COMMENTS CONCERNING LIMITED SCOPE INCOME TAX EXAMINATIONS IN THE INTERNAL REVENUE SERVICE’S LARGE AND MID-SIZE BUSINESS DIVISION

The following Comments represent the individual views of the individual members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on Administrative Practice. Principal responsibility was exercised by Melissa E. Welch, Esq., Thomas J. Callahan, Esq., and Gregory J. Gawlik, Esq. Substantive contributions were made by Phillip L. Mann, Esq., Thomas J. Callahan, Esq., and Gregory J. Gawlik, Esq. The Comments were reviewed by William Kalish, Esq. of the Section’s Committee on Government Submissions and by Loretta C. Argrett, Esq., Council Director for the Committee on Administrative Practice.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principals addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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EXECUTIVE SUMMARY

In an effort to improve tax administration within the Internal Revenue Service’s (the “Service”) Large and Mid-Size Business Division (“LMSB”), the Commissioner of LMSB, Larry Langdon, solicited the views of the individual members of the Committee on Administrative Practice of the Section of Taxation. Specifically, Commissioner Langdon requested responses to a list of seven questions concerning the development of limited, issue-focused income tax examinations and increased participation by taxpayers in the audit planning process.

The individual members of the Committee on Administrative Practice have responded to this initial list of seven questions (attached hereto as Exhibit A), as well as an eighth question regarding the development of a materiality threshold suggested during the course of a recent discussion between Service representatives and ABA Tax Section members (See Exhibit B). The Comments of the individual members of the Committee on Administrative Practice reflect the thoughts and experiences of both individual members who practice before the Service and individual members who are in the industry.

As we set forth our Comments on these matters, we want to take this opportunity to commend LMSB for seeking to improve both the examination process and relations with taxpayers.
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1. In order to accelerate the examination process in relation to rollover issues (timing issues that affect multiple examination years), would you be willing to:
   a) compute rollover issue adjustments and present them to the team for incorporation into the Revenue Agents Report,
   b) amend your return for rollover issues, or
   c) could you suggest more efficient ways of handling rollover issues? If so, please explain.

We support the practice of computing agreed rollover adjustments for presentation to the examination team for inclusion in the Revenue Agents Report. In fact, our experience has shown that many taxpayers currently make such computations as part of their audit procedures.

While we are not completely opposed to amending returns for rollover issues, we note that such a procedure is only practical when final agreement has been reached as to all issues or when the Service has indicated that it does not intend to audit affected years subsequent to the current audit year. For purposes of making this a more favorable option, perhaps the Service could articulate both the advantage or necessity of amending returns for a single agreed issue while others may remain in dispute, and a fair procedure for making limited review of amended returns possible.

In addition, the avoidance of unnecessary timing adjustments will increase the efficiency of the examination process. We would encourage Revenue Agents to work with taxpayers to determine if issues may self-correct within the current audit cycle or shortly thereafter before making such timing adjustments.

2. In order to accelerate the examination process in relation to recurring issues (technical issues that appear in multiple years), would you be willing to:
   a) disclose recurring issues and compute the adjustments so the team could incorporate them into the Revenue Agents Report,
   b) amend your return for recurring issues, or
   c) could you suggest more efficient ways of handling recurring issues? If so, please explain.

In situations where the recurring issue is agreed, we believe that disclosure of such issues is appropriate on a going-forward basis. If for no other reason, disclosure of such recurring agreed issues should be encouraged because it provides an early indication of the eventual impact of the issue and enables both sides to make appropriate resource allocation decisions. As with the computation of rollover issues in Question 1, we believe that many taxpayers are already disclosing recurring agreed issues and providing relevant computations in an effort to help Revenue Agents accelerate the examination process.
On the other hand, where the Service and the taxpayer disagree on the proper treatment of an issue, we feel that normal audit procedures are appropriate. In part, taxpayers’ fear of penalties may be a motivating force in their decisions not to disclose unagreed issues. As noted in later portions of these comments, we urge the Service to consider offering incentives for taxpayers, such as some form of penalty protection, to encourage disclosure of unagreed non-tax shelter issues.

