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Case Study 2.2

**INCENTIVE AND COMPLIANCE FACILITATION MECHANISMS
BASED ON THE BEHAVIOR OF TAXPAYERS**

**Internal Revenue Service
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I. Introduction

Large corporate taxpayers seek certainty and place a high value on the ability to finalize their tax positions quickly. This helps them to achieve predictability of cash flow and allows for better assessment and public reporting of the value of their business. In recent years, the Large and Mid-Size Business (“LMSB”) Division of the Internal Revenue Service (“IRS”) has implemented a number of innovative examination processes in an attempt to provide timely tax certainty to corporate taxpayers. Taxpayers have an incentive to work with the IRS to expedite the audit process so that they can get current and can focus on their business with less tax exposure. At the same time, the IRS benefits from real-time, reliable information, which allows for more efficient allocation of examination resources in an era of significant technological change and budgetary challenges.

II. Overview of the IRS Large and Mid-Size Business Division

LMSB is one of four operating divisions of the IRS. LMSB serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million. LMSB taxpayers include the largest corporate employers in the United States. LMSB taxpayers conduct business in an increasingly global environment, routinely dealing with highly intricate legal, accounting, and tax issues. Their tax returns tend to be very complicated and LMSB examinations can take months or years to complete under traditional examination processes. LMSB taxpayers are very influential in shaping legislation and policy both in the United States and globally. They are represented by the most sophisticated and highly-paid tax professionals in the business.

LMSB’s business operations are structured to support the IRS goals of improving taxpayer service and enhancing enforcement of the tax laws. Modernizing the agency through its people, processes, and technology is a key strategic approach to reaching the goals. For LMSB, the goal of improving taxpayer service generally means completing audit work more efficiently, maintaining high-quality measurement standards, and attempting to reduce the administrative burden placed on taxpayers to the greatest extent possible. The goal of enhancing enforcement means addressing areas of significant compliance risk through examinations and other methods and encouraging non-compliant taxpayers to meet their tax obligations. Modernization means strengthening the workforce and implementing efficient tools, systems, and processes LMSB and taxpayers use to perform their functions within the tax system.

III. LMSB Vision

When LMSB stood up in 2000 as part of the restructured IRS, our business processes were firmly rooted in tradition. Compliance activity between large and mid-size business taxpayers and IRS was, essentially, a function of performing in-depth, time-consuming, labor-intensive, paper-bound examinations that typically started a few years after filing and took about five years to complete, sometimes in an adversarial environment. This approach may have worked in the past, but the corporate tax environment began changing much faster than our internal capabilities. Tax law complexity, rapid globalization of business, and increased competitiveness lead to creative and aggressive tax structures and transactions that forced us, other regulatory agencies and the tax community to reassess our approaches to tax compliance and administration. Our processes did not adequately engage our stakeholders in compliance resolution, and our processes to identify tax compliance trends and high risk issues were dated and lacked alignment to financial statement accounting requirements.

Today, we are building a foundation that will result in our ability to better service our taxpayers and conduct our compliance improvement activities more effectively and timely. We have a comprehensive “concept of operations” plan in place that identifies the capabilities and business processes we need to effectively administer large business tax administration in an increasingly complex regulatory and global business environment. There is correlation between the attributes of the future state LMSB is moving towards and what our taxpayers tell us, through research, is important to them. The vision for LMSB is a tax administration that provides:

- Taxpayer transparency and certainty to improve tax compliance. It is important to tax administration that taxpayers’ positions, transactions and underlying accounting be as transparent as possible. At the same time, taxpayers have a need for certainty, an assurance that they are in compliance.
- A highly skilled and engaged workforce and leadership team capable of achieving our tax administration goals.
- Technology that enables business and workforce productivity, with information that supports informed decisions and actions.
- Issue focused compliance approaches to maximize resource effectiveness and provide resolution consistency.
- Effective relationships with taxpayers and stakeholders to enable informed business decisions. Engaging taxpayers, both at the corporate level and at the front line case level, promotes understanding, agreement, and ultimately results. Mutual understanding of issues and solutions is in the best interest of both tax administrator and taxpayer.

