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## Report Supplement Tax Administration

### Tax Compliance

#### IRS to Continue Tax Compliance Push; Effect on Audits, Planning Uncertain

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It is difficult to predict whether and how the Internal Revenue Service will act to increase its enforcement activities in 2007 compared with past years due to budget and other uncertainties, senior IRS officials said in interviews with BNA.

Meantime, practitioners said they are concerned future audit practices may be overly influenced by IRS's recent aggressive behavior toward marketed tax shelters and worry that examiner attitudes may not properly adjust to an environment where the inventory of blatant abusive behavior has largely been eliminated.

The agency's collection efforts, notably the decision to begin in 2006 to use private debt collectors to enforce audit decisions, remain deeply unpopular in the Congress; National Taxpayer Advocate Nina Olson recommended in early 2007 that Congress repeal IRS's authority to enter into contracts with outside firms to collect delinquent federal tax debt.

And fused to noncompliance efforts is the government's push to reduce the tax gap, the difference between taxes owed and taxes actually paid in a timely

fashion. The issue is likely to receive more congressional attention in 2007 than in past years, in part because a chief IRS critic concerning the tax gap, Sen. Max Baucus (D-Mont.), is serving as chairman of the Senate Finance Committee--a committee whose jurisdiction includes IRS.

As a result of these and other developments, many practitioners said 2007 likely will be a year in which IRS compliance efforts, and specifically its examination methods and agent behavior, may shift to focus on new or different compliance challenges.

"My experience tells me we're going to begin to see whether and how the IRS will make the transition as they apply [enforcement actions] to transactions that are aggressive but not abusive," said Miller & Chevalier practitioner Lawrence Gibbs, who served as IRS commissioner during 1986-1989. "I am hoping that the IRS will be able to deal with the individual judgment and training and management challenges and get it right, but I think the jury is still out on that."

### **'Dramatic Turnaround.'**

Practitioners and IRS officials largely agreed that government efforts to combat tax code noncompliance have significantly increased since the nation's 46th commissioner of internal revenue, Mark Everson, took office in May 2003.

And while many said enforcement trends under Everson have improved continually, current IRS enforcement levels nevertheless are far below levels registered 10 and even 30 years ago. Some IRS critics also have complained that service to taxpayers has suffered as IRS ramps up its enforcement work.

A chief indicant of Everson's tenure has been a marked statistical improvement in many enforcement areas, such as the number of audits performed on individual and corporate taxpayers and revenues collected as a result of enforcement activities.

For example, IRS collected a record \$48.7 billion in enforcement revenue in fiscal year 2006, an increase from \$47.3 billion in FY 2005 and \$33.8 billion in FY 2001, according to IRS data released Nov. 20.

Audits of companies with assets of less than \$10 million, Subchapter S corporations, and partnerships all increased during FY 2006 compared with FY 2005, the data showed. Audits of all classifications of businesses increased 67 percent between FY 2004 and FY 2006.

"It has been a dramatic turnaround," former IRS commissioner Donald Alexander told BNA.

But Alexander said some enforcement measures are significantly below levels registered in the past. "I think [IRS] had a very long way to go and I think they haven't gone as far as they should yet. ... [T]hey still haven't developed a comprehensive compliance program and put it into effect as existed in the years before the disasters of 1997 and 1998," said Alexander, referring to a period of general backlash against IRS enforcement actions due in part to Senate hearings highlighting what hearing witnesses claimed were abusive IRS enforcement tactics.

Further, IRS wants to continue to increase its audit coverage for at least certain groups of taxpayers. "If we receive additional resources, our intent would be to increase our coverage ... but without knowing [IRS's approved budget] it's hard to comment," IRS Large and Mid-Size Business Division Commissioner Deborah Nolan said in an interview.

### **Fewer Audits**

Indeed, IRS audited 50 percent fewer total companies in FY 2006 than it did in FY 1997, the IRS data showed. In fact, every category of business taxpayer--small business, large taxpayer, and even tax exempt--was audited fewer times in FY 2006 than in FY 1997 when expressed as a percentage.

