

Speech to NY TEI
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The LB&I Reorganization
What Is It and What's in It for Taxpayers?

The state of the IRS?

In case you haven't heard, the IRS is says it has a shortage of funds to accomplish its mission. Indeed, Congress has been in a mood in recent years to cut resources for the IRS, leaving it in a difficult spot. As late Commissioner Don Alexander used to observe, tax collectors have never been popular, going all the way back to biblical times. Add a measure of errors in judgment by a small part of the organization responsible for administration of an area outside the agency's core mission, and the picture for the IRS gets much worse. That said, it is essential that the agency find ways to increase its efficiency to carry out its core mission. The task would be easier with fewer non-mission critical responsibilities.

But, let me ask you -

How many of you are learning to do more with less?

Are your budgets ever cut without a corresponding reduction in what you have to do?

Are your budgets always increased to reflect additional responsibilities?

Could you tell your boss, if you give me less, I'm going to do less?

I think we know the answer to each of these questions!

I don't intend to be critical of the Commissioner, who assumed a difficult job and has done it well, but here's the issue. Saying that "if you give us less, we're going to do less" may help increase IRS employee morale for a time, but ultimately, it fails to inspire. More important, it hasn't resulted in more funds. It is time to rethink the approach.

And that's where the LB&I reorganization comes in.

LB&I Reorganization

In certain respects, the LB&I reorganization is like every IRS reorganization you've ever witnessed. There are boxes moving around an org chart, with old jobs eliminated and new jobs created. You may be hearing from your teams and their managers about this part of the reorganization. Why? Because it's personal. It's about jobs. Who loses one? Who gets one? Where will they work? How will they work? How will their routines change?

I'm not going to talk about this part of the reorganization because I don't expect it to have a significant impact on how exams are conducted - at least not standing alone. In many respects, it reflects a return to the IRS's historic geographical organization with some additional specialist groups added to the structure.

I want to talk about the other aspects of the LB&I reorganization because it is what sets this reorganization apart from every other reorganization. It's about more than the boxes on an org chart, how they're labeled, and who occupies them. And that's the important aspect of the LB&I reorganization. Once implemented, it should fundamentally change the way LB&I operates. In my view, for the better.

Let's consider the current operation. A distinction is drawn between the largest companies and everyone else. The largest roughly 1000 companies - the CIC taxpayers - have been audited year in and year out. Why? Because they're big. Not because they've been found to be noncompliant or because large adjustments have been found and sustained or because new risks turn up year after year. To some extent it is because even minor proposed adjustments can appear to produce large amounts of additional tax even though the adjustments may turn around quickly in subsequent years because they are timing issues. The fact that they are timing issues doesn't affect the way the dollars are counted.

Of the next roughly 100,000 companies - the IC taxpayers - approximately 10% are pulled for exam on the basis of compliance scores, prioritized, sent to the field, and worked as resources permit. How does the compliance scoring work, you ask? I don't know. While I was at Treasury, I was briefed on changes to the scoring of returns in Small Business and Self-Employed - but only at a high level. When I asked a question requiring a more detailed explanation, I got the standard CIA line: they could tell me, but then they'd have to kill me!

Whether it's the CIC or IC taxpayer, there is a fundamental similarity in that the revenue agent or team assigned to the case is in control of deciding what issues to examine, what resources to devote, and how to do the examination. This is where the most significant LB&I reorganization change comes in. Once implemented, the LB&I reorganization will no longer provide 100% coverage on CIC taxpayers and will no longer vest decision-making about what to examine with the revenue agent or team.

Instead, decisions would be made at a "corporate" level - that is, on a nationally centralized, coordinated basis. This approach will decide what to examine, which in turn will determine which returns to examine.

To those of us in the private sector whose daily activities are dictated by the priorities set by our organizations, our bosses, our bosses' bosses, the board, there is nothing surprising about this. Indeed, it's hard to imagine operating otherwise. None of us is allowed to freelance. But this is a sea change for the IRS which has relied on the capacity of agents to discover the issues that matter, one return at a time. Successful implementation of this aspect of the reorganization will make examinations more efficient and effective.

What are the obstacles to success?

There are several. Let's go through a few.

Independence. Revenue agents have been independent, fiercely so, to guard against the possibility of inappropriate meddling in the examination of a taxpayer. The independence stems from scandals that occurred over 60 years ago. The transparency that is common today makes them highly unlikely to recur. In addition, the fears of inappropriate intervention which led to the emphasis on independence are overstated by some based on my over 30 years in and out of government. In any event, for the reorganization to succeed, the revenue agent's definition of independence will have to change. Decisions about resources and how to spend them will be decided on a coordinated and centralized basis. Agents will still be expected to exercise independent judgment and will not have blinders on. Thus, they should and will raise issues they find for further consideration, but whether to devote the additional resources that would be required to audit new issues will be centrally determined.

I think the coordination and centralization is a very good thing. I recall times from my government service when revenue agents made decisions to pursue penalties which precluded the examination of returns with the same deficiencies. Result: one taxpayer paid additional tax *plus penalty* while another taxpayer escaped without adjustment. Balance is needed and that can only be provided on a coordinated, centralized basis.

