

Statement

of

J.A. (Drew) Glennie
General Manager — Tax & Insurance
Shell Canada Limited



on behalf of

Tax Executives Institute, Inc.

on

IRS Enforcement Challenges

before the

IRS Oversight Board

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Good afternoon. I am Drew Glennie, General Manager — Tax and Insurance for Shell Canada Limited. I appear today as the President of Tax Executives Institute, the preeminent association of business tax professionals. I am accompanied by the chair of TEI's IRS Administrative Affairs Committee, David L. Bernard of the Kimberly-Clark Corporation, as well as the Institute's Executive Director, Timothy McCormally, and by our General Counsel and Director of Tax Affairs, Fred Murray. The Institute is pleased to participate in the Oversight Board's hearing.

Background

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 53 chapters in the United States, Canada, and Europe. Our 5,200 members are accountants, attorneys, and other business professionals who work for 2,800 of the largest companies in North America and Europe; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI represents the business community as a whole, and our members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis. TEI is dedicated to the development and

effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

The companies that employ TEI's members have almost without exception been assigned to the IRS's Large and Mid-Size Business (LMSB) Division. The largest 1,600 taxpayers within LMSB are subject to ongoing audits as part of the Coordinated Industry Cases (CIC) program. The Institute's testimony is largely based upon our experience with this segment of IRS operations. We are pleased to offer our views on the enforcement challenges within LMSB.

The Components of an Effective Enforcement Strategy

TEI believes that a successful enforcement strategy has the following characteristics:

- **Clarity.** The ability to understand the tax law — and to comply with it in an efficient fashion — is a critical component of an effective tax system. Taxpayers must understand their responsibilities and commit resources to comply with the law in as efficient a manner as possible. Sadly, the current state of the law — which is marked in many cases by complex, ambiguous provisions that may produce unintended consequences — leaves much to be desired. We recognize that true simplification begins with Congress, but there are ways in which the law can be made simpler by the IRS. For example, the Treasury and IRS are to be commended for the inclusion of *de minimis* rules and safe harbors in the recent proposed regulations on the capitalization of expenditures. We also believe the consultative process used by the government before issuing these proposed regulations — last year the government used an advance notice to invite comments on a broad range of issues and then reflected many of those comments in the proposed regulations — will produce rules that reduce compliance and administration costs and minimize uncertainty and controversies to the benefit of taxpayers and the government. This approach could serve as a model for other projects.
- **Confidence.** Taxpayers must have confidence in the integrity of the tax system. The law must be applied evenhandedly, and taxpayers must believe that no one is getting a better “deal” upon audit. An effective enforcement strategy must be equitable and ensure that similarly situated taxpayers are being treated alike.
- **Competence and Continuity.** An effective enforcement strategy also depends upon a committed, well-trained, and stable work force. It is not enough to announce new procedures and policies from the National Office; there must be buy-in from the field to make the policies work. In addition, field personnel must know and understand the

tax law and how it relates to the businesses they audit. Qualified individuals must also be recruited to take the place of the many seasoned agents who will be retiring over the next few years. The training and recruitment of field personnel are critical keys to any successful enforcement strategy.

- **Currency.** TEI's members generally work for companies that are under continual audit by the IRS. Both the taxpayer and the IRS have a common goal of completing these audits in a fair, timely, and efficient manner. Several innovative procedures — such as Fast Track Mediation and Settlement, Accelerated Issue Resolution, and Early Referral to Appeals — have been introduced in the last two years to improve the examination process and promote currency. An effective enforcement strategy must increase the efficient use of government and taxpayer resources during the course of an audit. The backlog of cases must be addressed, however, before significant efficiencies can be obtained. The lack of currency in audits creates significant recordkeeping burdens for taxpayers. If taxable years are closed in a timely manner, there is less need to retain records relating to those years. Thus, becoming current on audits is another critical component of an effective enforcement strategy — one which LMSB is seeking to implement.

Implementing an Effective Enforcement Strategy

LMSB has shown a refreshing openness to trying new and different ways of doing business. More than a year ago, the division announced several “pre-filing” initiatives, emphasizing the need to resolve issues *before* a return is filed. This increased attention on “front-end” activities — by the use of pre-filing agreements and industry issue resolution techniques — potentially could reduce contentious audits and prolonged litigation.

Last year we stated that in order to substantially complete its change to pre-filing activities, the IRS must improve the currency of its audits. Thus, we are pleased with LMSB's recent announcement of its “LIFE” initiative. LIFE stands for **limited issue focused examinations**; it is an innovative process to focus government and taxpayer resources on the most significant issues on a taxpayer's return. The new initiative requires the execution of a formal memorandum of understanding between the taxpayer and IRS that will govern key aspects of the examination, including the imposition of a dollar threshold on a case-by-case basis below which both the taxpayer and IRS agree not to raise issues or make claims.

