Bloomberg BNA

Daily Tax Report®

NUMBER 0 JANUARY 11, 2012

Tax Compliance

Budget Erosion, Looming Retirements Add to Demands on IRS Compliance As Health Care Reform, FATCA Implementation Swing Into Play for 2012

The Internal Revenue Service is facing an erosion of budget and bodies that will greatly impact taxpayers and the agency itself, public and private sector stakeholders told Bloomberg BNA.

Through the lens of tax compliance, the effects range from increased reporting requirements and enforcement to the launch of new initiatives, all in the hopes of maximizing IRS resources while taking on increasing responsibilities, such as implementation of the health care reform legislation and the Foreign Account Tax Compliance Act, enacted as part of the Hiring Incentives to Restore Employment Act (Pub L. No. 111-147).

Mike Dolan, director of KPMG's Washington National Tax Practice and a former deputy commissioner at IRS, told Bloomberg BNA that he has already seen the effect of budget constraints on IRS staff travel. More work is being done over the phone in Appeals and in the Large Business and International Division, he said.

Simple meetings can be handled over the phone, Dolan said, but travel matters for more involved interviews. LB&I Commissioner Heather Maloy has put a premium on sending line managers out to interact with taxpayers and this constrains that initiative, he said. Interaction with the industry, such as trade associations or industry-specific meetings, could also dial back because what money is available must first be allocated to cases in the pipeline, Dolan said.

The reduced travel trend has also been noticed by Linda Stiff and Kevin Brown of PricewaterhouseCoopers's tax controversy and dispute resolution practice. They expect a similar reduction in the agency's ability to handle calls.

The concern over resources is perhaps highest in the Appeals unit, where caseloads have increased every year for the last three years, and where roughly 64 percent of the staff is eligible for retirement, IRS Appeals Chief Chris Wagner told Bloomberg BNA.

Appeals: No Hiring and Retirements Loom

The focus in 2011 was on the budget because it was less than what IRS would have liked, Wagner said, although Appeals was one of the few divisions that did some hiring.

Budgetary concerns continue, with an increase in resources unlikely to come anytime soon, Wagner said. "2012 paints a different picture," he said. Appeals will not be doing any hiring.

Appeals staff will get a slight reprieve this year, however, as case inventory is expected to drop to 145,000 in 2012 from 147,000 receipts in 2011, Wagner said, adding it is a small but welcome dip. The decrease is caused in part by a ripple effect from the 2011 hiring dip in IRS's compliance division. Compliance hired less than normal, which means a decrease in the number of cases circulating through, Wagner said.

Beyond the budget, concern over staffing stems from the number of eligible retirees. Appeals hires the most technically experienced staff, and with those years of experience comes retirement maturity, Wagner said. While staff tends to stay into their retirement years, he said the division has to be ready for them to leave at any time.

Despite the 2012 breather, the high average number of receipts combined with workforce concerns is forcing Appeals to revamp its procedures, he said. A few avenues already taken include a push for quick resolutions when taxpayers come in for conferences, Wagner said. Alternative dispute resolution options are also a division priority, as they minimize the use of resources.

Fast Track a Top ADR Option

The fast track appeal is one of many alternative dispute resolutions available to taxpayers, and is the one

 ISSN 0092-6884

favored by LB&I taxpayers, probably because of its stringent timeline, Wagner said.

The LB&I fast track process is limited to 120 days, compared to normal resolution routes that could take as many as 480 to 600 days, he said. There is not a lot for the taxpayer to lose when they enter the program, and a significant amount of time is saved. Eighty percent of LB&I fast-track cases have been settled within an average of 90 days, Wagner said.

Appeals is seeing a different response from Small Business/Self-Employed Division taxpayers, Wagner said. The fast track pilot program for SB/SE taxpayers rolled out in eight cities in 2006 and the numbers have not changed since, he said.