- Capability to quickly identify emerging trends and issues, and resolve issues quickly through enhanced training, knowledge retention, and issue management. Tax administration functions in a very dynamic environment. What tax administration confronts next year is more than likely to be different from what is confronted today, or last year. LMSB systems and processes are changing to enable our people to adapt quickly to deal with those changes.

IV. Traditional Post-filing Examinations

Post-filing tax return examinations are the traditional method used to promote higher levels of taxpayer compliance. Limited numbers of examination personnel are available to examine tax returns, however, and not all tax returns can be examined by the IRS. The IRS therefore uses computer-based techniques and manual review to classify and select returns for examination with the greatest potential for tax change and revenue yield.¹

The traditional post-filing examination process requires the performance of an in-depth, often time-consuming and labor-intensive taxpayer audit, which sometimes takes place in an adversarial environment. During a post-filing examination, taxpayers are often asked to produce records and information that will help the IRS understand business decisions from prior years. Taxpayers are statutorily required to maintain and keep books of account and records sufficient to establish income, deductions, credits, and other matters reportable on their income tax returns. IRC § 6001. Tax examiners and revenue agents are statutorily authorized to examine any books, papers, records, or other data that are relevant or material to the audit of a tax return, and summon any person liable for any tax in question or any person having custody of books or other records relating to a return under examination to appear and produce documents and give testimony relating to the examination of the return. IRC § 7602.

¹ For examination purposes, LMSB taxpayers are divided into two groups; Coordinated Industry Case (“CIC”) taxpayers and Industry Case (“IC”) taxpayers. CIC taxpayers are very large, complex taxpayers seen as requiring centralized audit management and coordination. They are essentially subject to constant audit, with IRS personnel specifically designated to their cases over a long period of time. CIC taxpayers are determined on the basis of the application of pointing system, based on a variety of characteristics including, gross assets, gross receipts, number of entities, total related transactions, and total foreign assets. A team manager is assigned to oversee the CIC audit. Various specialists are available to assist the team manager, including international specialists, computer audit specialists, financial product specialists, employment tax specialists, engineers, and economists. If a primary taxpayer qualifies as a CIC taxpayer, all of its effectively controlled entities, plus those that are unrelated but associated with the taxpayers in activities having significant tax consequences will be examined. IC taxpayers are those that do not meet the criteria to be classified as CIC taxpayers. Some may be as large and complex as a CIC taxpayer, but they are not necessarily subject to constant audit. In Fiscal Year 2007, revenue collected from LMSB compliance audit activities totaled \$14.2 billion. The overall audit coverage rate was 16.8 percent for all LMSB corporations, ranging from 15 percent for \$10-50 million asset companies to 62.9 percent for \$5-20 billion asset companies. For those over \$20 billion, the exam coverage was 100 percent.

As time passes, though, a taxpayer's personnel responsible for filing the return may have left its employment, records may be unavailable, and it may be increasingly difficult for taxpayers to provide requested information. This can complicate an audit for taxpayers and the IRS, extending the period of the examination and resource requirements on both sides. If issues remain unresolved, taxpayers may be required by financial accounting rules to maintain tax reserves on their books, which can often affect their financial statements, public reporting, and even share price.

LMSB's annual customer surveys regularly showed that its taxpayer base desired ways to reduce the administrative burden of the examination process, including the length of the audit and the length of the process, as well as a way to achieve earlier certainty with regard to audit issues.

In an effort to address these concerns, LMSB has introduced a variety of tax administration initiatives that focus on improving the identification and timely resolution of audit issues for both the IRS and taxpayers. The goals of these initiatives have been to reduce audit cycle time, improve audit currency, reduce taxpayer burden, and improve overall efficiency. The overriding philosophy of these initiatives has been the idea that bringing significant issues to the forefront of an examination quickly and efficiently, with mutual cooperation by the IRS and corporate taxpayers is good for both taxpayers and the tax administrator.

V. Improving the Post-filing Examination Process

A. Issue Focused Examination Process

In recent years, LMSB has improved the traditional examination process, implementing an Issue Focus approach to compliance examinations under which it classifies significant issues based on a tiering system associated with compliance risk. Under this process, the IRS focuses on high-risk and significant issues in an effort to improve tax compliance and leverage resources. Compliance issues are identified by the IRS through examinations, Schedule M-3 reviews, and other sources. Analysis of these issues determines non-compliance risk and priority. LMSB executives evaluate the issues to determine whether they rise to a high priority level.

