knowledge ✓ Respond quickly to changing circumstances ✓ Align resources to match changing business models, e.g., expansion in global operations, e-commerce, employment patterns and use of independent contractors, innovations in business structures and financial products ✓ Use information exchange programs with other taxing jurisdictions ✓ Identify taxpayers who should, but are not registered and filing 	<p align="center">Potentially stem from failure to - -</p> <ul style="list-style-type: none"> ✓ Receive clear and timely guidance on meaning and intended working of the tax laws ✓ Appreciate growing use of joint ventures/alliances/partnerships/agents/etc. and their unique tax issues ✓ Use technology ✓ Understand taxpayers’ registration, reporting, filing and remittance obligations ✓ Failure to gather/access needed data ✓ Failure to use data that has been gathered ✓ Team within and outside LMSB ✓ Maximize value of internet search tools ✓ Identify inappropriate transfer pricing, among other technical issues ✓ Reflect a broad view of the likelihood that the facts and circumstances generally encountered differ from those the taxpayer reports ✓ Note that taxpayers not filing complete and accurate information ✓ Treat taxpayer with similar facts and circumstances consistently and equitably ✓ Adjust audit program for taxpayer’s remedial efforts, e.g., adding needed personnel, greater use of outside consultants, improved reviews and reconciliations, improved tax accounting processes ✓ Plan and manage tax resources ✓ Maintain or provide supporting documentation ✓ Provide timely and non-burdensome access to functional and industry specialists ✓ Access to tax planning support opinions and workpapers ✓ Disclose overpayments to taxpayer ✓ Comply with laws and regulations ✓ Document findings and open questions ✓ Understand changes in tax laws ✓ Abate tendency of Technical Advisors to seek more documentation and develop more stringent approaches to technical issues then warranted under existing guidelines. ✓ Understand and adjust the audit program accordingly for the taxpayer’s –Commercial structure, size and activities; Quality of its processes and accounting systems; Behavior; Extent of agreement over interpretation of the law; Involvement in enterprise business planning; Legal structure; Taxpayer’s compliance with laws and regulations; Degree of taxpayer’s cooperation, risk appetite and transparency; Relevant financial statement restatements; Frequency of seeking PLRs; The nature of tax reporting errors, e.g. if due to complexity, clerical mistakes or fraud; Its regulatory restrictions; Internal control requirements; Encourage use of TAMs early in the exam process; Accounting standards; Voluntary v. involuntary disclosure of tax planning strategies; ✓ Receive current, relevant and reliable information

2. Determine Key Tax Compliance Risks (KTCRs)

After inherent risks were identified, they were prioritized based upon an assessment of their likelihood of occurrence and impact on tax compliance. Both likelihood and impact were ranked on a scale of 1-3, with a “1” representing a low ranking and a “3” representing a high ranking. Given the large number of potential inherent risks, rankings were assigned in increments of 1/10 of a point to better isolate KTCRs. The rankings used for purposes of the work done by the RMTF were provided by select members of LMSB and the Subgroup. The overall assessments assigned each potential inherent risk were determined by computing an average from the total rankings attained.

For determining likelihood and impact rankings, a ranking of “1” was defined as an event not likely to occur within one year. A ranking of “2” was defined as an event that was possible to occur within one year on a continuous basis. And, a ranking of “3” was defined as an event highly likely to occur within one year and continue to occur on a systematic and ongoing basis. Further details regarding the criteria used to rank each potential inherent risk are contained below in Table Two.

Table Two - RISK PROFILE DESCRIPTIONS

Criteria		High	Moderate	Low
Impact	Strategic	Adverse publicity or damage to reputation at the senior leadership level and/or to national confidence in the tax system	Adverse publicity or damage to reputation at the department head level and/or to regional or industry confidence in the tax system	Adverse publicity or damage to reputation at the examination team or member level, and/or to a taxpayer's confidence in the tax system
	Compliance	Substantial failure to comply with regulatory and statutory requirements; excessive oversight scrutiny	Failure to comply with regulatory and statutory requirements; increased oversight scrutiny	A non-serious or isolated failure to comply with regulatory and statutory requirements
	Operational	Substantial harm to the internal operations of LMSB, e.g., excessive staff turnover, disruption to operations or delay in regulatory/other external reporting deadlines, loss of credibility with external audit	Harm to the internal operations of LMSB, e.g., excessive staff turnover, disruption to operations or delay in regulatory/other external reporting deadlines, loss of credibility with external audit	A non-serious or isolated failure within the internal operations of LMSB, e.g., excessive staff turnover, disruption to operations or delay in regulatory/other external reporting deadlines, loss of credibility with external audit
Likelihood		- Highly likely to occur within 1 year - Systematic - Ongoing	- Possible to occur within 1 year - Continuous	- Not likely to occur within 1 year

Measured against impact and likelihood, the top four potential inherent risks identified by category were as follows: For *Strategic Risks*, the top four KTCRs were a possible failure to: provide an appropriate level of transparency internally and externally; provide sufficient staffing; identify non-reported transactions; and, identify technical issues that present the greatest dangers of underpayment. For *Operational Risks*, the top four KTCRs were a possible failure to attract tax expertise; provide sufficient staffing; respond quickly to changing circumstances; and maintain commercial awareness. And, for *Compliance Risks*, the top four KTCRs were from a possible failure to: provide/receive clear and timely guidance on the meaning and intended working of the tax laws; have access to tax

planning support opinions and workpapers; comply with laws and regulations; and receive current, relevant and reliable information.

Note: Assessment of impact and likelihood by a greater number of individuals, or individuals with different experiences and roles within LMSB, might have resulted in four different top KTCRs. For purposes of the work done by the Subgroup this year, however, the KTCRs identified were deemed to sufficiently validate that LMSB has, in fact, adopted strategies aimed at these KTCRs.

3. Application of an Improve and Monitor Plan (IMP)

While reviewing the multitude of strategies that LMSB has in place to address KTCRs was beyond the scope of available resources and designed work plan, one strategy was selected to test if improvements were feasible and should be implemented. The Tier Issue Focus (TIF) Strategy was selected by the RMTF for this test.

To aid in the development of its IMP, questions were developed and delivered through LMSB to its employees responsible for various aspects of the TIF Strategy. In a nutshell, the questions asked how issues in the TIF Strategy are identified, prioritized, tracked, managed and mitigated. Based upon the information learned from this interview process, among other sources, an IMP was developed. Following are the high level RMTF conclusions that were developed from its IMP. A full copy of the IMP and its more detailed recommendations can be found in “Attachment A” of this report.

D. An IMP of the Tier Issue Focus (TIF) Strategy²

Based on the IMP prepared by the RMTF, see *infra* Attachment A, the following comments were developed.

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 great strides in alleviating most of the concerns raised during the implementation phase of the TIF Strategy - communicating and clarifying through the use of its public website, 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

LMSB should enhance its internal control and audit programs designed to test and verify continuing adherence to (and execution of) the methodologies, processes and safeguards that have been developed to assure the TIF Strategy achieves its intended purposes and goals. As feedback has established, without such monitoring, lack of consistent and focused execution of the TIF Strategy will result in unintended consequences that can trespass on other equally important goals to the efficient administration of tax laws.

