# LARGE & MID-SIZE BUSINESS
# SUBGROUP REPORT

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# I. INTRODUCTION

The Large & Mid-Size Business Subgroup (hereinafter the "LMSB Subgroup") consists of professionals who represent large and mid-sized businesses and in-house tax counsel from large multinational firms and associations. The members of the LMSB Subgroup come to the task without personal agendas. Rather, the overriding LMSB Subgroup agenda is to provide assistance to the IRS generally and LMSB specifically for the purpose of insuring efficient and fair tax administration and the development of equitable tax policy.

The Subgroup has been busy since February 2004 with five separate multi-day meetings conducted in Washington D.C. and several conference calls with LMSB personnel and executives. The LMSB Subgroup is most grateful for the time devoted by the executives and personnel of the Large & Mid-Size Business Operating Division and the staff of the National Public Liaison. Without their time and assistance, the year would have been less meaningful.

We have structured this Report around the four issues of primary importance to LMSB which were identified at the beginning of the year. Although not exhaustive, the list of issues helped us to focus on areas where we could be the most effective in providing assistance to LMSB. The report which follows identifies the issues and recommendations that were developed by the LMSB Subgroup during this year.

# II. ISSUES AND RECOMMENDATIONS

## A. LMSB COMPLIANCE REENGINEERING

### 1) LMSB Productivity Improvement Phase II (IDR, 5701, and 30-day Letter Processes for Current Cases/Cycles)

**Discussion**

Phase II was the second phase of a three phase approach to implement LMSB improvement initiatives. These initiatives have the goal of creating measurable improvements in case currency, cycle time and in direct examination time. Phase I, which created case delivery improvements and implemented an aged inventory closure initiative, was completed, and a break through team was organized to work on Phase II. The LMSB Subgroup strongly commends the members of the break through team and LMSB for their efforts and improvement initiatives, and we fully support efforts to increase productivity and reduce cycle time. We were presented with the preliminary report from the break through team and we responded with a written document discussing our concerns and recommendations.

Phase II strategies originally included recommendations for changes in Information Document Request (IDR) management, and for changes to Form 5701, the Revenue Agent Report (RAR) and the 30-Day Letter. The proposal would have established arbitrary rules for IDR processing times, eliminated the RAR by combining it with the 30-Day Letter and eliminated extensions to respond to the 30-Day Letter. Based on the comments and suggestions of the LMSB Subgroup and outside stakeholders LMSB did not implement the Phase II proposals.

The LMSB Subgroup strongly supports the goal of currency and shortened cycle times. Accordingly, we made several recommendations to improve Phase II of the LMSB Productivity Improvement Plan. We are pleased that LMSB did not implement Phase II as originally proposed.

**Recommendations**

1. The IDR cycle should be recognized as part of an overall process to achieve a goal. It should not be viewed in isolation. Therefore, documents should refer to LIFE procedures, joint audit planning, and Pre-Filing Agreements (PFA's), and include references to accelerated issue

resolution techniques and early referral to appeals. There should also be recognition of the use of "rules of engagement".

2. The taxpayer should invest the time to educate the team about the company and how its business is conducted. This should eliminate unnecessary IDR's that would otherwise be issued.

3. IDR's should be issued based on risk assessment using methodology determined during the joint audit planning process.

4. IDR's should be well developed, specific, focused and clear. This should be accomplished by discussion with the taxpayer before the IDR is developed and issued.

5. IDR's should be limited to one issue or item.

6. The team coordinator should have responsibility for the timing of the issuance of all IDR's, including specialists, to prevent "bunching" of IDR's.

7. The team coordinator should review and have responsibility for the wording of all IDR's before they are issued. This will increase consistency within the team to the goal of greater cooperation and openness, ensure clarity and eliminate duplication between team members.

**2) <u>Schedule M-3 Reporting of Book-Tax Differences</u>**

**<u>Discussion</u>**

The Treasury Department and the Internal Revenue IRS issued a new draft schedule for Form 1120, Corporation Income Tax Return, which will be required for LMSB taxpayers instead of Schedule M-1, and a new Revenue Procedure. The purpose of this new Schedule M-3 is to increase transparency of corporate tax return filings by requiring greater disclosure and consistency among taxpayers in reporting transactions with significant book-tax differences.

