

**INTERNAL REVENUE SERVICE
ADVISORY COUNCIL
SMALL BUSINESS & SELF-EMPLOYED
SUBGROUP REPORT**

**TIMOTHY B. CLAY
FELECIA G. DIXSON
MICHAEL W. EVANISH, SUBGROUP CHAIR
ANN K. HUBBARD
PAMELA P. KULISH
SUSAN W. MARTIN
CAROL B. TREMBLE**

NOVEMBER 6, 2003

**SMALL BUSINESS & SELF-EMPLOYED
SUBGROUP REPORT**

TABLE OF CONTENTS

I. INTRODUCTION

II. ISSUES AND RECOMMENDATIONS

ISSUE ONE: COMPLIANCE

ISSUE TWO: NATIONAL RESEARCH PROJECT

ISSUE THREE: OFFER IN COMPROMISE PROGRAM

ISSUE FOUR: K-1 MATCHING

ISSUE FIVE: ELECTRONIC FILING AND E-SERVICES

ISSUE SIX: PREPARERS

I. INTRODUCTION

The IRSAC Small Business & Self-Employed Subgroup (hereinafter “SB/SE Subgroup”) consists of tax professionals who represent tax preparers and small and medium-sized businesses, having significant representation in professional organizations comprised of such preparers. The current SB/SE Subgroup has had two years of experience in their capacity as Subgroup members and, during this time, have had the opportunity to learn and become seasoned in their approach. The SB/SE Subgroup is thankful to the IRS as a whole, and to SB/SE Executives and Personnel in particular, for facilitating our meetings with key personnel, enabling our visits to program operations in campuses across the country, such as the Offers in Compromise program at the Brookhaven and Memphis sites. As discussed in the General Report, members of the SB/SE Subgroup also attended the Nationwide Tax Forums, as focus group participants, in four sites across the nation. The SB/SE executives have been cooperative and frank in their discussions with us and we thank them for their candor.

An Executive Summary of our Issues and Recommendations highlights several key observations:

1. Compliance. Enhanced enforcement must be weighted against taxpayer service to significantly improve eroding taxpayer compliance.
2. The National Research Program (“NRP”). The NRP launch involving Form 1040 individual audits is promising and well-planned; however, the NRP pass-through entity segment appears to be rushed and we strongly encourage proper planning and education of Revenue Agents.

3. Offer in Compromise Program (“OIC”). The OIC program has been improved significantly, which was in evidence during our visits to the Brookhaven and Memphis processing sites. However, more proactive taxpayer education is warranted to prevent the development of OIC cases. Likewise, settlement of more OIC cases at both Brookhaven and Memphis is encouraged to reduce the field office backlog of OIC cases.

4. K-1 Matching. The IRS is to be applauded for their cooperative approach in improving the K-1 matching program despite the early unannounced launch. The IRS has been extremely responsive to the SB/SE Subgroup and other stakeholder in providing feedback to improve the process. Additional enhancements will increase computer matching and reduce labor intensity for deployment to other initiatives.

5. Electronic Filing and e-Services. The concept of e-services to engage and incentivize e-file to the practitioner community is well-founded. The threat of mandates is not encouraged to increase e-filing activity. The benefits and incentives that accrue to practitioners as a result of e-filing should be marketed and explained to engage and transition practitioners.

6. Preparers. Poorly educated and unethical preparers are a serious compliance problem that the IRS must address through a tax preparer certification program applicable to all preparers. The Taxpayer Advocate has outlined such a preparer registration program.

The following list of SB/SE Subgroup recommendations is not all-inclusive; rather these items represent the issues the Subgroup deemed to be of primary importance, and thus were matters the Subgroup examined across the past year.