High-priority issues are assigned to an issue management team, headed by an IRS executive, to develop an overall compliance strategy. The goal of this approach is to get consistency and efficiency in resolving the tiered issues. Earlier identification and analysis of these significant issues and affected taxpayers enable the IRS to address non-compliance more quickly, which improves currency for taxpayers and audit cycle time for the IRS.

B. Joint Audit Planning Process

At the outset of a tax examination the IRS examination team engages the taxpayer in a joint audit planning process to mutually develop agreement and plan for the conduct of the examination. The process promotes a timely and orderly tax examination, which benefits both parties, by establishing agreement on roles and responsibilities, accountability, timeframes, and methods for fact finding, issue development and resolution. For IRS, this is a particularly effective approach to managing the resources needed for a tax examination, where the IRS examination case manager must have a clear understanding of the specialist resources needed, such as engineers, computer audit specialists and technical advisors. For the taxpayer, the process also maximizes resource and time efficiency, as well as promoting certainty. Throughout the course of the examination the joint audit plan is continually monitored and updated to both reflect and best ensure an efficient examination in light of all available information.

C. Accelerated Issue Resolution

Even before LMSB was established in 2000, the IRS had already begun to work toward the policy goals of examination currency and significant issue identification that are now at the forefront of all of LMSB's initiatives. In 1994, the IRS established the Accelerated Issue Resolution ("AIR") program in Revenue Procedure 94-67. AIR was an examination process designed to enhance the resolution of the same or similar issues arising from an examination of a CIC taxpayer from one or more tax periods to other tax periods. Extending the examination of issues to more current tax periods was seen as allowing the audit team to examine taxpayer books and records that were more contemporary and more accessible than might have otherwise been the case.

D. Limited Issue Focus Examination

In 2002, LMSB introduced the Limited Issue Focus Examination ("LIFE") process as an alternative to the traditional, full-scope examination process. Under LIFE, LMSB uses detailed risk analysis and materiality considerations (including dollar value, permanency, and timing) to limit the scope of an examination to specific issues determined to be material in the analysis. The LIFE process is far more streamlined and issue-focused than a traditional full-scope examination. Its cornerstone is a Memorandum of Understanding ("MOU"), in which the taxpayer and LMSB must commit to actions regarding key aspects of the process. The LIFE MOU identifies issues to be examined and materiality thresholds to govern any expansion in the scope of the examination and requires cooperation between LMSB and the taxpayer to complete an examination. If a taxpayer does not meet its MOU commitments on the limited issues, the LIFE process may be terminated and the scope of the examination expanded to include large, unusual, and questionable items identified in the LIFE risk analysis.

The LIFE process is not automatically available to a taxpayer, although a taxpayer can suggest a LIFE to its revenue agent. Ultimately, the examination Team Manager decides whether to make the LIFE process available to a taxpayer. When a taxpayer has indicated a willingness to participate in the examination and cooperate with the IRS, an exam team will likely offer or agree to a LIFE.

E. Fast Track Settlement

In 2001, the IRS implemented an LMSB Fast Track Dispute Resolution Pilot Program, jointly supported by LMSB and the IRS Office of Appeals.

The IRS Office of Appeals (“Appeals”) operates independently from the other IRS functions and has the “exclusive and final authority” to determine liability for most taxes. Appeals is delegated this authority by the Commissioner of the IRS. Appeals serves as the appellate forum of last resort within the IRS, with the objective of settling tax controversies without litigation on a basis that is fair and impartial to both the government and the taxpayer. Appeals officers consider taxpayer appeals, hold conferences, and negotiate settlements. If a taxpayer does not settle its case in Appeals, the next step would be litigation.