LMSB has recognized from empirical research that the larger the difference between book and taxable income, the larger the risk in the return. In addition, many taxpayers and tax shelter promoters take undue advantage of the differences between rules for financial accounting and rules for tax accounting. Schedule M-3 is intended to be utilized by US corporate taxpayers with total assets of $10 million or more. It is anticipated that the schedule will be finalized for use with federal income tax returns for tax years ending on or after December 31, 2004. Recently released Revenue Procedure 2004-45 allows all taxpayers that are required to disclose significant book-tax differences on Form 8886 (in accordance with the Regulations for Section 6011 relating to tax shelter disclosure), the option to use the corporate Schedule M-3 to report such differences instead of Form 8886. The purpose of the Revenue Procedure is to alleviate burden (double reporting of significant book-tax differences) in as much as Schedule M-3 requires the reporting of all book-tax differences. The Revenue Procedure should also encourage taxpayers to adopt the new Schedule M-3 earlier. Commissioner Everson believes that the new schedule will help target examination efforts on higher risk areas and thusly improve and speed the audit process. The LMSB Subgroup concurs.

We congratulate Commissioner Nolan and LMSB on this initiative. We believe that it is another "breakthrough" initiative that will result in increased effectiveness in the usage of IRS resources. We agree with Commissioner Nolan that it will allow agents to swiftly focus on emerging issues and will result in a more current and efficient examination procedure aimed at those returns with the greatest compliance risk. We believe that this will also have the effect of increasing taxpayer satisfaction, through reduced overall taxpayer burden.

**Recommendations**

In order to help ensure the effectiveness of this new initiative, the LMSB Subgroup has the following recommendations:

1. Joint taxpayer and examining agent training should be implemented to ensure the proper understanding of the preparation and purpose of the new Schedule M-3. Stakeholder groups should be approached to help develop and implement such joint training.
2. Increased resources should be allocated to the Schedule M-3 implementation team.
3. The M-3 initiative should closely coordinate with the business e-filing program and with the Remote Examination Process program.
4. Schedule M-3 or an equivalent form should be required on all business returns with assets greater that $10 million, not just corporations. This should include partnerships, LLC's, S corporations and foreign corporations.
5. Schedule M-3 should be reviewed annually by LMSB to ensure that the form highlights emerging issues and remains current.
6. Schedule M-3 should be used as a key component in risk analysis and selection of business taxpayer returns for examinations. However, being sensitive to taxpayer burden, data collected should be used, or the requirement to deliver it should be eliminated. Regular monitoring of the use of the data collected on Schedule M-3 and regular maintenance of Schedule M-3 should be built into the process of managing it in order to eliminate undue burden on taxpayers and IRS systems alike.
7. Following on recommendations 1-6 above, and because the M-3 concept should become bedrock for LMSB, an institutional home or functional champion should be appointed to regulate and maintain the various iterations of M-3 that will evolve.

8. "Frequently Asked Questions" should be updated monthly between now and the extended filing date for tax years ending on or after December 31, 2004 (through at least the first filing cycle) and then quarterly thereafter.
9. The IRS should recognize publicly that many taxpayers have not engaged in abusive tax shelters and one purpose of Schedule M-3 is to recognize this difference in taxpayers and to allocate resources accordingly.
10. The list maintenance requirement for tax advisors under Section 6112 should be modified or eliminated for book-tax differences if the taxpayer is making a Schedule M-3 disclosure.

### 3) LMSB/SBSE Flow-Through Compliance Committee

**Discussion**

The Large and Midsize Business Operating Division continues to pursue innovative methods to identify tax returns, which will provide its division with the greatest potential for change. One of its latest innovative processes is the establishment of its Flow-Through Compliance Committee ("FTCC"). The FTCC was established by the Enforcement Council in October 2003 and given the direction to develop a process to identify issues on flow-through returns not normally captured during the course of an LMSB examination, and to develop return selection criteria using data mining techniques such as Compliance Risk Patterns (CRISP'S) and Predictive Association Rules ("PAR")

The LMSB operating priorities included coordination with SBSE, TEGE, Appeals, Counsel, and CI on:

- Abusive tax avoidance transactions that affect high wealth individuals and mid-market corporate taxpayers.