Additionally, LMSB should continue to initiate and reinforce the strong measures it has already taken to further improve the operation of the TIF Strategy. In this regard, the Subgroup urges LMSB to continue to work more closely with its external stakeholders in framing issue-specific strategies that

² For those unfamiliar with the TIF Strategy, a description of the strategy and how it fits into other issue management strategies employed by LMSB can be found under “Background” of Attachment A, *infra*.

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.

E. Additional Improve And Monitor Plans Needed

Over the past several years LMSB has done a good job developing strategies to address KTCRs. These strategies include, among others, the: “Industry Issue Resolution” (IIR) Program, the “Industry Issue Focus” (IIF) Initiative, the Compliance Assurance Program (CAP), the Limited Issue Focused Examination (LIFE) Program, the Fast Track Settlement (FTS) Strategy, and the Pre-Filing Agreement (PFA) Strategy.

LMSB should continue to initiate and reinforce strong measures already taken to further improve the implementation and operation of all its compliance strategies, new and old. Each existing strategy should undergo an Improve and Monitor Plan (IMP) Analysis, potentially developed as a variant of the IMP process that was employed by the Subgroup in its illustrative review of the TIF Strategy. From the IMPs, recommended areas of improvement should be addressed and enacted where warranted.

F. Best Practices: Lessons From Other Taxing Authorities

While the RMTF believes that LMSB would better allocate its resources in the near future by incrementally enhancing and executing on its current KTCR strategies, this recommendation is not intended to suggest that LMSB not continue to actively monitor and search for best practices.³

Both LMSB and various taxing jurisdictions are continually experimenting with new compliance risk management strategies. For example, the Large Business Service (“LBS”) of HM Revenue & Customs (“HMRC”) recently implemented a novel and fairly bold approach to managing taxpayer compliance risk for the United Kingdom’s very largest business taxpayers. This program, among others, offer concepts that may be valuable to LMSB as it executes on its current, and develops future tax compliance strategies. An analysis of the UK program, along with various recommendations, can be found in Appendix B of this report.

To aid in its identification and use of emerging best practices, LMSB should continue to systematically monitor compliance risk strategies under development in other taxing jurisdictions. Thus, for example, 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 in its ongoing efforts to develop new and improved approaches for identifying and managing large taxpayer compliance risks and incentivizing those LMSB taxpayers who are especially cooperative in facilitating such efforts. Such consideration would be particularly germane, we believe, to LMSB’s continuing evaluation and modification of its Compliance Assurance Program (“CAP”) and Limited Issue Focus Examination Program (“LIFE”), both of which similarly seek to ease the burden of tax audits as the result of enhanced cooperative relationships with participating taxpayers.

³ 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: 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).

G. Closing Observations And Recommendations

Risk management is an evolutionary process, with risk oversight improving over time. Realistic expectations must be set, with internal audit charged with monitoring the effectiveness and execution of the risk management plan.

Continued senior level attention and leadership are critical components of an effective risk management plan. Without a silo risk management approach will evolve and may create unanticipated risks to other IRS Divisions.

Similarly, the risk management program developed by LMSB should fit within and complement an overall Service enterprise risk management program. To this end, IRSAC may be an appropriate vehicle for assisting in assuring that a greater degree of oversight of risk management on an IRS wide basis develops.

A process should be developed to continually challenge ways to obtain better risk intelligence to aid in strategic planning. This process should assure that management be responsible for providing up-to-date information about its assessment of KTCRs.

II. TRANSPARENCY TASK FORCE

A. Background / Overview

LMSB's interest in transparency as a means of fostering a higher degree of tax compliance appropriately stems from its role as the nation's tax administrator. The Subgroup believes that LMSB should continue to pay close attention to the Organization for Economic Cooperation and Development's (OECD's) recent study into the Role of Tax Intermediaries (the "study"). A brief review of the original focus of that study and its conclusions is worth noting.

The original focus of the Study was to identify approaches that are or can be used by tax authorities to respond to "tax intermediaries'" involvement in aggressive tax planning. "Tax intermediaries" include tax advisors such as attorneys, tax consultants, accountants, investment bankers, and other professionals.

Ultimately, the study concluded that a much more comprehensive approach was needed to address aggressive tax planning behaviors because tax intermediaries are only the supply side of a three-part relationship. Taxpayers represent the demand side and ultimately make the decisions about tax plans to be implemented. The tax authorities, charged with developing the compliance framework and enforcement processes in their jurisdictions, are a third-party stakeholder.

The study noted that in addition to maintaining a robust risk assessment process, tax authorities should deal with taxpayers in a fair, balanced, informed, open and consistent manner. Through doing so, taxpayers would be encouraged to be more transparent and provide information beyond their statutory obligations. This new "enhanced relationship" based on mutual trust would theoretically result in more relevant information being provided on a timely basis to the tax authorities leading to more rapid risk assessment and resolution.

In initial meetings, LMSB asked the Transparency Task Force (hereinafter referred to as "Task Force") to consider a number of ways in which LMSB could obtain relevant information that is not presently available to enhance its effectiveness. Discussions included:

- How the IRS can achieve an enhanced relationship with taxpayers;
- New voluntary disclosures or procedures;
- Voluntary production in filed income tax returns of issues addressed by taxpayers in their tax accrual workpapers; and
- Information that may exist outside the scope of tax accrual workpapers.

The Task Force agrees that information is critical and acknowledges that information gaps in the tax authorities' understanding of a transaction can result in lost tax revenue. Such gaps can also result in an inappropriate assessment of tax. Therefore, it is important for taxpayers to understand that full disclosure of relevant information can be mutually beneficial, leading to quicker resolution of issues and audits, freeing valuable time for resource constrained taxpayers and tax authorities alike.

B. Scope of Work and Methodology Employed

The Task Force approached the project with an open mind as to how LMSB/taxpayer relationships could be enhanced and thereby result in more transparency and more efficient audits. There was significant "brainstorming" among Task Force members and between the Task Force and LMSB about a range of ideas, some of which are highly controversial, including waivers of attorney-client privilege and LMSB access to tax accrual work papers.

In addition to the brainstorming, the Task Force participated in the LMSB Transparency Roundtable and reviewed the following documents:

- The 2008 OECD Study;
- The 2003 Joint Audit Planning Process resulting from a joint LMSB/TEI effort; and,
- Relevant portions of data from LMSB's 2007 employee engagement and customer satisfaction surveys.

Finally, the Task Force asked the Tax Executives Institute (TEI) to survey its membership to (i) obtain current data regarding the transparency in relationships, (ii) measure the impact that the use of pre-filing and audit management tools may have on relationships, and (iii) identify both positive and counterproductive behaviors or practices that facilitate or impede the openness of the audit relationship. Elements of the survey feedback were then reviewed with LMSB's Management Advisory Group (MAG) to obtain insight and reactions relative to the TEI feedback.

C. Recommendations

Based upon the above discussions and analysis, the Task Force developed the following recommendations.

- The current IRS "policy of restraint" with respect to tax accrual work papers under Announcement 2002-63 should be continued. However, the IRS should offer incentives to taxpayers that disclose uncertain positions for which tax reserves have been established.
- The IRS should employ limited waivers of privilege with respect to certain documents for the purpose of encouraging taxpayers to allow IRS review of tax opinions or other transaction-specific documents, without causing complete subject matter waiver.