The Fast Track Settlement (“FTS”) program provides LMSB taxpayers with a way to resolve audit issues early and while LMSB retains jurisdiction of the case, by utilizing the settlement authority and mediation skills of the Office of Appeals. During the course of an examination, LMSB taxpayers can request early resolution for a specific issue or issues through the FTS program. The taxpayer and representatives from LMSB work to achieve a mutually acceptable resolution to tax issue(s) by meeting with an Appeals Officer who serves as a neutral party and functions as a mediator to guide LMSB and the taxpayer to a mutually acceptable resolution for each issue. The Appeals Officer serving as the mediator uses his or her delegated settlement authority to implement an agreed resolution. Under the FTS program, the Appeals organization may advocate a proposed resolution to the issues, but cannot impose a resolution on either party.

The FTS program was designed to use alternative dispute resolution techniques within LMSB to promote issue resolution at earlier stages and reduce the overall time from return filing to issue resolution. In most cases, the FTS process is complete in less than 90 days. FTS typically reduces the combined LMSB-Appeals process by at least two years.

Beginning in November 2006, LMSB mandated that its examination teams discuss the FTS process and the benefits it can provide during the opening conference of all LMSB examinations. The mandate also requires LMSB examination teams to request the taxpayer’s consideration of using FTS at the point it is clear an agreement cannot be reached on a specific issue.

VI. Real Time and Pre-Filing Issue Resolution

In addition to the initiatives and new approaches LMSB is implementing improve tax administration in a post-filing environment, LMSB is taking steps to improve tax administration in the pre-filing environment to provide certainty and resolve issues prior to the taxpayer filing the tax return.

A. Pre-filing Agreements

Following LMSB's standup in 2000, the IRS announced the creation of a pilot program known as the Pre-filing Agreement ("PFA") program, which had as its goal the pre-filing resolution of contentious issues arising from completed transactions. See Notice 2000-12.² Under the program, any taxpayer under LMSB's jurisdiction could apply for a PFA on factual issues or issues governed by well-settled law. PFAs can cover the current and up to four future tax years, but the transaction must be complete and the return unfiled at the time of entering the agreement. PFAs may be used to determine appropriate methodology for determining tax consequences affecting future years.

Since the program's inception (through 9/30/08), LMSB has accepted 206 of 306 applications filed and closed 139 with an agreement. The most common issues brought into the program involve worthless stock/bad debts, research credit, cost segregation studies, and the disposition or acquisition of a subsidiary.

In the most recent annual Congressional report on the program, all respondents to a survey conducted at the end of the PFA process said they were satisfied (or very satisfied) with the process; all said they were likely (or very likely) to recommend the PFA process to others. Several taxpayers have completed multiple PFAs.

B. Industry Issue Resolution

Also in 2000, the IRS announced a pilot program known as the Industry Issue Resolution ("IIR") program. See Notice 2000-65.³ The IIR program's goal was to resolve frequently disputed or burdensome business tax issues that affect a significant number of taxpayers by providing clear guidance, reducing the time and expense associated with resolving issues on a case-by-case basis during tax examinations.

The IIR program is available to all business taxpayers served by LMSB. Business taxpayers, industry associations, and other interested parties may submit issues for resolution at any time. The IRS and Treasury evaluate the requests semi-annually. Factors considered include the appropriateness of the issue for the program and whether the requested guidance promotes sound tax administration.

Once a project is selected for the IIR program it is announced publicly. For each issue selected, an IIR team of IRS and Treasury personnel gather relevant facts from taxpayers or other interested parties affected by the issue. Resolution of an issue is generally through published guidance (typically a revenue ruling or revenue procedure), but may include administrative guidance.

² The PFA program was recently made permanent in Revenue Procedure 2009-14.

³ The IIR program was formalized and made permanent by Revenue Procedure 2003-36.

Business tax issues appropriate for the program must have at least two of the following characteristics: (1) the proper tax treatment of a common factual situation is uncertain; (2) the uncertainty results in frequent, and often repetitive, examinations of the same issue; (3) the uncertainty results in taxpayer burden; (4) the issue is significant and impacts a large number of taxpayers, either within an industry or across industry lines; and (5) the issue requires extensive factual development, and an understanding of industry practices and views concerning the issue would assist the IRS in determining the proper tax treatment. The IIR program cannot be used to resolve: (1) issues that involve transactions that lack a bona fide business purpose; (2) transactions with a significant purpose of improperly reducing or avoiding federal taxes; or (3) issues involving transfer pricing or international tax treaties.