- Enhance tax shelter promoter compliance.

- Take actions to increase examination compliance on tax shelter promoter activity including identification of investors.

- Improve workload selection models for flow-through entities ("FTE").

LMSB has taken an aggressive role in attempting to identify lower tier partners or shareholders of FTE's that will generate the greatest degree of a potential for tax change and issues relevant to a broad range of taxpayers.

The increased filing of returns for partnerships and S-corporations leads one to conclude that increased flow-through examinations may lead to a higher rate of compliance. Over the last three years, FTE tax return filings have collectively increased 11.6%, whereas corporate returns, over the same period, have increased an average of 4.85%.

| TAX RETURNS FILED | FY 00 GROWTH OVER PY | FY 01 GROWTH OVER PY | FY 02 GROWTH OVER PY |
|---|---|---|---|
| 1065 | 15.5% | 10.88% | 13.6% |
| 1120-S | 13.93% | 4.5% | 11.2% |
| 1120 | 4.17% | -5.2% | 15.6% |

Given the above information, the FTCC established two sub-committee's 1.) Research and 2.) Compliance Risks and Resources. Research concluded that FTE's filed Forms K-1 affecting 7 million LMSB payees and more than 15 million SBSE payees. Using its data mining capabilities, FTCC has the ability to identify key relationships of income and deductions, and flow through losses which will ultimately affect LMSB taxpayers. Providing LMSB examination teams early referral cases with relevant flow-through issues will complement examination audit plans. More important, while enhancing LMSB's audit plan, the FTCC case delivery methodology will increase the SBSE coverage of mid-market pass-through entities.

In the LMSB Subgroup report dated November 6, 2003, it was noted that close to sixty percent of the pass-through entity filing populations involved a tiering paradigm such that the entity itself is either a member/partner/shareholder of a higher level entity or it has member/partners /shareholders that are flow-through entities themselves. Since that report was issued, it was noted that the LMSB examination plans do not reflect appropriate levels of coverage to examine FTE taxpayers. The FY 04 and 05 compliance plans for LMSB agents working Forms 1065's and 1120S follow:

| | Form 1065 | | | | | Form 1120S | | | |
|---|---|---|---|---|---|---|---|---|---|
| | LMSB | | SBSE | | | LMSB | | SBSE | |
| | DESY* | Returns | DESY | Returns | | DESY | Returns | DESY | Returns |
| Fy03 | 142 | 1533 | 102 | 4253 | | 89 | 1486 | 164 | 7587 |
| FY04 | 155 | 1242 | 109 | 4501 | | 61 | 307 | 139 | 4540 |
| FY05 | 194 | 2119 | 117 | 6311 | | 102 | 1243 | 156 | 6373 |

*Direct Exam Staff Years

The LMSB Subgroup believes that the LMSB operating division should make increasing audit coverage (particularly for upper and mid size pass-through entities) a high priority, while it reduces its cycle time and increases coverage of Coordinated Industry Cases ("CIC") and Industry Cases ("IC"). Given the above information, it is apparent that the FTCC can provide detailed information to LMSB examination teams to perform detailed examinations where a CIC/IC taxpayer has significant pass-through investments or structures that warrant review. We believe that LMSB examination teams typically are not well versed in pass-through issues and administrative processes such as TEFRA, and that providing each team a journeyman SBSE agent to facilitate examination coverage of any pass-through entity related to a CIC or IC taxpayer would enhance the examination team audit plan and potentially reduce cycle time.

Given the above projected levels of coverage, it appears that LMSB/SBSE are not dedicating sufficient staff years to address compliance issues identified by FTCC. In FY04, collectively 248 DESY's were dedicated to examining only 9,041 tax returns. In FY 05 the divisions

increased DESY's by 10.9% to 273 agents with coverage exceeding 12,684 returns. With the increased filing of forms 1065 and 1120 averaging 11.6 % clearly each of the divisions are barely maintaining a level of coverage rather than increasing coverage of the overall population.

