INTERNAL REVENUE SERVICE ADVISORY COUNCIL

SMALL BUSINESS & SELF-EMPLOYED SUBGROUP REPORT

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I. INTRODUCTION

The SBSE Subgroup met in three working sessions held in Washington, D.C. and participated in several conference calls with Small Business/Self-Employed executives and personnel. In addition, as discussed in the General Report, many subgroup members participated in Nationwide Tax Forum focus groups across the country. The subgroup reviewed the Transition Report of the 2001 IRSAC SBSE Subgroup to begin this year's term, opting to primarily emphasize the areas of Budget, Compliance, Offers-in-Compromise, and K-1 Matching.

The Small Business/Self-Employed Operating Division serves the largest taxpayer segment of the four Operating Divisions; a responsibility compounded by the fact that the Operating Division's taxpayer base is at greatest risk to encounter compliance problems. Small Business/Self-Employed taxpayers often lack the requisite knowledge needed to comply with all areas of the tax law and can fall out of compliance quickly. It is for these reasons that the SBSE Subgroup, though not examining this area in 2002, would like to commend the IRS for its efforts in the areas of education and outreach. Education efforts will reduce taxpayer compliance issues in the future.

The mission of the Small Business/Self-Employed Operating Division is "to provide s[mall Business/Self-Employed] taxpayers with top quality service by educating and informing them of their tax obligations, developing educational products and services, and helping them understand and comply with applicable laws, and to protect the public interest by applying the tax law with integrity and fairness to all." However, the Division's ability to achieve this mission is complicated by a severe funding shortfall. That this problem can be resolved by Congress alone notwithstanding, the SBSE Subgroup believes that the accumulated shortfall has reached a critical point. Action is needed to prevent a dramatic decline in voluntary compliance. The number of field examiners must increase, as must the audit rate, and the growing perception that the "audit lottery" carries little risk must stop.

Problematic compliance issues will always exist, but the current economic environment that fosters rapidly increasing change requires an IRS that is fully staffed by adequately trained and versatile personnel, ready to meet the challenges created by such an economy. Large, centralized programs will help, but it will be the field examiners who surface new compliance problems. Accordingly, it is vital that these examiners receive adequate training and are given the authority to address the issues they discover.

The Offer-in-Compromise Program has been problematic for some time. In fiscal year 2002, steps were taken to improve processing and reduce the existing backlog. Work must begin to drill down Offer-in-Compromise Program data for the purpose of determining the cause or causes giving rise to an exponential increase in the number of taxpayers who find themselves in need of this program. A process must be put in place to monitor future compliance for taxpayers whose offers are accepted. Education and compliance elements must also be added to the program.

The K-1 Matching Program began in earnest during fiscal year 2002. Several problematic issues lead Small Business/Self-Employed executives and K-1 Program personnel to suspend the distribution of CP notices subject to an analysis of K-1 data that is currently underway. While the results of the compiled K-1 matching data are not yet available, as discussed in the General Report, the IRSAC believes that a matching program should focus on taxpayers that have omitted K-1's from their returns. Further, the SBSE Subgroup believes that the K-1 Matching Program is the first step in a much needed compliance effort involving all pass-through entities.

ISSUE ONE: THE BUDGET

The Small Business/Self-Employed Operating Division lacks the funding necessary to provide adequate resources for the wide-ranging taxpayer issues within its jurisdiction. The Division is under-staffed, audit rates are down, compliance issues are increasing, and implementation of new initiatives and much-needed programs is delayed. As the scope and complexity of Small Business/Self-Employed issues increase,

the corresponding need for enhanced training likewise increases, and management must allocate resources between service and compliance issues at the expense of many worthwhile compliance initiatives that cannot be undertaken due to budget constraints. In short, funding is not keeping pace with the frenetic growth of the workload. Indications suggest that in the coming years:

- the number of SBSE taxpayers will increase;
- the number of SBSE tax returns will increase;
- the complexity of tax returns will increase; and
- funding shortfalls will continue.

It is challenging for any management team to meet its mission without adequate staffing, and it is staff working face-to-face with taxpayers, staff working face-to-face with practitioners, and staff working manageable caseloads that make effective, customer-oriented compliance possible.

