

# Internal Revenue Service Advisory Council

Annual Report

November 2004





**INTERNAL REVENUE SERVICE  
ADVISORY COUNCIL  
PUBLIC MEETING**

**NOVEMBER 10, 2004  
1111 CONSTITUTION AVENUE NW  
WASHINGTON, DC**

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**INTERNAL REVENUE SERVICE  
ADVISORY COUNCIL**

**PUBLIC MEETING  
BRIEFING BOOK  
NOVEMBER 10, 2004**

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**2004 ADVISORY GROUP**  
**WORKING SESSION & PUBLIC MEETING**  
**NOVEMBER 09 – 10, 2004**  
**1111 CONSTITUTION AVENUE – RM. 3313**  
**INTERNAL REVENUE SERVICE ADVISORY COUNCIL (IRSAC)**  
**AGENDA**  
**WEDNESDAY, NOVEMBER 10, 2004**

Time	Topic	IRSAC/IRS Representatives
8:30 - 9:15	Coffee/Refreshments	
9:15 - 10:15	Opening Remarks	Mark W. Everson Commissioner, Internal Revenue Frank Keith, Chief Communications & Liaison Paul Mamo, Acting Director National Public Liaison Tracy Hollingsworth, IRSAC Chairperson
10:15 - 10:35	IRSAC Overview Report	Tracy Hollingsworth, IRSAC Chairperson
10:35 - 10:50	BREAK	
10:50 - 11:35	Wage & Investment Subgroup Report	Henry Lamar, Commissioner, W& I Susan Boehmer, Director for Strategic Operations Judy Akin, Chair, W&I
11:35 - 1:00	Lunch	
1:00 - 1:45	Large & Midsize Business Subgroup Report	Deborah Nolan, Commissioner, LMSB Betty Wilson, Chair, LMSB Subgroup
1:45 - 2:00	BREAK	
2:00 - 2:45	Small Business & Self Employed Subgroup Report	Kevin Brown, Commissioner, SBSE Steve Whitlock, Deputy Director, Office of Professional Responsibility Susan Smoter, Director, Internet Development Service, ETA Pamela Kulish, Chair, SBSE Subgroup
2:45	Closing Remarks	Tracy Hollingsworth, IRSAC Chairperson Paul Mamo, Acting Director, National Public Liaison
3:00	Adjourn	

**INTERNAL REVENUE SERVICE  
ADVISORY COUNCIL**

**GENERAL REPORT**

**JUDY AKIN  
TIMOTHY B. CLAY  
JON CONTRERAS  
RICHARD D'AVINO  
FELICIA G. DIXSON  
JOHN GLENNIE  
MARY HARRIS  
TRACY HOLLINGSWORTH  
ANN HUBBARD  
PAMELA P. KULISH  
RICHARD LIPTON  
SUSAN W. MARTIN  
KENNETH NIRENBERG  
GARY ROHRS  
DENISE STRAIN  
CAROL TREMBLE  
WILLIAM REILLY  
DAVID UHLER  
THOMAS WHARTON  
BETTY M. WILSON**

**NOVEMBER 10, 2004**

**GENERAL REPORT  
OF THE  
INTERNAL REVENUE SERVICE ADVISORY COUNCIL**

The Internal Revenue Service Advisory Council (IRSAC) serves in an advisory capacity under the Federal Advisory Committee Act, Public Law No. 92-463. Its predecessor, the Commissioner's Advisory Group (CAG), was established in 1953 as a "national policy and/or issue advisory committee." The CAG was renamed in 1998 to reflect its agency-wide scope.

The primary purpose of the IRSAC is to provide an organized public forum for IRS officials and representatives of the public to discuss relevant tax administration issues. The IRSAC reviews existing tax policy and offers recommendations on emerging tax administration issues. The IRSAC suggests operational improvements, offers constructive observations regarding current or proposed IRS policies, programs, and procedures, and advises the Commissioner and the IRS with respect to issues having substantive effect on federal tax administration.

The 2004 IRSAC is well suited to convey the public's perception of IRS activities and advise the IRS, from that perspective, on various aspects of tax administration. The membership includes nine heads of private companies that assist smaller firms and individuals with filing tax returns; five current or retired corporate tax executives, including two former international presidents of the Tax Executives Institute; a lawyer who is a former chair of the Tax Section of the American Bar Association; one academic; a tax software developer; an association tax counsel; and two representatives from accounting firm tax practices.

The IRSAC is organized into three subgroups, corresponding to three of the four IRS Operating Divisions: the Large & Mid-Size Business Subgroup (hereinafter the “LMSB Subgroup”); the Small Business & Self-Employed Subgroup (hereinafter the “SBSE Subgroup”); and the Wage & Investment Subgroup (hereinafter the “W&I Subgroup”). Each subgroup has issued a report that is included following this general report of the entire IRSAC. All reports are the products of working sessions held in Washington during the year, onsite meetings, and conference calls between IRSAC members and key IRS personnel. The cooperation and efforts of IRSAC members and representatives of the Service made the work of the IRSAC and these reports possible. The members of the IRSAC extend special thanks to the staff of the Office of National Public Liaison for ensuring that the Council had all resources necessary to perform its advisory function.

The IRSAC was pleased to testify before the IRS Oversight Board on January 29, 2004. The IRSAC testimony recommended that increased efforts be made to enhance enforcement. The testimony stressed the importance of assuring taxpayers that all are being treated equally and all are paying their fair share and commended Commissioner Everson for recognizing the need to find a proper balance between service and enforcement. IRSAC suggested that effective risk assessment and risk management strategies and tools are the keys to improving enforcement and deploying resources to the greatest effect. The multi-pronged attack on tax shelters was cited as an example of effective use of the combined tools of guidance, publicity, and enforcement to address concerns and to foster improved compliance. The IRSAC testimony looked forward to the results of the National Research Program (NPR), which should greatly enhance the Service’s risk assessment capabilities with respect to individual taxpayers, particularly when combined with Business Systems

Modernization. As it has many times in the past, the IRSAC supported funding that will adequately support IRS objectives in the areas of service, enforcement, and productivity.

The Subgroups were active in responding to operating division requests for assistance and input. Each division asked its Subgroup to concentrate on specific areas, which became the focus of Subgroup activities. As is indicated in the Subgroup reports, each carefully studied the issues presented, interacted with Division personnel, and provided advice and commentary. The IRSAC believes that this aspect of its advisory role is particularly helpful to the IRS in shedding light on public perception and, on occasion, in forestalling missteps.

The Subgroups interacted with Service personnel in various ways. These included regular sessions during the course of IRSAC meetings, conference calls, written commentary, and a field trip by the SBSE subcommittee to Austin, Texas to learn first hand about processes for handling offers in compromise. Throughout these interactions, IRSAC members provided candid advice and commentary with the sole purpose of assisting the IRS to carry out its various missions and functions.

The IRSAC met formally in February, May, July, and September to address issues of Service-wide on which the entire group could provide helpful input. We heard from, among others:

- Frank Keith, Chief Communications and Liaison;
- Nina Olson, Taxpayer Advocate;
- Donald Korb, Chief Counsel and Nicholas DeNovio, Deputy Chief Counsel (Technical);



- SBSE Commissioner Kevin Brown;
- W&I Commissioner Henry Lamar and Deputy Commissioner Richard Morgante;
- Russell Geiman, Acting Director, National Research Program (NRP) and Cliff Jones, current NRP Director;
- Blaise Dusenberry, Special Counsel, Procedures and Administration;
- JoAnn Bass, Director, Strategic Services, MITS, and Tom Parisi, Program, Analyst, MITS;
- Shar Turner, Chief, Payroll and Practitioner Groups, Steve Bayder, IRS Notice Gatekeeper, and Patricia Evans, IRS Notice Gatekeeper;
- Chris Wagner, Deputy National Taxpayer Advocate, and Arlene Kay, Executive Director, Systemic Advocacy.

The IRSAC appreciated the time, effort, and candor of each of the presenters. Their preparation and willingness to discuss key issues informed the IRSAC and permitted members to perform their advisory function.

At each meeting, the Subgroups reported to the whole IRSAC on the issues being worked at the behest of the Divisions. This facilitated tracking the progress of assignments and identifying issues of concern to the entire Council. The remainder of this general report addresses those broader matters that warrant comment from the IRSAC as a whole.

### **ISSUE One: Fulfilling the IRS Strategic Plan**

On July 12, 2004, the IRS unveiled its 2005-2009 Strategic Plan. It states three broad goals: improved service to taxpayers, enhanced enforcement of the tax laws, and

modernization of the Service's workforce, process and technology. While the plan makes clear that service and enforcement are priorities of equal weight, there is a renewed and greater or perhaps sharpened focus on enforcement priorities to:

- Discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high income individual taxpayers, and other contributors to the tax gap.
- Ensure that attorneys, accountants and other tax practitioners adhere to professional standards and follow the law.
- Detect and deter domestic and off-shore based tax and financial criminal activity.
- Discourage and deter non-compliance within tax-exempt and government entities and misuse of such entities by third parties for tax avoidance and other unintended purposes.

In addition, the plan speaks to the Service's need to modernize not just technology but also business processes and workforce. This represents an important expansion of the concept of modernization by linking it with processes and most importantly with people, the Service's most valuable resource.

The IRSAC agrees that the strategic goals set by the IRS reflect the areas of greatest concern in the current environment, specifically:

- Preserving and building on gains in customer service;
- Achieving enforcement that detects, discourages, and deters non-compliance,
- Bringing the forces of modernization to bear on these goals.

The Service must ensure that service plus enforcement really does equal compliance. The IRSAC believes that “touching” more taxpayers whether by public pronouncements, notices, or direct interaction is as important as actual auditing. IRS has shown that it can use the tools of communication to promote compliance and deter taxpayers from succumbing to schemes promoted by others.

The strategic plan properly recognizes the importance of people in an effective service organization. IRS must find ways to ensure that the workforce is fully equipped with skills and training, as well as technology. Key to this is attracting and developing new talent, while making the most of the existing organizational knowledge. The Service also must ensure that it has an adequate number of enforcement personnel.

The IRSAC recommends that the Service also give thought to the human capital represented by the preparer community. We believe that well trained and ethical providers promote compliance and assist the IRS in meeting its goals. Enhanced communications with preparers can be useful. Taking steps to address abuses by paid preparers also is essential. Taxpayers should be protected from unethical service providers. Overall compliance would be improved if—at a minimum—existing rules, e.g., penalties, were consistently applied.

The IRSAC urges IRS to continue to explore ways of measuring risk and deploying resources in effective response to identified concerns. The organization-wide response to tax shelters is a good example of marshalling multiple means to attack a compliance problem. We believe that service-wide resources can be applied to other risk areas, such as flow-through entities. Further, in some respects tax shelter activities represent practitioner risks that also are found in other areas, such as EITC scams.

## **ISSUE Two: Resources and Workload**

Inadequate resources and unpredictable funding would hamper the IRS and could prevent it from meeting the goals of the updated strategic plan. The IRS needs full funding for its workforce, both new hires and annual raises, as well as for its strategic initiatives.

As the Commissioner stated in a recent letter to Senator Baucus, shortfalls—a perennial feature of the budget process—in IRS funding make the Service less able to fulfill its own service and enforcement plans. In particular, the IRS might not be able hire the 4,100 additional enforcement personnel it believes are needed. Moreover, shortfalls in funding threaten the Service’s ability to pay existing personnel, including those hired during FY 2004, and to replace service and enforcement personnel who have retired or otherwise left the IRS. The Commissioner’s letter also details some of areas where full funding would be particularly helpful.

## **ISSUE Three: Strategic Risk Assessment and Management**

One of the themes that runs through most of the presentations made to the IRSAC and to the Subgroups is the critical role of “risk assessment” and “risk management.” The results of the NRP will provide tools for measuring risk in individual returns. Additional NRP projects will provide risk indicators in other returns over the years. In addition, data mining exercises are identifying other areas of potential risk. The LMSB Subgroup, for example, heard a presentation on a recent study of linked flow-through entities.

The IRSAC believes that the IRS is at the beginning, in a sense, of finding new ways to identify risk and then to manage it. Modernized systems and electronically filed returns will make accurate data available far more quickly to both enforcement personnel and to those who study compliance trends. The IRSAC hopes that these new tools and enhanced

means of developing information will assist the IRS in targeting risk areas on as close to a real time basis as possible and, then, rolling out quick responses. As important, IRS agents will be able to hone in on risk areas, leading perhaps to quicker and more focused audits.

#### **ISSUE Four: New Processes**

The Divisions individually and collectively have been engaged in efforts to reengineer processes to improve “currency” and to identify trends that may warrant action by the IRS—in the form of guidance, communications, program changes or specific enforcement activities. Addressing a conference recently, Deputy IRS Commissioner Mark E. Mathews pointed out that the “perfect audit” is not necessarily the one that collects the last nickel of tax. He suggested, and we think rightly, that “the return on investment for that last 50 percent or 70 percent of effort may not be that great.”

As the LMSB subgroup reports, the Division has been working various reengineering projects, one of which—now entering pilot form—would focus audits on key issues to be addressed even before the return is filed. Other projects, such as the Limited Issue Focused Examination (LIFE), also aim at applying resources to “material” issues. And, SBSE is working with the concept of materiality to assist in defining the scope of audits.

Approaches that aim at reaching more taxpayers in less depth—but at the right level of materiality—are productive, and they allow the IRS to use its resources efficiently and effectively. They may run counter, though, to a culture that is devoted to rooting out that last nickel of unpaid tax.

