INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

SMALL BUSINESS/SELF-EMPLOYED
SUBGROUP REPORT

KENNETH C. NIRENBERG, SUBGROUP CHAIR
KARLA R. HYATT
JONI JOHNSON-POWE
ROBERT E. PANOFF
CATHY BROWN PEINHARDT
GARY C. ROHRS

NOVEMBER 15, 2006

SMALL BUSINESS/SELF-EMPLOYED
SUBGROUP REPORT

TABLE OF CONTENTS

INTRODUCTION/EXECUTIVE SUMMARY

ISSUES AND RECOMMENDATONS

ISSUE 1: Customer Satisfaction

ISSUE 2: Examination Recruit Hire Curriculum Redesign

ISSUE 3: Improving the Performance of Tax Preparers

ISSUE 4: Tax Gap and the Cash Economy

INTRODUCTION/EXECUTIVE SUMMARY

The IRSAC SB/SE Subgroup (hereafter "Subgroup") consists of a diverse group of tax professionals who have significant professional experience and organizational affiliations. The Subgroup has representation from CPAs, Enrolled Agents, Tax Attorneys and Software Developers. Each member, along with specific areas of expertise, has wide experience with both the taxpaying public and the IRS. We are pleased that the IRS has requested our views on issues of importance to both the general public and the IRS.

The Subgroup thanks the IRS personnel for their availability and candor in presentations and discussions. In particular, we appreciate the time that Commissioner Kevin Brown and Director Beth Tucker have spent with us in our Subgroup working sessions. They have made a determined effort to enlighten us with updates on SB/SE efforts concerning the tax gap and other issues. We also want to thank the staff of the National Public Liaison (NPL) for their hard work and dedication. Due to the flood damage at 1111 Constitution Ave, it has been a challenging several months for IRS personnel in the DC area. Our liaisons have done an exemplary job of organizing phone conversations to compensate for our canceled July working session.

During the course of the year, the Subgroup has researched and reported on the following four key issues:

1. Customer Satisfaction – The IRS would like to improve customer satisfaction with the collection process. However, the IRS desires to balance increases in taxpayer satisfaction with the overall effectiveness of collections. The IRS has traditionally used a survey to gauge taxpayer satisfaction with the collection

process. In 2005, 60-65% of taxpayers surveyed indicated that the experience was satisfactory, while 22-25% were dissatisfied. The IRS would like to improve these results.

2. Examination Recruit Hire Curriculum Redesign – The Examination Recruit Hire Curriculum Redesign ("Redesign Initiative") is in the process of redesigning the methodology used to train new Revenue Agents. The Redesign Initiative focuses primarily on creating computer based training and a more practical hands-on curriculum with the goals of (1) producing new Revenue Agents that are better prepared for the challenges of taxpayer service and (2) reducing the time necessary to fully prepare new Revenue Agents for the field.
3. Improving the Performance of Tax Preparers – Competent tax preparers facilitate efficient tax administration. IRS efforts to improve preparer performance have focused on education and discipline. We support continued emphasis on education and increased emphasis on discipline.
4. Tax Gap and the Cash Economy – The IRS' most recent estimate of the Tax Gap, the difference between what taxpayers should have paid and what they actually paid on a timely basis, is in the neighborhood of $345 billion for tax year 2001. The IRS has been successful in recovering approximately $55 billion of this shortage. The remaining shortfall of $290 billion is still unacceptable. Greater efforts to address this problem simply must be undertaken.

Each issue contains specific recommendations. We hope that each recommendation will be considered and create meaningful dialog within the IRS.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: CUSTOMER SATISFACTION

Executive Summary

The IRS would like to improve customer satisfaction with the collection process. However, the IRS desires to balance increases in taxpayer satisfaction with the overall effectiveness of collections. The IRS has traditionally used a survey to gauge taxpayer satisfaction with the collection process. In 2005, 60-65% of taxpayers surveyed indicated that the experience was satisfactory, while 22-25% were dissatisfied. The IRS would like to improve these results.

Background

The IRS has utilized the assistance of Pacific Consulting Group (PCG) to administer customer surveys regarding its field collection efforts. Surveys are generally mailed to taxpayers after a case has closed, and the response rate to the surveys has been approximately 19%. In the years following the 1998 restructuring of the IRS, there were significant improvements in customer satisfaction as measured by the PCG survey. However, there has been little significant movement--positive or negative--in overall survey results since FY 2001.