"So, they still have a way to go [but] at last they're moving in the right direction," said Alexander, who served as IRS commissioner from 1973-1977 and is now a partner at Akin Gump Strauss Hauer & Feld LLP.

Mark Matthews, who resigned from his post as IRS deputy commissioner Dec. 1, agreed. "While there have been some remarkable advances in the last few years, we're still barely back to some of the levels that existed 10 years ago. And in 10 years, the number of taxpayers has grown, the complexity of the code has grown, the size of the economy has grown. So, I would think they still need to do more," he said.

### **Narrowing the Tax Gap**

Combating tax law noncompliance is a direct attack upon the tax gap, and closing the tax gap will continue to be a chief IRS goal in 2007, IRS Deputy Commissioner Kevin Brown said in an interview.

"When I was commissioner of [IRS's Small Business/Self-Employed Division] this was my number one concern and it remains my number one concern in this job, and I know it's extremely high on the commissioner's list as well," said Brown, who succeeded Matthews as one of IRS's two deputy commissioners.

An IRS research project estimated the tax gap for tax year 2001 alone was \$345 billion.

Matthews, currently a partner at Morgan, Lewis & Bockius LLP, told BNA that while increased focus on the tax gap helped to highlight the issue, it also publicized just how difficult it will be to effectively minimize it. "I think it took us decades to get a tax gap of this size and recognize what it is, and it's going to take us a long time to reduce the tax gap," he said.

"The tax gap will always be with us. It's a matter of its size and the management of it," Matthews said. "We are not going to enforce our way out of the tax gap. You wouldn't want to live in a country that tried to do that," he added. "There are no quick fixes for the tax gap."

### **Noncompliance Concerns Outlined**

At the beginning of the 2007 tax filing season, senior IRS officials discussed what tools used to combat noncompliance have worked in the past and IRS's plans to combat noncompliance with the tax code in 2007 and beyond.

For instance, Nolan said IRS is paying closer attention to several types of transactions possessing international components. A chief concern is transactions generating foreign tax credits.

"That is one that we feel is probably one of the more abusive ones, and then there are some very broad issues such as transfer pricing, which can even be industry specific such as tangible assets or intangibles," Nolan told BNA.

University of Michigan law professor Reuven Avi-Yonah told BNA his research indicates abusive offshore activity such as falsely claiming foreign tax credits is "flourishing" and costs the U.S. treasury about \$50 billion each year, more than all domestic tax shelter abuses combined.

Smaller business taxpayers, too, have attracted the attention of IRS noncompliance efforts because IRS estimates a large portion of the tax gap is attributable to small businesses and self-employed individuals. Sideman & Bancroft LLP practitioner Wendy **Abkin** told BNA that in 2007 she likely will advise clients submitting income on Form 1040's Schedule C to be cautious due to the possibility of an increasing chance of audit.

IRS in 2007 is likely to possess a "renewed emphasis on looking at the small businesses that constitute more than \$100 billion of the tax gap," Matthews said.

In part to hone its auditing skills of those taxpayers, IRS will continue its work on a

major research project to update IRS's data on small business and self-employed taxpayers.

### **Auditing Sample**

A chief component to the study is an auditing sample of about 5,000 Subchapter S corporations. IRS Small Business/Self-Employed Division Commissioner Brady Bennett said in an interview the audits likely will conclude in April 2007, with conclusions based on the data developed by December 2008.

Brown said such audit programs aim to help IRS identify compliance risk areas and help improve auditing practices to reduce the number of no-change audits.

"Our plan now is to do more research and to refresh that data on a regular basis," Brown said. Such data helps determine the extent of the tax gap while helping IRS better target its resources, he added.

Another tool IRS will attempt to use in 2007 in its work to combat noncompliance is to again forward to Congress legislative proposals to help fight the tax gap. A chief legislative proposal in IRS's FY 2007 budget, rejected by Congress, was to require payment card companies to send information related to vendors' business gross receipts to IRS to combat the underreporting of income.