- The IRS and taxpayers should closely adhere to the Joint Audit Planning Process developed in 2003, and certain positive practices should be added to the process.
- Expand usage of the Limited Issue Focused Examination (“LIFE”) process and Compliance Assurance Program (“CAP”).
- The IRS should be more transparent in the development of issues. The issue expert should be clearly identified, and the taxpayer should meet directly with that individual to agree on relevant facts before issues become proposed adjustments.
- Pre-filing processes should be streamlined and marketed by the IRS to encourage usage. The PFA and APA programs should be reviewed to identify and remove barriers.
- Reduce uncertainty and complexity through the issuance of clear, timely regulations and more Revenue Rulings addressing controversial matters. Establish a quality review process for PLRs, TAMs and FSAs.
- The IRS should engage various taxpayer industry groups in order to establish educational programs to further develop commercial awareness and enhance industry-specific technical tax skills within LMSB.
- The IRS should request to review taxpayers’ transaction approval committees’ meeting minutes during the course of examinations.

D. Reasoning Behind the Recommendations

1. *Tax Accrual Workpapers: Policy of Restraint*

Any discussion of increased transparency inevitably leads to a discussion as to whether the IRS should abandon its policy of restraint with respect to tax accrual work papers described in Announcement 2002-63, 2002-27 C.B. 72. The Task Force recommends against any change in that policy.

There is a tremendous level of taxpayer sensitivity on the subject of disclosure of issues or tax reserve information. In response to survey questions, TEI members generally expressed an unwillingness to disclose tax reserve information beyond that required by the SEC. Respondents noted that transparency is a “two-way street,” and that present SEC disclosures, required return disclosures, and the M-3 already provide substantial taxpayer transparency.

The Task Force believes that routine requests of tax accrual work papers present an issue of fundamental fairness. Simply put, it would not be fair for taxpayers to be required to disclose the analysis and numerical amounts contained within their tax accrual work papers to the IRS. Furthermore, IRS requests for tax accrual work papers raise serious concerns regarding privilege. See Regions Financial Corp. v. United States, 2008 WL 2139008 (N.D. Ala. 2008); and United States v. Textron, 507 F. Supp. 2d 138 (D.R.I. 2007). (The Task Force acknowledges that, under the current Internal Revenue Manual, exam teams may ask a taxpayer for the total amount of a company's reserves without showing unusual circumstances or seeking executive approval for the request. Internal Revenue Manual §4.10.20.2 (07-12-2004). However, this does not compel a taxpayer to comply with the request nor provide the IRS with issue-identifying information.)

The Task Force also believes that a change in IRS policy would result in fewer cases being resolved at the audit or Appeals level, and more litigation. Taxpayers' desires to limit FIN 48 reserves could force more decisions to litigate "should" and "more likely than not" positions rather than attempt to negotiate a resolution at Appeals.

As noted earlier, the OECD Study focuses on increasing transparency through an enhanced relationship, and a significant change in the policy of restraint would have an exact opposite effect, damaging the audit relationship. All of the above reasoning led to a Task Force conclusion that LMSB should offer incentives to taxpayers who voluntarily identify uncertain tax positions taken in returns or disclose specific issues for which reserves had been established.

The Task Force therefore proposes an alternative to a change in the policy of restraint. Instead, taxpayers should be given incentives to disclose information relative to uncertain tax positions. One incentive considered by the Task Force would be the adoption of a limited-issue review audit policy in cases where a taxpayer voluntarily discloses the issues present in its tax return for which a FIN 48 reserve has been established. Under this policy, the scope of the audit would focus solely on the issues disclosed absent evidence of fraud or gross negligence. Other incentives that should be considered as a quid pro quo for such voluntary disclosures of uncertain tax positions for which tax reserves are maintained include immunity from penalties and "hot interest," and an abbreviated 1120 process.

2. Limited Waivers of Privilege

As a general matter, the attorney-client privilege is waived with respect to communications that are disclosed to third parties. A taxpayer may risk a waiver of the attorney-client privilege with respect to a particular subject matter when the taxpayer puts an otherwise privileged communication "at issue" in a controversy. 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. The premise of this is one of basic fairness, whereby a privilege holder cannot use the privilege as both a "sword" and as a "shield" (i.e., a party cannot selectively disclose favorable communications and assert privilege with respect to unfavorable communications).

Examination teams routinely ask for privileged tax opinions during the course of audits, presumably, because they believe such documents would be useful in conducting audits in a more effective manner. A tax opinion would serve to educate an examination team about a transaction by providing a recitation of the relevant facts and an analysis of the applicable law. A review of the tax opinion would then allow an examination team to understand a transaction promptly and approach the audit in a more targeted and efficient manner.

Taxpayers generally do not know if they will be able to successfully resolve an issue with an IRS examination team. Accordingly, most taxpayers are hesitant to disclose attorney-client privileged documents and, thus, risk a subject matter waiver of privilege. Under certain circumstances, however, taxpayers may be willing to provide privileged tax opinions to examination teams. A taxpayer would only produce a privileged tax opinion, however, if the IRS would not use the fact of its production to argue that there has been a subject matter waiver of privilege.

The Task Force believes that providing privileged tax opinions, in certain instances, could only help to expedite the audit process. Furthermore, the Task Force does not see any disadvantage to the IRS by executing a limited waiver agreement. The Task Force recognizes that an argument may be made

that a limited waiver may not be binding on third parties. The Task Force appreciates this point; however, it believes that it is a risk that could only impact the taxpayer. A taxpayer, therefore, would consider this as a possible risk in making the determination of whether or not to produce the opinion.

3. Joint Audit Planning Process

This process, developed by LMSB in partnership with TEI in 2003, provides a complete set of recommendations regarding LMSB and taxpayer behavioral expectations. Although LMSB management has strongly encouraged its agents to employ the process, TEI survey responses reflect inconsistent use and application.

The Task Force acknowledges the fact that a limited number of taxpayers are simply uncooperative and may refuse to participate. Nonetheless, the IRS should endeavor to ensure that all aspects of the Joint Audit Planning Process are used in every LMSB audit. Also, the benefits and success of process should be marketed to taxpayers through IRS presentations at corporate taxpayer functions and in tax publications. Moreover, the Task Force recommends that the Joint Audit Planning Process include specific reference to, or better highlight, the following practices:

- i. Pre-Audit Taxpayer Presentations – The existing Joint Audit Planning process refers to an “orientation” focused on reviewing the taxpayers’ business and structure. However, more detailed presentations have been identified as a practice that facilitates more open, collaborative audit relationships by a number of TEI members. Pre-audit presentations of major transactions and potential issues to the broad LMSB exam team should be an expectation in the planning process. Such presentations should include new Schedule M adjustments, method changes, and other transactions with a significant tax consequence, together with the treatment on the return.
- ii. Pre-Issuance Discussion of IDRs - There were numerous responses to the 2008 TEI survey referencing this practice. Taxpayers report significant improvements in the audit process when this practice is followed. Issues can be resolved without the issuance of an IDR, IDRs are more focused, and the flow of IDRs and responses is improved. Although the current Joint Audit Planning process references this practice, its inconsistent use in audits indicates more emphasis is required.
- iii. Continuous Open Communication - Case Managers and Team Coordinators should continuously communicate openly regarding the status of issues with taxpayers. Taxpayers deserve feedback quickly after IDR responses are provided. Potential adjustments should be discussed immediately, not after 5701s are drafted. Continuous communication with and management of specialists to ensure adherence to the audit plan is also required. Taxpayers should also know when Counsel’s office or technical advisors are being consulted.