Based upon the data obtained from the surveys in recent years, the IRS would like to improve taxpayer satisfaction with the overall collection process in four main areas:

1. Taxpayer updates from the IRS on the overall status of the collection process;
2. Notification of taxpayers concerning case closure;
3. Decrease in cycle time resolution; and
4. Prompt acknowledgment by IRS of receipt of information.

As mentioned above, the IRS does not want to negatively impact the effectiveness of the collection process in order to increase overall taxpayer satisfaction with the process. The SB/SE Division has created a team to cultivate customer satisfaction in the area of collections. Representatives of the team met with IRSAC to discuss their efforts to date, and we encourage their continued work in this area.

Recommendations

1. IRSAC noted that the lowest satisfaction scores were associated with questions asked last in the PCG surveys. Periodically changing the order of the questions might eliminate a possible source of response bias.
2. The IRS needs to improve its communication with taxpayers by providing more timely response and follow-up during the collection process. The IRS should improve its traditional means of communicating with taxpayers by continuing to explore the use of electronic mail or online availability of collection information on a secured network. Online access to information can improve responsiveness to the taxpayer, while decreasing mailing costs and burden for the revenue officer and customer service representatives.
3. Improvement in the IRS' integrated databases is necessary to allow for real-time access of information by revenue officers and customer service representatives. Databases should be kept up to date as cases are closed or information is received. Furthermore, documentation received from taxpayers should be kept in electronic format to allow online viewing by collection agents and customer service representatives.

4. The use and visibility of local revenue officers within the vicinity of the taxpayer would facilitate better response time, acknowledgement of receipt of information from taxpayers and, thus, overall customer satisfaction with the process.
5. The IRS should provide better training and education for its revenue officers and customer service representatives regarding service to taxpayers.
    a. The IRS needs to increase training on "soft skills" such as communication between revenue officers and taxpayers. This goal may be accomplished through use of outside firms that develop problem solving and team building skills and utilize nontraditional training techniques, such as role playing, as part of the training curriculum.
    b. Efforts should be made to monitor revenue officers for signs of burnout.
6. Tools such as the Balanced Measurement System for evaluating the overall progress of its performance regarding customer satisfaction and overall business results should continue to be used by IRS.
    a. Evaluation of variables such as field collection quality, percentage of cases overage, percentage of Offers in Compromise processed in less than six months, number of cases closed, and employee satisfaction in conjunction with the Customer Satisfaction Survey score should continue to be utilized in the Balanced Measures for the collection process.
    b. Additional variables such as customer outreach and taxpayer education should be defined.
7. Although taxpayers brought into the collection system are currently provided with a large number of letters and brochures regarding the collection process, much of

the information provided is not read or understood. Efforts should be made to streamline and simplify the material provided. Moving toward more graphic presentations of timelines and other information would help to set reasonable taxpayer expectations regarding the collection process.

8. The IRS should continue to use focus groups and other initiatives, such as tax forums, to better understand the customer experience.

ISSUE TWO: EXAMINATION RECRUIT HIRE CURRICULUM REDESIGN

Executive Summary

The Examination Recruit Hire Curriculum Redesign ("Redesign Initiative") is in the process of redesigning the methodology used to train new Revenue Agents. The Redesign Initiative focuses primarily on creating computer based training and a more practical hands-on curriculum with the goals of (1) producing new Revenue Agents that are better prepared for the challenges of taxpayer service and (2) reducing the time necessary to fully prepare new Revenue Agents for the field.

Background

The purpose of the Redesign Initiative is to provide new hires more comprehensive training in the most practical and efficient manner possible. The development team for the Redesign Initiative (Core Team) is headed by Monica Baker and Shelley Foster, who have accomplished significant improvements in a short period of time. The April 2006 hires were the first class to experience some of the curriculum changes. The Core Team evaluated the experience of the April 2006 class, made modifications and implemented more comprehensive curriculum changes for the June 2006 hires, including suggestions

made through informal conversations with the Subgroup. Although the curriculum changes have been successful overall, there are still many improvements and implementations on the horizon. IRSAC applauds the efforts of the Core Team thus far and encourages a continuing commitment to the Redesign Initiative.