Initially, the division was waiting for a rise in participation before expanding the program across the country but the thinking has reversed. The hope is that the lack of response was because of the limited number of cities involved, and by increasing the number of locales the program will see an increase in participation. Expansion will begin in 2012 and likely go through 2013, Wagner said.

Appeals is also asking practitioners and stakeholders to spread the word about the fast track program and other ADRs. Appeals can only do so much in terms of advertising, he said. The LB&I group is smaller than the SB/SE group, making it easier to inform the former about the availability of the program, he said.

Another fast track expansion on the horizon involves tax-exempt entities, Wagner said. Currently there is a nationwide pilot program and Appeals is working to make it permanent. He said the Treasury Department seems to be on board and he expects permanent status to come in 2012.

Ex Parte Communication Concerns

Final guidance on ex parte communications is high on the 2012 priority list, which should be music to the ears of taxpayers who have been anxiously awaiting its release. Notice 2011-62, issued by IRS in July 2011, contained a proposed revenue procedure setting out remedies for breaches of ex parte rules (139 DTR G-1, 7/20/11).

Stakeholders provided Appeals with input in August 2011 and Wagner said the division has since been reviewing that information. A meeting on the guidance was held ''recently,'' Wagner told Bloomberg BNA in mid-December, and a draft of changes will ''soon'' be sent to the Treasury Department.

Wagner said his hope is to have final guidance released in the second quarter of 2012. As for hints on what that guidance will look like, he said it will clarify Revenue Procedure 2000-43, issued more than 10 years ago, and will no longer have a question-and-answer format.

A guiding principles section has been added, he said, as have clarifications surrounding remedies and multifunctional meetings. The guidance should also have a discussion on interactions with counsel and chief counsel, Wagner said.

Globalization Driving LB&I

The number of companies going international is rising dramatically, and LB&I is in turn stepping up its focus on the international arena with new requirements on and heightened attention to those same multinational taxpayers.

The accelerating pace of globalization and the information that is now required for tax compliance reporting is at an all-time high, Kate Barton, Ernst and Young's Americas Vice Chair of Tax Services told Bloomberg BNA. The expansion of business operations into emerging markets and new countries, even for middle market companies, has increased the volume of filings, while at the same time, the complexity of reporting has increased with more requests for information and transparency. The current requirements for Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, ''is a perfect example,'' Barton said.

On the taxpayer's side, one trend she is seeing is the shared service center. Companies are starting to use SSCs to streamline their back office functions into a single financial team for entire regions, Barton said. One SSC might serve all of Europe, for example, instead of using one team for each European country in which a company is operating.

A proliferation of split-ups and spin-offs in the wake of the recession means a lot of newly independent public companies will be facing stand-alone compliance for the first time in 2012, E&Y's Kate Barton said.

Companies are also looking toward technology to streamline their reporting processes. ''Efficient, consistent technology systems are especially helpful for companies currently in, or hoping to join, the Compliance Assurance Process, Barton said.''

One other ''mega trend'' worth mentioning involving large or multinational corporations is a proliferation of split-ups and spin-offs, Barton said. The prevailing ideology in 2011 was that the parts were worth more than the whole.

This is not an uncommon corporate strategy when coming off a big recession, but is new ground for some corporations, she said. All these newly independent public companies will, in 2012, have to be ready to file as such. Getting ready for this stand-alone compliance will be a big undertaking, Barton said.

   ISSN 0092-6884

On the agency side, the restructuring of LB&I from the Large and Mid-Size Business Division was a coordinated move to consolidate the division in order to focus on key international issues, such as cost sharing, transfer pricing, information reporting, and joint audits, along with FATCA, Stiff and Brown of PricewaterhouseCoopers said.

Other division priorities for 2012 include the Compliance Assurance Process and Schedule UTP, Uncertain Tax Position Statement, they said.

UTP Driving Taxpayers to CAP?