4. Expansion of LIFE and CAP Programs

As LMSB is aware, the OECD Study identified several mechanisms that could assist in building enhanced taxpayer-tax authority relationships. One such mechanism was formal or informal agreements between the two parties covering how the parties intend to work together. The IRS already has two such mechanisms in LIFE and CAP. (The study references CAP in this context.)

The LIFE process is a means by which large case 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 non-bonding document signed by both LMSB and the taxpayer.

Nearly 68 percent of respondents to the 2008 TEI survey who have used the LIFE process rate their overall audit experience as “open and collaborative” as compared to just over 41 percent who have not used LIFE. However, only 20 percent of respondents indicated that their company had utilized LIFE. This suggests that expanded usage would positively impact most LMSB/Taxpayer relationships where the LIFE process is not presently employed.

Just under 100 large corporate taxpayers are now in the CAP program. LMSB and taxpayer feedback generally indicate satisfaction with the process. For example, of the 23 respondents to the TEI survey who indicated they were in CAP, 74 percent indicated an open and collaborative audit experience in comparison to the 47 percent of overall responses describing their audit as open and collaborative. Also, 39 percent of the CAP respondents indicated that the audit relationship had improved over the last three years whereas only 24 percent of the total survey respondents indicated improvement over that time period.

5. Direct Communication with IRS Issue Expert

As indicated above, the OECD Study stated that tax authorities should deal with taxpayers openly, fairly, consistently, and in an informed manner.

TEI survey data indicates that taxpayers are frustrated by the way LMSB develops issues. LMSB should continue to be more explicit with taxpayers about how to use its published Rules of Engagement (RoE) 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.

6. Pre-Filing Programs: Usage Fees and Timing

Pre-filing processes such as PFAs and APAs are excellent examples of existing programs where taxpayers openly identify uncertain tax positions and provide all relevant information to the tax authorities to obtain certainty with respect to a potentially contentious issue. Hence, the use of these programs should be encouraged. However, only 12 percent of the respondents to the 2008 TEI survey indicated their company had utilized PFAs and only 15 percent had utilized APAs. These usage levels are low considering how long the programs have been in existence. Some taxpayers report that they have not used or discontinued use of pre-filing processes due to either the cost or inordinate delays in resolution.

The user fee to participate in the PFA program is \$50,000 and represents a significant barrier to program participation for some taxpayers, particularly small and mid-sized companies. Charging sizeable fees to taxpayers willing to disclose uncertain tax positions which are not likely to be otherwise audited is questionable policy. Also, the processing time for PFAs has increased from 173 days in 2001, its first year, to 393 days in 2007, which reduces the usefulness of the program.

As in the case of PFAs, the fee charged for an APA request is \$50,000, or \$22,500 in the case of small taxpayers (defined as having gross income of less than \$200 million). In 2007, the average time required to complete a new APA was over three years, and the average time to complete an APA renewal was over two years. One TEI response indicated that in a renewal of a bilateral APA, four years passed before the IRS issued its draft position paper.

A taxpayer's primary reason for requesting an APA is generally to achieve certainty before risks accumulate in filed returns. While the fees charged for APAs may not be significant relative to the magnitude of the transfer pricing dollars at issue in many cases, the time required to complete an APA runs counter to taxpayers' primary motivation to use the program.

Although the Task Force recognizes that LMSB controls neither the level of usage fees nor the APA process, the Task Force recommends that LMSB should encourage the IRS to (i) study these programs to determine barriers which limit usage, and (ii) streamline the programs to remove such barriers. Appropriate publicity about the study and resulting changes would serve to market the enhanced programs.

7. Continued Improvement of Guidance Process

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 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.

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 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.

8. Enhancement of IRS Commercial Awareness

LMSB as acknowledged by the OECD Study has recognized that revenue bodies need to acquire a "commercial awareness." The OECD perceives "commercial awareness" as having two aspects, general and specific. The general aspect requires the revenue bodies to understand various broad concepts, including how taxpayers operate in the markets. The specific aspect requires the revenue bodies to understand, among other things, "the peculiarities or unique characteristics of a taxpayer's industry and business." In short, revenue bodies need to become more "connected" to the businesses they examine in order to gain a better understanding of matters from both a commercial and a tax perspective. A business-provided education or training program is an appropriate way to acquire such "commercial awareness."

In addition to the core training and continuing professional education programs that LMSB offers its employees, the Task Force believes that establishing educational programs would have mutual benefits for both taxpayers and the IRS. Specifically, the IRS would gain additional information that it believes is critical in order to efficiently enforce the internal revenue laws through the allocation of limited resources. Taxpayers would receive the benefit of resolving tax controversies more quickly and with finality and, thus, would achieve greater tax certainty.

Taxpayers would expect the IRS to approach the educational programs committed to reciprocity. That reciprocity should take the form of an open dialogue on any issues of concern including the IRS' objective reaction to the issues, specific concerns and any perceived changes that are required. In short, taxpayers expect a "business-like" discussion regarding the matters that allows businesses to reduce uncertainty and clarify areas of agreement and disagreement.

9. Taxpayer Transaction Approvals

Taxpayers have various control processes to mitigate financial and franchise exposure to any risks. These processes set forth formal corporate policies and procedures that are designed to address the risks (credit, market, operational, legal, and reputational) associated with the transactions in which they engage.

As part of its transaction approval controls, many taxpayers have developed policies, procedures, and systems with which to have a transaction vetted and perform due diligence. Management committees are often used to monitor compliance with policies and approve transactions, although this practice varies by industry and from company to company.

In terms of transparency, reviewing the risk management policies and minutes from related management committee meetings would be very useful to the IRS. Such review would keep the IRS abreast of current corporate decisions and transactions. Thus, taxpayers should be asked to identify the management committees within their companies, and the IRS should then request minutes of those meetings that may incorporate tax issues.

The Task Force recognizes that review of such internal committee meeting minutes may present issues with regard to privileged documents or communications. However, these types of privilege issues could be identified and resolved on a case-by-case basis, perhaps using limited waivers of privilege, and should not prevent the IRS from seeking to review the meeting minutes.

ATTACHMENT A – An IRSAC Prepared “Improve And Monitor Plan” Addressing The Tier Issue Focus Strategy

Executive Summary: While good progress has been made, the Tier Issue Focus (TIF) Strategy is not evolving as quickly as needed and as LMSB had anticipated. LMSB should continue to apply strong measures to further improve the operation and fairness of the TIF Strategy. In this regard, the Subgroup urges LMSB 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.

A. 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. For example, one such issue management strategy, the Pre-Filing Agreement (PFA) Strategy, is a way for taxpayers and the IRS to reach agreement on issues through a cooperative effort before a tax return is filed. Issues eligible for this program are typically factual in nature and addressed by well established law.

Similarly, the Fast Track Settlement (FTS) Strategy, provides a mechanism where a taxpayer may work with LMSB and Appeals to resolve audit issues during the examination process. The goal of the FTS Strategy is to reduce the combined LMSB-Appeals process by at least two years.