Recommendations

1. A methodology should be developed to evaluate the skill level of each new hire to better tailor the training experience. For example, a new Revenue Agent who is hired from private practice will come to the IRS with a different skill set than a recent college graduate. Training should be tailored to allow the more experienced hires to "test out" of certain training modules. We understand that any such methodology would need to comply with National Treasury Employees Union guidelines.
2. The Core Team should develop and implement knowledge testing for the self-study modules. This would allow trainees and coaches to better evaluate each trainee's progress and the effectiveness of the self-study module. We understand the Core Team is currently working on developing a form of knowledge testing, but must ensure that any such testing complies with National Treasury Employees Union guidelines.
3. The Core Team should continue to explore and expand the utilization of retired IRS personnel to teach the classroom portion of training in order to minimize the time active Revenue Agents are out of the field.

4. A process should be developed to train the on-the-job training coaches to ensure each trainee receives uniform training. For example, a “train the trainer” program should be developed.
5. The Core Team has recognized that each trainee should be assigned a mentor. A mentor could be an individual with less experience than a coach, but could assist the trainee with non-technical issues. The use of a mentor would alleviate some of the time constraints on each coach.
6. The Core Team should continue to solicit feedback from trainees and coaches in order to improve the training program with each new class of hires.
7. The Core Team should continue to explore and expand its use of “off-the-shelf” computer training programs in an effort to maximize efficiency and minimize cost. Similarly, the Core Team should continue to explore and develop web-based training, because it is the simplest way to create tailored training.
8. The Redesign Initiative should continue to receive adequate funding regardless of whether the new hires reflect an overall increase in Revenue Agents or simply attrition hires.
9. The current Core Team should remain intact to ensure the vision that has already been developed will reach its full potential.

ISSUE THREE: IMPROVING THE PERFORMANCE OF TAX PREPARERS

Executive Summary

Competent tax preparers facilitate efficient tax administration. IRS efforts to improve preparer performance have focused on education and discipline. We support continued emphasis on education and increased emphasis on discipline.

Background

The IRS has long recognized that tax professionals are vital to fair and efficient administration of the U.S. tax system. Although paid preparers are required to sign the returns they prepare, their identities are not currently tracked in any single database, and it is not possible to determine the number of persons who prepare returns for others with any certainty; however, the number is estimated to exceed 1 million. Over half of all individual returns submitted are prepared by paid preparers, and the percentage of partnership and corporate returns is even higher.

As Free File and other initiatives for taxpayers with simple returns increase, many preparers are finding that their workloads are shifting toward more complex returns. Moreover, as the IRS steps up its enforcement efforts, preparers are seeing more "remedial" situations that require skills beyond mere return preparation. The tax code itself is becoming more and more complex. All of these factors "raise the bar" for tax preparers.

To the extent that paid preparers perform honestly and competently, efficient tax administration is enhanced. When a preparer is dishonest or incompetent, both the IRS and the taxpaying public are ill-served. IRS efforts to improve preparer performance

have traditionally included both education and enforcement. We believe that continued efforts in both directions are essential.

Tax professionals are commonly divided into two categories: (1) attorneys, CPA's and Enrolled Agents who are governed by IRS Circular No. 230 and (2) unenrolled preparers who have more limited rights to represent taxpayers before the IRS and are governed by Revenue Procedure 81-38, printed as Publication 470 "Limited Practice Without Enrollment." The education, training and experience levels within these groups vary widely. Although many preparers belong to professional organizations that certify the credentials of their members and/or require continuing professional education, the quality of the education obtained is not uniform. Some preparers have no specific training or education in tax preparation. Efforts to improve preparer performance need not be limited to a specific group since improving the performance of both enrolled and unenrolled preparers will benefit the IRS.

There has been widespread publicity of an early 2006 General Accounting Office (GAO) study of preparers from large national tax preparation chains. The study, which found significant errors in the returns prepared by nineteen individual preparers, was far too limited to permit conclusions about preparers in general. It does, however, publicize what diligent preparers across the country have known for years: some poorly-informed, incompetent, or unscrupulous preparers exist. One approach to this problem is to attempt to "drive out" all such preparers. Another is to raise their level of competence.