ISSUE ONE: RECOMMENDATION

Within the Small Business/Self-Employed Operating Division, increased resources are necessary to meet the challenge of an increasing taxpayer base and the increasing complexity of the tax law. While funding for critical infrastructure has been secured, and the badly needed upgrade of computer systems is underway, a long-term budgetary commitment in the area of staffing is essential to achieve necessary compliance levels. The human element must not be forgotten. Notwithstanding the quantity and quality of equipment or the inventiveness of computer programmers, it is the front-line employees who are most essential.

Given the current staffing shortages within the Small Business/Self-Employed Operating Division, the SBSE Subgroup believes that Small Business/Self-Employed management and staff should be commended for their achievements across the past few years. Accordingly, we recommend that sufficient resources be provided to fully staff Small Business/Self-Employed in a manner compatible with good

management practices, which will provide proper staff training. We understand that this will require a multi-year commitment of both funding and implementation. We further recommend that funding be part of all mandates from Congress.

ISSUE TWO: COMPLIANCE

We examined and support implementation of the following priority compliance programs that were outlined for the subgroup:

A. **NATIONAL RESEARCH PROGRAM** – The National Research Program ("NRP") is a much needed, top priority program that will begin this fall. Designed to measure compliance and help effectively identify compliance issues, this program is vital for ensuring that the IRS has accurate, up-to-date information with which to detect trends in noncompliance and select the returns appropriate for examination. Data gathered by the NRP will enable the IRS to update existing screening techniques used to select tax returns for examination. With updated information, the NRP effort will prevent thousands of "no change" audits each year.

B. **THE UNREPORTED INCOME DISCRIMINANT INDEX FORMULA -** (hereinafter "UIDIF") - is a vital compliance tool that the IRS has developed, along with the NRP, that will greatly increase the effectiveness of auditors and taxpayer compliance. Unreported income represents the largest component of the tax gap. This tool was developed to identify returns with a high probability of unreported income.

C. **HIGH-INCOME TAXPAYERS AND NON-FILERS** are being targeted as potential noncompliance problems as they aggressively seek to reduce their tax burden or simply drop out of the system.

D. **OFFSHORE CREDIT CARDS AND OTHER ABUSIVE TAX SCHEMES** are important areas to target. Early intervention by the IRS is important to prevent the abusive shelters currently

marketed to taxpayers. Abusive schemes that are openly marketed decrease the public's perception of a fair tax system.

E. **SPECIAL RESEARCH PROJECTS SUCH AS THE CALIFORNIA RESTAURANT PROJECT** - spearheaded by Taxpayer Education and Communication (hereinafter "TEC"), Southern California restaurant owners who potentially had underreported gross income in recent years received letters educating them about the need to accurately and properly report business income. Called the California Restaurant Industry Compliance Project (hereinafter "CRICP"), recipients of the letters were encouraged to review their federal tax returns for accuracy and contact their tax practitioner should changes have been required. Educational letters were also sent to preparers of discrepant returns. Taxpayer Education and Communication met with the California Restaurant Association and a number of tax professional organizations to introduce this project and outline the educational efforts made through workshops, online access, and trade and practitioner newsletters. The project will soon expand nationwide.

The SBSE Subgroup commends everyone involved in setting the current divisional compliance priorities. It is also encouraging to hear that auditor training will begin to focus not only on code and number issues but also on improved investigation skills. Beyond the numbers, examiners will have an expanded view of the audit to ensure that everything "feels right". While this approach may lengthen the amount of time certain cases are open; the results should justify the time invested.

ISSUE TWO: RECOMMENDATION

The SBSE Subgroup agrees with and endorses all of these priorities as well as expanding investigation skills training for examiners. There is a vast amount of data, both internal and external, available to the IRS that could be utilized in the matching or case building process. The Small Business/Self-Employed

Operating Division should maximize use of internal and external data to create compliance matching and audit initiatives for purposes of detecting and targeting noncompliance and non-filers. The California Restaurant Industry Compliance Project was a particularly well designed initiative to increase compliance. Similarly designed/managed projects should be implemented. Efforts should also be made to increase early intervention with respect to non-filing and non-payment of taxes.