The IRSAC urges IRS to continue to find new ways to perform audits. As Mr. Mathews suggested, the first 30 to 50 percent will find most of the tax due and allow the auditor to move on to another taxpayer. This would be good management of limited

resources. However, the IRS will need to constantly communicate its goals and train personnel in audit techniques particularly with respect to measuring risk and defining materiality. Further, the measure of what is a “good” audit many require changes.

### **Conclusion**

The 2004 IRSAC has appreciated the opportunity to serve this year as an advisory sounding board for the IRS. We appreciate the time and efforts of Commissioner Everson, the Division Commissioners, and the many other IRS personnel who facilitated our meetings and activities. We trust that the Service will continue to grow the ways it employs and deploys the collective knowledge and talent found in this IRSAC and those of the future.

**WAGE & INVESTMENT  
SUBGROUP REPORT**

**MARY HARRIS  
WILLIAM REILLY  
JUDITH A. AKIN, EA, SUBGROUP CHAIR**

**NOVEMBER 10, 2004**

## **I. INTRODUCTION:**

The members of the Wage and Investment Subgroup (W&I Subgroup) of the Internal Revenue Service Advisory Council appreciate the opportunity to interact with the Internal Revenue Service to improve communications with the taxpaying public. In addition, the members applaud the Service for the time and cooperation of the W&I Subgroup representatives and management with whom we have met to resolve issues. We look forward to our continued involvement with the W&I division of the Service so that we create a win-win situation for the Internal Revenue Service, practitioner community and the taxpayers.

## **II. EARNED INCOME TAX CREDIT (EITC)**

The Wage and Investment (W&I) Subgroup of the Internal Revenue Service Advisory Committee (IRSAC) has been requested to assist the IRS in its efforts to:

1. Reduce the Backlog of EITC Examinations.
2. Review the existing audit process and improve the quality of communication.
3. Increase outreach efforts.
4. Streamline the proof of concept tests which include:
  - a. Qualifying child test
  - b. Filing Status Test
  - c. Under-reporter Test

At this time, our subgroup is pleased to report that there has been significant progress in reducing the excessive inventory of EITC audits. As of June 2004, only 1.3% of EITC Audits were in process more than 365 days.



Compliance has reduced audit cycle time by 7.51% from prior year.

We applaud the service on the implementation of new outreach tools. These tools include, but are not limited to, such items as an EITC Eligibility Checklist for tax year 2004, a flier “Will you qualify for the EITC this year?” and postcards designed in both Spanish and English offering to assist low-income taxpayers in determining if they are eligible for EITC.

By June 2004, of the 25,000 taxpayers selected for review under the “qualifying child test”, the IRS had received responses from 16,400. This number filed their returns, claimed EITC and a child’s exemption. The IRS has completed reviewing and processing approximately 50% of these cases.

For the “filing status test”, 26,800 of the 36,000 taxpayers selected have responded to the IRS communication. These taxpayers filed single or head of household status and claimed EITC. The IRS has completed reviewing approximately 65% of these cases.

Regarding the “under-reporter test”, the IRS has successfully completed reviewing all 300,000 EITC returns with unreported income resulting in assessments of \$121.5 million.

Recommendations:

The Wage and Investment subgroup of IRSAC recommends that the IRS continue to increase outreach to EITC eligible individuals who do not file a return or file and fail to claim the allowable EITC.

We suggest that the IRS develop more multi-language self-help tools.

We request that all IRS employees communicating with taxpayers be educated as to the document requirements for claiming EITC. Some areas currently have different criteria as to the documentation necessary to qualify for EITC.

As for the qualifying child, one of the current proofs of residency test is that if the taxpayer has a post office box, they must submit the Postal Form 1093 for proof of residency. The US Post Office will not release the taxpayers completed Form 1093 except in response to a subpoena or court order. We recommend that the IRS permit use of an alternative to the Post Office form, such as, but not limited to, a utility bill that shows both the mailing address to a post office box as well as the actual residential service address.

### **III. ITIN PROGRAM**

The Wage & Investment Subgroup has been working on enhancements and the streamlining of the acceptance agent procedures and requirements.

1. All new ITIN applicants must show a federal tax purpose for seeking an ITIN.
2. The number of documents that will be accepted as proof of identity to obtain an ITIN has been reduced from 40 to 13.
3. The ITIN acceptance notification has changed from a card to a letter of authorization.

The key initiatives that will be developed and worked on with internal and external stakeholders are:

A. **Reduce ITIN processing cycle time and improve accuracy.**

Currently, it takes approximately 9 days to process an ITIN

application when it is attached to a tax return and approximately 20 days to process when not attached to a tax return. Approximately 70% of all applications had an income tax return attached this year.

- B. **Expand and improve the Acceptance Agent program.** At this time an Electronic Return Originator (ERO) that applies to be an Acceptance Agent does not have to go through suitability checks. However, Andover Submissions Processing Campus will still conduct a credit check and check for timely filing of required tax returns and payments. This includes individual, business and payroll tax reports. If the applicant has an installment agreement, payments must be current.
- C. Improve accuracy and timeliness of processing applications by developing and implementing a real time system to eliminate dependency on legacy systems.
- D. Determine the merits and feasibility of an employer TIN validation system.
- E. Determine whether an ITIN/SSN cross-indexing system is cost effective to identify and tax unreported income and identify victims of identity theft.

**Recommendations:**

W&I Subgroup recommend that the IRS develop an outreach program that will encourage more providers to serve as acceptance agents.

The IRS educate state agencies that an ITIN should not be used for anything other than tax reporting.

#### **IV. NOTICE REDESIGN**

The W&I Subgroup continue to work with Ann Gelineau, Jay Duffy, and their Dynamic Processing Team on notice redesign and simplification. During the current phase of the program, balance due notices (CP 501, 503 and 504) are being addressed along with delinquency notices (CP 515 and 518). During subsequent phases, the teams will be looking at notices used by the Automated Collection System, Automated Substitute for Return, Backup Withholding, Refund Hold and Installment Agreement programs.

Issues that are being addressed:

1. User Issues – identify needs that can be handled with modifications to the form, ignoring the technical limitations.
2. Functionality – rules and features that should be redesigned in the notices to support the business requirements.
3. Messaging – tone, word sophistication, readability, text font, formatting, notice length and, other customer satisfaction requirements.
4. General comments and needs – comments that have been expressed by taxpayers and practitioners who have received notices.

#### **Recommendations:**

The W&I Subgroup recommend that:

- A. Statements such as, but not limited to, “Final Notice before Levy”, should be in a different font and bold to make it more noticeable to the taxpayer.
- B. The readability of the notice should not exceed 6<sup>th</sup> grade level.
- C. The notices should be as short as possible with the primary issue being stated in the beginning.

## **V. E-SERVICES**

The Wage & Investment Subgroup of IRSAC supports the Internal Revenue Service’s E-Services program. At this time, we would like to suggest enhancements to the program that are in the best interest of the service, taxpayers, and the practitioner community.

1. Open online e-services to all Federally Authorized Tax Professionals.
2. We applaud the IRS for putting notices on-line for our viewing; however, it would be even more helpful if we could access the actual notices sent to taxpayers.



**LARGE & MID-SIZE BUSINESS  
SUBGROUP REPORT**

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## I. INTRODUCTION

The Large & Mid-Size Business Subgroup (hereinafter the “LMSB Subgroup”) consists of professionals who represent large and mid-sized businesses and in-house tax counsel from large multinational firms and associations. The members of the LMSB Subgroup come to the task without personal agendas. Rather, the overriding LMSB Subgroup agenda is to provide assistance to the IRS generally and LMSB specifically for the purpose of insuring efficient and fair tax administration and the development of equitable tax policy.

The Subgroup has been busy since February 2004 with five separate multi-day meetings conducted in Washington D.C. and several conference calls with LMSB personnel and executives. The LMSB Subgroup is most grateful for the time devoted by the executives and personnel of the Large & Mid-Size Business Operating Division and the staff of the National Public Liaison. Without their time and assistance, the year would have been less meaningful.

We have structured this Report around the four issues of primary importance to LMSB which were identified at the beginning of the year. Although not exhaustive, the list of issues helped us to focus on areas where we could be the most effective in providing assistance to LMSB. The report which follows identifies the issues and recommendations that were developed by the LMSB Subgroup during this year.

## II. ISSUES AND RECOMMENDATIONS

### A. LMSB COMPLIANCE REENGINEERING

#### 1) LMSB Productivity Improvement Phase II (IDR, 5701, and 30-day Letter Processes for Current Cases/Cycles)



## **Discussion**

Phase II was the second phase of a three phase approach to implement LMSB improvement initiatives. These initiatives have the goal of creating measurable improvements in case currency, cycle time and in direct examination time. Phase I, which created case delivery improvements and implemented an aged inventory closure initiative, was completed, and a break through team was organized to work on Phase II. The LMSB Subgroup strongly commends the members of the break through team and LMSB for their efforts and improvement initiatives, and we fully support efforts to increase productivity and reduce cycle time. We were presented with the preliminary report from the break through team and we responded with a written document discussing our concerns and recommendations.

Phase II strategies originally included recommendations for changes in Information Document Request (IDR) management, and for changes to Form 5701, the Revenue Agent Report (RAR) and the 30-Day Letter. The proposal would have established arbitrary rules for IDR processing times, eliminated the RAR by combining it with the 30-Day Letter and eliminated extensions to respond to the 30-Day Letter. Based on the comments and suggestions of the LMSB Subgroup and outside stakeholders LMSB did not implement the Phase II proposals.

The LMSB Subgroup strongly supports the goal of currency and shortened cycle times. Accordingly, we made several recommendations to improve Phase II of the LMSB Productivity Improvement Plan. We are pleased that LMSB did not implement Phase II as originally proposed.

## **Recommendations**

1. The IDR cycle should be recognized as part of an overall process to achieve a goal. It should not be viewed in isolation. Therefore, documents should refer to LIFE procedures, joint audit planning, and Pre-Filing Agreements (PFA's), and include references to accelerated issue

resolution techniques and early referral to appeals. There should also be recognition of the use of “rules of engagement”.

2. The taxpayer should invest the time to educate the team about the company and how its business is conducted. This should eliminate unnecessary IDR’s that would otherwise be issued.

3. IDR’s should be issued based on risk assessment using methodology determined during the joint audit planning process.

4. IDR’s should be well developed, specific, focused and clear. This should be accomplished by discussion with the taxpayer before the IDR is developed and issued.

5. IDR’s should be limited to one issue or item.

6. The team coordinator should have responsibility for the timing of the issuance of all IDR’s, including specialists, to prevent “bunching” of IDR’s.

7. The team coordinator should review and have responsibility for the wording of all IDR’s before they are issued. This will increase consistency within the team to the goal of greater cooperation and openness, ensure clarity and eliminate duplication between team members.

## **2) Schedule M-3 Reporting of Book-Tax Differences**

### **Discussion**

The Treasury Department and the Internal Revenue IRS issued a new draft schedule for Form 1120, Corporation Income Tax Return, which will be required for LMSB taxpayers instead of Schedule M-1, and a new Revenue Procedure. The purpose of this new Schedule M-3 is to increase transparency of corporate tax return filings by requiring greater disclosure and consistency among taxpayers in reporting transactions with significant book-tax differences.

LMSB has recognized from empirical research that the larger the difference between book and taxable income, the larger the risk in the return. In addition, many taxpayers and tax shelter promoters take undue advantage of the differences between rules for financial accounting and rules for tax accounting. Schedule M-3 is intended to be utilized by US corporate taxpayers with total assets of \$10 million or more. It is anticipated that the schedule will be finalized for use with federal income tax returns for tax years ending on or after December 31, 2004. Recently released Revenue Procedure 2004-45 allows all taxpayers that are required to disclose significant book-tax differences on Form 8886 (in accordance with the Regulations for Section 6011 relating to tax shelter disclosure), the option to use the corporate Schedule M-3 to report such differences instead of Form 8886. The purpose of the Revenue Procedure is to alleviate burden (double reporting of significant book-tax differences) in as much as Schedule M-3 requires the reporting of all book-tax differences. The Revenue Procedure should also encourage taxpayers to adopt the new Schedule M-3 earlier. Commissioner Everson believes that the new schedule will help target examination efforts on higher risk areas and thusly improve and speed the audit process. The LMSB Subgroup concurs.

We congratulate Commissioner Nolan and LMSB on this initiative. We believe that it is another “breakthrough” initiative that will result in increased effectiveness in the usage of IRS resources. We agree with Commissioner Nolan that it will allow agents to swiftly focus on emerging issues and will result in a more current and efficient examination procedure aimed at those returns with the greatest compliance risk. We believe that this will also have the effect of increasing taxpayer satisfaction, through reduced overall taxpayer burden.

### **Recommendations**

In order to help ensure the effectiveness of this new initiative, the LMSB Subgroup has the following recommendations:

1. Joint taxpayer and examining agent training should be implemented to ensure the proper understanding of the preparation and purpose of the new Schedule M-3. Stakeholder groups should be approached to help develop and implement such joint training.
2. Increased resources should be allocated to the Schedule M-3 implementation team.
3. The M-3 initiative should closely coordinate with the business e-filing program and with the Remote Examination Process program.
4. Schedule M-3 or an equivalent form should be required on all business returns with assets greater than \$10 million, not just corporations. This should include partnerships, LLC's, S corporations and foreign corporations.
5. Schedule M-3 should be reviewed annually by LMSB to ensure that the form highlights emerging issues and remains current.
6. Schedule M-3 should be used as a key component in risk analysis and selection of business taxpayer returns for examinations. However, being sensitive to taxpayer burden, data collected should be used, or the requirement to deliver it should be eliminated. Regular monitoring of the use of the data collected on Schedule M-3 and regular maintenance of Schedule M-3 should be built into the process of managing it in order to eliminate undue burden on taxpayers and IRS systems alike.
7. Following on recommendations 1-6 above, and because the M-3 concept should become bedrock for LMSB, an institutional home or functional champion should be appointed to regulate and maintain the various iterations of M-3 that will evolve.