**Recommendation**

The LMSB Subgroup recommends that LMSB redeploy resources to reflect the overall population of tax returns filed in the pass-through arena. Rather than deploying a specific number of agents dedicated to pass-through entities, LMSB/SBSE should deploy a set percentage of DESY's dedicated to examining pass-through entities. This application would ensure that as inventory grows minimum audit coverage of the FTE population will also be maintained. As FTCC develops a list of issues that warrants examination, it is important that LMSB provide the resources to examine these returns.

**4) Compliance Assurance Process**

**Discussion**

LMSB continues to find ways to strive to reduce cycle time and achieve voluntary compliance, while rewarding compliant taxpayer behavior. The LMSB Subgroup believes the Compliance Assurance Process ("CAP") pilot examination program provides a sound basis for achieving these results. The CAP pilot program invites a group of large taxpayers to participate in an early examination process, whereby the taxpayer is examined during the course of the tax year rather than after filing as in traditional post filing processes. Because the traditional CIC process fails to resolve issues for compliant taxpayers and identify and deter abusive activities by noncompliant taxpayers in a timely manner, we believe this innovative process will identify key

examination tools and measurements that can be utilized in other CIC cases and can be implemented in similar IC cases.

As highlighted by LMSB in its presentation to the LMSB Subgroup, audit resolution for the largest CIC taxpayers takes on average 60 months from filing date. For those 27% of CIC taxpayers with unagreed issues it takes an average of 86 months to reach resolution. This long cycle time inhibits early identification of significant tax issues, timely processing of issues, and adversely impacts taxpayer's business planning while increasing examination management costs for both taxpayer's and the IRS. The CAP pilot requires that the IRS and the taxpayer cooperate to look at key events and transactions early in the tax year and resolve any uncertainties by the filing date.

Through a Memorandum of Understanding ("MOU"), the IRS and the CIC taxpayer enter into an agreement which outlines the objectives of the process, the participants, and each party's roles and responsibilities during the course of the examination. The LMSB Subgroup was provided a draft of the MOU, and although conceptually we are in agreement with its content, we believe that it would be more acceptable and result in more CIC taxpayers signing the document, if the language used in the MOU were more "taxpayer friendly", and if the MOU included a statement that existing IRS policies regarding privileged documents and tax accrual work papers will be followed. The LMSB Subgroup has provided its recommended draft language to LMSB for consideration.

We believe the MOU is the focal point of CAP and may cause the greatest issues and concerns with those CIC taxpayers that volunteer for the program. While the MOU sets forth

and describes the process and expectations of both parties, we believe that it needs to be a contract of process versus a contract of requirements.

With the advent of the Sarbanes-Oxley legislation, the changed corporate environment provides a unique opportunity to improve the overall compliance process. Using "tools" implemented by the law, the CAP process can leverage off those corporate governances.

**Benefits of CAP**:

- Provide quicker resolution of issues and cases, while providing prompt guidance to industry issues
- Address emerging issues that may impact other taxpayers, and simultaneously avoid any controversy and reduce prolonged litigation
- Provide real-time response to transactions, thus eliminating the IRS agents' need to "catch up"
- Resolve issues prior to filing with a greater certainty of final resolution
- Be consistent with the financial statement model of examining a taxpayer promptly
- Complement current corporate governance and accountability, while providing timely and more concise financial reporting
- Reward compliant behavior
- Allow for redeployment of CIC Revenue Agents to non-compliant taxpayers and an expansion of IC and flow through examinations

- Reduce or eliminate need for post-filing examination

**Risks of CAP**

- It may increase costs for both the IRS and the taxpayer during the initial phase, however, it should save time and resources for both in the long run

- Because this is a real-time process of reviewing significant transactions, the IRS risks being viewed as a tax advisor to the taxpayer

**Questions regarding CAP**

- Can the IRS effectively and efficiently deal with the more complex real-time issues, such as research and development and foreign tax credits, by the filing date?