Companies are showing heightened interest in entering CAP, and one driver is possibly the new requirement to report uncertain tax positions, Stiff and Brown said.

The certainty gained from entering the CAP program may be seen by taxpayers as a way to mitigate the uncertainty surrounding the Schedule UTP, they said. 2011 has been a learning year for IRS and for taxpayers regarding UTP, and this will continue through 2012, Stiff and Brown said.

There are still questions being raised by stakeholders about the UTP exam teams, such as when they will be formed and what will be done with them, they said. Despite the remaining questions, they praised Maloy's efforts thus far, and welcomed her announcement that Schedules UTP will be centrally screened and examiners will be well-trained before viewing the filed schedules.

The increase in CAP participation is also likely driven by the positive feedback from those involved, they said. There are roughly 160 companies currently in the CAP program, 140 of which are from the pilot period, Maloy recently told Stiff and Brown. CAP was made permanent March 31, 2011, and 2012 marks the first year taxpayers can opt into the program.

''It will be interesting to see what happens in the next year,'' Stiff said. Taxpayers will either jump on board or will stand on the sidelines, and it is unclear whether IRS has a sense of just how many will jump aboard, she said.

A turn could come in the CAP-UTP relationship. About 1,500 Schedules UTP were filed in the fall of 2011 and roughly 3,500 disclosures were made, KPMG's Dolan said. Approximately half of the returns with a UTP had only one disclosed position, he said.

Dolan, Stiff, and Brown said that the areas examiners seemed to hone in on were fairly common auditing issues, such as transfer pricing, Internal Revenue Code Section 162 business expense deductions, and the research and development tax credit. As a result, taxpayers who previously felt queasy about UTP and were considering CAP participation may now rethink the need to enter the program, they said.

What is certain, according to Stiff and Brown, is that LB&I is committed to the program—it is a division priority. CAP allows the division to curtail the number of agents and auditing times, enabling them to work more efficiently while allocating the division's scarce resources to other areas, they said.

The program is not perfect, however, they said, citing complex transfer pricing and research credit issues as two areas that do need work within CAP. Solving these issues in a real-time environment is very difficult, they said, and the problems often continue into the auditing process.

One possible remedy available to a taxpayer is to reach a prefilling agreement or advance pricing agreement based on an agreed methodology that can be applied year after year, they said. Then the taxpayer simply has to plug in the new year's information and can do so in real-time aligning with the CAP time frame, Stiff and Brown said.

CAP and the APA program could change the way IRS deals with taxpayers, Dolan said. As for UTPs, IRS could find they are not very insightful for the top taxpayer group but find it very enlightening for the $50 million to $100 million category, where the agency has had little audit presence to date, he said.

Progress on QEP, FATCA Rules

With regard to other initiatives, PwC's Stiff and Brown said IRS's Quality Examination Process has been an improvement over the Joint Audit Planning Process.

There are few bumps in the program, which is the case for any new initiative involving a large number of people, they said. ''It absolutely will smooth out as time goes by,'' they said.

Barton said that it is an interesting program with a number of good elements articulated. Those that are using it like it, she said. As for the wrinkles, she expects no changes to be made in the foreseeable future because it is too early in the life of the program to see what really needs to be enhanced or modified.

As for FATCA, it marks a big change in reporting withholding information, Barton said, and financial services clients are looking forward to the regulations, expected in January.

LB&I Success Trickles Down

The general rule of thumb is that what works for LB&I gravitates to other IRS divisions, such as SB/SE, Larry Campagna of Chamberlain, Hrdlicka, White, Williams & Aughtry told Bloomberg BNA.

The fast track process is one historic example, he said. Another is IRS's newly created Global High Wealth Industry Group, which some people are referring to as ''wealth squads,'' Campagna said.

The LB&I teams now send to high-wealth taxpayers information document requests that are incredibly lengthy and extensive, he said. They ask everything about what these taxpayers could have, to determine what they do have, he said. Then examiners and related specialists are assigned accordingly.