The NRP and UIDIF are programs that should facilitate a more efficient audit selection process, improve selection of non-compliant returns for audit while minimizing resources, i.e., audit time, to secure maximum results. Further, when a case reaches an auditor, it is important that the auditor be able to secure data from sources he or she deems important. It is likewise important that the audit rate increases. Voluntary compliance and compliance enforcement has decreased in recent years. Only an increase in the number of audits, greater efficiency in audits performed, and a change in the public's perception that significant risk does *not* attach to the "audit lottery" can reverse this trend.

The Small Business/Self-Employed Operating Division recognizes the importance of education and educational tools for improving compliance. It is likewise important to understand the significance attaching to the education of future as well as present taxpayers. For this reason we believe that programs aimed at educating high school students should be aggressively undertaken.

ISSUE THREE: THE OFFER-IN-COMPROMISE PROGRAM

The Offer-in-Compromise Program (hereinafter "OIC") has given rise to many problematic issues. This is particularly true from a cost/benefit perspective, i.e., the cost of collection versus the amount collected. However, in fiscal year 2002, several improvements took place. The centralized offer process has reduced the amount of time required to process an offer. In the past, OIC settlements could take years to settle. New procedures are clearing fifteen to twenty percent of the offers submitted by screening non-qualifying cases based on information supplied by the taxpayer.

The offer of a "reasonable collection potential amount", as computed on Form 433B, is the first step in a processable offer. Case building activities take place later in the process. A pre-screening process has been implemented that prevents cases the IRS determines can be paid in full from entering the OIC process. These cases are subsequently turned over to Account Collection Services. Accordingly, this simple screening process has resulted in reclaiming and redirecting valuable resources to internal processes for purposes of addressing the OIC backlog. Further, where an offer has been allowed to remain on someone's desk too long, thus rendering the offer/package outdated, taxpayers are no longer required to begin the entire OIC process again, eliminating re-computations of financial statements and valuations.

Notwithstanding improvements, much work remains. The entire process is too long and offers continue to consume inordinate amounts of resources to collect relatively insignificant amounts of tax dollars. Collection rates of twelve- to fourteen- cents on the dollar remain, second and third requests for additional or updated information persist, and general frustration with the program thrives. Taxpayers deserve faster answers, fewer requests for less redundant information, and a higher rate of return on the resources dedicated to the program.

The staggering volume of submissions is part of the challenge. Offers submitted by taxpayers that are aware that collection efforts are suspended during pendency of an offer comprise one component of the increased volume in OIC submissions. Others result from advertising that touts a taxpayer's right to settle cases for pennies on the dollar.

Currently, installment agreements outside of the OIC Program must be full pay, as it was decided that partial pay Installment Agreements required legal clarification. Prior to that decision, fewer offers and more partial pay Installment Agreements existed. Better tracking and annual refund capture procedures are in effect for Installment Agreements. The Government Accounting Office and Taxpayer Advocate Service have recommended that partial pay Installment Agreements may be a more efficient method of collection.

Beyond the problematic time and dollar issues, an improved follow-up program is needed. Accepted offers require that a taxpayer remain compliant for five years. A formal monitoring program is needed to enforce this provision.

Lastly, a program is needed to track the underlying reasons for the substantial increase in the number of taxpayers utilizing this program in the first place. What factors are giving rise to the large numbers of offers submitted and what changes can be made to reduce such demand?

ISSUE THREE: RECOMMENDATIONS

Addressing the conditions that source a taxpayer's need to enter the OIC Program should be a condition precedent to any compliance agreement. For example, a taxpayer entering the program due to nonpayment of employment taxes should be required to make employment tax deposits subject to strict enforcement and should be tracked to ensure compliance.

Attention must also be given to the taxpayer. If actions can be undertaken to prevent future problems, such actions should become a condition precedent of the five-year agreement. Entry into the program may be sourced in conditions created by regulations or result from taxpayer ignorance or inattention.

Further, we recommend the following:

- Track taxpayers whose offers were rejected to determine the amount of tax, if any, ultimately collected;
- Automate the five year post-offer tracking;
- Compare the centralized offer programs for management best practices, such as progress tracking, and standardize across Service Centers;
- Provide taxpayers with an information number to the site working his or her case;
- Develop a process by which to resubmit claims that are processable but which were returned unprocessable;

- Compare current and previous two years agreed offers with the offshore credit card database (and review anomalies);
- Provide education program requirements as a condition precedent to settlement agreements;
- Continue working to reduce cycle time;
- Evaluate the penalty structure to determine a proper balance between incentives to file and timely pay versus unreasonable build-up of debt that overwhelms the taxpayer.
- Determine if taxpayers offering unrealistically low amounts received professional advice to do so, and from whom.