There have been 19 completed IIR issues since the program began as a pilot in 2000. Some significant issues that have been resolved through the IIR program include: a conformity election by banks for bad debts (Rev. Rul. 2001-59); an inventory valuation method for re-buildable motor vehicle cores (Rev. Proc. 2003-20); a safe harbor method for treating fiber optic cable (Rev. Proc. 2003-63); health care provider incentive payments (Rev. Proc. 2004-41); and a safe harbor for heavy equipment dealers for use of replacement costs of parts (Rev. Proc. 2006-14).

C. Compliance Assurance Process

In early 2004, LMSB assembled a team of experts to identify opportunities to improve corporate tax administration made possible by enactment of the Sarbanes-Oxley Act of 2002.⁴ Over a period of months, the group conceived of an entirely new compliance approach, dubbed the “Compliance Assurance Process” or CAP, that appeared to offer potential to completely transform corporate tax administration. The CAP model incorporated elements from both the PFA and LIFE programs previously described, but with expanded focus and stringent controls. CAP was introduced in 2005 on a pilot, voluntary basis to 17 corporate taxpayers.

Under CAP, LMSB agents and specialists work with a taxpayer in a *cooperative, real-time, pre-filing* environment to identify and resolve substantive tax issues affecting the taxpayer’s tax liability. Simply put, the goal of CAP is to identify and resolve the taxpayer’s compliance issues *before* the taxpayer files its return, thereby reducing or eliminating the need for a post-filing audit of the return. In theory, this lessens administrative and time burdens for both the taxpayer and Service and enables the Service to use the time saved to improve compliance by examining other taxpayers’ returns. In exchange for its increased cooperation and commitment to transparency, the taxpayer gains the possibility of achieving tax certainty sooner than would be possible through traditional post-filing examinations.

⁴ The Sarbanes-Oxley Act (“SOX”) was a legislative effort to rein in abusive corporate activities through stricter rules for corporate governance, oversight, data integrity, and disclosure for financial reporting purposes.

CAP requires extensive communication and cooperation between the IRS and participating taxpayers. Early in the CAP cycle, a taxpayer enters into an MOU with the IRS. The MOU outlines the roles and responsibilities for both parties, describes the process that will be followed, including communication and disclosure responsibilities. It also enables the taxpayer and the IRS to jointly establish materiality thresholds that will apply to the CAP review, although the ultimate decision of identifying issues for the compliance review remains within the discretion of the IRS.

Transparency and communication are essential elements of the CAP approach and are emphasized in the MOU. The taxpayer enters CAP with the expectation of having to provide pertinent information to the IRS' lead revenue agent on the case (account coordinator) relating to the issues and completed transactions under review. In return, the account coordinator is expected to actively partner and communicate with the taxpayer, efficiently manage and coordinate information data requests, and keep the review process moving forward to timely completion. A taxpayer may be removed from CAP for failing to comply with the terms of the MOU.

There is broad, general agreement within LMSB that the CAP approach has been successful. It has resulted in accelerated pre-filing determinations on key issues and assisted in the identification of emerging issues. Time charged on cases has decreased under CAP, while resolution of significant, unagreed issues has accelerated. The number of taxpayers interested in participating in the program continues to increase. From customer service surveys, the IRS has found that over 90 percent of the taxpayers participating in CAP have been satisfied with their experiences, particularly their working relationships with the CAP account coordinators. These indicators compare very favorably to those of traditional examination approaches.

What's more, taxpayer interest in CAP continues to grow. This year, the program admitted 104 taxpayers, and LMSB currently is evaluating options for its future.

CAP sets a very positive example of how LMSB can interact effectively with large corporate taxpayers to focus on the issues of greatest compliance risk and bring tax return certainty to taxpayers more quickly. CAP is a viable option for taxpayers who are willing to engage with the IRS by showing a willingness to meet transparency and disclosure requirements and participate in open dialogue.