The use of materiality standards in examinations is an approach that TEI has long supported, and we commend LMSB for thinking outside the box to resolve the significant back log of cases within the division. The LIFE initiative holds great promise for creating an atmosphere where the examination process is less time-consuming and more efficient for all parties.

As the IRS has acknowledged, however, the new approach represents a major culture shift for LMSB. Critical to its success is the involvement — and training — of IRS field personnel. Without a commitment from the examination team and their supervisors, the new procedure could well be viewed as the latest “flavor of the week,” *i.e.*, a mere reworking of other initiatives without an underlying change in philosophy. We understand that LMSB has begun training its agents in the new process and remain hopeful that the LIFE process will succeed in institutionalizing “best practices” for IRS examinations and providing consistency in the treatment of taxpayers.

Another innovative approach to resolving issues is the IRS’s new **tax shelter settlement initiatives**. In October, the IRS announced proposed settlement options in three groups of cases: corporate-owned life insurance (COLI), 302/318 basis-shifting transactions, and contingent liability transactions. These cases have the potential for clogging the tax system, consuming undue resources, and preventing LMSB from making progress on other important issues.

The three initiatives offered taxpayers an opportunity to settle these issues in a timely manner and were intended to bring the cases to a comprehensive resolution, based on the IRS’s assessment of the strength and weaknesses of its legal positions. Although some may disagree with that assessment, the process demonstrates a willingness to let taxpayers resolve a contentious issue and move on. We understand, for example, that the COLI initiative has resulted in the resolution of nearly all outstanding cases. Special mention should be made of the contingent liability transaction initiative, which provides taxpayers with a variety of approaches to settlement, ranging from acceptance of the IRS offer, to use of the Appeals process to determine what, if any, liability exists, to use of arbitration to settle the dispute. We understand that the IRS is working on settlement options for several other transactions and we encourage the agency to continue its undertaking to resolve issues on a wholesale, rather than a “retail” or case-by-case, basis.

Barriers to an Effective Enforcement Strategy

It will come as no surprise to this Board that one barrier to implementing an effective enforcement strategy is the **lack of adequate and reliable funding**. The current reorganization is the most far-reaching yet, and at the five-year mark is approximately one-half of the way through the original planning horizon.

Much has been accomplished under the IRS Restructuring and Reform Act, but much remains to be done. TEI is concerned about recently published reports that the Office of Management and Budget has substantially pared back the IRS budget authorization request for business modernization for fiscal year 2004. We recognize that the IRS has experienced problems in the past with its modernization programs, but we believe that the agency has made substantial progress in dealing with internal management systems. Indeed, the IRS’s processes for acquiring modernized business solutions has just been recognized by an independent research group. *See IR-2002-136, IRS Earns*

Recognition for Modernization Processes (Dec. 11, 2002). The IRS must receive the funding it needs to continue its systems modernization efforts, as well as to develop and implement new procedures and audit processes.

Money and stability are also required for the agency to recruit, train, and retain qualified personnel. LMSB Commissioner Larry Langdon reported recently that the division suffered a 5.3 percent attrition in 2001 and that 46 percent of its workforce is eligible to retire within the next three years. With the additional emphasis on auditing tax shelter issues, the IRS will need to deploy its resources carefully. Modern technology is important, but the lack of qualified, experienced personnel will almost certainly hinder an effective enforcement strategy.

Stated simply, whether the promise of the reorganization can be realized depends in large measure on the IRS's securing sufficient funds to do its job. TEI has consistently supported both adequate funding for the Internal Revenue Service and adequate oversight by this Board, the Treasury, and Congress. We know the Board shares our concern and urge you to continue to press for adequate funding of the IRS. We are encouraged that the President has nominated Mark W. Everson to be Commissioner of Internal Revenue and are hopeful that the modernization effort undertaken by former Commissioner Charles O. Rossotti will continue to progress under his tenure.

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We have one final comment that is a follow up to the 2002 Board hearing. Last year TEI testified about the need for new procedures to relieve the significant burdens imposed on corporate taxpayers concerning the requirement that extensive records be maintained in respect of taxable years subject to audit. We recommended that the IRS make use of records retention agreements. We are pleased to report that the IRS has established a working group to review the challenge of constantly changing technology and to consider the development of a new revenue procedure; we look forward to working with the agency on this issue. We thank the Board for providing the Institute with an opportunity to express its concern about this issue.

Tax Executives Institute commends the IRS Oversight Board for holding this public hearing. TEI looks forward to working with the Board and the IRS itself to improve tax administration.

TAX EXECUTIVES INSTITUTE, INC.

By: 

J.A. (Drew) Glennie
International President