- Will external auditors feel compelled to become more involved or collaborate on treatment of transactions with IRS auditors or the resolution thereof?

- Will the IRS and the taxpayer be able to provide appropriate resources?

- Because new programs sometimes generate unanticipated problems, can the IRS and taxpayers remain flexible and collaborative throughout the entire process?

- CAP Account Coordinators, who are the taxpayer's primary contact, are not IRS management officials. With this status, do the coordinators have the flexibility to manage the process, people, and issues to meet the real-time needs of the taxpayer and the IRS?

**Recommendations**

1. LMSB should continue to pursue significant improvements to the timeliness of the current CIC audit process using a private sector model of real time issue resolution to strengthen corporate governance and improve overall compliance.

2. The MOU should be revised, as per the redraft that we furnished to LMSB, in order to be a more "taxpayer friendly" document and to assure taxpayers that the current IRS policies regarding privilege and tax accrual work papers will be followed.

3. LMSB needs to further collaborate with CIC taxpayers to ensure that this pilot program produces effective and efficient processes to examine the largest taxpayers. Its initial prototype has great merit, but to be successful it must overcome potential obstacles.

**5) Remote Examination Process (REP)**

**Discussion**

The Remote Examination Process (REP) is an alternative to the traditional full blown examination. The program, as planned, consists of an offsite examination of one or two pre-identified significant issues. The REP is primarily aimed at Industry Cases (IC). These companies are generally non-public companies and as such are largely outside the reach of the impact of Corporate Governance on Tax Administration (Sarbanes-Oxley). The REP, as currently envisioned, appears to include only C Corporations in Activity Codes 219, 221 and 223 (assets between $10 million and $250 million).

The LMSB Subgroup congratulates Commissioner Nolan and LMSB for this innovative program. We believe that this program will help to accomplish many of the goals of Commissioner

Everson and will increase taxpayer compliance and more efficiently utilize IRS resources by increasing audit coverage, increasing currency and reducing average examination time. We believe that the program will also help the IRS achieve some of its other goals by attracting new, highly qualified employees who possess great skills but are unable to participate in the traditional forty hour workplace, such as single parents, and handicapped persons. Since this program does not require on-site visitations, it permits the development of a more flexible workplace and work schedule.

**Recommendations**

LMSB views the REP as one of the "breakthrough" ideas being developed to increase enforcement and to increase voluntary compliance. Accordingly, LMSB Subgroup recommends:

1. The REP should be expanded to include S Corporations, LLC's and partnerships as well as C Corporations.
2. The REP should include business taxpayers in Activity Codes 225 (assets greater than $250 million) where risk analysis has shown that implementation of Sarbanes-Oxley and responsible corporate governance has reduced the need for the level of traditional resources allocated to these "top tier" taxpayers
3. Resources re-allocated from Code 225 taxpayers should be allocated first to Activity Code 223 taxpayers based on risk analysis and REP should be instituted on the remainder of Code 223 taxpayers in addition to Activity Code 219 and 221 taxpayers
4. REP should be coordinated with the new Schedule M-3 program (another "breakthrough" initiative) as well as with the Industry Issue Resolution program
5. REP should be assigned resources to increase, to the fullest extent possible, IRS coverage of tax returns that would not otherwise be examined. The LMSB Subgroup believes that it is

clear that voluntary compliance increases with taxpayer awareness of increased examination coverage

6. REP should be utilized as quickly as possible, after filing of the taxpayer's return, and be coordinated with the developing business return e-filing programs in order to support LMSB's and Commissioner Everson's currency initiatives
7. Taxpayers should have the right to request a face to face meeting with the examining agent and their supervisor to enhance communication and mutual trust and understanding.
8. REP has many secondary goals, but it should be remembered that its primary goal is to increase audit coverage of business taxpayers that would not normally be examined
9. REP should be utilized when the IRS receives information from external sources including DOJ and press reports.