As for amending returns for recurring issues, we reiterate our observations made above in Question 1 with respect to amending returns for rollover issues.

3. **Assuming that a subsequent cycle will not be examined or the taxpayer has yet to file a subsequent year return, what mechanism would the taxpayer suggest to provide the Service with assurance that these rollover and recurring issues will be dealt with as agreed upon during the examination, thus eliminating the need for an examination of these issues?**

A closing agreement entered into at the examination stage is the best method of providing assurance that taxpayers will deal with agreed rollover and recurring issues in subsequent unaudited years in the manner agreed upon during the current examination. We note that the complexities of, and delays in, obtaining approval for formal closing agreements are counterproductive to the goals of simplification and expediency that the Service hopes to achieve. Therefore, we recommend the reformation of the closing agreement process to allow the execution of a “fast-track” closing agreement for rollover and recurring issues at the examination stage.

4. **If the IRS indicated that it would conduct a limited, issue focused examination, what would you be willing to do to enhance the process? Examples may include, providing three-year comparative analysis of the Schedule M, enhanced disclosure of the significant issues on the return, or meaningful participation in the audit planning process.**

We enthusiastically welcome opportunities for taxpayers meaningfully to participate in the audit planning process. Because truly controversial and significant issues often have an impact on the taxpayer's business beyond the current year, taxpayers want (and need) a chance to voice concerns regarding industry-specific issues as well as to present information on the business' history and future goals.

Of course, active participation by taxpayers in the audit planning process may logically require increased disclosure, which seems to be one of the primary themes of the Service's efforts to improve tax administration. Accordingly, to the extent that taxpayers may be expected to increase their level of voluntary disclosures concerning current transactions, material issues, etc., we would encourage the Service to respond in kind with future incentives, such as penalty protection. Our primary concern is that taxpayers, who are actively participating in the audit planning process and who are making
disclosures in good faith, will not be subject to penalties or other reprisals for failing to identify or disclose any particular issue that the Service unilaterally deems material.

We believe that taxpayers would be willing to provide comparative Schedule M analysis to the Service even though this information is already in the hands of the examination team. As indicated in our answer to Question 8, we believe that it would be appropriate to apply some form of materiality threshold to amounts reflected on Schedule M or for purposes of making audit decisions.

5. **If you had the Forms 5701, Notice of Proposed Adjustment, for all of the issues, would you be willing to forgo receipt of a Revenue Agents Report if the case was totally unagreed? Would you have any concerns if Appeals provided the final computations upon completion of the Appeals proceeding?**

Because the Revenue Agents Report ("RAR") is often a compilation of the Forms 5701, we acknowledge the expediency and simplification of foregoing the RAR in totally unagreed cases. Additionally, taxpayers would benefit from the fact that “hot interest” would not begin to run in the absence of a 30-day letter. Furthermore, we see no problem with having Appeals provide the final computations upon completion of the Appeals proceeding.

6. **What are the existing barriers to taxpayers and the IRS working together to conduct limited, issue focused examinations? Please provide barriers that exist for both the IRS and you as a taxpayer. What are your suggestions for eliminating these barriers?**

The most significant barriers to limited, issue-focused examinations are the parties' predispositions, "results-driven" attitudes, and lack of knowledge.