8. “Frequently Asked Questions” should be updated monthly between now and the extended filing date for tax years ending on or after December 31, 2004 (through at least the first filing cycle) and then quarterly thereafter.
9. The IRS should recognize publicly that many taxpayers have not engaged in abusive tax shelters and one purpose of Schedule M-3 is to recognize this difference in taxpayers and to allocate resources accordingly.
10. The list maintenance requirement for tax advisors under Section 6112 should be modified or eliminated for book-tax differences if the taxpayer is making a Schedule M-3 disclosure.

### 3) **LMSB/SBSE Flow-Through Compliance Committee**

#### **Discussion**

The Large and Midsize Business Operating Division continues to pursue innovative methods to identify tax returns, which will provide its division with the greatest potential for change. One of its latest innovative processes is the establishment of its Flow-Through Compliance Committee (“FTCC”). The FTCC was established by the Enforcement Council in October 2003 and given the direction to develop a process to identify issues on flow-through returns not normally captured during the course of an LMSB examination, and to develop return selection criteria using data mining techniques such as Compliance Risk Patterns (CRISP’S) and Predictive Association Rules (“PAR”)

The LMSB operating priorities included coordination with SBSE, TEGE, Appeals, Counsel, and CI on:

- Abusive tax avoidance transactions that affect high wealth individuals and mid-market corporate taxpayers.
- Enhance tax shelter promoter compliance.
- Take actions to increase examination compliance on tax shelter promoter activity including identification of investors.
- Improve workload selection models for flow-through entities (“FTE”).

LMSB has taken an aggressive role in attempting to identify lower tier partners or shareholders of FTE’s that will generate the greatest degree of a potential for tax change and issues relevant to a broad range of taxpayers.

The increased filing of returns for partnerships and S-corporations leads one to conclude that increased flow-through examinations may lead to a higher rate of compliance. Over the last three years, FTE tax return filings have collectively increased 11.6%, whereas corporate returns, over the same period, have increased an average of 4.85%.

<b>TAX RETURNS FILED</b>	<b>FY 00 GROWTH OVER PY</b>	<b>FY 01 GROWTH OVER PY</b>	<b>FY 02 GROWTH OVER PY</b>
1065	15.5%	10.88%	13.6%
1120-S	13.93%	4.5%	11.2%
1120	4.17%	-5.2%	15.6%

Given the above information, the FTCC established two sub-committee's 1.) Research and 2.) Compliance Risks and Resources. Research concluded that FTE's filed Forms K-1 affecting 7 million LMSB payees and more than 15 million SBSE payees. Using its data mining capabilities, FTCC has the ability to identify key relationships of income and deductions, and flow through losses which will ultimately affect LMSB taxpayers. Providing LMSB examination teams early referral cases with relevant flow-through issues will complement examination audit plans. More important, while enhancing LMSB's audit plan, the FTCC case delivery methodology will increase the SBSE coverage of mid-market pass-through entities.

In the LMSB Subgroup report dated November 6, 2003, it was noted that close to sixty percent of the pass-through entity filing populations involved a tiering paradigm such that the entity itself is either a member/partner/shareholder of a higher level entity or it has member/partners /shareholders that are flow-through entities themselves. Since that report was issued, it was noted that the LMSB examination plans do not reflect appropriate levels of coverage to examine FTE taxpayers. The FY 04 and 05 compliance plans for LMSB agents working Forms 1065's and 1120S follow:

**Form 1065**

**Form 1120S**

**LMSB**

**SBSE**

**LMSB**

**SBSE**

**DESY\***

**Returns**

**DESY**

**Returns**

**DESY**

**Returns**

**DESY**

**Returns**

Fy03	142	1533	102	4253		89	1486	164	7587
FY04	155	1242	109	4501		61	307	139	4540
FY05	194	2119	117	6311		102	1243	156	6373

\*Direct Exam Staff Years

The LMSB Subgroup believes that the LMSB operating division should make increasing audit coverage (particularly for upper and mid size pass-through entities) a high priority, while it reduces its cycle time and increases coverage of Coordinated Industry Cases (“CIC”) and Industry Cases (“IC”). Given the above information, it is apparent that the FTCC can provide detailed information to LMSB examination teams to perform detailed examinations where a CIC/IC taxpayer has significant pass-through investments or structures that warrant review. We believe that LMSB examination teams typically are not well versed in pass-through issues and administrative processes such as TEFRA, and that providing each team a journeyman SBSE agent to facilitate examination coverage of any pass-through entity related to a CIC or IC taxpayer would enhance the examination team audit plan and potentially reduce cycle time.

Given the above projected levels of coverage, it appears that LMSB/SBSE are not dedicating sufficient staff years to address compliance issues identified by FTCC. In FY04, collectively 248 DESY’s were dedicated to examining only 9,041 tax returns. In FY 05 the divisions



increased DESY's by 10.9% to 273 agents with coverage exceeding 12,684 returns. With the increased filing of forms 1065 and 1120 averaging 11.6 % clearly each of the divisions are barely maintaining a level of coverage rather than increasing coverage of the overall population.

### **Recommendation**

The LMSB Subgroup recommends that LMSB redeploy resources to reflect the overall population of tax returns filed in the pass-through arena. Rather than deploying a specific number of agents dedicated to pass-through entities, LMSB/SBSE should deploy a set percentage of DESY's dedicated to examining pass-through entities. This application would ensure that as inventory grows minimum audit coverage of the FTE population will also be maintained. As FTCC develops a list of issues that warrants examination, it is important that LMSB provide the resources to examine these returns.

#### **4) Compliance Assurance Process**

##### **Discussion**

LMSB continues to find ways to strive to reduce cycle time and achieve voluntary compliance, while rewarding compliant taxpayer behavior. The LMSB Subgroup believes the Compliance Assurance Process ("CAP") pilot examination program provides a sound basis for achieving these results. The CAP pilot program invites a group of large taxpayers to participate in an early examination process, whereby the taxpayer is examined during the course of the tax year rather than after filing as in traditional post filing processes. Because the traditional CIC process fails to resolve issues for compliant taxpayers and identify and deter abusive activities by noncompliant taxpayers in a timely manner, we believe this innovative process will identify key

examination tools and measurements that can be utilized in other CIC cases and can be implemented in similar IC cases.

As highlighted by LMSB in its presentation to the LMSB Subgroup, audit resolution for the largest CIC taxpayers takes on average 60 months from filing date. For those 27% of CIC taxpayers with unagreed issues it takes an average of 86 months to reach resolution. This long cycle time inhibits early identification of significant tax issues, timely processing of issues, and adversely impacts taxpayer's business planning while increasing examination management costs for both taxpayer's and the IRS. The CAP pilot requires that the IRS and the taxpayer cooperate to look at key events and transactions early in the tax year and resolve any uncertainties by the filing date.

Through a Memorandum of Understanding ("MOU"), the IRS and the CIC taxpayer enter into an agreement which outlines the objectives of the process, the participants, and each party's roles and responsibilities during the course of the examination. The LMSB Subgroup was provided a draft of the MOU, and although conceptually we are in agreement with its content, we believe that it would be more acceptable and result in more CIC taxpayers signing the document, if the language used in the MOU were more "taxpayer friendly", and if the MOU included a statement that existing IRS policies regarding privileged documents and tax accrual work papers will be followed. The LMSB Subgroup has provided its recommended draft language to LMSB for consideration.

We believe the MOU is the focal point of CAP and may cause the greatest issues and concerns with those CIC taxpayers that volunteer for the program. While the MOU sets forth

and describes the process and expectations of both parties, we believe that it needs to be a contract of process versus a contract of requirements.

With the advent of the Sarbanes-Oxley legislation, the changed corporate environment provides a unique opportunity to improve the overall compliance process. Using “tools” implemented by the law, the CAP process can leverage off those corporate governances.

**Benefits of CAP:**

- ▶ Provide quicker resolution of issues and cases, while providing prompt guidance to industry issues
- ▶ Address emerging issues that may impact other taxpayers, and simultaneously avoid any controversy and reduce prolonged litigation
- ▶ Provide real-time response to transactions, thus eliminating the IRS agents’ need to “catch up”
- ▶ Resolve issues prior to filing with a greater certainty of final resolution
- ▶ Be consistent with the financial statement model of examining a taxpayer promptly
- ▶ Complement current corporate governance and accountability, while providing timely and more concise financial reporting
- ▶ Reward compliant behavior
- ▶ Allow for redeployment of CIC Revenue Agents to non-compliant taxpayers and an expansion of IC and flow through examinations

- ▶ Reduce or eliminate need for post-filing examination

### **Risks of CAP**

- ▶ It may increase costs for both the IRS and the taxpayer during the initial phase, however, it should save time and resources for both in the long run
- ▶ Because this is a real-time process of reviewing significant transactions, the IRS risks being viewed as a tax advisor to the taxpayer

### **Questions regarding CAP**

- ▶ Can the IRS effectively and efficiently deal with the more complex real-time issues, such as research and development and foreign tax credits, by the filing date?
- ▶ Will external auditors feel compelled to become more involved or collaborate on treatment of transactions with IRS auditors or the resolution thereof?
- ▶ Will the IRS and the taxpayer be able to provide appropriate resources?
- ▶ Because new programs sometimes generate unanticipated problems, can the IRS and taxpayers remain flexible and collaborative throughout the entire process?
- ▶ CAP Account Coordinators, who are the taxpayer's primary contact, are not IRS management officials. With this status, do the coordinators have the flexibility to manage the process, people, and issues to meet the real-time needs of the taxpayer and the IRS?

## **Recommendations**

1. LMSB should continue to pursue significant improvements to the timeliness of the current CIC audit process using a private sector model of real time issue resolution to strengthen corporate governance and improve overall compliance.
2. The MOU should be revised, as per the redraft that we furnished to LMSB, in order to be a more “taxpayer friendly” document and to assure taxpayers that the current IRS policies regarding privilege and tax accrual work papers will be followed.
3. LMSB needs to further collaborate with CIC taxpayers to ensure that this pilot program produces effective and efficient processes to examine the largest taxpayers. Its initial prototype has great merit, but to be successful it must overcome potential obstacles.

## **5) Remote Examination Process (REP)**

### **Discussion**

The Remote Examination Process (REP) is an alternative to the traditional full blown examination. The program, as planned, consists of an offsite examination of one or two pre-identified significant issues. The REP is primarily aimed at Industry Cases (IC). These companies are generally non-public companies and as such are largely outside the reach of the impact of Corporate Governance on Tax Administration (Sarbanes-Oxley). The REP, as currently envisioned, appears to include only C Corporations in Activity Codes 219, 221 and 223 (assets between \$10 million and \$250 million).

The LMSB Subgroup congratulates Commissioner Nolan and LMSB for this innovative program. We believe that this program will help to accomplish many of the goals of Commissioner

Everson and will increase taxpayer compliance and more efficiently utilize IRS resources by increasing audit coverage, increasing currency and reducing average examination time. We believe that the program will also help the IRS achieve some of its other goals by attracting new, highly qualified employees who possess great skills but are unable to participate in the traditional forty hour workplace, such as single parents, and handicapped persons. Since this program does not require on-site visitations, it permits the development of a more flexible workplace and work schedule.

### **Recommendations**

LMSB views the REP as one of the “breakthrough” ideas being developed to increase enforcement and to increase voluntary compliance. Accordingly, LMSB Subgroup recommends:

1. The REP should be expanded to include S Corporations, LLC’s and partnerships as well as C Corporations.
2. The REP should include business taxpayers in Activity Codes 225 (assets greater than \$250 million) where risk analysis has shown that implementation of Sarbanes-Oxley and responsible corporate governance has reduced the need for the level of traditional resources allocated to these “top tier” taxpayers
3. Resources re-allocated from Code 225 taxpayers should be allocated first to Activity Code 223 taxpayers based on risk analysis and REP should be instituted on the remainder of Code 223 taxpayers in addition to Activity Code 219 and 221 taxpayers
4. REP should be coordinated with the new Schedule M-3 program (another “breakthrough” initiative) as well as with the Industry Issue Resolution program
5. REP should be assigned resources to increase, to the fullest extent possible, IRS coverage of tax returns that would not otherwise be examined. The LMSB Subgroup believes that it is

clear that voluntary compliance increases with taxpayer awareness of increased examination coverage

6. REP should be utilized as quickly as possible, after filing of the taxpayer's return, and be coordinated with the developing business return e-filing programs in order to support LMSB's and Commissioner Everson's currency initiatives
7. Taxpayers should have the right to request a face to face meeting with the examining agent and their supervisor to enhance communication and mutual trust and understanding.
8. REP has many secondary goals, but it should be remembered that its primary goal is to increase audit coverage of business taxpayers that would not normally be examined
9. REP should be utilized when the IRS receives information from external sources including DOJ and press reports.

## **B. IMPACT OF CORPORATE GOVERNANCE ON TAX ADMINISTRATION (SARBANES-OXLEY)**

### **Discussion**

Recent corporate scandals such as WorldCom and Enron have resulted in new legislation, Sarbanes-Oxley, which promulgates rules and procedures that are meant to help prevent future such scandals. Sarbanes-Oxley implements a strict regime of corporate governance, part of which requires the Chief Executive Officer and the Chief Financial Officer to attest to the correctness of reported financial statements, including the numbers reported on those financial statements together with the notes thereto. It is noted that particular attention is paid to the tax provision. Companies are required to implement strict policies and procedures in an effort to publish correct financial data. The company's outside auditors are then required to attest that the company has or has not implemented the requirements of the legislation. Under this legislation, if the published financial

data is not correct, severe financial and jail term penalties may be applied to the offending individuals.