Issue identification. In the reorganized LB&I, the compliance program will depend on LB&I's ability to ferret out the issues requiring attention without individual revenue agents and teams going through returns one at a time. How will this happen? Anyone remember Secretary Rumsfeld's line about known unknowns and unknown unknowns? The job of a revenue agent is not easy!

Over the years, many means have been developed to highlight the key issues on large business tax returns. There is coordinated disclosure by businesses and their advisors. In addition, there are Schedules M and UTP. There also are many sources of public information outside of the tax return including audited financial statements and other public financial filings, press reports, whistleblowers, academic studies, and NGOs and think tank reports.

In short, it won't be easy to identify issues without soup-to-nuts examinations, but it can be done. LB&I has to devote its resources to determining how to mine and use information to develop the issues to examine.

I want to talk about the campaigns. (Not the presidential variety!) Another novel part of the LB&I reorganization is the recognition that examining returns and proposing adjustments is only one way to improve compliance. To that end, LB&I contemplates employing different mechanisms - under the rubric of campaigns - to improve compliance with respect to the issues identified. The issues could be examined. They could be the subject of an industry issue resolution or other form of published guidance. They could give rise to proposals to change the law. They could be approached indirectly via a third party. Or they could be addressed through something entirely different. Disclosure, for example. In my view, the disclosure that has been added over the last couple of decades represents a significant way in which the IRS has positively affected compliance. Disclosure brought sunlight. Sunlight has altered behavior.

Altered behavior means fewer issues to examine - also known as “compliance,” which is, of course, the goal.

Culture. The IRS is charged with administering the law. When it comes to the tax law, some use the word “enforcement” to describe the IRS mission. I don’t like the word “enforcement.” I dislike it so much that while in government I objected to use of “enforcement” as the title for one of the Commissioner’s Deputies. We ended up with a compromise title – service and enforcement. Let’s remember that the agency is the Internal Revenue *Service*. The IRS does so much more than enforce. It administers. It interprets. It advises. It collects. Yes, it enforces, but enforcement is a last resort, and the tactics associated with it are best reserved for those who choose not to comply. If enforcement becomes the dominant characteristic, the agency risks losing its balance in dealing with taxpayers, large and small, the vast majority of whom are doing their best to comply and need *service* to assist them in voluntarily meeting their tax obligations, not *enforcement*.

Distrust and suspicion. The relationship between business and the IRS is too often marked by distrust and suspicion. This is a two way street. With or without LB&I’s reorganization, administration of the tax law would be improved if there were a conscious effort to be transparent, speak openly, understand opposing points of view, and work together to resolve issues. Part of this involves giving criticism. Criticism can be difficult to take, especially when it doesn’t appear to be offered constructively. But taxpayers, advisors, and the IRS must learn to give and take constructive criticism if we are to improve and make examinations more effective and efficient for all involved.

Collaboration. The government benefits significantly from what it learns from external sources. The fact of the matter is that we all do. In the networked world in which we operate, a decision not to collaborate is a decision to fail. Use the crowdsourcing concept we hear so much about today as a metaphor. My partner who leads the NY Metro practice tells of the difference between two new hires, one of whom has a network and the confidence to use it and the other of whom does not and is afraid to ask for help. Given the same assignment, when the project is due, the first turns in a product that has had the benefits of input from the network - a template, a precedent, a model, a spreadsheet, a shortcut, a similar experience - that results in a polished work product. It has, in effect, been crowdsourced. The second turns in a product that reflects what the new hire has been able to figure out alone. The first turns in a top quality work product. The second turns in a product that needs work. Fear, distrust, and suspicion are impediments to collaboration, but collaboration among taxpayers, advisors, and the IRS is essential to more effective and efficient tax administration.

Making use of the 80-20 rule. There is a rule of thumb that 80% of you-name-it comes from 20% of the effort to generate you-name-it. For example, 80% of a company’s sales come from 20% of its products. That doesn’t mean the remainder deserves no attention, but it does suggest how resources should be allocated. Moving towards a compliance system that operates on the basis of identifying issues before an examination begins and focusing the

examination on those issues represents a dramatic embrace of a reallocation of resources to focused issues. The result should be more effective and efficient examinations.

Clarity of vision. The essential ideas behind the reorganization will require considerable effort to rethink many of the programs and procedures currently in place. In the meantime, operational decisions are being made, some of which, at least at the surface, are hard to align with the logic of the reorganization. For example, what happens with CAP? For now, we understand that CAP will remain in place; however, companies that had been working towards admission to CAP in 2016 have been advised that they will not be admitted. Companies that are part of CAP understandably want to preserve the program and the “certainty sooner” that the transparency of CAP brings. For many companies, CAP has not meant a reduction in resources, though the process is much more efficient because it is current and focused on *resolution* of issues rather than *raising* issues as is often the case with the normal examination process. I understand the same is true of the IRS’s resources. If the IRS intends to allocate resources more effectively, then I believe it must consider more radical steps. If CAP taxpayers represent the most compliant companies, why not move all of them into CAP maintenance and replace them with the new applicants? Or if the new applicants have earned a place in CAP, perhaps they, too, should be moved directly to CAP maintenance.