Additionally, the Industry Issue Resolution (IIR) program is an issue management strategy aimed at developing published guidance that will resolve frequently disputed or time consuming tax issues that impact a large number of taxpayers.

Among the newest of these issue management strategies is 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 Tier Issue Focus (TIF) Program. Hence, hereafter, the IIF Initiative will be referred to as the TIF Strategy.

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 submitted issues results in order to rank them based on their current and/or potential non-compliance risks.

At least annually, each Industry Director (with assistance from an Industry Issue Coordinator who manages the process on a day-to-day basis) evaluates issues received from the field to determine their priority. Subject to the approval of the Compliance Strategy Council (CSC), the Industry Director classifies each significant issue meeting the parameters of the program as either a Tier I, II, or III issue.

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 issue, generally are industry-related and have been earmarked for consideration by LMSB audit teams.

B. Stated Purpose and Goals of the TIF Strategy

On April 1, 2007, the Commissioner, LMSB, issued new section IRM §4.51.5, Industry Focus and Control of LMSB Compliance Issues. On August 1, 2007, the Commissioner, LMSB, issued new section IRM 4.51.6, Issue Management Process Guide.

The purpose of IRM 4.51.5 is to strengthen the industry focus within LMSB on compliance issues by imposing procedures on LMSB Industry Directors to designate and control compliance issues with strategic or significant industry importance. This IRM provides an overview of the tiering of industry issues and outlines the process for identifying and tiering such issues. The purpose of IRM 4.51.6 is to issue guidelines for organizing Issue Management Teams (ITMs) designed to provide expedited direction to the field on significant compliance issues.

The expressed goals of IRM 4.51.5 and IRM 4.51.6 is to (1) promote consistent tax treatment between similarly situated taxpayers; and, (2) facilitate issue resolution.

To assist in better understanding the process and goals in which the TIF Strategy has been designed and should be approached both internally and externally, LMSB has issued various additional communications, including (1) an Issue Focus Tiered Strategy Flowchart; (2) a Tier I Issues (Non-Tax Shelter) Matrix At A Glance; and (3) a series of Tier I Quick Reference Guide Pamphlets.

Also, to aid management in better understanding the implementation issues still requiring attention, LMSB surveyed its managers to solicit feedback regarding the value of the TIF Strategy from their perspective and collective experiences.

C. Recommended TIF Strategy Improvements

As part of the process used by the RMTF in developing recommended improvements to the TIF Strategy, questions were developed and put to the LMSB owners that focused on how issues in the Tier Strategy are identified, prioritized, tracked, managed and mitigated. Based upon the information learned from this interview process, among other sources, a better idea of the risks that accompany each of these discrete areas was developed. Following the development of list of risks, the following recommendations by category were developed.

1. Identification of Issues

- a) In large part, the issues selected for the TIF Strategy originate in the field. However, the tools used to identify issues in the field are not conceptually complete. For example, statistical models used for *flowthrough returns* rely on limited transcribed data. Greater data, including prior audit results, would allow for better selection. Accordingly, to enhance identification and selection of Tier Issues, enterprise risks and year-to-year changes should be considered.
- b) Currently LMSB employs a flexible process, continually modified for lessons learned, to select issues for the Tier Strategy. To improve the timely and efficient identification of appropriate risks, LMSB should continue to develop a methodology and related list of factors to consistently evaluate issues nominated for the TIF Strategy. To avoid misunderstanding, guidance should be issued that these factors will not be equally weighted from one context to the next, but will retain a certain degree of flexibility to accommodate factual nuance.

- c) Currently LMSB should continue to solicit significant input from external stakeholder groups to aid it in identifying and better understanding risks associated with transactions of interest. Greater leveraging of external technical resources would alleviate internal resource strains and, perhaps, aid in a quicker start-to-completion cycle of the Identification Phase. Expanded use of these resources need not and should not be viewed as an opportunity for external stakeholders to negotiate.

2. Prioritization of Issues

- a) Given the rapid expansion of e-filings, this more timely and accessible data should be employed as soon as practicable to validate the prioritization of issues across and within industry lines. As now being done, it is anticipated that LMSB will continue to move issues up or down, or add/eliminate them from the Tier Strategy as warranted pursuant to clearly communicated criteria.
- b) The factors used to prioritize risks within the program and as applied to individual taxpayers should be identified and clearly communicated to resolve open questions in this area. Factors used to prioritize different risks may include, among other things, the potential revenue streams that have or could be lost, likelihood of reoccurrence, degree of relationship to business purpose and non-tax economic substance, negative impact on otherwise timely completion of examinations, possibility that Appeals or the courts may settle based on hazards of litigation, and the resources and time needed to resolve issues.
- c) Significant uncertainty remains concerning the priority and application of procedures that will apply in any given case. While progress has been made over the last year, more work remains. LMSB must continue to emphasize that audit teams should have open and up-front discussions with the taxpayer. These discussions should occur while defining the scope of the upcoming examination. Also, they should include a review of the impact, if any, that a Tier issue may have on an individual taxpayer. Continually re-enforcing those issues that require mandatory versus discretionary examinations and settlements, will aid significantly in advancing the stated goals of the TIF Strategy.

3. Tracking and Managing Issues

- a. The Issue Management System (IMS) provides information on open and closed cases. It provides information on the size and frequency of issues, the time associated with examining each type of issue, and whether the related examination disposition was agreed to or not by the taxpayer. Because IMS is limited to examination activity, it does not currently capture resolution of Tier issues appealed and, thus, removes from consideration an important aspect for testing identification, prioritization, management and mitigation risks. As determined cost-beneficial, Appeals and ultimate case/issue resolutions should be incorporated into the IMS. In the alternative, an automated and complimentary system should be devised to capture this information.
- b. To better track issues, consider greater use of electronic system technology to supplement the IMS with manual reviews done by designated issue specialists, as is done with partnership and S Corporation returns.
- c. Based on feedback from the field requested by LMSB, it understands the need for just-in-time training to aid new agents, among others, in more fully understanding and executing the TIF Strategy. As necessary, training and testing should be undertaken to address these needs as soon as possible. With the growing use of Web-based learning technology, it is anticipated that this issue among others can be tested and addressed by LMSB in an efficient manner.
- d. Tracking for IMT, Shelter and CIP cases is enhanced by the addition of a Project Code or Tracking Code on the Audit Information Management System (AIMS) and/or the Examination

Returns Case Processing System (ERCS). These two systems provide time and results data at the return, but not issues level when the case is closed. Consider expanding AIMS/ERCS data to include in-process monitoring to enhance national office testing of field compliance, as well as the efficient allocation of resources assigned to the various Tier issues.

- e. IMTs and tax shelter executive owners frequently employ ad hoc systems that track cases, time, and results on a case-by-case basis. For IMT, Shelter and CIP returns not being examined primarily or exclusively for the project issue, determine if a supplement or expansion of the AIMS/ERCS data is feasible and would be cost effective. Moreover, consider feasibility and value of rolling up information possessed by technical advisors on the size and unique variations of cases they are tracking. This would allow better evaluation of uniform disposition of matters that cross any specific issue.
- f. To minimize delays, comments from the field indicate a desire for quicker responses from specialists, technical advisors and counsel for their expertise. LMSB should continue to evaluate the work loads being carried by these resources, and look at additional resources hired or trained as needed to avoid unintended results arising out of the Tier Strategy.