It is the LMSB Subgroup's opinion that the IRS should be able to rely on this legislation to allow increased efficiency in administering the tax system. Sarbanes-Oxley generally applies to companies whose shares are listed on a US stock exchange. These are also the companies on which the IRS focuses a great deal of its audit resources.

We believe that the IRS can reduce its audit time and audit coverage of companies subject to Sarbanes –Oxley because appropriate reliance can be placed on the accuracy of published data, particularly the tax provision. We are not suggesting that the IRS ignore this population entirely, but rather implement a compliance assurance test similar to those employed by the outside auditors who sign the financial statements (CAP, discussed above, is an example of such a process). This should allow the IRS to become more current with respect to this particular population, and on an ongoing basis should allow the IRS to focus more time and resources on the examination of taxpayers that are currently not subject to audit. One might expect that taxpayers who have not been subject to audit in the past may not be in complete compliance with the tax law. Together with other initiatives of the IRS, this should result in greater audit coverage of midsized taxpayers who may be a compliance risk. The IRS should be able to refocus resources to “touch” more taxpayers and thereby improve tax compliance.

### **Recommendation**

The IRS should leverage the Sarbanes-Oxley legislation to develop and utilize a compliance assurance process in order to reduce audit time and coverage of the largest taxpayers and reallocate resources to the mid sized taxpayer base which is not currently the focus of examinations.



## **C. TAX SHELTER STRATEGY**

### **1. Strategy to Re-emphasize Penalty Administration**

#### **Discussion**

The LMSB Subgroup strongly supports the IRS in its “crackdown” on abusive tax shelters and tax shelter promoters. Tax shelters are destructive to the underlying fabric of the tax system and strong administrative action is appropriate in response to abusive tax shelter activity.

The IRS has begun to take a much harder line with taxpayers who engaged in tax shelter activity. This new approach is evidenced best by the settlement offer that was made in connection with transactions described in Notice 2000-44; in order for a taxpayer to settle the case without trial, the IRS required the imposition of penalties except in the case of taxpayers who had voluntarily disclosed their tax shelter activities during the limited period provided in Notice 2002-2. Based on anecdotal evidence, we believe that the IRS is taking a similar “tough” position in its settlement discussions concerning other listed transactions.

We generally support the approach that has been taken by the IRS. Consistent application of penalties is an important aspect of tax administration. Taxpayers who engage in tax shelter activities need to know that they will have to pay penalties (and not just tax plus interest) if they are caught. The threat of penalties provides a significant deterrent to taxpayers.

We also support the imposition of penalties on tax shelter promoters. We understand that the IRS has made investigation of tax shelter promoters a priority, as it should be. The only way to inhibit future tax shelter activity is to find and penalize the persons who sell them.

We are concerned, however, that the “hard line” that has been taken with respect to taxpayer penalties may also result in a strain on the IRS’s resources if the IRS is unable to settle a large

percentage of individual tax shelter cases. Some individuals may have legitimate arguments that they are not subject to penalties because they relied upon tax professionals. Whether or not these arguments will be persuasive in court is not certain, so that the IRS may eventually be subject to some unfavorable decisions. This could be particularly true with respect to penalties that are imposed on unsophisticated individual taxpayers, since a taxpayer may be able to avoid penalties by claiming that he relied upon the advice of counsel.

The IRS will need to continue to focus on finding the “happy medium” in settlement guidance for tax shelter cases so as to provide incentives to taxpayers to settle cases, preserve the fundamental principle that improper taxpayer behavior must be penalized, and recognize taxpayers’ rights. We believe that the IRS is aware of this tension, but continued diligence is required.

### **Recommendations**

1. The IRS should continue to pursue abusive tax shelters as a top priority, with particular emphasis on promoters, including the imposition of penalties.
2. The IRS should continue to be diligent with regard to the tension between taxpayer rights and penalizing improper taxpayer behavior.

### **2) Other Tax Shelter Matters and Settlement Initiatives**

#### **Discussion**

One of the more difficult problems raised by tax shelter cases involves how to settle them. Should there be global settlements? What role should Appeals play? Should a hearing before Appeals on a tax shelter case be barred, as such hearings were barred in the settlement concerning Notice 2000-44 transactions? Can Fast Track be used to resolve tax shelter cases? Should taxpayers who engaged in tax shelters be forced to choose between trial and complete concession?

Again, there are no clearly correct answers to these questions. We are concerned that Fast Track may not be the appropriate vehicle for the settlement of tax shelter controversies; anecdotal evidence indicates that tax shelters are rarely settled in Fast Track conferences. It may be more appropriate for the IRS to offer taxpayers the ability to go to Appeals in connection with tax shelters, although access to Appeals could be denied in those situations in which forcing taxpayers to choose between a settlement and litigation is in the best interests of the IRS (as was the perception within the IRS with respect to Notice 20004- 44 transactions). Ideally, the IRS would prepare guidelines under which Appeals could resolve each type of tax shelter, taking into account the IRS's view of the law and each taxpayer's particular circumstances. Such an approach would be fair and relatively expeditious.

The most important aspect of tax shelters is to prevent them before they happen, which occurs only if the IRS targets the promoters as well as the taxpayers involved. That appears to be the approach that the IRS is taking, and we commend it. The imposition of penalties against promoters may be as (or more) important in preventing a re-occurrence of the tax shelters that emerged over the last decade as any other single step that the IRS has taken. We also believe that the focus on mid-market compliance (discussed below) is an integral aspect of this issue, because "touching" more taxpayers makes it more likely that abusive tax shelters can be identified before they spread.

### **Recommendations**

1. The IRS should prepare guidelines under which Appeals can resolve each type of tax shelter, taking into account the IRS's view of the law and each taxpayer's particular circumstances.
2. The IRS should continue to aggressively target and apply penalties to tax shelter promoters.

3. The IRS should focus more attention and resources on mid-market taxpayers.

### **3) Joint International Tax Shelter information Center**

#### **Recommendation**

We received limited information concerning this initiative. However, given the growth of tax shelters from a domestic to an international problem, this seems like an excellent idea. We should also encourage other countries to adopt disclosure mechanisms (as contained in our new provisions under Section 6011) so that they may be able to ferret out tax shelter strategies that are not, as of this time, known to the IRS.

### **D. FOCUS ON MID-MARKET TAXPAYER COMPLIANCE**

#### **Discussion**

The LMSB Subgroup has consistently expressed concern that the mid-market taxpayer base has gone basically un-audited for many years. The IRS has dedicated significant resources to auditing the largest taxpayers on a continuous basis, simply because they are the largest taxpayers. We continue to believe that this is not the best use of resources. We commend LMSB on their initiatives designed to improve currency and reduce cycle time, on the new auditing techniques and processes that have been developed and used such as LIFE, and on the “breakthrough” ideas that are being developed such as REP and CAP. We believe that all of these efforts should be aggressively pursued, and that they should result in the ability to reallocate resources to examine mid-market taxpayers, to “touch” more taxpayers who have historically not been “touched” by the IRS. Focusing on mid-market taxpayer compliance is a component of each of the other three issues identified as having primary importance to LMSB and covered in previous sections of this report.

Re-focusing resources to this basically untouched taxpayer base should pay dividends to the IRS by significantly increasing taxpayer compliance.

**Recommendation**

We believe that LMSB should use all of the tools, techniques, and new processes that have been developed to free up resources and reallocate them to examining, or in some way “touching”, a significant number of mid-market taxpayers.

**INTERNAL REVENUE SERVICE  
ADVISORY COUNCIL**

**LARGE & MID-SIZE BUSINESS  
SUBGROUP REPORT**

**JON CONTRERAS  
RICHARD D'AVINO  
JOHN GLENNIE  
RICHARD LIPTON  
DENISE STRAIN  
DAVID UHLER  
THOMAS WHARTON  
BETTY WILSON, SUBGROUP CHAIR**

**NOVEMBER 10, 2004**

**INTERNAL REVENUE SERVICE  
ADVISORY COUNCIL (IRSAC)**

**SMALL BUSINESS & SELF-EMPLOYED (SB/SE)  
SUBGROUP REPORT**

**TIMOTHY B. CLAY**

**FELECIA G. DIXSON**

**ANN KATHERINE HUBBARD**

**SUSAN W. MARTIN**

**KENNETH C. NIRENBERG**

**GARY C. ROHRS**

**CAROL B. TREMBLE**

**PAMELA P. KULISH, SUBGROUP CHAIR**

**NOVEMBER 10, 2004**

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

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## I. INTRODUCTION

The IRSAC Small Business & Self-Employed Subgroup (hereafter “SB/SE Subgroup”) is comprised of tax professionals who represent tax preparers and small and medium sized businesses, having significant representation in professional organizations comprised of such preparers. Many of the current SB/SE Subgroup have had three years of experience in their capacity as Subgroup members and, during this time, have had the opportunity to become knowledgeable about SB/SE operations and programs. The SB/SE Subgroup is thankful to the IRS for arranging meetings with key leadership personnel in Washington D.C. and visits to key field locations such as the Offers in Compromise Group 10 Field Office in Austin, Texas.

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

1. Offer in Compromise Program. There has been significant improvement in inventory management and cycle time. Yet significant IRS resources are still being expended for a low payback upon the amount of time invested in this program.
2. Abusive Tax Schemes – Shelters and Scams. A continuous stream of new and creative shelters and scams are marketed to the taxpaying public. The new initiatives of the IRS are beginning to crack down on these but much education needs to be done to create public awareness of what is right and wrong.

## II. ISSUES AND RECOMMENDATIONS

### **ISSUE ONE: OFFER IN COMPROMISE PROGRAM (OIC)**

In OIC taxpayers with admitted tax debt who can't full pay ask to pay a personal maximum. In contrast are the large numbers of delinquent taxpayers that know the IRS has no effective way to collect and ignore their responsibility to settle their obligations. Year after year these “unreachable” tax receivables swell while legislative permission to engage outside collection agencies is sought. The OIC should become the model, the funnel, the vortex for pulling these citizens who ignore their tax obligations into monitored compliance and payment agreements. The SBSE subgroup has been following the progress of the OIC program for the last 3 years with the encouragement and support of the IRS. Over the last 3 years we have seen significant improvement in inventory management and cycle time.

The OIC inventory of cases has dropped from 94,931 in FY 2001 to 49,683 in FY 2004. The total OIC inventory thru June 2004, at 49,683, is at the lowest level since May 1999.

This drop in caseload is a result of the implementation of the centralized sites at Brookhaven and Memphis in July, 2001. The implementation of these Centralized OIC processing sites (COIC) along with revised, streamlined procedures in the areas of returns and financial analysis have contributed significantly to reversing the past history of growth in case inventory. Positive improvements noted are:

- a) COIC fully processes almost all “wage & investment” OICs
- b) All processability determinations are made in COIC
- c) COIC completes internal case-building on Field cases

Prudent use of return procedures has substantially reduced the impact of taxpayer procrastination on inventory growth and OIC cycle time.

- d) “Full Pay” screening process quickly resolves unrealistic offers, as well as mitigates the negative impact of the “offer mills.”

The IRS implemented the OIC application fee in November 2003. Through June 2004, the IRS has collected approximately \$4.7 million in application fees. The application fee requirement appears to have contributed substantially to a 15-20% reduction in OIC receipts. Implementation of the fee has also increased the number of OIC’s returned as not processable.

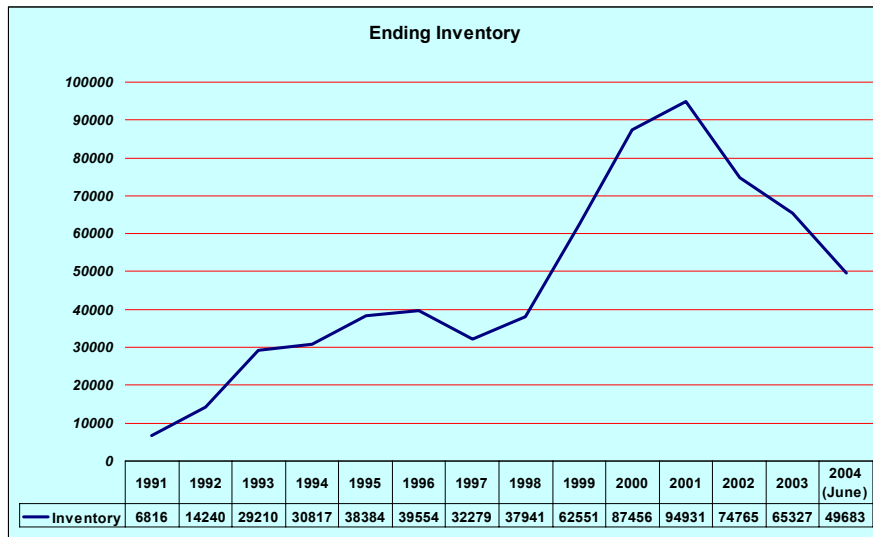
These actions have helped reduce cycle time and increase the number of cases that are worked. Along with the COIC sites and the processing fee the technology being used to help case building was improved and decreased the length of time that it is taking to complete cases. The result is a drop from an average 18 months in FY 2001 to 6 months in FY 2003. *Congratulations IRS, this is a great accomplishment.* The OIC application fee, along with the new return procedures have contributed to a 30% reduction in OICs that have to be closed as process able returns. COIC also reports that the quality of responses to additional information requests has improved considerably. The investment of field-based revenue officers into the OIC program has been reduced from almost 1100 in FY-01 to approximately 435 today.