SB/SE examiners are starting to use portions of these IDRs to zero in on their own target audits, because the program has been effective at LB&I, he said. The IDRs are available in the IRS Manual, so there is nothing other than good sense and good group management required for an SB/SE revenue agent to issue the extensive IDRs in an SB/SE examination, Campagna said.

In addition to LB&I crossover trends, the Voluntary Classification Settlement Program for employers with worker classification issues is one to watch for those following the SB/SE Division, Campagna said.

New Worker Classification Program Raises Concerns for Some

The VCSP program is only a few months old, Campagna said, and from the tax perspective it is a great program. However, it only solves the IRS side of the equation and does not address additional ''minefields'' at the Department of Labor and state revenue offices, he said.

Scott Schapiro, a principal at KPMG, agreed, saying that companies like the VCSP but are not going to jump on it because there is no companion program at the state level. A company that does enroll in VCSP could be left open to exposure at the state level, he said—all of a sudden workers are coming on to state unemployment programs, and these state returns will have ''pop ups'' putting the company at risk.

The push to properly classify workers at the state and federal levels continuously comes up in legislative debate, especially at the federal level, Schapiro said. He expects that debate to continue, especially around the ''Section 530'' safe harbor, part of the Revenue Act of 1978 (Pub. L. 95-600)—something many on Capitol Hill would like to eliminate, he said.

VCSP has raised a lot of concern, especially in California, William Weissman, Littler Mendelson, told Bloomberg BNA, as it has triggered passage of a state law that authorizes the California Labor and Workforce Development Agency to impose penalties between $5,000 and $25,000 for each instance of ''willful misclassification.''

VCSP has especially raised concerns in California, said William Weissman of Littler Mendelson, as it has triggered passage of a law authorizing the state's labor agency to impose penalties between $5,000 and $25,000 for each instance of "willful misclassification."

Determining proper classification is not an easy task on the state or federal level, and the definition of employee differs across states and federal agencies. If you met with five employers on five different days you would have five different answers in regard to proper classification of employees, Weissman said. Each company has to consider its own culture, he said.

Focused Enforcement, Increased Reporting

Campagna and Weissman said they expect a continuation in the trend of increased enforcement and increased reporting requirements.

IRS's 2009-2013 strategic plan is all about enforcement, motivated in part by the lackluster economy and the need for more revenue, Campagna said, and with bolstered enforcement comes increased reporting requirements. He said he expects to see more focus on Section 1031 like-kind exchanges and S corporations' salary compensation for officers.

Weissman said reporting requirements may expand and contract for a time, but overall they will expand because the way to keep money from disappearing into the system and minimize the tax gap is increased reporting. Minimizing the tax gap is where the National Research Program comes into play.

''It will be two years before we know what it will tell us,'' Weissman said of the service's NRP. Although he believes some data will come out in 2012 and will reveal a few problem areas, such as fringe benefits and accountable plan issues.

Specifically, de minimis fringe benefits, such as $5 and $10 gift cards given to employees, could raise issues, Weissman said. And accountable plans related to business expense reimbursements in certain industries, such as transportation, could fall under the microscope.

Schapiro said that beyond the NRP, the agency will be looking at fringe benefits in general, especially in areas such as leased vehicles, spousal travel, and those gift cards.

A final theme playing out for the SB/SE Division, Weissman said, is the continued ''tinkering'' with the payroll tax system—that is, expanding credits through the payroll system that are non-Social Security and Medicare related items.

Politics and Payroll Taxes

Political tinkering with the payroll tax system is a cheap and easy way for Congress to distribute social benefits, Weissman said.

He cited recent examples, including the payroll tax cut, hiring subsidies for veterans, and the Consolidated Omnibus Budget Reconciliation Act coverage credit. These temporary tax credits were meant to put money in people's pockets to incentivize spending and boost the economy. There is a lot of money within the system Congress can tap into, but they do not realize how hard their actions are on the IRS, he said.