4. Mitigating Issue Risks

- a) LMSB employs various strategies focused on industry tax compliance issues. At times, the differences between these programs are very subtle and cause confusion among stakeholders who might otherwise attempt to engage the system. It is recommended that LMSB take on a comprehensive review of these complimentary strategies to see where simplification is possible.
- b) Objective measurements should continue to be developed to evaluate the success of the Tier Strategy. This will better arm LMSB in its requests for appropriations and in responding to questions concerning its tax compliance strategies. Also, it will better inform LMSB where it should seek law changes to more quickly, efficiently and uniformly resolve Tier issues. These measurements should include feedback from employees as well as external stakeholders.
- c) The list of issues embodied in the Tier Strategy should continue to be freshened on an on-going basis. As soon as possible, the Pre-Filing and Technical Guidance Group should complete a methodology and related list of factors for addressing how issues will be removed, or reduced to a lower tier.
- d) To address the gap between intended and unintended results attributable to the TIF Strategy, within a more transparent system, LMSB should allocate a higher priority to the establishment of resolution guidelines and uniformity of actions.
- e) One of the intended goals of the strategy is to accelerate issue resolution. While directives and tools, such as standard IDRs have been provided to the field, room for additional progress remains in training field agents as to those circumstances where they can resolve issues.

D. On-going Monitoring Needed to Reduce TIF Strategy Risks

LMSB should deploy a robust internal control program designed to test and verify continuing adherence to (and execution of) the methodologies, processes and safeguards that have been developed to assure the TIF Strategy achieves its intended purposes and goals.

ATTACHMENT B - Large Taxpayer Compliance Risk Management in the U.K.

In seeking to enhance the effectiveness of its own compliance risk management programs and strategies, LMSB may find instructive at least certain aspects of the large taxpayer risk management now being utilized by tax administrators in other countries. A recently implemented large taxpayer initiative in the United Kingdom is of particular interest in that regard.

A. LBS Initiative

The Large Business Service (“LBS”) of HM Revenue & Customs (“HMRC”) recently implemented a novel and fairly bold approach to managing taxpayer compliance risk for the United Kingdom’s very largest business taxpayers (the “LBS Initiative”).⁴ This group presently includes around 700 companies, which collectively account for more than 50 percent of the business taxes and duties collected by HMRC -- and each of which meets minimum thresholds in terms of gross revenues (at the current Pounds-Dollar exchange rate, approximately \$1 billion) or net asset value (approximately \$3.5 billion). The cornerstone of the new program is an intensive, comprehensive and collaborative compliance risk review and analysis by LBS personnel with respect to each LBS “customer,” resulting in the assignment of a “low risk” or “high risk” profile.

A “low risk” designation carries distinct benefits for LBS taxpayers, including, most significantly, the elimination of most, and possibly all, future HMRC audit activity with respect not only to income tax matters, but also as to VAT, employment tax and other special tax regimes over which HMRC exercises administrative and enforcement responsibility. In lieu of regular full scale audits, interaction between low risk LBS taxpayers and HMRC generally is limited to periodic informal discussions intended to facilitate the voluntary disclosure by the taxpayer of candid and complete information regarding significant recent transactions or other business developments and associated tax issues.

From HMRC’s perspective, the LBS Initiative is expected to provide important opportunities for shifting personnel and other compliance resources to higher risk taxpayers. Because of the high level of confidence in the quality and integrity of information provided by low risk taxpayers, LBS personnel normally can limit their focus to larger or other significant issues that may exist and spend little or no time verifying tax computations or the taxpayer’s treatment of smaller or routine items. The assignment of a “low risk” profile signifies a high degree of trust and confidence on the part of HMRC that its ongoing relationship with the taxpayer will be transparent, open and honest; that the taxpayer takes seriously its tax compliance responsibilities and has implemented effective and consistently applied internal systems and procedures toward that end; and that it is not prone to engage in abusive, overly aggressive or otherwise inappropriate tax behavior. During 2007 a full risk review was completed with respect to all LBS taxpayers, and “low risk” profiles were determined for approximately 40 percent of that group, *i.e.*, some 280 companies.

⁴ For more detailed information on the LBS Initiative and its implementation thus far, *see* “Links with Large Businesses (Nov. 2006),” “Review of Links with Large Businesses” (March 2007) <http://www.hmrc.gov.uk/budget2007/large-business-plan07.pdf> ; and “The framework for a better relationship -- Making a difference: Review of Links with Large Business” (Budget 2008), www.hmrc.gov.uk/budget2008/framework-better-relations.pdf .

B. Risk Review Process

Principal responsibility for the LBS risk analysis and ongoing management of the HMRC relationship with participating taxpayers lies with the Client Relationship Manager (“CRM”), a position typically filled from a pool of senior-level LBS personnel. Each LBS customer is assigned a CRM; some CRMs have only one LBS customer, while others manage multiple customers. All CRMs draw substantial support from dedicated teams of audit and technical specialists.

The risk review process for LBS customers focuses on two basic categories of potential tax compliance risks: Inherent Risks and Behavioral Risks. The principal areas of inquiry with respect to Inherent Risks include (i) the occurrence of important operational, financial or strategic changes in the taxpayer’s business (*e.g.*, mergers, dispositions, new line of business, geographic expansion); (ii) the complexity of the taxpayer’s organizational structure (*e.g.*, number and location of subsidiaries or other affiliates); and (iii) the existence of “boundary” issues (*e.g.*, cross-border transactions with related entities). The evaluation of Behavioral Risks is more subjective in nature, relating to an assessment of factors such as (i) how transparent the taxpayer is in its dealings with HMRC; (ii) whether the taxpayer has adequate internal systems and processes for effectively discharging its tax compliance responsibilities; and (iii) the “business tax strategy” historically pursued by the taxpayer (*i.e.*, aggressive *v.* conservative; frequency of disputes with HMRC). Perceived weaknesses with respect to Behavioral Risks -- especially a lack of openness and transparency, but also a tendency to engage regularly in aggressive tax planning -- are the principal drivers of “high risk” profiles; but a “low risk” profile remains possible notwithstanding the presence of significant Inherent Risks, provided those risks are being properly managed by the taxpayer. In addition to examining Inherent and Behavioral Risks, each LBS risk review also takes into account the so-called “contribution” factor – *i.e.*, whether taxes paid by the taxpayer appear to be in line with what might be expected in light of the nature and level of its economic activity, as well as appropriate comparisons to reported tax liabilities of its competitors or other comparably-sized businesses.

As noted above, the main benefit of a low risk profile to LBS taxpayers is that HMRC “interventions”, *i.e.*, audits, will be the exception rather than the rule. That generally will be the case on a continuing basis, subject to follow-up risk reviews every 2-3 years and no change in risk profile as a result of those reviews. To the extent that the taxpayer has significant actual or potential new issues, it is expected that these will be brought to the attention of HMRC so that they can be resolved, or at least fully developed from a factual standpoint, before or shortly after return filing deadlines. The fact that disagreements may arise with respect to specific issues, with the result that litigation becomes necessary, will not of itself jeopardize a low risk relationship with the taxpayer.