OIC Handbook (IRM 5.8) was revised in May 2004. The revision includes considerable feedback from OIC employees, as well as other stakeholders such as TAS and Appeals. It addresses a variety of common complaints from external stakeholders and taxpayers. There are new procedures on process able returns designed to improve communication and service

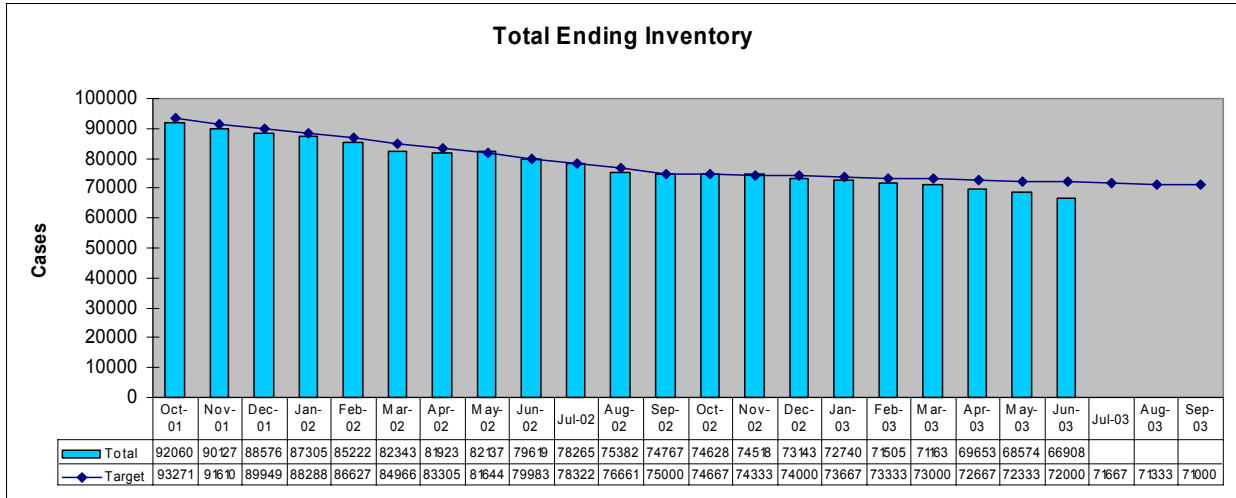
to taxpayers, as well as mitigate any unintended negative impact of the OIC application fee. Along with the new procedures on process able returns there is also new procedures for taxpayers who “substantially complied” to our requests for additional information, and return reconsideration procedures for taxpayers who did not respond timely due to circumstances beyond their control.

The exhibits that follow illustrate that the OIC program has made major improvements and is setting goals and achieving them.

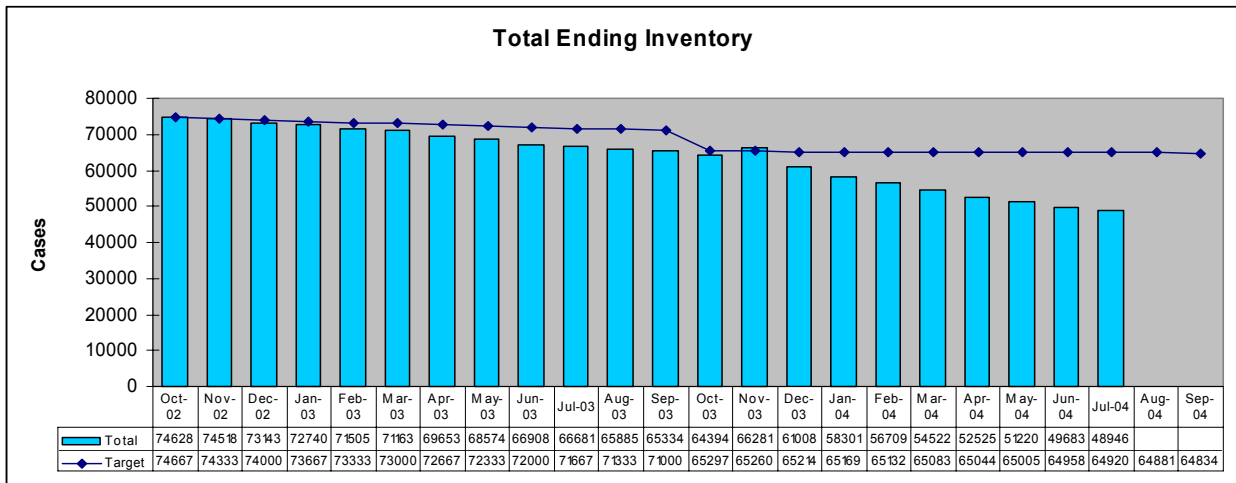
1991 – 2004



October 2001 thru September 2003



October 2002 thru January 2004



The SBSE Committee had the opportunity to visit both Brookhaven’s COIC site as well as Area 10’s group field office in Austin, Texas, to review the OIC process. Revenue Offer Specialists explained their OIC procedures and their concerns. Their hard work and professionalism is worthy of recognition.

Although the OIC program is improved there is a still concern that far too many scarce IRS resources are utilized compared to the amount of actual tax assessed and collected; particularly given the billions in receivables that remain uncollected and untouched.

**ISSUE ONE: RECOMMENDATIONS**

1. The SBSE Subgroup encourages the IRS to take a hard look at the types of tax accounts that are routinely considered for offers in compromise. In particular we question the business sense of compromising relatively current accounts receivable, where most or all of the collection statute is available to pursue more productive collection alternatives. A more focused approach on the type of tax delinquencies that more realistically warrant OIC consideration would not only help the IRS better manage its resources in this area, but could also result in more accepted offers in appropriate situations.
2. Offer Specialists need ongoing Continued Education in appropriate tax law forensic accounting and financial investigative tools and skills to improve quality and timeliness of case fieldwork. The Offer Specialist needs strong understanding of how to analyze routine and complex business financial statements in an efficient manner.
3. In conjunction with recommendation number two Continued Education needs to be ongoing with both the Service and the practitioner community so there is a joint understanding of what is a processable offer.
4. In order to improve the quality and efficiency of field investigations, the financial statement for businesses, Form 433-B should be required from self employed taxpayers, in addition to corporations and partnerships.

5. The SBSE Subgroup recommends better training for RO's and practitioners on the differences of an 8821 Tax Information Authorization, 2848 Power of Attorney and the check box on the 656 would ensure consistent application of the rules in the area of taxpayer representation.

6. The SBSE subgroup supports the inclusion of the practitioner signature line on the revised 656. This can help define those individuals or firms that submit fraudulent filings. Along with this the group also recommends that the paid preparer of the OIC whether licensed or non-licensed should be subject to the same Circular 230 prepare penalties as are enrolled preparers.

## **ISSUE TWO: ABUSIVE TAX SCHEMES – SHELTERS AND SCAMS**

It has been said that there are two types of tax debtors – the “can’t pays” and the “won’t pays.” Those who seek out scams, or who fall for a shelter con artist, are gullible due to their own greed.

The IRSAC has heard a number of presentations on tax schemes. In a news release dated March 1, 2004 (IR-2004-26), the Service details in plain English the types of scams the average American is likely to stumble over. “Put it all in a trust! Deduct everything – your home, your kids, and your food. Deduct other people’s kids! And deduct all your income because taxes are illegal!”

Another production, Publication 3995, was released just over a year ago. Called “Recognizing Illegal Tax Avoidance Schemes” and subtitled “Is It Too Good to Be True?” this two page document furnishes the reader with tools for critically evaluating any tax saving

pitch. The reader can judge the merits and see the difference between a bona fide scam vs. tax planning with aggressive marketing by comparing the elements.

The IRSAC commends IRS on these clear, straightforward documents. They provide a valuable service to the taxpaying consumer who can fall prey to skillful marketing of fraudulent and abusive tax schemes.

For the “high end” taxpayer, IRS has provided a number of Regulations, Notices and Rulings which spell out the intricacies of some of the craftiest scams. Titles like “Lease Strips” and “Producer Owned Reinsurance Corp” and “Debt Straddles” clog the comprehension pathways of the average, middle class tax practitioner. In Notice 2003-76, the Service collected over a dozen years worth of these Abusive Transaction promulgations, and numbered them. A paragraph each was provided to describe the content. These leave the reader with the impression that abuses are only found in the LMSB world. Currently, there are 31 of them. They are listed with links to each at this address:

<http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>

Sadly, as soon as the IRS bears down on the abusive schemes, the promoters close up shop and reopen elsewhere remarketing another tactic. They peddle watered down versions of complicated schemes to SBSE individuals and investors. Those same wordsmiths who produced the publication and the news release mentioned above need to be assigned a more detailed publication. This would be addressed to the middle class preparer who thinks that Notice 2003-76 and Form 8886, “Reportable Transaction Disclosure Statements” are not applicable to his or her practice. For instance, the very existence of a Roth IRA scam means a taxpayer with middle class income. A punch list of questions should be worked out



to assist the practitioner with ferreting out the legitimate plans from those requiring disclosure and more. The practitioner needs to know that the middle class is quite capable of tools such as:

“dummy” offshore employee leasing companies

“dummy” annuity and or insurance vendors

“dummy” suppliers, landlords or anyone else.

## **ISSUE TWO: RECOMMENDATIONS**

1) The IRS should improve and expand informative publications to educate taxpayers and preparers about abusive tax schemes. The practitioner needs to know that in today’s world, Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts” might be the most important form they screen for. The Service should not stop there, and should translate into plain examples how schemes can be adapted to the SBSE realm. We can’t just settle for the 31 nasties on an interview sheet: “You can be caught” and “it rips off every taxpayer in the country” just doesn’t inspire much contrite compliance. It is more likely to be labeled as a scold with no enforcement teeth behind it.

Go for the heart. Fill the remainder of this publication with true life stories. Turn, for example, to the testimony of Dale F. Brown. He testified on July 21, 2004 to the Senate Finance Committee holding hearings on *Bridging the Tax Gap*. Reprint his story. He explains how he was lured down the easy money path and ruined his life in the process. There are others. Their families are suffering as much or more than they are.

Dale wished that he had seen a story like his years ago, in time to reverse his course. He wished it was written up in Parade Magazine or aired on TV or radio. Unfortunately, the IRS has little budget to run public service announcements on radio or to buy prime air time during sports playoffs. Still, enough true stories posted on the IRS web site or other public venues might get the message moving.

We compliment Commissioner Everson on his brilliant telephone call to the “Car Talk” radio show. He exposed the negative issues surrounding donated cars and promoted legitimate deduction methodology. He made excellent use of his gravitas as Commissioner.

2) The Service should give taxpayers information on how to cope if they have been scammed or burned by a promoter or an unscrupulous preparer. A flowchart, some FAQ’s on the Web or other quick start method would point victimized taxpayers to file complaints with the Office of Professional Responsibility or with other consumer watchdogs, such as the BBB, Attorney General or Small Claims Court.

### **ISSUE THREE: TAX GAP**

The tax gap is the difference between what the Internal Revenue Service collects from taxpayers and what taxpayers actually owe. Recent estimates hold it to be over \$311 billion annually. The overall compliance rate is now 85% and declining. This growth in noncompliance threatens the integrity of our voluntary tax system. Senator Baucus challenged the IRS on April 13, 2004 to raise the voluntary compliance rate to 90% by 2010.

The IRS Oversight Board was created in 1998 to provide long-term guidance and direction to the agency. The 2004 report listed the agency's first priority as closing the

compliance gap. It commissioned a public opinion survey of taxpayer attitudes, and received the results last year. Nearly one in five taxpayers thinks occasional tax cheating is acceptable.

The National Taxpayer Advocate, in her 2003 Annual Report to Congress, called the Tax Gap the second largest problem facing taxpayers today. It costs each taxpayer \$2,000 per year.

On July 21, 2004, the Senate Finance Committee held a hearing entitled “Bridging the Tax Gap.” Commissioner Mark Everson was summoned to the Hill, as were Taxpayer Advocate Nina Olsen and representatives of TIGTA, GAO, and other stakeholders.

The Commissioner and the Oversight Board seek budget increases for the IRS to increase enforcement. Congress believes that more can be done by the Service to make better use of existing IRS resources, coupled with changes to the tax law.

Noncompliance types are classified in three groups. First is *filing*, as in non-filing and/or late filing. Second is *reporting*. Returns are filed with incomplete or incorrect information. *Paying* compliance refers to tardy and partial payments as well as non payment.

The IRS has reengineered the examination and collection processes. A virtual mosaic of new strategies are in various stages of deployment for coping with the multitude of this group. The National Research Project will also furnish sorely needed target data for areas of high noncompliance.

Self-employed taxpayers account for the largest segment of the overall tax gap; 26% of it. This amounts to \$81 billion in unpaid income taxes and \$51 billion in unpaid self-

employment taxes. One in ten self-employed taxpayers *never* files; 82% of the unfiled returns have balances due. One in six pays late. In fact, they also account for half of the income tax portion of the tax gap! A full 40% of the payroll tax gap comes from Schedule C filers.

The ranks of the self-employed continue to grow. Some are the proverbial proprietors founding their own firm, making their own dream. Many more are involuntarily self-employed. They may be immigrants barred by language, experience, education or documentation. They are factory workers, whose livelihoods have been outsourced beyond our oceans, pensions and reach. They are wage earners who moonlight nights and weekends to make ends meet, or just make party money. And, they are wage earner wannabes, who get handed checks or cash (wink wink), each week, and a 1099 at years' end. They need their jobs, they want their jobs, they won't complain, and they remember how easy was to do their taxes, when the withholdings were done at work. They want help, they want it now, and they want it from the IRS Commissioner. They want help in systemic processes that makes it easy to succeed at paying their taxes. Make tax paying easy and effortless for the self-employed. Offer withholding at the source!