II. ISSUES AND RECOMMENDATIONS

ISSUE ONE: COMPLIANCE

The SB/SE Operating Division and the SB/SE Subgroup are well aware of the role enforcement plays in enhancing compliance which is necessary to ensure that our tax system is fair for all taxpayers. Over the past twelve months, the IRS has focused its attention on special programs currently marketed to taxpayers, such as Off Shore Credit Cards and Abusive Schemes, to identify fraudulent tax methods designed solely for the purpose of tax evasion. The taxpayer may not have been aware that the Off Shore Credit Card marketed to them was an illegal tax evasion scheme. However, when informed that such schemes are not in compliance with the tax law, taxpayers participating in such schemes wanted to become compliant and did so. The IRS must get the message out that improved customer service will be accorded the same emphasis as enforcement enhancements designed to increase compliance. There should be a balance within the IRS as between customer/taxpayer service and enforcement. For enforcement to be effective, it must be fair and balanced, yet the IRS must be careful not to create the perception that it is returning to its "old" ways. As such, it is important that the IRS distance itself from the methods employed before the Restructuring and Reform Act of 1998 that gave rise to significant criticism and the perception that the tax law was not being applied fairly or equitably. There are many effective ways to accomplish an increase in compliance yet prevent a return to the "old" IRS. When the taxpaying public becomes aware that the chances of detection for noncompliance have increased dramatically, compliance will rise. The taxpayer needs to believe that there exists a

sufficient likelihood of detection for noncompliance, fraud, and tax evasion schemes to believe the system is fairly administered. With budget restraints limiting available resources with which to launch new initiatives, the SB/SE Operating Division has a challenging and difficult task with respect to increasing compliance.

ISSUE ONE: RECOMMENDATIONS

The SB/SE Subgroup feels that the IRS should continue the educational outreach programs developed by the Taxpayer Education and Communication (“TEC”) program.

The IRS should reach out and “touch” more taxpayers to increase compliance rather than spend long periods of time on fewer taxpayer cases. The more taxpayers that are “touched” by the IRS, the more the taxpaying public will believe the likelihood of fraud, abuse and evasion detection and the penalties associated with same. With help from the NRP, the IRS should align resources to produce an efficient audit program. The Large & Mid-Size Business (“LMSB”) Operating Division is developing an innovative audit program called LIFE which focuses on taxpayers that have been cooperative in the past. Pursuant to the LIFE program, the IRS and taxpayer agree to focus audits based on certain parameters, and subject to materiality constraints. Similarly, SB/SE could develop such a program focused on high-income taxpayers for purposes of streamlining the audit process for cooperative taxpayers.

ISSUE TWO: NATIONAL RESEARCH PROGRAM

During the past year, the NRP has focused solely on Form 1040 taxpayers. The goal of the NRP is to update the profiles utilized to more accurately select returns for audit that are more likely noncompliant. The Questions and Answers booklet regarding

NRP states that “The purpose of the National Research Program is to ensure that our nation’s tax system is fair.” The Form 1040 individual tax return is the first stage in NRP and is well designed, employs well-trained Revenue Agents, and, accordingly results to date are very positive. While no taxpayer and/or preparer looks forward to an audit, the approach taken to date has helped greatly with the attitude of the taxpaying public.

Because the NRP has just launched and the number of Form 1040 NRP audits completed to date is small, the final impact and outcome of NRP’s stage one cannot be determined at this time. As of August 15, 2003 examiners had completed 9,557 cases; which translates into twenty-two percent of the NRP Form1040 sample. National Research Program evaluation tools that will be rolled out soon that should enhance the program’s probability for success; such as surveys that will be mailed to NRP participants (both preparers and taxpayers). The NRP information gleaned from the NRP taxpayer and preparer surveys should provide insights that will enable the IRS to maximize the success of the next NRP phase (pass-through entities).

The SB/SE Subgroup applauds all those involved in the Form 1040 NRP launch on what appears to be a job very well done.

Recently the SB/SE Subgroup was briefed on the pilot for the pass-through entity stage of the NRP. The IRS’ attitude seemed to be that the Form 1040 NRP template could simply be used for the pass-through entity stage, with a few simple modifications. Pass-through entities (i.e., partnerships, subchapter S corporations, LLC corporations, etc.) represent an entirely different and extremely complex taxpayer base, entirely different Internal Revenue Code sections from those typically applicable to Form 1040 taxpayers, and require a much different level of expertise to effectively conduct pass-

through NRP audits. Although the SB/SE Subgroup expressed such concerns, we fear our concerns may have been taken lightly. Pass-through entity returns are among the most complicated returns to file, with taxpayers often comprised of and filing for multiple pass-through entities. If the design and implementation of this NRP stage is not carefully planned, and effective training of the revenue agents not employed (as was done with the Form 1040 stage) the effort may well fail. Poor planning of the NRP pass-through entities stage could waste resources, provide meaningless results with which to profile and select future returns for audit, and a perception among taxpayers and preparers that the IRS does not know what it is doing which would encourage fraud and abuse.