C. Higher Risk Taxpayers

Those taxpayers not designated as “low risk” generally can expect a more intensive level of HMRC attention, including more regular risk reviews and interventions; more in-depth reviews of internal tax compliance systems and processes; a greater use of information powers (*i.e.*, requests for documents or other information, if necessary through court enforcement actions); and more disputed matters that ultimately need to be litigated (as opposed to being resolved administratively). At the same time, CRMs are committed to supporting the efforts of higher risk taxpayers to achieve a low-risk profile as rapidly as possible. In the interim, high levels of transparency and cooperation by such taxpayers can generally be expected to result in fewer audit inquiries and an otherwise less intrusive relationship with HMRC; but those taxpayers whose tax planning strategy includes reliance on aggressive avoidance transactions (even if fully disclosed and arguably lawful) cannot expect to achieve a low-risk profile or the full range of benefits normally associated with such status.

D. Other Large Taxpayers

As an extension of the LBS Initiative, HMRC is developing similar risk management measures for approximately 14,000 other large and complex business entities that are under the operational jurisdiction of the Local Compliance division of HMRC (“LC”).⁵ Up to 2,000 of these taxpayers will undergo full-risk review through Customer Managers (generally equivalent to CRMs) and will be assigned high or low-risk profiles that will result in their being dealt with by HMRC in essentially the same manner as LBS taxpayers with similar profiles.⁶ Though in a more limited way, LC will also risk review the remaining 12,000 “large” LC taxpayers (targeted for completion by April 2009). Those considered lower risk also can generally expect to experience audit scrutiny on only an exceptional basis; and all risk-reviewed LC taxpayers will have clear lines of communication with LC personnel in order to facilitate prompt resolution of issues or problems that may arise.

E. Possible Lessons for LMSB

At least a few years actual experience under the LBS Initiative (including its expansion to LC taxpayers) will of course be necessary before any reasonable assessment can be made as to its overall effectiveness from the perspective of HMRC and participating U.K. companies. The initial feedback from LBS customers has generally been positive, and the levels of cooperation both during and since the risk reviews have reportedly been high. 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 in its ongoing efforts to develop new and improved approaches for identifying and managing large taxpayer compliance risks and incentivizing those LMSB taxpayers who are especially cooperative in facilitating such efforts. Such consideration would be particularly germane, we believe, to LMSB’s continuing evaluation and modification of its Compliance Assurance Program (“CAP”) and Limited Issue Focus Examination Program (“LIFE”), both of which similarly seek to ease the burden of tax audits as the result of enhanced cooperative relationships with participating taxpayers.

1. CAP and LIFE Parallels

Announced as a pilot project in late 2005, CAP is designed to facilitate the identification and resolution of issues prior to filing of the tax return. As stated in IRS Announcement 2005-87 (Dec. 12, 2005):

The CAP requires extensive cooperation between the Service and participating taxpayers. Throughout the tax year, these taxpayers are expected to engage in full disclosure of information concerning their completed business transactions and their proposed return treatment of all material issues. Participating taxpayers that resolve all material issues will be assured, prior to the filing of the tax return, that the Service will accept their tax return, if filed consistent with the resolutions ..., and that no post-filing examination will be required. If

⁵ Although both part of HMRC, LBS and Local Compliance report to different offices within HMRC – the “Director General for Business Tax” (LBS) and the Director General for Enforcement of Compliance. The cut-off for large LC taxpayers is (i) 250 U.K. employees (100 U.K. employees for multi-national companies) or (ii) approximately \$350 million of gross revenues at current exchange rates.

⁶ As these risk reviews are still in progress, the portion of this group that will be considered “low risk” is not yet known.

all issues cannot be resolved prior to the filing of the return, the program will identify the remaining items that will need to be resolved through traditional examination processes.

Almost 100 large corporate taxpayers are now participating in CAP. Nearly all of these participants are Coordinated Industry Case (“CIC”) taxpayers -- *i.e.*, they are part of a group of approximately 700 large corporate taxpayers that comprise several major industries (*e.g.*, manufacturing; transportation; utilities; financial services; communications; consumer goods); meet a composite of various other quantitative benchmarks (*e.g.*, gross assets of at least \$500 million; gross receipts of at least \$1 billion; foreign assets of at least \$250 million⁷); and are regularly audited by LMSB “examination teams” and supporting specialists from other IRS offices. Only those companies that historically have exhibited a high level of tax compliance behavior are invited to participate in the program. Each participant is assigned an LMSB Account Coordinator who works with a team of IRS specialists (including from Chief Counsel and Appeals) to identify and resolve issues as quickly as possible. In contrast to the 2-3 year risk review cycle of the LBS Initiative, CAP operates on a year-by-year basis and gives no promise of reducing or eliminating audit activity for future years. However, the number of CAP taxpayers that remain in the program, *i.e.*, repeat participants, is steadily increasing; and it is reasonable to expect that the high levels of transparency, trust and confidence that presumably now exist between LMSB and such taxpayers will continue to grow and solidify with each passing year. As a result, it may be appropriate at some point (*e.g.*, after 5 years of successful participation in CAP) to consider implementing a multi-year risk compliance approach, including a potential moratorium on audit activity, along the lines of the LBS Initiative.

The LIFE program also parallels the LBS Initiative in certain respects. First implemented in late 2002, the main thrust of LIFE is to streamline and shorten the audit examination process by focusing only on issues which are identified, after a full risk analysis, as having the greatest compliance risk and meeting agreed materiality thresholds and other criteria set forth in a memorandum of understanding signed by IRS and the taxpayer. Among other commitments, LIFE taxpayers are expected to (i) disclose all significant business events and practices to the examination team; (ii) agree to established response times for IDRs and to otherwise communicate regularly with the examination team; and (iii) agree to raise and file any refund claims in accord with established materiality thresholds and time parameters. Examination team responsibilities under LIFE include, among other things, (i) involving the taxpayer in the audit plan and risk analysis process; (ii) discussing contemplated IDRs and notices of proposed adjustment before issuance; and (iii) promptly issuing follow-up IDRs where necessary.

While LIFE is not automatically available in all audits, and is not mandatory if offered to the taxpayer, its use must be considered in all LMSB examinations (including the largest CIC audits). Although LIFE eligibility is determined on a cycle-by-cycle basis (each requiring a full-scale risk analysis), many taxpayers have been offered and utilized the program for successive cycles. At some point, given the high levels of cooperation presumably received from LIFE taxpayers, consideration might be given to making repeat eligibility for the program essentially automatic – for example, subject only to a candid discussion with the taxpayer about any significant recent transactions or potential issues.

⁷ CIC inclusion is determined more specifically under a “point criteria” system and other factors described in §4.46.2 of the Internal Revenue Manual.

2. Scope of Similar LMSB Initiatives

If and to the extent that LMSB ultimately desires to emulate the LBS Initiative, whether as an evolution of CAP and/or LIFE or via some other risk management mechanism, it probably should do so initially under a pilot program open only to a relatively small group of CIC taxpayers. In time, if experience under the program proves favorable, eligibility requirements could be modified and the number of participants increased.