### **Improving Dispute Resolution Trends**

IRS officials and practitioners said IRS has been successful in reducing both audit currency and the time it takes to perform an audit.

"A few years ago it would have been considered common for audits to stretch back eight or nine years and you just don't see that anymore. ... Currency is vitally important to the tax directors at large corporate taxpayers. So once IRS made being current a priority it was a straightforward matter to get there," Cleary Gottlieb Steen & Hamilton LLP partner Edward Kleinbard said in an interview.

Kleinbard attributed much of that success to Everson and IRS Chief Counsel Donald Korb. "They've made it a high priority and that is reflected in the audit process," he said.

IRS officials also said the agency would continue its use of alternative dispute resolution tools in an attempt to reach relatively quick agreement with taxpayers engaged in tax disputes with the government.

## **Fast Track Settlements**

One key type of alternative dispute resolution is fast-track settlement, under which taxpayers and IRS agree to nonbinding arbitration in an attempt to resolve outstanding tax disputes. "Fast track, I would say is one of the key successes in terms of our issue management strategy, and just from a pure cycle time standpoint it takes an issue that was traditionally resolved in almost two years down to about three months," Nolan said.

IRS initially rolled out fast-track settlement for LMSB taxpayers in 2003; on Aug. 22, 2006, the service expanded fast track settlement on a two-year pilot basis to SB/SE taxpayers in three metropolitan areas.

Bennett, who assumed his responsibilities Dec. 1, said it is too early to discuss whether the program is helping to resolve tax controversies in his division. But he did say his division will try to mirror the success larger taxpayers have had with alternative dispute resolution tools.

Nolan pointed to increased use of other tools aimed at avoiding, or resolving quickly, tax-related legal disputes. One of them is the compliance assurance program (CAP), a prefiling agreement under which taxpayers consult with IRS about complex tax issues before tax forms are filed.

But the number of taxpayers participating in CAP is less than 100, and Nolan said a chief driver for companies wanting to participate in the program is not pure tax concerns but rather reporting requirements introduced by the Financial Accounting Standards Board's Statement No. 109 and Interpretation No. 48.

"I think the results we are seeing on the CAP program are mixed. It sounds wonderful in concept but in implementation I think a number of clients are experiencing difficulties," former Treasury Department Tax Legislative Counsel Helen Hubbard told BNA.

## **Auditor Experience, Attitude**

Many practitioners expressed varied concerns about IRS's auditing process and its examination staff, including sober criticisms regarding the quality of examiners' work. IRS officials have conceded that attrition of agents and the need to train new ones is, and will be, a chief challenge for the service in 2007 and beyond.

"The quality of some of the 30-day letters I've seen lately, frankly--my sixth-grader could write a better report. When they are disallowing millions of dollars of a deduction, when they're having an impact like that on somebody, I think it offends the taxpayer to have a report that is not even grammatically correct or even more troubling it just doesn't have the facts correct. They've taken a canned opinion

and done a bad cut-and-paste job," Sideman & Bancroft's **Abkin** said.

Not all practitioners had such criticisms, however. "I have seen a lot of new agents lately. A lot are from law firms and accounting firms, they have experience, they understand how things work and that actually makes the audit flow more smoothly," Deloitte Tax LLP practitioner Debra Estrem, a former IRS special trial attorney, told BNA.

Another topic mentioned by many practitioners was IRS examiners' attitude toward the exam process and taxpayers. Because many of today's auditors were trained at a time when IRS began scrutinizing alleged tax shelters and other blatant abuses occurring in the late 1990s, they have an aggressive approach to auditing that may not be warranted as those abusive cases are eliminated from IRS's audit inventory, they said.

"As to the past IRS actions ... taken against abusive tax shelters, I think [IRS agents] were probably as tough as they had to be in order to convince taxpayers that the IRS was serious and to deter taxpayers from doing similar transactions in the future," former IRS Commissioner Gibbs said.