One can comb American history, government reports and internal service research to find many of the following ideas. Studies have shown repeatedly that withholding the tax at the source is the most effective device for proper collection. Tax withholding was first set up during the Civil War. It was discontinued after the war debts were recouped.

When contemporary wage withholding was legislated in 1942 to collect the Victory Tax, most personal service and labor earnings were in the form of wages. The growth of self-employment has eroded the success of wage withholding for income and social tax

collections. *Policy changes should enable all who want to pay as early as possible to do so with minimum friction.* Setting up processes for the masses who will be served by withholding enablement serves two goals:

It brings in the “swing” payers who cannot budget or keep books, or who are otherwise just passive, overwhelmed or otherwise disconnected;

It allows the Service to test withholding, matching, collection and filing methods prior to mandates, should they be legislated.

Currently, procedures block the ability of taxpayers who want to pay timely. Procedure and policy changes could remove compliance obstacles.

Businesses with bona fide contractors have no direct way to offer withholding as an option. Today, withholding is only available if the contractor signs, under oath, on form W-9, that he or she *is* subject to backup withholding. So, the contractor needs to commit perjury to work around the form language and request payer to withhold. There is no range of tax rate. No other *passive* option of voluntary compliance is offered! Not on the form, not in the instructions or the publications is there any voluntary, passive payment compliance opportunity. Furthermore, that W-9 stays on file forever. It is not updated annually like a W-4, which addresses withholding rate changes for employees.

The self-employed are expected to be proactive. They must gauge their annualized tax balances of both income and self-employment taxes. Then, they need to save their funds. Four preset payment dates which range from two to four months apart are presented as the only venue for fiscal compliance.

### **ISSUE THREE: RECOMMENDATIONS**

Address the causes of non compliance, and reduce the opportunities for noncompliance! Enable and simplify voluntary payment and filing compliance!

#### **1. Make available voluntary withholding at the source.**

The IRS should make it simple for any taxpayer to withhold and prepay taxes from any income type. Streamline and encourage both sides of the process, for the payor and the payee. Then, encourage it.

#### **2. Estimated Tax Adaptations**

With EFTPS, any taxpayer can set up online voluntary Estimated Tax drafts from their bank account. Taxpayers and practitioners should be provided screen picture samples of weekly or monthly estimated tax management. Anyone with paper ES payment vouchers can pay more often than once per “quarter.” IRS needs to tell some taxpayers that frequency is good, welcome and not penalized.

#### **3. Data Mining**

Touch the more compliance resistant occupations by utilizing their trade associations and their licensing authorities. Furnish timely articles for their periodicals. Speak at the conventions. Have the compliance presentations pre-qualified where possible for continuing education credit. Work with state and local governments issuing the licenses to include tax information handouts. Check the feasibility of the various trade unions carrying the message. Post notices or leave handouts with tax information, criminal referral numbers and

education opportunities in malls and superstores with community bulletin boards or handout racks.

#### **4. Tip Reporting**

- a. Verify tip income reported on Form 941
- b. Monitor and periodically adjust as appropriate the allocated tip rate
- c. Treat all charged tips as wages.
- d. Expand the Form 8027 requirement so it applies to more industries.
- e. Work with representatives of all industries with tipped employees to optionally allow all tips to be included on the invoice.

#### **5. Public Opinion, Compliance and Personal Integrity**

The public's attitude towards taxation needs to be refocused, emphasizing integrity, responsibility and commitment to the public good. Our system is *voluntary*. Proper voluntary compliance will maintain the integrity of the nation's tax system. Therefore, the IRS should continue to inform the public about the ways it is enforcing the law. Enforcement needs to be perceived as fair and evenhanded, and likely to occur when a taxpayer is noncompliant.

#### **ISSUE FOUR: PARTNERSHIPS AND FLOW-THROUGH ENTITIES**

The IRS is aware of the continuing rise in filings for flow-through entities. Their studies show the number of filings has risen steadily over the past 4 years from 1998 to 2002 by approximately 4% per year. The K-1 matching program was a major compliance initiative, which resulted in a high no change rate. A high no-change rate implies to the Service that its classification and selection criteria are not efficient in selecting the returns most in need of examination. Because the IRS has not increased

resources for compliance for the 1065 and 1120S return types, it is important for them to have a better method of “targeting” the returns which will net a result of an increase in collectible tax. In resolving mismatches in the K-1 matching program, agents have gained a better understanding of current business practices although the process was labor intensive. They need to build automated selection models because manual selection processes are unaffordable. Past methods of identification were a DIF score used for pass through entities which is a 15 year old formula and needs to be reevaluated. The Service performed a High Income Study of individuals with Total Positive Income (TPI) in the ranges of \$250K to \$1million and over \$1million using 4 measurement techniques and found 60% of issues were in the flow-through entities reported to these individuals. This study suggests there needs to be more compliance resources devoted to understand and plan targeted enforcement strategies for the flow-through entities.

The SB/SE Subgroup supports expanding the National Research Project into the flow-through area to get more information about current business practices and update the DIF score tabulation formulas. The SB/SE Subgroup also supports the K-1 matching program and its continuation for increased compliance.

The SBSE Subgroup suggests that high no change rates are not the only measurement to use to evaluate the effectiveness of a compliance initiative. The mere fact taxpayers got notices made them aware that flow-through entities were not exempt from examination. The resulting increase in compliance cannot be easily measured. The SB/SE Subgroup feels effective tax administration is to “Touch More Taxpayers” regardless of whether or not more tax is collected and the process will encourage more compliance. The SB/SE Subgroup supports the changes which have been made in page two of Schedule E which help to identify possible differences in matching K-1’s to individual tax



3. Tax Gap. The tax gap continues to grow between what is the proper amount of tax due and what is actually reported, remitted and paid. Withholding at the source needs to be expanded to enhance the perception of fairness and to simplify payment. Good business practices need to be advertised and rewarded.
4. Partnerships and Flow-Through Entities. More partnerships and flow-through entities need to be “touched” by the IRS to create an awareness of the importance of compliance and proper reporting. The K-1 matching program was a positive step in the right direction to increase reporting compliance.
5. E-Services. E-services has had a successful launch and will have a powerful effect on the way the IRS interacts with the tax preparing public. It creates a strong incentive for tax preparers to e-file and should provide significant cost savings for both the IRS and the preparers. To achieve these efficiencies and savings, e-services should be expanded to include Reporting Agents and other taxpayer representatives as quickly as possible.
6. Office of Professional Responsibility. OPR is in the process of enhancing public confidence in the tax preparer community. For this to take place, OPR has begun a process to improve what information the OPR receives and the handling of that information. It appears that the internal process developed has strengthened the Office of Professional Responsibility and should continue to accomplish the goal of improving the professional integrity of the tax preparer community.

returns and also educates the taxpayer of the presence of the matching program. The SB/SE Subgroup also supports a uniform K-1 to better compare information reported on the K-1 form to individual taxpayer returns.

#### **ISSUE FOUR: RECOMMENDATION**

1) The SBSE Subgroup recommends continuing the current compliance initiatives. The SB/SE Subgroup would like to see more resources devoted to compliance for flow-through entities even if it means reallocating compliance resources from individual taxpayers as there is a feeling among individual taxpayers that corporations “get away” with more non-compliance than individuals do.

2) The SB/SE Subgroup supports the compliance initiative to further investigate any S-Corporation in a service type business with no wages or salaries reported on form 1120S or with an unreasonably low officers compensation reported. Other areas of possible compliance deficiencies include the following:

- Reporting of multi-year losses for an S-Corporation without basis for those losses.
- Final year issues for both partnerships and S-corporations
- Employment tax issues regarding misclassification of employees
- Invalid TIN's
- Improper classification of partners as active or passive

#### **ISSUE FIVE: E-SERVICES**

E-services is a suite of web-based products designed to allow tax professionals and payers to do business with the IRS electronically. E-services is an important element of the IRS Business Systems Modernization agenda and of the President's E-Government initiative. It is an essential ingredient toward the achievement of the IRS mandate of 80 percent electronically filed returns by 2007.

Reporting Agents. This is a group that is computer literate and has been requesting e-services through their organizations. They would embrace e-services immediately on behalf of over one million business taxpayers and would significantly reduce IRS' resources that are devoted to the human handling of Reporting Agent inquiries.

The SB/SE Subgroup commends the Service for the e-services features that were developed this past year. Since e-services are so new, and adequate capacity and turnaround times must be ensured, it is understandable that the Service has proceeded at a measured pace in further implementations.

#### **ISSUE FIVE: RECOMMENDATIONS**

1) Though mindful of the rationale for a measured implementation approach, the SBSE Subgroup recommends the development of additional e-services features as soon as possible. Doing so will speed the penetration of e-services in the tax preparer community, contributing toward both cost reduction and transition to electronic tax return filing.

2) Through August 2004, there were 30,000 registered e-services users, and this number was increasing at an average rate of 1,000 per week. However, only 8,500 of these users were eligible for the premium services. Furthermore, the total population of firms eligible to use the premium services is estimated at 50,000. A study should be done to determine why only 8,500 firms of the 50,000 populations, that are eligible for the premium e-services, have registered for e-services. There is suspicion that this is due to lack of authorization from the principals of firms. This should be verified and a strategy developed to dramatically expand adoption of the program.

3) The SBSE Subgroup agrees with the position of the IRS Oversight Board as stated in its 2003 Annual Report on Electronic Filing, "Ultimately, the more incentives the

IRS can reasonably provide to all types of electronic filers, the more it will encourage e-filing. In the Board's view similar electronic services should be extended to other third party partners such as payroll providers, as both the IRS and the third party providers will benefit from quicker, less error prone electronic services."

4) The SBSE Subgroup believes that significant cost reductions can be obtained by increasing the e-services customer base. This can be accomplished by lowering the 100 e-file threshold for individual returns and providing e-services to Reporting Agents and others, such as the mortgage industry, who have thus far been excluded. Although the 100 return threshold for e-services is an incentive for preparers to e-file, rather than paper file, returns, cost savings could be achieved at little or no extra cost to the Service by reducing, and eventually eliminating, this entry requirement.

5) Because of the 2007 mandate and the cost reductions that both IRS and the tax preparer community can achieve from the use of e-services, we support all initiatives that will increase the utilization of e-services. This includes both increasing the number of features in the e-services suite of products and broadening the population that can partake of e-services. The SBSE Subgroup believes that e-services has been very successfully launched and would like to ensure that momentum in this project continues.

#### **Issue: Office of Professional Responsibility**

The Office of Professional Responsibility (OPR) is charged with the oversight of those who may practice before the Internal Revenue Service as defined by Circular 230.

This group comprises a relatively small percentage of the approximately 1.2 million preparers. Best estimates are that between 300,000-600,000 tax return preparers are not

regulated by any licensing authority. In addition, they are not subject to any minimum requirement of competency or requirement to engage in continuing professional education for their field of endeavor. Those who are licensed and so regulated by virtue of Circular 230 or by state licensing, may be punished for substandard work by OPR. The rest, who are unregulated are subject only to the civil suit process brought by their clients or criminal/civil suit brought by the Justice Department.

Fraudulent preparation, failure to sign as the paid preparer and promotion of abusive tax shelters are some of the more egregious acts of those less than qualified in the tax preparation field. Preying upon unsuspecting clientele who assume there is oversight and control of this field, is made easy under the current system. In the past OPR generally waited for the problem to be brought to them, either the taxpayer filed a formal complaint or another operating division of the Service would sometimes forward such concerns internally. OPR has developed an internal communication and action process to address the numerous issues that involve this office. The sharing of information and concerns regarding the preparer/practitioner community by internal stakeholders has been almost nonexistent. At the present OPR has recognized 68 separate areas of concern where the internal IRS process needs improvement to elevate the involvement, awareness and strengthen IRS' programs in the tax preparer/practitioner arena. The areas fall into four separate categories: a) Communications-Education and Outreach, b) Penalties, c) Fraud/Referrals/Ethics, and d) Legislation and Regulation. Within each area there are Recommendations, Resolutions, Stakeholder ownership and Status to help improve the communication process as well as the result. Of the 68 areas 58 have been addressed and completed or are of such a nature that

they are ongoing. One of the areas under Communication-Education and Outreach is to encourage best practices and positive behavior of a tax preparer, as well as educating the public on choosing a preparer and the importance of a preparer's signature. The 68 internal process improvements were identified just a few months ago and are already seeing improvement. The SB/SE Subgroup fully supports this process. Elevation of the office of OPR was long overdue and will only increase overall compliance especially in the practitioner community.

The SB/SE Subgroup understands that there is an issue as to once the program is completed and functioning who should have ownership, since there are many stakeholders involved. The options are a) leave the program with OPR, b) hand the program to SB/SE, or c) give each item back to the major stakeholder.

#### **ISSUE SIX: RECOMMENDATIONS**

- 1) The SB/SE Subgroup recognizes the effort expended by OPR and the enormous task that lies ahead. We also understand that ownership of these issues is paramount. We recommend that OPR should continue to oversee these internal process and whatever ultimate action taken will be jointly determined. If the process is given back to each stakeholder or SBSE only, OPR may be left out of the loop.
- 2) The SB/SE Subgroup recommends that future concerns as related to the office of OPR, initially identified within the operating divisions, be immediately forwarded to OPR for cooperative action.