ISSUE TWO: RECOMMENDATION

The SB/SE Subgroup recommends that the IRS use even *greater* care in the design of the pass-through entity phase of the NRP than was utilized in the Form 1040 stage. The Internal Revenue Code is very complex as applied to pass-through entities; published instructions are confusing, many preparers and taxpayers have drifted far into the “gray areas” due to lax enforcement, and there exists a knowledge gap among many Revenue Agents that must be closed. In the long run, it will be far better to affect great care in rolling-out the pass-through entities stage of the NRP, for purposes of success. The IRS must design a unique program for pass-through entities and permit only those Revenue Agents having the proper knowledge and experience to perform such audits or effectively train other Revenue Agents similarly to perform such audits.

ISSUE THREE: OFFER IN COMPROMISE PROGRAM

The SB/SE Subgroup has followed the Offer in Compromise program very carefully for the past two years with the support and cooperation of the IRS. All of our members have visited at least one of the two centralized processing sites in Brookhaven and/or Memphis. We have seen the “wall” of offer packages waiting for missing information and observed the courteous manner in which the agents reviewing cases speak with taxpayers by phone. We have seen the full-pay calculation worksheet and have been periodically briefed on developments in the implementation of strategies for reducing the backlog of offers and decreasing processing time. We applaud the efforts being made to streamline the processing by centralizing, standardizing procedures, and training people in this specific collections area. We remain concerned that there are far too many valuable resources utilized in this area particularly as compared to the relatively small portion of the actual tax assessment collected. Thus, the return on resource investment is extremely low despite the professionalism of IRS employees engaged in OIC work. There continue to be offer filings by nonqualifying taxpayers, taxpayers who do not submit all required documents with the initial submission, and an apparent “churning” of offers (submitting more than one offer within a 180 day period). The IRS Web site now has an online self screening product to affect a reduction in the number of offers submitted by potential nonqualifying OIC taxpayers. When we visited the OIC processing sites at Brookhaven and Memphis, we were consulted regarding implementation of the application fee and the design of Form 656A regarding the low income fee waiver. We support the application fee as an effort to discourage frivolous

filers and to offset program costs, and we sincerely appreciate the efforts of the IRS to facilitate our visits to OIC processing sites and solicit our input regarding the details of the application fee process.

ISSUE THREE: RECOMMENDATIONS

The SB/SE Subgroup would like the IRS to take a harder look at the types of tax liabilities that place taxpayers in a collection position and thus, give rise to entry into the OIC program. A study should be commissioned regarding situations that ultimately give rise to a taxpayer's application/entry to the OIC program. The results of such a study would prove extremely useful in developing educational tools and collection processes that provide early intervention to prevent acceleration of a taxpayers resulting in an OIC position. In other words, identify common taxpayer scenarios that result in unpaid taxes and provide early IRS notification, intervention, tools, and collection processes that can assist a taxpayer in preventing its tax debt from accelerating out of control. As such, collection of taxes will increase and correspondingly reduce collection receivables and the OIC backlog.

The SB/SE Subgroup believes that there should be better follow-up on settled offers to ensure that the taxpayer remains in compliance for the required five year period, and some form of enforcement should apply to those who don't.

Implementation of the Application Fee will necessitate that offers be submitted to the Centralized Sites. Therefore, we recommend that these sites attempt to resolve more cases, thereby resulting in fewer cases that must be sent to the field where a backlog already exists. The Revenue Officers in the field should adopt some of the successful

procedures implemented in the centralized sites in an attempt to meet the six-month turnaround time goal for all offers.

The SB/SB Subgroup strongly encourages a signature line on Form 656 to determine the number of offers currently submitted by single persons who may need additional education and the number of offers submitted by individuals who should be prosecuted for fraudulent filings. If Form 656 could also provide a designated area to provide discussion as between the preparer and the IRS with respect to the return (notwithstanding that the preparer is not an enrolled agent, CPA, or lawyer), closure of OIC cases might be expedited.