"The key question now is whether the IRS will continue to use the same tough actions against taxpayers and practitioner behavior that is not as abusive," he said.

If so, Gibbs said, "IRS could be seen as being too tough and too intrusive. Is the revenue agent going to be able to tell the aggressive transactions that are not abusive from the abusive transactions of the past?"

"There was a lot of outrage over the marketed tax shelter programs, but I think that attitude has now spilled over to what previously was regarded as ordinary tax planning. And it's hard to know how this is going to wind up. I do think that the government feels very empowered these days to go after big companies," King & Spalding LLP partner Robert Woodward told BNA.

### **'Looking for a Problem'**

How agents will act in the time following IRS's attack on abusive tax shelters "is a fair concern," **Abkin** said. "They are going in looking for a problem. That is what they're trained to do, that is after all their job."

"But if that hostile attitude toward shelters carries over, then I think it is going to feel like a kind of persecution to a taxpayer. It should be a neutral situation in terms of the attitude the agent brings to an exam," she said.

"There were a lot of illegitimate tax shelters out there and I think IRS has dealt with them very strongly and pretty well wiped them off the map. But in wiping them off the map I think some IRS people, in their zealotry to apply strict construction, have imposed ... penalties where penalties should not be asserted and have demanded particular results," Alexander said.

"What we're seeing today is a proliferation of penalties," said Gibbs.

### **Taxpayer Reaction**

Taxpayers, in response to those enforcement measures and auditing practices, have reacted in many ways. First, taxpayers are now undoubtedly more conservative in their tax strategies, transactions, and behaviors. This conservatism is also fueled by new financial statement requirements, practitioners said.

"In the domestic arena there is much more caution about engaging in aggressive transactions. People have to think about how aggressive they want to be," University of Michigan law professor Reuven Avi-Yonah told BNA.

Gibbs said he suspects that "taxpayers are still going to do tax planning. But what that is likely going to mean is that more taxpayers are going to have to spend more time and more money dealing with the compliance side, that is to say IRS audits of transactions. ... I think taxpayers are certainly more conservative than they were in the 1990s, but I don't think they're pulling back so far that they're not doing transactions designed to minimize taxes," Gibbs said.

Also, the willingness--some practitioners said eagerness--of IRS auditors to examine new types of transactions is causing uncertainty in the auditing process, with many practitioners complaining that IRS examiners misinterpret existing statutes due in part to a lack of published guidance on complex components of the tax code.

"My sense is that there are a lot of things being used to attempt to be more effective from an audit perspective and that there is so much change going on in the audit process that it is going to be some time before things settle down and we reach the point of maximum efficiency," Hubbard said.

An example is IRS's decision to centralize decision making for certain tax controversy issues, Hubbard said. "When you have a situation where many taxpayers have done the same thing, then centralization makes all the sense in the world because you have consistent results for taxpayers, and individual agents don't have to reinvent the wheel," she said.

"But when you use centralization where there are factual differences among cases and the taxpayers are not able to have interaction with the decision makers, then the process begins to break down," she said. That problem could be fixed with additional guidance issued on specific tax related controversies, Hubbard said.

### **Next Steps**

Additional success enhancing tax compliance and combating the tax gap in 2007 will depend in large part on IRS's appropriations for fiscal years 2007 and 2008, the service's ability to shift workers to front-line enforcement positions, and paying more attention to areas of noncompliance IRS has not targeted yet, the IRS officials said.

While the 109th Congress did not approve an IRS appropriation for FY 2007 before it adjourned, it did approve Dec. 9 a continuing resolution expiring Feb. 15 that funds federal agencies aside from the Defense Department and the Department of Homeland Security at the lowest of three appropriation levels--the level approved by the House, the Senate, or its FY 2006 budget. If funding for IRS is not increased in FY 2007 it would mark the first time in Everson's tenure IRS did not receive a budget boost.