D. Similar International Approaches

Outside the United States, programs similar to CAP have begun to be implemented. In Ireland, for example, Irish Revenue's Large Cases Division ("LCD") introduced a similar approach to managing tax compliance, known as the Co-operative Approach to Tax Compliance. Like CAP, the goal of the Irish pilot program was to promote a collaborative, mutually beneficial approach to compliance, facilitate more efficient use of business and government resources, reduce tax uncertainty, and recognize taxpayer openness. Under the program, large-business participants are expected to share knowledge of their business, business events, and emerging tax risks in real time with

the LCD case manager. The LCD case manager works with the large business to focus on the important issues and, where possible, resolve them. Selective revenue checks then occur to assure the LCD case manager that the business is complying with its obligations.

The Netherlands has also put into place a pilot program similar to the CAP program in the United States. The Netherlands Tax and Customs Administration requires a participant company at its executive level to commit itself to full transparency on current tax issues through a “supervision agreement” signed by the company’s Chief Financial Officer. In return, the government agrees to provide a binding opinion on each issue expeditiously.

E. Advance Pricing Agreements⁵

Internal Revenue Code (IRC) § 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more commonly controlled businesses if necessary to reflect clearly the income of such businesses. Under regulations, the standard to be applied in determining the true taxable income of a controlled business is that of a business dealing at arm’s length with an unrelated business. The arm’s length standard has also been adopted by the international community and is incorporated into the transfer pricing guidelines issued by the Organization for Economic Cooperation and Development (OECD).⁶ Transfer pricing issues by their nature are highly factual and have traditionally been one of the largest issues identified by the IRS in its audits of multinational corporations. The APA Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional examination process. An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method (TPM).

Since 1991, the IRS has offered taxpayers, through the APA Program, the opportunity to reach an agreement in advance of filing a tax return on the appropriate TPM to be applied to related party transactions.

An APA generally combines an agreement between a taxpayer and the IRS on an appropriate TPM for the transactions at issue (Covered Transactions) with an agreement between the U.S. and one or more foreign tax authorities (under the authority of the mutual agreement process of our income tax treaties). With such a “bilateral” APA, the taxpayer ordinarily is assured that the income associated with the Covered Transactions will not be subject to double taxation by both the U.S. and the foreign jurisdiction. It is the policy of the United States to encourage taxpayers that enter the APA Program to seek bilateral or multilateral APAs when competent authority

⁵ The content of this section is extracted from “Announcement and Report Concerning Advance Pricing Agreements,” issued March 27, 2008 as Announcement 2008-27.

⁶ OECD, “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (1995)

procedures are available with respect to the foreign country or countries involved. However, the IRS may execute an APA with a taxpayer without reaching a competent authority agreement (a “unilateral” APA).

A unilateral APA is an agreement between a taxpayer and the IRS establishing an approved TPM for U.S. tax purposes. A unilateral APA binds the taxpayer and the IRS, but does not prevent foreign tax administrations from taking different positions on the appropriate TPM for a transaction. Should a transaction covered by a unilateral APA be subject to double taxation as the result of an adjustment by a foreign tax administration, the taxpayer may seek relief by requesting that the U.S. Competent Authority consider initiating a mutual agreement proceeding pursuant to an applicable income tax treaty (if any).

When a unilateral APA involves taxpayers operating in a country that is a treaty partner, information relevant to the APA (including a copy of the APA and APA annual reports) may be provided to the treaty partner under normal rules and principles governing the exchange of information under income tax treaties.

VII. Other IRS Efforts at Taxpayer Transparency and Improved Reporting

In addition to the programs described above, the IRS has put into place other programs designed to promote taxpayer transparency and better reporting. The goal of these programs has been to improve risk assessment of return filings by the IRS, resulting in earlier tax return certainty for taxpayers.

A. Modernized E-Filing

Most corporations have been able to file electronically using the modernized e-file system the Service implemented in early 2004. Beginning with tax years ending on or after December 31, 2005, certain large corporations are now required to electronically file their returns.⁷ The IRS spent several years collaborating with large corporate taxpayers, practitioners, and software developers to develop systems and rules to facilitate the ability of taxpayers to comply with the electronic filing mandate. Electronic filing of these complex corporate returns is greatly improving the speed and accuracy of tax administration, cutting many months off of the traditional examination process and allowing the IRS to develop sophisticated analytical tools to better select areas of audit inquiry. Taxpayers are benefiting by having return uncertainties resolved more quickly.