First, the parties often come to the table with preconditioned feelings of fear and distrust: the Revenue Agent thinks that the taxpayer is hiding significant issues that he might miss; the taxpayer anticipates that the Revenue Agent will take unreasonable positions and inappropriately impose penalties. Second, instead of consistently focusing on the "right" result, both sides become preoccupied with the pressures of "prevailing" as to the overall outcome of the examination. This makes it difficult to reach mutual agreement on a limited number of material issues on which to focus. Third, both parties lack knowledge with respect to certain substantive issues. From the taxpayer’s perspective, this often manifests itself in uncertainty as to the Service's willingness to impose penalties in certain situations or the Service's position on various transactions (both new and old). From the Revenue Agent’s side, a lack of thorough understanding of the specific industry often causes them to focus on insignificant issues, or nonissues, thus lengthening the audit.
These barriers may be eliminated (or lowered) in several ways. First, as an initial step toward changing the parties' attitudes, perhaps the parties could sign an informal agreement upon commencement of the audit planning stage. In the spirit of cooperation, the agreement would state the taxpayer's intention to make good faith efforts to disclose all material facts and transactions in an attempt to formulate a limited issue-focused examination plan. In turn, the agreement would set forth the commitment of the Revenue Agent to limit the issue-focused audit to only the issues agreed upon. Such a commitment on the part of the Revenue Agent is particularly important because unless selection procedures have some binding force, the Revenue Agent may unnecessarily prolong the audit by becoming entrenched in issues insignificant to the particular industry at hand. Second, the Service should assign to the audit only Revenue Agents who are familiar with the industry in order to avoid unnecessary expenditures of time and effort. Third, the Service should make a renewed effort to impose penalties only in the most egregious cases. The automatic assertion of penalties inhibits voluntary disclosure and fuels unwarranted taxpayer fears. Finally, the development of materiality standards (see Response to Question 8 below) and increased Revenue Agent training as to industry issues would be extremely helpful.

7. **What are the benefits to taxpayers and the IRS working together to conduct limited, issue focused examinations?**

Cost savings are perhaps one of the biggest benefits to taxpayers and the Service working together to conduct limited, issue-focused examinations. Streamlining the audit process will enable both sides to commit less time and fewer resources to each examination.

Additionally, we see the potential for improvements in overall attitudes and compliance in the long run. By focusing resources on a select number of truly significant issues, there is an increased likelihood that the "right" result will be obtained. Such an approach is more beneficial than spreading resources thin, resulting in the inadequate resolution of an inordinate number of less significant issues over a prolonged period of time.

8. **How can the Service develop a standard for materiality to be used in connection with tax examinations? In this regard, the Service is interested in developing a numeric based model for materiality.**

Keeping in mind that materiality thresholds should be adjusted on an industry-by-industry basis, we think the following items generally should not be considered to be material:

- Timing adjustments, not involving a change of method of accounting, that turn around in a year or two.
- Repair expenses, and travel and entertainment expenses, that are not out of line with industry averages by more than 5%.
- Estimates of fair market value that are within 10% of the estimates of the Service’s experts.
- Section 482 adjustments and inventory adjustments, not involving a change of method of accounting, that do not vary taxable income by more than 2%.

Additionally, in developing its materiality standards, the Service could do the following:

- Review acquisition and divestiture transactions which exceed the lesser of (i) $10 million and (ii) 10% of the net book value of the assets of the taxpayer.
- Review all Schedule M items in excess of 3% of net gross receipts.

For public companies, the Securities law filings should also disclose major items or events.

In conclusion, we want to take this opportunity to thank the Service for soliciting our Comments and suggestions concerning methods to improve tax administration within LMSB. In that regard, if you have any questions or comments with respect to the matters discussed herein, please call either Thomas J. Callahan (216-566-5612) or Melissa E. Welch (703-369-4738).
On May 22, 2002, various Service representatives and ABA Tax Section members conducted a conference call in which they discussed the Service's primary objectives with respect to its initiative on improved tax administration within LMSB.

During the course of discussion regarding the original set of seven questions issued by LMSB Commissioner Larry Langdon for consideration, an eighth question was suggested by Service representatives. The basic substance of that question was as follows:

How can the Service develop a standard for materiality to be used in connection with tax examinations? In that regard, the Service is interested in developing a numeric based model for materiality.

Participants in the conference call included:

Phillip L. Mann, Esq.
Craig A. Leeker
Frank Ng
Amy Liberator
Thomas J. Callahan, Esq.
Herbert N. Beller, Esq.
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