

**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,<sup>1</sup> 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.

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<sup>1</sup> 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><b>STRATEGIC RISKS</b> – [Instances of Bad Publicity/Reputation; Loss of Trust in the Self-Assessment System]</p>	<p><b>OPERATIONAL RISKS</b> – [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><b>COMPLIANCE RISKS</b> – [Inability to Comply With Regulatory and Statutory Requirements; Excessive Oversight Scrutiny]</p>
<p style="text-align: center;"><b>Potentially stem from failure to - -</b></p> <ul style="list-style-type: none"> <li>✓ Develop an audit selection system</li> <li>✓ Provide an appropriate level of transparency internally and externally</li> <li>✓ Seek needed law changes</li> <li>✓ Catalogue compliance strategies</li> <li>✓ Analyze and prioritize compliance behaviors (e.g., causes and options for treatment)</li> <li>✓ Maintain taxpayer privacy</li> <li>✓ Optimize collections under the law while maintaining taxpayer confidence in the tax system</li> <li>✓ Maintain a robust internal audit function</li> <li>✓ Be innovative</li> <li>✓ Evaluate tax intermediaries’ risk appetite, e.g., the commoditization or one off selling of abusive tax shelters</li> <li>✓ Monitor the external environment, e.g., public opinion, Congress, economic conditions, governmental policy</li> <li>✓ Shape internal capabilities, e.g. organizational culture; organizational structure; information technology and business systems; and staff and business capabilities</li> <li>✓ 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.</li> <li>✓ Identify and remediate strategic and operational risks</li> <li>✓ Maintain cost-benefit strategies</li> <li>✓ Avoid requests for data already available from another source</li> <li>✓ Align strategic and operational decisions to taxpayers’ and tax intermediaries’ risk appetites, i.e., risk/return trade-offs</li> <li>✓ Maintain a sufficient degree of LMSB senior management’s time in risk planning</li> <li>✓ Maintain a robust internal audit function</li> <li>✓ Sufficient staffing</li> <li>✓ Provide clear avenue for Voluntary Disclosures</li> <li>✓ Integrate LMSB with other Service Operating Divisions, accounting and legal departments</li> <li>✓ 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;</li> <li>✓ Leverage the impact of information learned through taxpayer interventions</li> <li>✓ Guard against internal fraud</li> <li>✓ Map major compliance risks to the relevant taxpayer population</li> <li>✓ Develop of a risk management program</li> <li>✓ Compare risks across the total responsibilities of LMSB to determine what not to audit</li> <li>✓ Clearly communicate roles and responsibilities</li> <li>✓ Cost-efficiently optimize tax collections</li> <li>✓ Provide training within and without LMSB</li> <li>✓ Attract and retain tax expertise</li> <li>✓ Participate in IRS/Treasury business planning</li> <li>✓ Maintain appropriate reporting structures</li> <li>✓ Identify non-filers</li> <li>✓ Identify nonreported transactions</li> <li>✓ Modify organizational structure to respond to changes in business operations and/or legislation</li> <li>✓ 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</li> <li>✓ Use best efforts to pursue an “enhanced relationship” with taxpayers as envisioned in the OECD report on tax intermediaries</li> <li>✓ Identify technical issues that present greatest dangers of underpayment</li> <li>✓ Track appeals and issue disagreements</li> <li>✓ Develop and communicate risk appetite to staff</li> </ul>	<p style="text-align: center;"><b>Potentially stem from failure to - -</b></p> <ul style="list-style-type: none"> <li>✓ Provide timely adequate and sufficient administrative guidance</li> <li>✓ Maintain shared values and compliance with policies and procedures</li> <li>✓ Fully understand organizational objectives</li> <li>✓ Receive needed (appropriated) funds</li> <li>✓ Establish procedures to resolve exams when agent indicates retirement</li> <li>✓ Minimize employee turnover.</li> <li>✓ Undertake generational planning reflecting anticipated changes in demographic factors</li> <li>✓ Treat taxpayers with similar facts and circumstances consistently and equitably</li> <li>✓ Maintain commercial awareness</li> <li>✓ Provide sufficient staffing</li> <li>✓ Provide needed training</li> <li>✓ Lack of uniform execution across all field offices and taxpayers</li> <li>✓ Implement strategies consistently up and down the organization</li> <li>✓ Attract tax expertise</li> <li>✓ Provide access to taxpayer data</li> <li>✓ Provide responsive tax resources</li> <li>✓ Leverage non-tax personnel supporting tax</li> <li>✓ Plan and manage tax resources</li> <li>✓ Recognize and respond to external factors</li> <li>✓ Assign individuals to the audit with relevant tax law knowledge</li> <li>✓ Respond quickly to changing circumstances</li> <li>✓ 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</li> <li>✓ Use information exchange programs with other taxing jurisdictions</li> <li>✓ Identify taxpayers who should, but are not registered and filing</li> </ul>	<p style="text-align: center;"><b>Potentially stem from failure to - -</b></p> <ul style="list-style-type: none"> <li>✓ Receive clear and timely guidance on meaning and intended working of the tax laws</li> <li>✓ Appreciate growing use of joint ventures/alliances/partnerships/agents/etc. and their unique tax issues</li> <li>✓ Use technology</li> <li>✓ Understand taxpayers’ registration, reporting, filing and remittance obligations</li> <li>✓ Failure to gather/access needed data</li> <li>✓ Failure to use data that has been gathered</li> <li>✓ Team within and outside LMSB</li> <li>✓ Maximize value of internet search tools</li> <li>✓ Identify inappropriate transfer pricing, among other technical issues</li> <li>✓ Reflect a broad view of the likelihood that the facts and circumstances generally encountered differ from those the taxpayer reports</li> <li>✓ Note that taxpayers not filing complete and accurate information</li> <li>✓ Treat taxpayer with similar facts and circumstances consistently and equitably</li> <li>✓ 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</li> <li>✓ Plan and manage tax resources</li> <li>✓ Maintain or provide supporting documentation</li> <li>✓ Provide timely and non-burdensome access to functional and industry specialists</li> <li>✓ Access to tax planning support opinions and workpapers</li> <li>✓ Disclose overpayments to taxpayer</li> <li>✓ Comply with laws and regulations</li> <li>✓ Document findings and open questions</li> <li>✓ Understand changes in tax laws</li> <li>✓ Abate tendency of Technical Advisors to seek more documentation and develop more stringent approaches to technical issues then warranted under existing guidelines.</li> <li>✓ 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;</li> <li>✓ Receive current, relevant and reliable information</li> </ul>

## 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) Strategy<sup>2</sup>

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

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<sup>2</sup> 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.<sup>3</sup>

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.

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<sup>3</sup> 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”).<sup>4</sup> 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.

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<sup>4</sup> 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](http://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”).<sup>5</sup> 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.<sup>6</sup> 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*

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<sup>5</sup> 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.

<sup>6</sup> 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 million<sup>7</sup>); 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.

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<sup>7</sup> 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.<sup>8</sup> 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.

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<sup>8</sup> 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.