Matthews said if the American public wants to see continued tax law compliance improvements, Congress likely will have to increase IRS's budget. "When you look at the trajectory of the turnaround and see double-digit increases in some of the percentages [such as audit coverage increases], they've done a pretty good job. ... But at the end of the day if the Congress wants those trend lines to continue IRS is going to need some more funding support," he said.

Another way for IRS to improve tax code compliance in 2007 is to continue shifting resources toward enforcement actions, IRS officials and practitioners said. Since at least 2005, IRS has been eliminating service jobs and using that funding to hire enforcement workers. IRS also is looking at shifting its internal auditing resources.

"One of the ideas they're looking at is shifting the mix of the work in the corporate community. The notion of increased scrutiny on midmarket companies is clearly an agreed upon goal," Matthews said.

### **Solomon Confirmation**

Another development that could affect tax policy, and thus possibly tax compliance, is the confirmation of Eric Solomon to be assistant treasury secretary for tax policy, a position that had been vacant since Pamela Olson left the job in

February 2004.

Hubbard, who worked closely with Solomon during her tenure as Treasury's tax legislative counsel, said his appointment "could make a significant difference because Treasury has been operating on what was, in essence, a short staff at the top level for a very long time."

Treasury possesses six top lawyer positions, and there was a period after Olson left when four were vacant, Hubbard said. With Solomon in place, Treasury is "actively" seeking to hire Treasury's senior tax policy staff, she said.

A full complement of Treasury Department tax policy lawyers will allow Treasury to increase its output of guidance, enhance its role in developing legislative proposals, and increase its ability to work with the tax writing committees on Capitol Hill, Hubbard said.

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### **Scrutiny of International Transactions to Rise**

The Internal Revenue Service will focus particular attention in 2007 on large taxpayers' international activities, IRS Large and Mid-Size Business Division Commissioner Deborah Nolan told BNA.

IRS Commissioner Mark Everson forecasted the types of actions IRS will scrutinize at a June 2006 Senate hearing when he said chief LMSB compliance concerns related to international transactions included shifting profits offshore in ways that result in the transfer of valuable intangibles to related foreign entities for inadequate consideration, abusive foreign tax credit transactions, arbitrage, and transfer pricing.

Nolan said IRS will pay close attention to three provisions in the American Jobs Creation Act (Pub. L. No. 108-357) to ensure taxpayers do not abuse the law's tax-related items. At the 2006 hearing, Everson said taxpayers could enter into abusive behavior related to those provisions, which: provide deductions for certain manufacturing activities conducted in the United States under Internal Revenue Code Section 199; allow taxpayers to repatriate foreign earnings to the United States at a reduced tax rate provided they satisfy certain requirements under code Section 965; and require, under code Section 409A, certain corporate executives to report all deferred amounts under nonqualified deferred compensation plans to the extent they are not subject to a substantial risk of forfeiture and generally not previously included in income.

**Designated Personnel.** Nolan said that while IRS has not decided on specific compliance measures or adjustments to auditing practices to monitor taxpayer use of the Jobs Act provisions, the agency has designated personnel to focus on each of the three provisions. "I think what you will see is more focus on international issues of compliance risk, and a great level of specialization and expertise internally," she said.

A chief concern of LMSB is the claiming of foreign tax credits, Nolan said.

Cleary Gottlieb Steen & Hamilton LLP partner Edward Kleinbard told BNA that the push to scrutinize foreign tax credits emanated from Everson and IRS Chief Counsel Don Korb. But, he said, the field "doesn't have any more guidance than it had two or three years ago." The result is an auditing process where both taxpayers and IRS examiners lack clear guidelines regarding which transactions work. "Everybody is making it up as they go along. We know there are some limits, but how they should be applied and be weighted is unclear," Kleinbard said. Eventually, however, appropriate guidance and other enforcement tools will be developed by IRS and a clear set of rules regarding foreign tax credits will emerge, he said.

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### **IRS Faces Compliance Personnel Challenges**

The Internal Revenue Service faces a significant challenge posed by retiring tax return examiners as it continues its work to enhance its compliance efforts, IRS officials said.