From time to time, the IRS has been asked to consider additional licensing and/or regulation of tax preparers. "The Taxpayer Protection and Assistance Act of 2005

(S. 832)" is one such measure. Some members of Congress have expressed concern that there are legal requirements for barbers, but no requirements for tax preparers. While it is correct that there are no barriers to entry, all paid preparers are, in fact, governed by provisions of the Internal Revenue Code that describe proper conduct of a preparer and specify penalties for violation of those provisions. Enforcement of those provisions, which is shared by a number of offices within the IRS and the Treasury Inspector General for Tax Administration (TIGTA), is vital.

A December 2001 IRSAC Position Paper on Tax Preparer Regulation expressed several concerns regarding IRS registration of tax preparers, including:

- Licensing may be an inefficient approach to specific preparer errors and abuses in areas such as earned income tax credits and refund anticipation loans.
- Increased regulation might reduce the supply and/or increase the costs of competent preparers, thus harming segments of the taxpaying public.
- Unscrupulous preparers might easily evade registration.
- The IRS lacks resources to effectively administer and enforce additional registration and licensing efforts.

The position paper concluded that additional research was needed before it would be possible to determine whether licensing of unenrolled preparers was appropriate. This conclusion remains valid today. Licensing of preparers alone is no more a guarantee of a competent job of tax preparation than licensing of barbers is a guarantee of a good haircut. Education and enforcement are critical.

Recommendations

1. Currently, at least four databases track subsets of preparers. E-file providers are identified by an Electronic Filer Identification Number (EFIN), persons authorized to represent specific taxpayers are listed on a Central Authorization File (CAF), payroll tax return preparers may be listed on the Reporting Agent File (RAF), and preparers who request an identifying number to use in lieu of their social security numbers are identified by a Preparer Tax Identification Number (PTIN). We recommend that all preparers be required to obtain and use a PTIN on returns they prepare. This would be an efficient approach to identifying the legal preparer population, would provide a reliable means of disseminating information to that population, and would facilitate additional data collection. Consideration should also be given to consolidating the information in these and other databases into a single file.
2. The IRS has committed significant resources to improving communications with tax professionals. The IRS website has been improved. Preparers are able to subscribe to a variety of news lists. Tax Talk Today, Tax Practitioners Institutes, and the Nationwide Tax Forums provide low-cost opportunities for preparers to refresh their knowledge of tax matters. SB/SE's Stakeholder Liaison Division has provided phone forums on a variety of topics, and its field offices have made efforts to contact preparers in their areas. These outreach efforts are important and should be continued. Continued efforts to publicize these avenues of communication are warranted.

3. The IRS currently partners with a variety of professional associations and other stakeholders to provide and obtain information regarding tax administration. Many of these groups provide educational opportunities to their members. Specific initiatives to identify areas of low compliance or particular complexity so that training and information can be targeted to those areas should be encouraged.
4. The IRS Practitioner Priority Service Hotline is an effective tool for practitioners with account-related issues. The IRS website provides numerous links to generic reference information. Consideration should be given to providing a hotline or e-mail site through which practitioners could ask questions regarding specific situations without having to link the issue to a particular taxpayer.
5. IRS enforcement efforts with regard to tax preparers have focused on the most egregious instances of preparer fraud and abuse. While this is an appropriate emphasis, the number of cases pursued remains small, and penalties levied are often not collected. To be effective, there must be more "touches" and more effective follow-through.
6. A March 2006 report by the Treasury Inspector General for Tax Administration (TIGTA) found that the IRS did not have an effective program for identifying practitioners whose licenses had been suspended or revoked by state authorities. It further found that the IRS did not have an adequate system for referring practitioners who were not current with their own tax obligations to the Office of Professional Responsibility (OPR) for review. OPR is instituting measures in both areas. Improved coordination of the preparer databases described earlier would assist with these efforts.

7. The IRS frequently publicizes common tax scams and abusive tax schemes to be avoided. The taxpaying public would benefit from additional information regarding positive qualities to look for in a tax preparer. Care must be taken to keep such recommendations general enough that they do not convey an unintentional "seal of approval" to a particular subset of preparers.