The SB/SE Subgroup believes that e-services has the potential to significantly improve the interaction between IRS and the tax preparing public. It will have an impact similar to that of e-pay and e-file and, quite simply, could completely change the way IRS provides service to tax professionals. Since e-services is available 24/7, tax preparers have the ability to receive needed information at any time – a vast improvement over telephone-based customer service methods, especially during the January-April tax period.

The first, basic e-services (registration, PTIN and e-file applications, TIN matching) were launched in October 2003. In the spring of 2004, IRS added important new “premium” features to e-services: Disclosure Authorization, Electronic Account Resolution, and Transcript Delivery System. While the combination of basic and premium services reduces telephone calls and provides a more cost effective, efficient experience for both IRS and e-services users, the premium services create the biggest impact. However, the premium services are available only to tax professionals who are active participants in the IRS e-file program and who e-file more than 100 *individual* income tax returns per year. These restrictions preclude the use of e-services by many individual income tax return preparers and by all business tax preparers and payroll processors.

Especially noteworthy is the lack of e-services for the 2,200 registered Reporting Agents. They represent the payroll provider industry that services more than one million employers with a combined total of more than 35 million employees – one third of the entire private sector workforce. By partnering with the Service, Reporting Agents have been instrumental in the development of the e-file and EFTPS systems. Nevertheless, Reporting Agents have been excluded from e-services to the detriment of both the Service and the tax paying public. In terms of cost reductions, there is a compelling case for e-services to



**INTERNAL REVENUE SERVICE  
ADVISORY COUNCIL (IRSAC)**

**SMALL BUSINESS & SELF-EMPLOYED (SB/SE)  
SUBGROUP REPORT**

**TIMOTHY B. CLAY**

**FELECIA G. DIXSON**

**ANN KATHERINE HUBBARD**

**SUSAN W. MARTIN**

**KENNETH C. NIRENBERG**

**GARY C. ROHRS**

**CAROL B. TREMBLE**

**PAMELA P. KULISH, SUBGROUP CHAIR**

**NOVEMBER 10, 2004**

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

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## I. INTRODUCTION

The IRSAC Small Business & Self-Employed Subgroup (hereafter “SB/SE Subgroup”) is comprised of tax professionals who represent tax preparers and small and medium sized businesses, having significant representation in professional organizations comprised of such preparers. Many of the current SB/SE Subgroup have had three years of experience in their capacity as Subgroup members and, during this time, have had the opportunity to become knowledgeable about SB/SE operations and programs. The SB/SE Subgroup is thankful to the IRS for arranging meetings with key leadership personnel in Washington D.C. and visits to key field locations such as the Offers in Compromise Group 10 Field Office in Austin, Texas.

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

1. Offer in Compromise Program. There has been significant improvement in inventory management and cycle time. Yet significant IRS resources are still being expended for a low payback upon the amount of time invested in this program.
2. Abusive Tax Schemes – Shelters and Scams. A continuous stream of new and creative shelters and scams are marketed to the taxpaying public. The new initiatives of the IRS are beginning to crack down on these but much education needs to be done to create public awareness of what is right and wrong.

## II. ISSUES AND RECOMMENDATIONS

### **ISSUE ONE: OFFER IN COMPROMISE PROGRAM (OIC)**

In OIC taxpayers with admitted tax debt who can't full pay ask to pay a personal maximum. In contrast are the large numbers of delinquent taxpayers that know the IRS has no effective way to collect and ignore their responsibility to settle their obligations. Year after year these “unreachable” tax receivables swell while legislative permission to engage outside collection agencies is sought. The OIC should become the model, the funnel, the vortex for pulling these citizens who ignore their tax obligations into monitored compliance and payment agreements. The SBSE subgroup has been following the progress of the OIC program for the last 3 years with the encouragement and support of the IRS. Over the last 3 years we have seen significant improvement in inventory management and cycle time.

The OIC inventory of cases has dropped from 94,931 in FY 2001 to 49,683 in FY 2004. The total OIC inventory thru June 2004, at 49,683, is at the lowest level since May 1999.

This drop in caseload is a result of the implementation of the centralized sites at Brookhaven and Memphis in July, 2001. The implementation of these Centralized OIC processing sites (COIC) along with revised, streamlined procedures in the areas of returns and financial analysis have contributed significantly to reversing the past history of growth in case inventory. Positive improvements noted are:

- a) COIC fully processes almost all “wage & investment” OICs
- b) All processability determinations are made in COIC
- c) COIC completes internal case-building on Field cases

Prudent use of return procedures has substantially reduced the impact of taxpayer procrastination on inventory growth and OIC cycle time.

- d) “Full Pay” screening process quickly resolves unrealistic offers, as well as mitigates the negative impact of the “offer mills.”

The IRS implemented the OIC application fee in November 2003. Through June 2004, the IRS has collected approximately \$4.7 million in application fees. The application fee requirement appears to have contributed substantially to a 15-20% reduction in OIC receipts. Implementation of the fee has also increased the number of OIC’s returned as not processable.

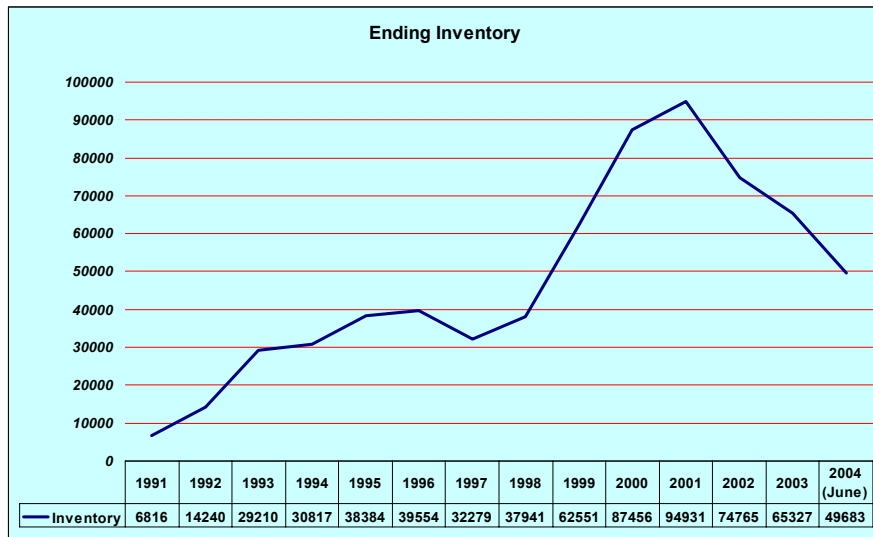
These actions have helped reduce cycle time and increase the number of cases that are worked. Along with the COIC sites and the processing fee the technology being used to help case building was improved and decreased the length of time that it is taking to complete cases. The result is a drop from an average 18 months in FY 2001 to 6 months in FY 2003. *Congratulations IRS, this is a great accomplishment.* The OIC application fee, along with the new return procedures have contributed to a 30% reduction in OICs that have to be closed as process able returns. COIC also reports that the quality of responses to additional information requests has improved considerably. The investment of field-based revenue officers into the OIC program has been reduced from almost 1100 in FY-01 to approximately 435 today.

OIC Handbook (IRM 5.8) was revised in May 2004. The revision includes considerable feedback from OIC employees, as well as other stakeholders such as TAS and Appeals. It addresses a variety of common complaints from external stakeholders and taxpayers. There are new procedures on process able returns designed to improve communication and service

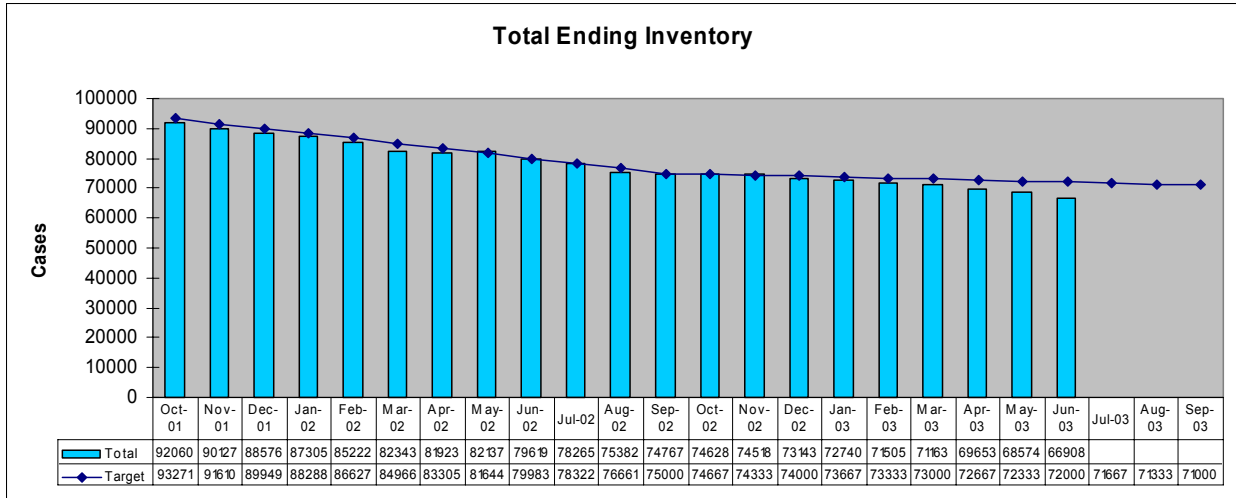
to taxpayers, as well as mitigate any unintended negative impact of the OIC application fee. Along with the new procedures on process able returns there is also new procedures for taxpayers who “substantially complied” to our requests for additional information, and return reconsideration procedures for taxpayers who did not respond timely due to circumstances beyond their control.

The exhibits that follow illustrate that the OIC program has made major improvements and is setting goals and achieving them.

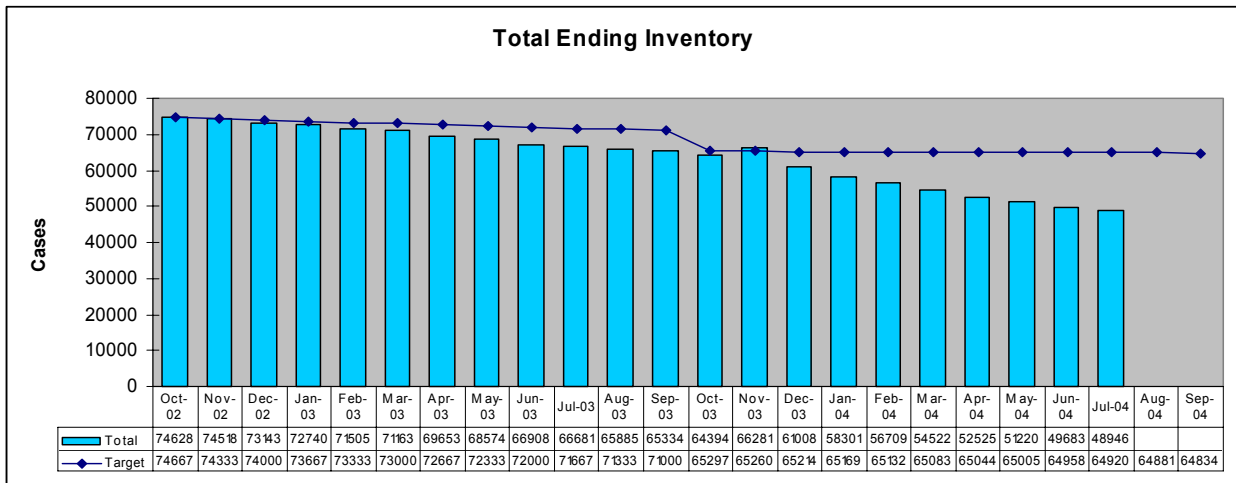
1991 – 2004



October 2001 thru September 2003



October 2002 thru January 2004



The SBSE Committee had the opportunity to visit both Brookhaven's COIC site as well as Area 10's group field office in Austin, Texas, to review the OIC process. Revenue Offer Specialists explained their OIC procedures and their concerns. Their hard work and professionalism is worthy of recognition.

Although the OIC program is improved there is a still concern that far too many scarce IRS resources are utilized compared to the amount of actual tax assessed and collected; particularly given the billions in receivables that remain uncollected and untouched.

**ISSUE ONE: RECOMMENDATIONS**

1. The SBSE Subgroup encourages the IRS to take a hard look at the types of tax accounts that are routinely considered for offers in compromise. In particular we question the business sense of compromising relatively current accounts receivable, where most or all of the collection statute is available to pursue more productive collection alternatives. A more focused approach on the type of tax delinquencies that more realistically warrant OIC consideration would not only help the IRS better manage its resources in this area, but could also result in more accepted offers in appropriate situations.
2. Offer Specialists need ongoing Continued Education in appropriate tax law forensic accounting and financial investigative tools and skills to improve quality and timeliness of case fieldwork. The Offer Specialist needs strong understanding of how to analyze routine and complex business financial statements in an efficient manner.
3. In conjunction with recommendation number two Continued Education needs to be ongoing with both the Service and the practitioner community so there is a joint understanding of what is a processable offer.
4. In order to improve the quality and efficiency of field investigations, the financial statement for businesses, Form 433-B should be required from self employed taxpayers, in addition to corporations and partnerships.



5. The SBSE Subgroup recommends better training for RO's and practitioners on the differences of an 8821 Tax Information Authorization, 2848 Power of Attorney and the check box on the 656 would ensure consistent application of the rules in the area of taxpayer representation.

6. The SBSE subgroup supports the inclusion of the practitioner signature line on the revised 656. This can help define those individuals or firms that submit fraudulent filings. Along with this the group also recommends that the paid preparer of the OIC whether licensed or non-licensed should be subject to the same Circular 230 prepare penalties as are enrolled preparers.