The number of IRS auditors decreased about 25 percent between 1998 and 2003, IRS Deputy Commissioner Kevin Brown said in an interview. Since 2003, IRS has worked to fill that gap, boosting its exam staff in real terms, he said.

Still, to train agents requires IRS to assign experienced audits to training duties instead of having them audit tax forms, Brown said. And recent attrition levels of IRS auditors is about 10 percent, Brown said. "This is likely to be an ongoing problem," he said.

"We anticipated a baby boomer effect for 2006, 2007, 2008, and we are seeing that. Fortunately most of our revenue agents stay a few years past retirement eligibility, and we'd like to think that's because they feel their jobs are meaningful, they enjoy public service, and they are engaged. But nevertheless that bubble is coming and so we need to prepare for it," Large and Mid-Size Division Commissioner Deborah Nolan said in an interview.

**More Auditors Hired.** One step LMSB has taken to deal with the attrition challenge is to simply increase its hiring of auditors. In fiscal year 2006 LMSB alone hired 670 auditors, Nolan said.

Second, IRS has begun hiring externally more experienced, higher worker-grade auditors in an attempt to combat the loss of senior auditors, she said.

Despite those efforts, practitioners said in interviews that current IRS auditing staff members at times can be inexperienced and possessing inadequate training. "I think there is a big difference between the theory and policy expressed at the higher levels [at IRS] and what is put into practice when you're in the trenches doing hand to hand combat with agents," Sideman & Bancroft LLP practitioner Wendy

**Abkin** told BNA.

"Personally, I feel part of that is attributable to the lack of experience that we're seeing now as the agency has had this drain of more experienced people leaving," she said.

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## FASB Guidance to Play Role

One developing circumstance affecting tax law compliance is the effect of financial reporting requirements such as the Financial Accounting Standards Board's Interpretation No. 48 (FIN 48) on accounting for uncertainty in income taxes, the head of the Internal Revenue Service's Large and Mid-Size Business Division said.

The Sarbanes-Oxley Act and FASB's Statement No. 109 on accounting for income taxes are other key compliance factors, LMSB Commissioner Deborah Nolan said.

FIN 48 is effective for fiscal years beginning after Dec. 15, 2006, which means taxpayers will need to comply with the interpretation for the first time during 2007.

"The corporate environment has changed pretty significantly over the last couple of years with Sarbanes-Oxley and increased corporate governance, at least for taxpayers requiring certified financials," she said.

**Practitioners Agree.** Taxpayers currently have their tax contingencies scrutinized by their audits more closely than in the past, King & Spalding LLP partner Robert Woodward told BNA. "I think that there's a parallel battle between companies and their auditors as well as potential future battles with the Internal Revenue Service. But the battle with the auditors comes first," he said.

"Almost everyone I talk to lists [FIN 48] as their number one issue. The uncertainty, the amount of documentation potentially required, the concern about what that documentation may ultimately be used for--the issues are tremendous. It is just mind boggling," Baker & McKenzie partner Helen Hubbard told BNA.

Many taxpayers seek to reduce uncertain tax positions relatively early and are turning toward LMSB's compliance assurance program (CAP), Nolan said. Under CAP, taxpayers participate in continuous audits in which issues may be resolved before a company's tax return is filed. "I think it's driving taxpayer interest and behavior, and for many taxpayers CAP will be very attractive. Prefiling agreements, advanced pricing agreements, any process that gives them certainty sooner," Nolan said.

In FY 2006, 39 taxpayers participated in CAP; Nolan said IRS is "engaged in discussions" with those firms and about 30 more about either staying in the program or entering it for the first time.

But not everyone is satisfied with CAP.

"I think the results we are seeing on the CAP program are mixed. It sounds wonderful in concept but in implementation I think a number of clients are experiencing difficulties," Hubbard said.

Indeed, some taxpayers have bluntly told IRS they do not want to participate in the program, practitioners said. 📄

*By Stephen Joyce*