Training. If you work in the tax area, you know that the need to upgrade your skills and knowledge is constant. Laws are changed. Regulations are written. Interpretations evolve. Cases are decided. It’s a challenge to stay up to date. Add to that the fact that tax is complicated and the world is complicated. If we don’t understand either of them well, it will make it difficult to perform our job. In the meantime, the IRS’s training budget has been cut making it more difficult for agents to acquire the skills they need to perform, which will result, absent the tax community contributing to the training effort, in inefficient examinations for all involved.

As Yogi Berra once said, “you have to be careful if you don’t know where you’re going, because you might not get there.” Part of the IRS’s effort to train its workforce is reflected in the International Practice Units (or IPUs) that the IRS has been releasing over the past few months. The IPUs represent an effort to educate, train, and direct LB&I’s international examiners into the issues most in need of examination and away from those that represent plain vanilla arrangements and standard operating procedures that don’t require examination. The IRS has specifically requested comments on the IPUs, which represents an opportunity to participate in the training process as well as to provide feedback to LB&I on the most effective allocation of resources. The drafting of the IPUs, which commenced under former LB&I Deputy Commissioner Mike Danilack, may have been the precursor to the concept of “campaigns” and represents a significant change in the IRS’s examination operation. Rather than embarking on a journey in search of a destination, the IRS has made a carefully considered decision to choose its destination (issues) and plot a course.

I have to note in conjunction with the efforts to improve the examination of international issues that global changes and other countries’ claims on the U.S. tax base are about to make the IRS job of administering the international rules much more important and difficult.

Changing the rewards system. Taxpayers often feel that they are held to a very high standard and question whether the IRS holds itself to similar expectations. From the perspective of the business community, I think it is safe to say that many would like to see a system that rewards IRS employees for the behaviors that foster a more collaborative, effective, and efficient tax system.

Other obstacles. The press, politics, well-intended NGOs, opponents of change, and others could make the implementation of the reorganization more challenging. For example, whatever decisions LB&I makes on what or whom to examine is certain to be questioned, doubly so when stories emerge, as they are certain to, about instances of noncompliance. It won't matter that compliance has been improved or that the noncompliance likely would have been missed even if LB&I had not reorganized and had continued to strive for compliance by examining one return at a time. LB&I has to be prepared for this kind of publicity. So does the business community because the real target of a complaint will be the business community's noncompliance, not the IRS's failure to eliminate it.

What's in the reorganization for business taxpayers?

If successful, the reorganization should end the perpetual soup-to-nuts examinations of large corporate taxpayers and replace it with exam plans that focus on genuine issues. This is a challenging undertaking, and I think LB&I will need a lot of help. Specifically, our help. TEI's help. The help of companies, trade associations, and professional organizations who understand the vital role of tax administration and who understand that we can improve the process if we work together.

Those of us who deal with IRS exams on a regular basis can easily tick off a number of problems with the examination process. In the view of many taxpayers, IRS examinations have become increasingly inefficient and unmanageable. Many of the problems observed in the examination process are the same obstacles to the success of the reorganization:

- Lack of centralized management, accountability, and transparency
- Inconsistencies and rigidity in the execution of the new IDR process
- Use of litigation tactics in an exam rather than a cooperative evaluation of the issues resulting in a lack of trust between taxpayers and the IRS

Done well, the reorganization of LB&I should result in more efficient and effective exams for both the IRS and taxpayers. I believe the key to improved tax administration and the success of the LB&I reorganization will be the ability of LB&I and taxpayers to work together. It has been a number of years since the last meaningful collaboration between taxpayers and the IRS on the design of the examination process. It is time to launch that process again. LB&I Commissioner Doug O'Donnell and his leadership team have shown a receptivity to a collaborative process and asked for the assistance of the business community with training and other measures to improve LB&I operations and make the reorganization a success.

To that end, a coalition of trade associations, supported by the corporate community and working with TEI, has put together a website - eetax.org - for effective and efficient tax administration - that sets out the challenges, catalogs the current impediments to effective and efficient examinations, and begins to propose options to address them. The items on the webpage reflect the current exam process, but they are a useful compendium of the problems that should be addressed in the interim and considered as LB&I develops and transitions to its new operating plan. One of the next steps the coalition is considering is a mechanism for crowdsourcing the drafting of details of an improved exam process. Sound far-fetched? The current quality examination program has its roots in the good work that TEI did with the IRS years ago. Together we can build a better process, and today's technology provides the platform for doing so.

Will the LB&I reorganization succeed?

To quote my favorite philosopher again: "predictions are hazardous, especially about the future." I believe it will because I believe it must for a simple reason. We will never return to a world with sufficient resources to achieve tax compliance one return at a time.

Thank you for your attention.