In all events, consistent with HMRC's efforts to apply at least some features of the LBS Initiative to LC (large) taxpayers, the Subgroup believes that LMSB should strive to develop an array of compliance risk initiatives and programs that are tailored to maximize the mutual benefits of enhanced taxpayer relationships for the full spectrum of LMSB customers (not only the very largest). We recognize that the challenges in this regard differ in many respects from those faced by HMRC, given especially marked differences in the demographics of the LMSB taxpayer population as compared to the LBS and LC large taxpayer groups.⁸ Moreover, while the core "risk review" feature of the LBS Initiative should surely be a focal point for LMSB as well, the weight properly assignable to the "tax planning strategy" factor of that analysis should be driven by rules, principles and attitudes reflecting the evolving state of U.S. law -- including especially the application of non-statutory doctrines (*e.g.*, business purpose; substance *v.* form; step-transaction; sham transaction) -- with respect to the fine line that often can exist between legitimate and abusive or otherwise overly aggressive tax planning strategies.

⁸ There currently are approximately 215,000 LMSB taxpayers, as compared to approximately 15,000 LBS/LC taxpayers. This disparity reflects in large part the generally lower size threshold for LMSB eligibility (only \$10 million gross assets). We note also that approximately 70 percent of LMSB customers are partnerships or other "pass-through" entities (again much higher than the predominantly corporate composition of LBS/LC); such business organizations require special compliance and enforcement mechanisms in order to encourage accurate reporting of tax liability at the partner level.

**Internal Revenue Service Advisory Council
2008 Member Biographies**

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Mr. Beller, JD, has practiced federal tax law in Washington, DC for over 35 years and is currently a partner with Sutherland Asbill & Brennan LLP. His particular focus is on corporate tax planning and controversy work for publicly-traded and closely held entities. In addition, he frequently represents taxpayers before the IRS National Office and IRS Appeals Offices, and has litigated tax cases in the U.S. Tax Court and Federal Claims Court. He also has significant experience in the exempt organizations area. Mr. Beller is a former Chair of the ABA Section of Taxation and served as Co-Chair of the National Conference of Lawyers and Certified Public Accountants. Also a CPA, he holds a J.D. (cum laude) from Northwestern University Law School and a BSBA from Northwestern. **(LMSB Subgroup)**

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Mr. Bernard, CPA, is the Vice President for Taxes and Real Estate for Kimberly-Clark Corporation in Neenah, Wisconsin. Mr. Bernard joined Kimberly-Clark in 1974 and has held various positions within the Tax Department, including chief tax officer for the last ten years. In 2005, his responsibilities were expanded to include the North American real estate management. His responsibilities include tax management, including tax strategies, risk management and talent development, and real estate. He has negotiated the resolution of scores of complex issues with the IRS Office of Appeals, as well as a number of issues with the Department of Justice. Mr. Bernard served as the Tax Executives Institute's ("TEI's") 2006-2007 International President and continues to serve on TEI's Board of Directors. He also serves on the National Advisory Board for the Michigan Technological University School of Business and is a member of that Board's Executive Committee. He is a CPA, and he holds a BSBA from Michigan Technological University and an MBA from the University of Wisconsin-Oshkosh. **(LMSB Subgroup)**

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Dr. Blumenthal is a professor of Economics at the University of St. Thomas in St. Paul Minnesota and works on small business and tax exempt issues. She has taught economics for 22 years. Dr. Blumenthal has published articles on a number of tax issues, including the annual compliance costs of the U.S. individual and corporate income taxes, experimental evaluations of alternative tax administrative strategies for increasing compliance (reducing the tax gap); and the participation of low-income households in the Earned Income Tax Credit. Dr. Blumenthal holds a Ph.D. degree from the University of Minnesota and A.B. and M.S.W. degrees from the University of Michigan. **(Tax Gap Analysis Subgroup)**

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Dr. Christian is a Professor at Arizona State University and currently serves as the Director of the School of Accountancy. He has taught federal taxation at the undergraduate level and a tax policy research seminar in the doctoral program for the past twenty-two years. During 1991-92, Dr. Christian worked with the Taxpayer Compliance Measurement Group of the IRS Research Division in Washington under an Intergovernmental Personnel Act appointment. In 2006 Dr. Christian spent nine weeks at Canterbury University, Christchurch, New Zealand, on a fellowship to study multinational tax issues and conduct research on income shifting by multinational corporations. Dr. Christian has published numerous articles on taxation and has given many presentations including one to the IRS LMSB Commissioner's Compliance Strategy Council. Dr. Christian holds a Ph.D. from the University of Georgia and a J.D. from the University of Virginia. **(Tax Gap Analysis Subgroup)**

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Mr. Fishman is a Managing Director of Financial Research Associates and has been actively engaged in the appraisal profession since 1974. He specializes in the valuations of business enterprises and their intangible assets including: patents, trademarks, customer lists, goodwill, and going concern. Mr. Fishman has co-authored several books, including the recently released *Standards of Value: Theory and Applications* and *Guide to Business Valuations* (both with Shannon Pratt), and written numerous articles on business valuation He holds a

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Mr. Hunt, CPA, currently serves as Director, Tax Assistance Program for the Accounting Aid Society in Detroit, MI. Mr. Hunt directs one of the largest free tax assistance programs in the nation for low-income taxpayers. His responsibilities include volunteer recruitment, retention, training, publicity, outreach, tax site selection, scheduling, and return preparation procedures. Under his direction Accounting Aid served over 8,000 low-income seniors and families in southeastern Michigan in 2007. He is also an adjunct lecturer in taxation at the University of Michigan-Dearborn. Prior to joining the Accounting Aid Society, Mr. Hunt was a Territory Manager for Heavy Manufacturing, Construction & Transportation, for the Large and Mid-Size Business Division at the Internal Revenue Service. Mr. Hunt holds a Masters of Science Degree in Taxation from Walsh College in Troy, MI and a BBA Degree from the University of Michigan-Dearborn. **(W&I Subgroup)**

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Dr. Mills is an Associate Professor at the University of Texas at Austin. Her published academic research concerns corporate tax

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His current research focuses on tax accounting issues and their interaction with businesses' financial reporting decisions. Dr. Plesko holds an M.S. and Ph.D. in Economics from the University of Wisconsin-Madison, and a B.A. in Economics from the George Washington University. **(Tax Gap Analysis Subgroup)**

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Ms. Rodriguez, CPA, JD, is the managing member of Donna L. Rodriguez, PLLC located in The Woodlands, Texas, where she operates a full service accounting and tax practice focusing on start up and small to medium companies. She is an attorney and Certified Public Accountant with a diverse background as corporate counsel, chief financial officer for an international conglomerate, Special U.S. Attorney/Assistant Attorney General-Guam, and with Ernst & Young. As a special US Attorney assigned to prosecute tax crimes in Guam, she became very familiar with the Tax Code. Ms. Rodriguez

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George K. Yin

Mr. Yin, JD, is the Edwin S. Cohen Distinguished Professor of Law and Taxation at the University of Virginia School of Law, Charlottesville, Virginia and has been in the tax profession for 30 years. He has been a law professor specializing in taxation for about 20 years. Mr. Yin has also served as Chief of Staff of the Joint Committee on Taxation where he supervised all aspects of the work done by the staff and testified more than 20 times before Congress at markups and hearings on a variety of tax matters. Mr. Yin holds a Juris Doctorate with honors from George Washington University and has a BA in Mathematics and Economics from the University of Michigan. **(Tax Gap Analysis Subgroup)**