⁷ For tax years ending December 31, 2005, corporations with assets of \$50 million or more that file Forms 1120 or 1120S, and file at least 250 returns annually, including income tax, excise tax, employment tax, and information returns, are required to electronically file their returns. For tax years ending December 31, 2006, corporations with assets of \$10 million or more that file Forms 1120 or 1120S, and file at least 250 returns annually, including income tax, excise tax, employment tax, and information returns, are required to electronically file their returns. Beginning in January 2007, the IRS began processing electronically-filed partnership returns (Form 1065 & 1065-B). As of December 7, 2008, more than 56,146 of the largest corporations (those with assets in excess of \$10 million) and more than 27,497 partnerships (with assets in excess of \$10 million) successfully made the transition from paper to electronic returns for the 2007 tax year. Although electronic filing is required of certain taxpayers, others may and have voluntarily converted to electronic filing.

B. Schedule M-3

One of LMSB's most significant recent initiatives is the Schedule M-3, also known as the book-to-tax reconciliation. The Schedule M-3 is designed to improve the ability of the IRS to evaluate compliance risk quickly, identify emerging issues and trends, and better select workload, based on that identified compliance risk.

Schedule M-3 provides data at the time of filing that LMSB can use to identify potential compliance problems. In the past, much of the data required by Schedule M-3 was not available to the IRS until a tax examination was underway, several months after the time of filing. In addition to speeding up needed compliance actions such as tax examinations, the Schedule M-3 is designed to more precisely target compliance problems.

The Schedule M-3 minimizes netting and combining differences between financial accounting net income and taxable income in regard to dissimilar items of income and expense that, in the past, have made it very difficult for the IRS to fully evaluate the risk in a particular return. In the past, taxpayers attached supporting data for the Schedule M-1 to the tax return. There was inconsistency among taxpayers in the content and methodology employed to arrive at the supporting data provided. As a result, the IRS spent considerable time with taxpayers attempting to make the data meaningful for proper issue and tax analysis.

The Schedule M-3 is not only an audit selection tool, but also a de-selection tool. It is allowing the IRS to more efficiently identify and exclude lower risk taxpayers from consideration for examination.

IRS has also revised and developed certain forms (Forms 1120 and 1065 and related schedules) filed by corporations and partnerships in the interest of increased transparency. These changes require reporting of information on the relationship between entities that make up complex business enterprise structures.

The IRS carefully balances requirements for increased information reporting against the potential increased burden on the taxpayer. The taxpayer incentive should be viewed as a shared interest in a tax administration system that requires time and resource expenditure only as needed to resolve issues.

VIII. Key Measures

LMSB employs the services of an independent research firm to measure customer satisfaction on various facets of the examination process for taxpayers who have been examined. Length of examination consistently over the years has been the major issue cited by taxpayers surveyed. Among the other factors influencing customer satisfaction are accuracy and propriety of tax adjustments, scope and depth of the examination and performance of the examiner, including consideration of taxpayer information. LMSB considers the results to identify improvement opportunities. The overall level of satisfaction for IC taxpayers is 82%, and 83% for CIC taxpayers, substantially the same levels as in 2005.⁸

⁸ Reference footnote 1 for an explanation of IC and CIC taxpayer designation.

Quality measurement and analysis of technical application and adherence to established auditing standards by examination personnel is continually performed as part of the LMSB business review process. Since 2005 there has been a marked increase in quality. Overall IC quality has improved from 77% to 88%. CIC quality has improved from 89% to 97%.

Another key measure related to customer satisfaction in cycle time, the length of time to conduct an examination. Since 2003 the average cycle time for all LMSB examinations has decreased from 42.4 months to 31.8 months.

LMSB is developing measures to gauge the effectiveness of the CAP program, which according to the earlier discussion, shows great promise for providing issue resolution and certainty through real-time and transparent interactions with taxpayers. It is interesting to note that CAP taxpayers give the process a 93% customer satisfaction rating. Additionally, cycle time for CAP during the pilot years has averaged less than 20 months.