The SBSE Subgroup further supports the following initiatives:

- The proposed user fee;
- Identification of paid Form 656 preparers through a signature line on the application;
- The ability of the taxpayer to enter into partial payment installment agreements; and
- Modify the OIC application such that the filing of full pay returns is less likely.

ISSUE FOUR: THE K-1 MATCHING PROGRAM

The SBSE Subgroup is in full support of a K-1 Matching Program. We commend the Service for recognizing the need for such a project. Substantial income is sourced in Forms K-1, $800 billion was reported on 20 million K-1 returns. The K-1 Matching Program is a key compliance program that began in earnest during fiscal year 2002. The IRS has begun the process of matching K-1 information to taxpayer returns, matching Form K-1 amounts with the corresponding amount entered on a taxpayer's income tax return. What was initially conceived as a simple program has evolved into an income verifying and difference reconciliation program.

Much time and money is expended entering Form K-1 data. When the Form K-1 amount and the corresponding Form 1040 amount do not match, creating a mismatch, a CP notice is generated. The Form K-1 information is then compared to the return - by hand. Over half of the mismatches generated by this

process are "screened out" as correctly filed by humans who review the return in toto and identify items found elsewhere in the return that plausibly explain the mismatch. Of the mismatches remaining, perhaps half ultimately result in no change. Each of the steps identified herein requires highly trained personnel generating significant costs. Accordingly, this program should be automated as soon and as much as possible.

For a K-1 Matching Program to be successful, the goal of the Program must be clearly delineated. Is it a matching program, or is it an income verification and reconciliation program? The type identified is extremely important. At the time this report was written, tabulation of the first notice results was underway. These results should indicate if the income gap is sourced in omissions or inaccurate reporting. Also problematic is the fact that varieties of due dates cause many taxpayers to estimate or omit K-1 income that is not received by the filing date.

ISSUE FOUR: RECOMMENDATIONS

Prior to implementing a verification/reconciliation program we recommend:

- Developing an appropriate program based on the results of notices sent this year;
- Examining the effect that changing due dates to March 15 would have on compliance for returns on which K-1's are includable;
- Enter amended Form K-1 data when received;
- Utilize automated function as much as possible and minimize human resources that could be utilized elsewhere;
- Move forward with the matching of K-1s on returns where K-1's have been omitted, and track the tax collected on underreported and unfiled returns;
- Rewrite Form K-1 generating instructions to provide for uniform handling of issues such as basis, partner expenses, elections, and other complicating factors;
- Redesign K-1 and Schedules E and SE to facilitate ease of computer verification with complete *e-file* compatibility.

Absent implementation of the above recommendations, we recommend the K-1 Matching Program be limited to verifying the inclusion/omission of Form[s] K-1 on a taxpayer's income tax return.

ISSUE FIVE: IRS/PRACTITIONER FOCUS GROUPS

We commend the IRS on the recent series of Focus Group Sessions conducted as part of the Nationwide Tax Forum Program. Approximately forty practitioners were asked to provide input on issues of their choosing as well as issues the Council was considering. The issues covered included:

- *e~file;*
- K1 Matching;
- Offer-in-Compromise;
- IRS successes, such as the improved phone services;
- Overall opinion of the IRS since reorganization.

The practitioners who participated in the Focus Group Sessions opined that the IRS is headed in the right direction albeit expressing support for a higher audit rate. At the same time however, they expressed frustration with confusing mailing addresses and mailing address changes, and communication problems resulting from routing phone calls across the country.

The members of the SBSE Subgroup wish to thank the Commissioner for allowing them to participate in and facilitate these sessions.

ISSUE FIVE: RECOMMENDATIONS

The SBSE Subgroup believes that the Focus Groups could be improved by:

- Increasing the number of practitioners involved in each session;
- Including the Focus Group Sessions in the Forum Schedule/Agenda;
- Not requiring attendance to be the responsibility of IRS staff; and
- Conducting sessions in central meeting locations contiguous to Forum seminars and visible to attendees.

These recommendations are meant to increase the ability of practitioners to be heard. We strongly support continuing these Focus Groups in the future.