ISSUE FOUR: TAX GAP AND THE CASH ECONOMY

Executive Summary

The IRS' most recent estimate of the Tax Gap, the difference between what taxpayers should have paid and what they actually paid on a timely basis, is in the neighborhood of $345 billion for tax year 2001. The IRS has been successful in recovering approximately $55 billion of this shortage. The remaining shortfall of $290 billion is still unacceptable. Greater efforts to address this problem simply must be undertaken.

Background

The greatest disparity between real and reported income, according to the National Research Project study, comes from those taxpayers falling under the jurisdiction of the SB/SE Operating Division. When this segment is examined, the errors consist chiefly of underreporting of income and overstatement of cost of goods sold. Underreporting comes mainly from the difficult-to-trace cash transactions of our economy. IRSAC's 2005 Annual Report contained numerous suggestions regarding underreported income. These issues are still of concern. Overreporting costs, by including items that are not legitimate business expenses, might be considered a more

egregious problem as it often involves intentional misrepresentation of expenses to disguise their real nature.

The IRS SB/SE Operating Division has proposed, and the President has included in his FY 2007 budget proposal, five legislative changes to begin addressing the tax gap. These are:

- Expanding third-party information reporting to include certain Government payments for property and services;
- Expanding third-party information reporting on debit and credit card reimbursements paid to certain merchants;
- Clarifying liability for employment taxes for employee leasing companies and their clients;
- Expanding beyond income taxes the requirement that paid return preparers sign returns, and impose a penalty when they fail to do so; and
- Authorizing the IRS to issue levies to collect employment tax debts prior to collection due process proceedings.

Recommendations

1. We support the first four legislative proposals, each of which will have an impact on reducing the tax gap. Our objection to the last proposal concerns the circumvention of due process. If the IRS desires an ability to move more swiftly on delinquent employment taxes, legislative efforts should be made to speed up due process rather than circumvent it.
2. There must be additional efforts to reach the middle-income taxpayer. Application of IRS resources often overlooks this area, since, individually, the

anticipated yield from them is believed to be small relative to the cost of collection. If these taxpayers do not experience scrutiny themselves nor see their contemporaries facing scrutiny, then they are encouraged to continue or, even worse, to begin doing what "everyone else is doing." The continued effect of non-compliance on the compliant taxpayer can lead to whip lash--honest taxpayers become dishonest. There must be a balance in the enforcement area. Large case emphasis is not the single answer, because large case emphasis means that fewer taxpayers will be examined. With a 16.3% non-compliance rate, the large case emphasis will not appreciably impact this segment. IRSAC has repeatedly said that there is a need for more touches between the IRS and the taxpayer community.

3. There must be an acceptance by the IRS and Congress that balance is needed between burden and compliance. Most initiatives to increase compliance create additional burden for the taxpaying public. If the compliance gains are great enough, the additional burden is justified. One of the best ways to improve compliance while *reducing* burden is to simplify the assessment, reporting and collection of tax. To whatever degree this is achieved, compliance will increase and all taxpayers will benefit.
4. We applaud the efforts by SB/SE Commissioner Brown to solicit suggestions for tax gap reduction from employees within SB/SE, from other IRS operating divisions and from external stakeholders. The initial tally of over 1,000 responses indicates that there is widespread interest in finding solutions for the tax gap. It is wise to pay attention to the Service's best resources--its employees and

stakeholders. The frequency with which certain ideas have been suggested gives credence to those suggestions. We urge the IRS to continue to gather input from these resources.

5. We continue to advocate the expanded use of third party reporting and the review of the 1099 de minimis amount rules. We give strong support to the implementation of withholding by those third party reporters where it is not now authorized. The value of this is attested to in comments by SB/SE Operating Division Commissioner Kevin Brown, who said "Where we have third party reporting, we have 90 percent compliance. Where you couple third party reporting with withholding, [we] are at 98 to 99 percent compliance." Among SB/SE taxpayers, due to the relatively low amount of third party reporting or withholding, the compliance rate is in the 55 percent range.
6. We recommend that the entire tip industry be scrutinized--not just the food and beverage segment. The Attributed Tip Income Program, a pilot program at present, is but another effort directed solely at the food and beverage industry. Hairdressers, cabbies, bellhops, valets, concierges and a host of other service providers are recipients of tips. Tip reporting programs, whatever they may be, should have mandated participation, even if achieving this requires legislation.