IX. Tax Administration Impacts in an Economic Downturn

In light of the current severe economic downturn, the IRS is taking steps to ensure a proper balance is maintained between the compliance responsibilities of tax administration, needed economic stimulus, and the financial hardship realities facing citizens and businesses. Because tax payment is a factor in cash flow for taxpayers, whether personal or business, the IRS is able to adjust processes and procedures relating to the collection of tax due and refund of tax overpayments, to preclude personal or business financial failure and, conversely, to support economic recovery. These considerations for taxpayers willing to meet their obligations, but who are financially not able to at this time include:

- Flexibility for missed payments,
- Adjusting terms of existing payment plans for outstanding tax under an existing installment agreement or offer-in-compromise (OIC)⁹,
- Re-evaluation of home asset values for purposes of accepting an OIC,
- Postponement or suspension of collection actions in hardship cases where taxpayers are unable to pay for such reason as job loss or other financial problem.

⁹ An installment agreement is a payment plan for outstanding tax due. An OIC is an agreement between the taxpayer and IRS that settles an outstanding tax debt for payment of a lesser amount. OIC's take into account the taxpayer's net worth.

A significant provision of U.S. tax law permits businesses to carry back a current year net operating loss (NOL) and claim a refund of prior year taxes. In anticipation that many corporations and other businesses are in a current year NOL position, IRS is taking steps to ensure such claims are processed expeditiously, as these tax overpayments represent revenue the affected businesses may need for continued successful business operation. IRS is also taking steps to ensure quick processing and delivery of refunds arising from amendments of prior year returns and overpayments of current year taxes

In addition to timely treatment of NOL and other refund claims, LMSB is currently assessing the tax ramifications of possible increased situations involving bankruptcy and mergers and acquisitions, to determine available actions that can provide affected taxpayers issue resolution and certainty.

X. Moving Forward – Taxpayer Transparency and Risk Management

The experiences of the past nine years since the creation of LMSB have demonstrated that there can be significant benefits to large corporate taxpayers in the management of their tax risk from the early disclosure and resolution of issues and benefits to the IRS from a resource allocation perspective.

From a taxpayer's standpoint, disclosure requirements arising from shareholder reporting rules¹⁰, which can affect share prices, and lengthy audits can be avoided when complex issues are resolved early in the process (ideally in real time or before a return is even filed). The availability of these benefits, though, should depend on the degree to which taxpayers are willing to be transparent in their relationship with the tax administrator.

From a tax administration standpoint, transparency can enhance risk assessment, enabling the government to employ its resources more efficiently, focusing on the highest areas of risk. A lack of transparency by a large corporate taxpayer is a sign to a tax administrator of high-risk behavior. Taxpayers that demonstrate high-risk behavior can expect to attract far more scrutiny than taxpayers who behave transparently. Taxpayers that behave transparently can take advantage of the lower compliance costs that can come from taking a cooperative approach with the government. When taxpayers are open and forthcoming about issues, tax administrators can use risk assessment to make informed decisions about how to allocate resources to areas that are most likely to benefit from attention.

¹⁰ For example, Interpretation 48 ("FIN 48"), issued in June 2006 by the Financial Accounting Standards Board ("FASB") mandates rules for recognition, de-recognition, measurement, and disclosure in U.S. GAAP financial statements of all tax positions taken or expected to be taken in income tax returns. Under FIN 48, a tax benefit may be reflected in the financial statements only if it is "more likely than not" that the company will be able to sustain the tax return position.

Going forward, LMSB is pursuing opportunities for improved transparency in connection with changes occurring in the financial accounting and regulatory environment. Closer alignment of tax reporting and compliance processes with financial statement accounting, corporate management reporting systems, and regulatory filing requirements is an area the IRS will continue to explore. There are significant opportunities to streamline and enhance the desired tax administration objective of greater taxpayer transparency and the desired taxpayer objective of earlier certainty by leveraging financial accounting and regulatory practices.

Many of the initiatives described above have been enhanced by engaging stakeholders in improving our business processes. In this past year, LMSB invited a wide range of external stakeholders to provide input on tax return transparency and disclosure and enterprise compliance risk. The IRS is evaluating the concerns received from this process as it looks to move forward on new tax administration approaches.