Electronic Tax Return Filing, Enterprise Data Structures and Tax Compliance Risk Assessment

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Introduction

- Electronic Filing Changes LMSB Risk Assessment
  - Allows Risk Assessment of Business Enterprise
  - As Opposed to Tax Return Filing Entity

- Enterprise Data Structures In Real Time
  - Using Open-Source XML and Object-Oriented Technologies
  - Programmatic Access to All Data and Structure of Data
    - Tax Returns, Financial Statements and Related Entities

- Opportunities
  - Tax Shelter Detection
  - Book-Tax Analysis
  - Simulation Modeling
LMSB Objective

- Allocate LMSB Audit Resources to Maximize Long-Run Voluntary Compliance
  - Estimate Issue-Specific Compliance Risk for Each Taxpayer
  - Transform Risk Measures into Resource Allocation Policy

- Data Corollary
  - Collect and Store All Relevant Data on Business Enterprise to Fully Understand Compliance Risk
    - Data May Be Multi-Dimensional in Nature
    - Structure of Data May Vary Over Units of Observation
  - Transform Data into Vector of Rankings Reflecting Resource Allocation Policy
Complex Business Enterprises

- LMSB Needs to Assess Compliance Risk in Context of the Broad Business Enterprise, Not Tax-Filing Entity
- Enterprise is Collection of Related Entities
  - Under Common Control
  - Acting for Benefit of Owners of Enterprise
- Proliferation of Partnerships Among LMSB Population
  - LLCs as Substitutes for Corporate Subsidiaries
  - Tiered Flow-Through Structures
- Ability of LMSB to Identify Aggressive Transactions Depends on Ability to See All Sides of Transaction
- Neither Consolidated Tax Returns Nor GAAP Financial Statements Report Whole Story
Enterprise Structure: Tax vs. GAAP Consolidation

- **Parent**
- **Tax Cons. Corporations**
- **VIE/SPE/SIV**
- **Tax Uncons. Corporations**
- **Foreign Corporations**
- **Pass-Throughs**
- **Direct**
- **Indirect**

**Legend**
- Tax & GAAP
- Tax Only
- GAAP Only
- Neither

Domestic | Foreign
Electronic Filing

- LMSB Corporations Required to File Returns in XML Format for Tax Years Ending on or After 12-31-05
- XML (eXtensible Markup Language)
  - Character-Based and Platform-Independent
  - Excels at Representing Hierarchically-Structured Data
    - Using Nested Tags
  - Can Represent Complex Business Enterprises
- Availability of Open-Source XML Technologies
  - To Convert, Combine and Restructure XML Data
- XML is Foundation for Analyzing Complex Business Enterprises and Their Features
Object-Oriented Technology

- Object-Oriented Technology Can Transform XML Enterprise Documents into Analytic Form
  - XML is Character-Based and Not Conducive to Analysis

- Can Create Enterprise Object Models
  - Comprised of Objects Representing Structural Components of Enterprise (e.g., Parents, Subsidiaries, Flow-Throughs)
  - Ownership Objects Keep Track of Entity Relationships
  - Risk Assessment Objects Compute Risk Measures Over Varied Enterprise Structures

- Can Access All Data and Structure of the Data
Stylized Enterprise Structure
AI CS Application

- Automated International Classification System (AI CS) Team Has Developed Application
  - Reads Return and Creates Enterprise Object in Real Time
  - Form 1120, 926, 1118, 5471, 5472, 8858 and 8865 Objects
  - Does Not Yet Include Financial Data or Related Entity Data
- Risk Assessment Objects for International Issues and Schedule M-3
- Results Represented in XML Compatible Format
  - Transformed into PDF Reports
  - Possible to Represent Results in XHTML Format
- Supports Several Compliance Initiative Projects
AI CS Application: Next Steps

- Incorporate Financial Statement and Related Entity Data into XML and Enterprise Objects
  - Identification of Related Entities from Schedule K-1 (and Other Sources)
    - Forms 1120 and 1065 to Require Ownership Information for Tax Years Ending On or After 12-31-08
  - Recursive Process Needed to Incorporate Chains of Related Entities
- Set Ownership/Control Parameters and Stopping Rules
- Resolve Complex Entity Relationships
Opportunities

- Tax Shelter Detection
  - Search for Conditions (e.g., Structural) Across Population
  - Analytic Version of YK1 Tool

- Book-Tax Analysis
  - Risk Assessment of Book-Tax Consolidation Differences

- Simulation Modeling
  - Simulate Changes in Features (e.g., Structure) of Profit-Maximizing Enterprise as Basis for Risk Assessment
  - Distinguish Economic- from Tax-Motivated Behavior
  - Alternative to Statistical Risk Assessment Models
Conclusion

- Electronic Filing Should Increase Accuracy of LMSB’s Compliance Risk Models
  - Access to Data on the Broad Business Enterprise
    - Including Structural Relationships Among the Component Entities
  - Ability to Perform Compliance Risk Assessment When Return is Filed

- Should Also Lead to More Efficient Workload Allocation Process
  - Better Targeted and More Informed Examinations
  - Reduced Burden on More Compliant Taxpayers