The SB/SE Subgroup would like to strongly recommend that the processing centers be strict in assessing the Application Fee. We feel it a *privilege* to have the opportunity to submit an Offer In Compromise, and the least the taxpayer can do is submit a complete package. If the offer is not complete, it should be returned immediately as “not processable” and the Application Fee should be retained. If the Fee is not attached to a submitted offer, and no waiver accompanies the submitted offer, the entire package should be returned to the taxpayer.

ISSUE FOUR: K-1 MATCHING

The K-1 matching program should provide the model for the IRS when planning to undertake a major compliance initiative that affects both internal and external stakeholders. Although the program initially was problematic due to an early unannounced start-up that gave rise to negative responses, the IRS subsequently has

worked conscientiously with stakeholders to establish an effective operating compliance initiative.

Compliance in K-1 matching is extremely important based upon the increased level of abusive tax schemes that are often formed using flow-thru entities through which to transfer income. Internal Revenue Service estimates reveal that a one percent increase in compliant K-1 reporting could increase tax revenue by \$500 - \$750 million per year.

Feedback received at the Focus Groups conducted at the Nationwide Tax Forums, revealed that many practitioners are unaware of the K-1 matching program and its effect on their clients. The March 2003 Treasury Inspector General for Tax Administration (“TIGTA”) audit report stated that in a sample of 100 returns containing Forms K-1, ninety two percent were prepared by practitioners.

There are several internal issues the IRS must consider. The modifications to the Schedule E are an important change that will enable matching to go smoothly and reduce labor costs required for matching. Since only partnerships with 100 members or more are required to e-file, the vast majority of K-1 filers *do not* e-file. Studies show that if partnerships with 10 or more members were required to e-file, 3.4 million Forms K-1 would be affected. The TIGTA audit also revealed that in some instances, IRS personnel incorrectly processed Forms K-1 to the wrong year’s database. This causes significant problems and costs in the matching process.

ISSUE FOUR: RECOMMENDATIONS

The IRS should involve Stakeholder Partnership Education and Communication/ Taxpayer Education and Communication programs (SPEC/TEC) to increase tax

practitioner awareness of the K-1 initiative, and its affect on their clients. This educational outreach would complement upcoming changes in the Schedule E which is currently undergoing redesign to facilitate matching of K-1 income to income reported on the Schedule E.

The SB/SE Subgroup recommends that the IRS continue to review form and procedural changes to convert the K-1 program to a true computer matching program and thus, reduce labor costs involved in the screening process which would permit such resources to be deployed more efficiently. The IRS should also work with software vendors to ensure that the transmitted K-1 is in a form that can be easily matched.

Although the IRS can mandate e-filing for Forms K-1 with fewer than 100 members (as is the current mandate), it is best to utilize *incentives* to motivate practitioners and businesses to e-file. E-filing is a worthy goal, leading to burden reduction, and the provision of information that can be used to maximize other compliance issues and studies. The SB/SE Subgroup also recommends better training of IRS personnel to assist in reducing input errors.

The IRS has corrected most deficiencies in the initial K-1 matching program to such an extent that it is becoming a worthy taxpayer compliance program which results in increased tax revenues. Increased outreach to the tax practitioner community, along with e-filing initiatives will improve the program across time and permit re-allocation of IRS resources to maximum efficiency.

ISSUE FIVE: ELECTRONIC FILING AND E-SERVICES

The SB/SE Subgroup would like to commend the IRS on the inroads made in the past twelve months to increase enhancements with respect to Electronic Tax Administration and E-Services. The SB/SE Subgroup fully supports the need for such a program for purposes of providing *e-filing* incentives, and we will continue to provide our *full* support.

Tax practitioners file nearly sixty percent of individual and more than eighty five percent of business returns. Some segments of the tax professional community have now adopted *e-filing* as their principle way of doing business, a behavior that, if adopted by all practitioners, would put the IRS past its eighty percent by 2007 e-file goal. However, many practitioners have not adopted this practice, and although more than thirty million returns are computer generated, they remain submitted on paper. Tax practitioners produce seventy two percent of computer prepared individual returns yet only forty six percent of these same practitioners e-file.

At the Nationwide Tax Forums, the SB/SE Subgroup elicited responses from non-e-filing practitioners. Software costs, transmission costs, changing office procedures, and added workload, including additional staff time and related costs, as well as signature timing of clients comprise the principal reasons cited by practitioners as significant barriers to e-filing.