## B. IMPACT OF CORPORATE GOVERNANCE ON TAX ADMINISTRATION (SARBANES-OXLEY)

**Discussion**

Recent corporate scandals such as WorldCom and Enron have resulted in new legislation, Sarbanes-Oxley, which promulgates rules and procedures that are meant to help prevent future such scandals. Sarbanes-Oxley implements a strict regime of corporate governance, part of which requires the Chief Executive Officer and the Chief Financial Officer to attest to the correctness of reported financial statements, including the numbers reported on those financial statements together with the notes thereto. It is noted that particular attention is paid to the tax provision. Companies are required to implement strict policies and procedures in an effort to publish correct financial data. The company's outside auditors are then required to attest that the company has or has not implemented the requirements of the legislation. Under this legislation, if the published financial

data is not correct, severe financial and jail term penalties may be applied to the offending individuals.

It is the LMSB Subgroup's opinion that the IRS should be able to rely on this legislation to allow increased efficiency in administering the tax system. Sarbanes-Oxley generally applies to companies whose shares are listed on a US stock exchange. These are also the companies on which the IRS focuses a great deal of its audit resources.

We believe that the IRS can reduce its audit time and audit coverage of companies subject to Sarbanes –Oxley because appropriate reliance can be placed on the accuracy of published data, particularly the tax provision. We are not suggesting that the IRS ignore this population entirely, but rather implement a compliance assurance test similar to those employed by the outside auditors who sign the financial statements (CAP, discussed above, is an example of such a process). This should allow the IRS to become more current with respect to this particular population, and on an ongoing basis should allow the IRS to focus more time and resources on the examination of taxpayers that are currently not subject to audit. One might expect that taxpayers who have not been subject to audit in the past may not be in complete compliance with the tax law. Together with other initiatives of the IRS, this should result in greater audit coverage of midsized taxpayers who may be a compliance risk. The IRS should be able to refocus resources to "touch" more taxpayers and thereby improve tax compliance.

**Recommendation**

The IRS should leverage the Sarbanes-Oxley legislation to develop and utilize a compliance assurance process in order to reduce audit time and coverage of the largest taxpayers and reallocate resources to the mid sized taxpayer base which is not currently the focus of examinations.

## C. TAX SHELTER STRATEGY

### 1. Strategy to Re-emphasize Penalty Administration

**Discussion**

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

The IRS has begun to take a much harder line with taxpayers who engaged in tax shelter activity. This new approach is evidenced best by the settlement offer that was made in connection with transactions described in Notice 2000-44; in order for a taxpayer to settle the case without trial, the IRS required the imposition of penalties except in the case of taxpayers who had voluntarily disclosed their tax shelter activities during the limited period provided in Notice 2002-2. Based on anecdotal evidence, we believe that the IRS is taking a similar "tough" position in its settlement discussions concerning other listed transactions.

We generally support the approach that has been taken by the IRS. Consistent application of penalties is an important aspect of tax administration. Taxpayers who engage in tax shelter activities need to know that they will have to pay penalties (and not just tax plus interest) if they are caught. The threat of penalties provides a significant deterrent to taxpayers.

We also support the imposition of penalties on tax shelter promoters. We understand that the IRS has made investigation of tax shelter promoters a priority, as it should be. The only way to inhibit future tax shelter activity is to find and penalize the persons who sell them.

We are concerned, however, that the "hard line" that has been taken with respect to taxpayer penalties may also result in a strain on the IRS's resources if the IRS is unable to settle a large

percentage of individual tax shelter cases. Some individuals may have legitimate arguments that they are not subject to penalties because they relied upon tax professionals. Whether or not these arguments will be persuasive in court is not certain, so that the IRS may eventually be subject to some unfavorable decisions. This could be particularly true with respect to penalties that are imposed on unsophisticated individual taxpayers, since a taxpayer may be able to avoid penalties by claiming that he relied upon the advice of counsel.

The IRS will need to continue to focus on finding the "happy medium" in settlement guidance for tax shelter cases so as to provide incentives to taxpayers to settle cases, preserve the fundamental principle that improper taxpayer behavior must be penalized, and recognize taxpayers' rights. We believe that the IRS is aware of this tension, but continued diligence is required.