These constant changes divert the agency's limited resources from other areas, in some cases only to have the change modified or repealed before it really gets off the ground, Weissman said.

One area of legislation that is pulling resources from across the agency is health care, sources told Bloomberg BNA.

Health Care Reform Impacting IRS

The complexity of health care reform implementation is really slowing the issuance of guidance and regulations in other areas, Karen Field, principal in the Compensation and Benefits group of KPMG's Washington National Tax practice told Bloomberg BNA.

There were a few things that were very close to being released that have now been tabled, including updates to qualified plans guidance under Revenue Procedure 2008-50 and possibly updated regulations on Section 457(f) vesting, Field said.

As far as health care guidance goes, a lot has come out at this point and people are now waiting for the implementation, she said. 2014 is the year the rules kick in, 2013 is the year the taxes kick in, and 2012 is the year the Form W-2, Wage and Tax Statement, reporting requirements kick in, Field said.

Companies have gotten over the size and scope of the law and are now doing what they can to get ready for

ISSN 0092-6884

the W-2 reporting requirements, Field said. Companies have the required information in their Human Resources systems, but locating the various bits of information is burdensome because they never had to be reported before, she said.

Major payroll companies Field works with have reported that a number of their clients are having trouble getting human resources systems to ''communicate'' with the W-2 systems, or they do not have the required information in a format that can be used for the W-2 reporting.

2012 is also the year employers must decide if they should ditch their coverage plans and let their employees enroll in the state exchange systems, Field said. A lot of companies are waiting to make that decision until they see what the states do and what the exchanges look like, she said.

Additionally there are two big taxes on the horizon, the 3.8 percent tax on unearned income and the Medicare tax. The latter will be fairly easy, Field said—it is a systems issue and she does not expect much more guidance on the matter.

The 3.8 percent tax, on the other hand, is not a systems issue. Taxpayers are hoping for more guidance, which indications suggest may come at the end of 2012, Field said. Neither of the taxes comes into play until 2013.

Another area to watch is the 9.5 percent safe harbor addressed by IRS Notice 2011-73, which for purposes of Section 4980H(b) allows affordability of an employer's minimum essential coverage to be measured by reference to an employee's wages from that employer. Under the safe harbor, the employee's portion of self-only premium for employer coverage cannot exceed 9.5 percent of wages reported on the W-2.

For health care reform, 2014 is the year the rules kick in, 2013 is the year the taxes kick in, and 2012 is the year the Form W-2, Wage and Tax Statement, reporting requirements kick in, KPMG's Karen Field said.

Some senators are arguing that the safe harbor provides an easy out to employers, allowing them to offer cheap self-only policies without an incentive to offer family coverage, Field said.

In addition to the safe harbor aspect, taxpayers are hoping for further guidance on minimum essential coverage as a whole, she said. Taxpayers are also looking for further guidance on automatic enrollment.

Half-Speed Ahead?

The rulemaking required as a result of the health care reform legislation, as well as that required by FATCA, has been and will likely continue to be among the biggest drivers of the guidance process, said Dolan, of KPMG.

PwC's Stiff and Brown suggested the issuance of guidance will be further slowed in 2012 because of the election year. The agency, and the Treasury Department, will want to wait and see what happens, whether there will be a change of administration or a power shift on the Hill, they said. The election year decline is not a new phenomenon, they said.

Despite the legislative constraints on resources, and the agency's budgetary hurdles, a number of initiatives were launched over the last few years, and Dolan said he has every expectation that IRS will stay the course. The question now is whether the agency will be able to move on as many fronts as fast as it originally wanted and as far as it originally thought.

If the budget constraints are determined to be a short-term phenomenon the impact may be negligible. If it looks endemic, he said, larger implications could lie ahead.

By Rachel Boehm