It should also be noted that taxpayers view practitioners as trusted advisors and are likely to follow a practitioner's advice regarding e-filing. Therefore, it is imperative that practitioners themselves are convinced of the added value provided by e-file or they will not sell it to their clients.

The SB/SE Subgroup supports the need for the E-Services program. The aim of the E-Services program is to provide practitioners who e-file valuable tools that assist them in reducing costs and improving services to customers. This program is likely to prove a *major incentive* to practitioners to e-file once it becomes operational and well-known among practitioners.

The SB/SE Subgroup was told that e-file mandates could be forthcoming, and that tax practitioners would have no choice but to comply. Coming from the IRS, this is perceived as especially negative and may well elicit increased push-back from the preparer community. Incentives for e-filing will be far more productive than mandates.

ISSUE FIVE: RECOMMENDATIONS

The IRS should:

- Streamline Federal/State E-filing – allowing multi-state returns to be e-filed for all states. E-file should be transparent by accepting all returns without limitations
- Eliminate the extra data entry required to e-file – such as Forms W-2 and 1099 data. The IRS should continue working on the 2D bar-coding to enable practitioners to scan the information.
- Continue with the increase of E-Service and provide additional value services on a timely basis as incentives to reach the eighty percent projection. Set the e-file requirement to increase the number of qualifying practitioners as regards the E-Service program.

- Understand how tax practices operate to remove hurdles, burdens, and significant costs of e-filing.

ISSUE SIX: PREPARERS

Paid preparers submit more than half of all tax returns filed and they prepare two-thirds of the Earned Income Credit returns filed. Paid preparers are estimated to number from 700,000 to 1.2 million. Of these, approximately half are subject to some form of professional accreditation or standards. Under the current system, Electronic Return Originators are held to higher standards than the remaining hundreds of thousands of tax preparers.

Any IRS effort to enhance enforcement should seriously consider the impact that *poorly educated and/or unethical preparers* are having on the increasing problem of non-compliance. The IRS should also consider the powerful and demoralizing message it sends to ethical preparers who lose clients to those with lower standards and fees by holding firm on standards for fraudulent and unethical return preparers. The SB/SE Subgroup's belief was validated by practitioners who attended the Nationwide Tax Forums. In our focus groups we heard many stories of taxpayers moving from preparer to preparer until they found a preparer who delivered the desired results. Taxpayers should be made more aware that the Service has public guidelines regarding choosing a reliable preparer (Tax Topic 254 and 1040 instructions).

The Service has available a system of preparer penalties, such as penalties for failing to sign a tax return they prepared. However, due to the lack of IRS enforcement, these penalties are not having the desired effect on the tax preparer community.

The Taxpayer Advocate, Nina Olson, has proposed a nationwide program for registering all preparers who file more than five returns for a fee. The recommended guidelines are: (a) register with the government; b) pass an initial examination based on the tax return, line by line; (c) annually pass a refresher exam on recent tax law changes and the most common errors from the previous filing season and d) receive a certification card.

The SB/SE Subgroup strongly supports a preparer certification program that will enhance the competency of individuals or firms that prepare tax returns for a fee. For a program to be effective it must receive adequate enforcement. This will, in turn, increase the morale of all tax return preparers.

ISSUE SIX: RECOMMENDATIONS

The SBS/E Subgroup believes that the Service should begin working with outside stakeholders to develop a program that immediately improves tax preparer competency.

We believe this group must examine the following issues to be successful:

- Review existing preparer penalty and regulation policies and practices. Can they be used more effectively? Will they integrate with the program or stand alone?
- Can the program be self-funded with a user fee?
- Should the program address individual preparer, firm-level responsibilities or both?
- Which entity should manage the program? The IRS Office of Professional Responsibility? or a newly created entity established solely for that

purpose? Additionally, what role can existing tax professional associations play in the managing of the program?

- Deterrents, fines and suspensions, must be reasonable, consistently applied, and timely.

The SB/SE Subgroup does not foresee an increase in taxpayer burden or other harm to result from these actions. Taxpayer confidence will increase with respect to the competence of those who serve them. Many taxpayers are surprised to learn that many tax preparers are not regulated by the IRS or at all.

The SB/SE Subgroup looks forward to working with IRS representatives to assist in the development of a preparer program that can be effective and, therefore, enhance compliance.