**Recommendations**

1. The IRS should continue to pursue abusive tax shelters as a top priority, with particular emphasis on promoters, including the imposition of penalties.
2. The IRS should continue to be diligent with regard to the tension between taxpayer rights and penalizing improper taxpayer behavior.

**2) Other Tax Shelter Matters and Settlement Initiatives**

**Discussion**

One of the more difficult problems raised by tax shelter cases involves how to settle them. Should there be global settlements? What role should Appeals play? Should a hearing before Appeals on a tax shelter case be barred, as such hearings were barred in the settlement concerning Notice 2000-44 transactions? Can Fast Track be used to resolve tax shelter cases? Should taxpayers who engaged in tax shelters be forced to choose between trial and complete concession?

Again, there are no clearly correct answers to these questions. We are concerned that Fast Track may not be the appropriate vehicle for the settlement of tax shelter controversies; anecdotal evidence indicates that tax shelters are rarely settled in Fast Track conferences. It may be more appropriate for the IRS to offer taxpayers the ability to go to Appeals in connection with tax shelters, although access to Appeals could be denied in those situations in which forcing taxpayers to choose between a settlement and litigation is in the best interests of the IRS (as was the perception within the IRS with respect to Notice 20004- 44 transactions). Ideally, the IRS would prepare guidelines under which Appeals could resolve each type of tax shelter, taking into account the IRS's view of the law and each taxpayer's particular circumstances. Such an approach would be fair and relatively expeditious.

The most important aspect of tax shelters is to prevent them before they happen, which occurs only if the IRS targets the promoters as well as the taxpayers involved. That appears to be the approach that the IRS is taking, and we commend it. The imposition of penalties against promoters may be as (or more) important in preventing a re-occurrence of the tax shelters that emerged over the last decade as any other single step that the IRS has taken. We also believe that the focus on mid-market compliance (discussed below) is an integral aspect of this issue, because "touching" more taxpayers makes it more likely that abusive tax shelters can be identified before they spread.

**Recommendations**

1. The IRS should prepare guidelines under which Appeals can resolve each type of tax shelter, taking into account the IRS's view of the law and each taxpayer's particular circumstances.

2. The IRS should continue to aggressively target and apply penalties to tax shelter promoters.

3. The IRS should focus more attention and resources on mid-market taxpayers.

**3) Joint International Tax Shelter information Center**

**Recommendation**

We received limited information concerning this initiative. However, given the growth of tax shelters from a domestic to an international problem, this seems like an excellent idea. We should also encourage other countries to adopt disclosure mechanisms (as contained in our new provisions under Section 6011) so that they may be able to ferret out tax shelter strategies that are not, as of this time, known to the IRS.

## D. FOCUS ON MID-MARKET TAXPAYER COMPLIANCE

**Discussion**

The LMSB Subgroup has consistently expressed concern that the mid-market taxpayer base has gone basically un-audited for many years. The IRS has dedicated significant resources to auditing the largest taxpayers on a continuous basis, simply because they are the largest taxpayers. We continue to believe that this is not the best use of resources. We commend LMSB on their initiatives designed to improve currency and reduce cycle time, on the new auditing techniques and processes that have been developed and used such as LIFE, and on the "breakthrough" ideas that are being developed such as REP and CAP. We believe that all of these efforts should be aggressively pursued, and that they should result in the ability to reallocate resources to examine mid-market taxpayers, to "touch" more taxpayers who have historically not been "touched" by the IRS. Focusing on mid-market taxpayer compliance is a component of each of the other three issues identified as having primary importance to LMSB and covered in previous sections of this report.

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

**Recommendation**

We believe that LMSB should use all of the tools, techniques, and new processes that have been developed to free up resources and reallocate them to examining, or in some way "touching" , a significant number of mid-market taxpayers.

# INTERNAL REVENUE SERVICE ADVISORY COUNCIL

# LARGE & MID-SIZE BUSINESS SUBGROUP REPORT


JON CONTRERAS
RICHARD D'AVINO
JOHN GLENNIE
RICHARD LIPTON
DENISE STRAIN
DAVID UHLER
THOMAS WHARTON
BETTY WILSON, SUBGROUP CHAIR


NOVEMBER 10, 2004