## **ISSUE TWO: ABUSIVE TAX SCHEMES – SHELTERS AND SCAMS**

It has been said that there are two types of tax debtors – the “can’t pays” and the “won’t pays.” Those who seek out scams, or who fall for a shelter con artist, are gullible due to their own greed.

The IRSAC has heard a number of presentations on tax schemes. In a news release dated March 1, 2004 (IR-2004-26), the Service details in plain English the types of scams the average American is likely to stumble over. “Put it all in a trust! Deduct everything – your home, your kids, and your food. Deduct other people’s kids! And deduct all your income because taxes are illegal!”

Another production, Publication 3995, was released just over a year ago. Called “Recognizing Illegal Tax Avoidance Schemes” and subtitled “Is It Too Good to Be True?” this two page document furnishes the reader with tools for critically evaluating any tax saving

pitch. The reader can judge the merits and see the difference between a bona fide scam vs. tax planning with aggressive marketing by comparing the elements.

The IRSAC commends IRS on these clear, straightforward documents. They provide a valuable service to the taxpaying consumer who can fall prey to skillful marketing of fraudulent and abusive tax schemes.

For the “high end” taxpayer, IRS has provided a number of Regulations, Notices and Rulings which spell out the intricacies of some of the craftiest scams. Titles like “Lease Strips” and “Producer Owned Reinsurance Corp” and “Debt Straddles” clog the comprehension pathways of the average, middle class tax practitioner. In Notice 2003-76, the Service collected over a dozen years worth of these Abusive Transaction promulgations, and numbered them. A paragraph each was provided to describe the content. These leave the reader with the impression that abuses are only found in the LMSB world. Currently, there are 31 of them. They are listed with links to each at this address:

<http://www.irs.gov/businesses/corporations/article/0,,id=120633,00.html>

Sadly, as soon as the IRS bears down on the abusive schemes, the promoters close up shop and reopen elsewhere remarketing another tactic. They peddle watered down versions of complicated schemes to SBSE individuals and investors. Those same wordsmiths who produced the publication and the news release mentioned above need to be assigned a more detailed publication. This would be addressed to the middle class preparer who thinks that Notice 2003-76 and Form 8886, “Reportable Transaction Disclosure Statements” are not applicable to his or her practice. For instance, the very existence of a Roth IRA scam means a taxpayer with middle class income. A punch list of questions should be worked out

to assist the practitioner with ferreting out the legitimate plans from those requiring disclosure and more. The practitioner needs to know that the middle class is quite capable of tools such as:

“dummy” offshore employee leasing companies

“dummy” annuity and or insurance vendors

“dummy” suppliers, landlords or anyone else.

## **ISSUE TWO: RECOMMENDATIONS**

1) The IRS should improve and expand informative publications to educate taxpayers and preparers about abusive tax schemes. The practitioner needs to know that in today’s world, Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts” might be the most important form they screen for. The Service should not stop there, and should translate into plain examples how schemes can be adapted to the SBSE realm. We can’t just settle for the 31 nasties on an interview sheet: “You can be caught” and “it rips off every taxpayer in the country” just doesn’t inspire much contrite compliance. It is more likely to be labeled as a scold with no enforcement teeth behind it.

Go for the heart. Fill the remainder of this publication with true life stories. Turn, for example, to the testimony of Dale F. Brown. He testified on July 21, 2004 to the Senate Finance Committee holding hearings on *Bridging the Tax Gap*. Reprint his story. He explains how he was lured down the easy money path and ruined his life in the process. There are others. Their families are suffering as much or more than they are.

Dale wished that he had seen a story like his years ago, in time to reverse his course. He wished it was written up in Parade Magazine or aired on TV or radio. Unfortunately, the IRS has little budget to run public service announcements on radio or to buy prime air time during sports playoffs. Still, enough true stories posted on the IRS web site or other public venues might get the message moving.

We compliment Commissioner Everson on his brilliant telephone call to the “Car Talk” radio show. He exposed the negative issues surrounding donated cars and promoted legitimate deduction methodology. He made excellent use of his gravitas as Commissioner.

2) The Service should give taxpayers information on how to cope if they have been scammed or burned by a promoter or an unscrupulous preparer. A flowchart, some FAQ’s on the Web or other quick start method would point victimized taxpayers to file complaints with the Office of Professional Responsibility or with other consumer watchdogs, such as the BBB, Attorney General or Small Claims Court.

### **ISSUE THREE: TAX GAP**

The tax gap is the difference between what the Internal Revenue Service collects from taxpayers and what taxpayers actually owe. Recent estimates hold it to be over \$311 billion annually. The overall compliance rate is now 85% and declining. This growth in noncompliance threatens the integrity of our voluntary tax system. Senator Baucus challenged the IRS on April 13, 2004 to raise the voluntary compliance rate to 90% by 2010.

The IRS Oversight Board was created in 1998 to provide long-term guidance and direction to the agency. The 2004 report listed the agency's first priority as closing the

compliance gap. It commissioned a public opinion survey of taxpayer attitudes, and received the results last year. Nearly one in five taxpayers thinks occasional tax cheating is acceptable.

The National Taxpayer Advocate, in her 2003 Annual Report to Congress, called the Tax Gap the second largest problem facing taxpayers today. It costs each taxpayer \$2,000 per year.

On July 21, 2004, the Senate Finance Committee held a hearing entitled “Bridging the Tax Gap.” Commissioner Mark Everson was summoned to the Hill, as were Taxpayer Advocate Nina Olsen and representatives of TIGTA, GAO, and other stakeholders.

The Commissioner and the Oversight Board seek budget increases for the IRS to increase enforcement. Congress believes that more can be done by the Service to make better use of existing IRS resources, coupled with changes to the tax law.

Noncompliance types are classified in three groups. First is *filing*, as in non-filing and/or late filing. Second is *reporting*. Returns are filed with incomplete or incorrect information. *Paying* compliance refers to tardy and partial payments as well as non payment.

The IRS has reengineered the examination and collection processes. A virtual mosaic of new strategies are in various stages of deployment for coping with the multitude of this group. The National Research Project will also furnish sorely needed target data for areas of high noncompliance.

Self-employed taxpayers account for the largest segment of the overall tax gap; 26% of it. This amounts to \$81 billion in unpaid income taxes and \$51 billion in unpaid self-

employment taxes. One in ten self-employed taxpayers *never* files; 82% of the unfiled returns have balances due. One in six pays late. In fact, they also account for half of the income tax portion of the tax gap! A full 40% of the payroll tax gap comes from Schedule C filers.

The ranks of the self-employed continue to grow. Some are the proverbial proprietors founding their own firm, making their own dream. Many more are involuntarily self-employed. They may be immigrants barred by language, experience, education or documentation. They are factory workers, whose livelihoods have been outsourced beyond our oceans, pensions and reach. They are wage earners who moonlight nights and weekends to make ends meet, or just make party money. And, they are wage earner wannabes, who get handed checks or cash (wink wink), each week, and a 1099 at years' end. They need their jobs, they want their jobs, they won't complain, and they remember how easy was to do their taxes, when the withholdings were done at work. They want help, they want it now, and they want it from the IRS Commissioner. They want help in systemic processes that makes it easy to succeed at paying their taxes. Make tax paying easy and effortless for the self-employed. Offer withholding at the source!

One can comb American history, government reports and internal service research to find many of the following ideas. Studies have shown repeatedly that withholding the tax at the source is the most effective device for proper collection. Tax withholding was first set up during the Civil War. It was discontinued after the war debts were recouped.

When contemporary wage withholding was legislated in 1942 to collect the Victory Tax, most personal service and labor earnings were in the form of wages. The growth of self-employment has eroded the success of wage withholding for income and social tax

collections. *Policy changes should enable all who want to pay as early as possible to do so with minimum friction.* Setting up processes for the masses who will be served by withholding enablement serves two goals:

It brings in the “swing” payers who cannot budget or keep books, or who are otherwise just passive, overwhelmed or otherwise disconnected;

It allows the Service to test withholding, matching, collection and filing methods prior to mandates, should they be legislated.

Currently, procedures block the ability of taxpayers who want to pay timely. Procedure and policy changes could remove compliance obstacles.

Businesses with bona fide contractors have no direct way to offer withholding as an option. Today, withholding is only available if the contractor signs, under oath, on form W-9, that he or she *is* subject to backup withholding. So, the contractor needs to commit perjury to work around the form language and request payer to withhold. There is no range of tax rate. No other *passive* option of voluntary compliance is offered! Not on the form, not in the instructions or the publications is there any voluntary, passive payment compliance opportunity. Furthermore, that W-9 stays on file forever. It is not updated annually like a W-4, which addresses withholding rate changes for employees.

The self-employed are expected to be proactive. They must gauge their annualized tax balances of both income and self-employment taxes. Then, they need to save their funds. Four preset payment dates which range from two to four months apart are presented as the only venue for fiscal compliance.

### **ISSUE THREE: RECOMMENDATIONS**

Address the causes of non compliance, and reduce the opportunities for noncompliance! Enable and simplify voluntary payment and filing compliance!

#### **1. Make available voluntary withholding at the source.**

The IRS should make it simple for any taxpayer to withhold and prepay taxes from any income type. Streamline and encourage both sides of the process, for the payor and the payee. Then, encourage it.

#### **2. Estimated Tax Adaptations**

With EFTPS, any taxpayer can set up online voluntary Estimated Tax drafts from their bank account. Taxpayers and practitioners should be provided screen picture samples of weekly or monthly estimated tax management. Anyone with paper ES payment vouchers can pay more often than once per “quarter.” IRS needs to tell some taxpayers that frequency is good, welcome and not penalized.

#### **3. Data Mining**

Touch the more compliance resistant occupations by utilizing their trade associations and their licensing authorities. Furnish timely articles for their periodicals. Speak at the conventions. Have the compliance presentations pre-qualified where possible for continuing education credit. Work with state and local governments issuing the licenses to include tax information handouts. Check the feasibility of the various trade unions carrying the message. Post notices or leave handouts with tax information, criminal referral numbers and



education opportunities in malls and superstores with community bulletin boards or handout racks.

#### **4. Tip Reporting**

- a. Verify tip income reported on Form 941
- b. Monitor and periodically adjust as appropriate the allocated tip rate
- c. Treat all charged tips as wages.
- d. Expand the Form 8027 requirement so it applies to more industries.
- e. Work with representatives of all industries with tipped employees to optionally allow all tips to be included on the invoice.

#### **5. Public Opinion, Compliance and Personal Integrity**

The public's attitude towards taxation needs to be refocused, emphasizing integrity, responsibility and commitment to the public good. Our system is *voluntary*. Proper voluntary compliance will maintain the integrity of the nation's tax system. Therefore, the IRS should continue to inform the public about the ways it is enforcing the law. Enforcement needs to be perceived as fair and evenhanded, and likely to occur when a taxpayer is noncompliant.

#### **ISSUE FOUR: PARTNERSHIPS AND FLOW-THROUGH ENTITIES**

The IRS is aware of the continuing rise in filings for flow-through entities. Their studies show the number of filings has risen steadily over the past 4 years from 1998 to 2002 by approximately 4% per year. The K-1 matching program was a major compliance initiative, which resulted in a high no change rate. A high no-change rate implies to the Service that its classification and selection criteria are not efficient in selecting the returns most in need of examination. Because the IRS has not increased

resources for compliance for the 1065 and 1120S return types, it is important for them to have a better method of “targeting” the returns which will net a result of an increase in collectible tax. In resolving mismatches in the K-1 matching program, agents have gained a better understanding of current business practices although the process was labor intensive. They need to build automated selection models because manual selection processes are unaffordable. Past methods of identification were a DIF score used for pass through entities which is a 15 year old formula and needs to be reevaluated. The Service performed a High Income Study of individuals with Total Positive Income (TPI) in the ranges of \$250K to \$1million and over \$1million using 4 measurement techniques and found 60% of issues were in the flow-through entities reported to these individuals. This study suggests there needs to be more compliance resources devoted to understand and plan targeted enforcement strategies for the flow-through entities.

The SB/SE Subgroup supports expanding the National Research Project into the flow-through area to get more information about current business practices and update the DIF score tabulation formulas. The SB/SE Subgroup also supports the K-1 matching program and its continuation for increased compliance.

The SBSE Subgroup suggests that high no change rates are not the only measurement to use to evaluate the effectiveness of a compliance initiative. The mere fact taxpayers got notices made them aware that flow-through entities were not exempt from examination. The resulting increase in compliance cannot be easily measured. The SB/SE Subgroup feels effective tax administration is to “Touch More Taxpayers” regardless of whether or not more tax is collected and the process will encourage more compliance. The SB/SE Subgroup supports the changes which have been made in page two of Schedule E which help to identify possible differences in matching K-1’s to individual tax

3. Tax Gap. The tax gap continues to grow between what is the proper amount of tax due and what is actually reported, remitted and paid. Withholding at the source needs to be expanded to enhance the perception of fairness and to simplify payment. Good business practices need to be advertised and rewarded.
4. Partnerships and Flow-Through Entities. More partnerships and flow-through entities need to be “touched” by the IRS to create an awareness of the importance of compliance and proper reporting. The K-1 matching program was a positive step in the right direction to increase reporting compliance.
5. E-Services. E-services has had a successful launch and will have a powerful effect on the way the IRS interacts with the tax preparing public. It creates a strong incentive for tax preparers to e-file and should provide significant cost savings for both the IRS and the preparers. To achieve these efficiencies and savings, e-services should be expanded to include Reporting Agents and other taxpayer representatives as quickly as possible.
6. Office of Professional Responsibility. OPR is in the process of enhancing public confidence in the tax preparer community. For this to take place, OPR has begun a process to improve what information the OPR receives and the handling of that information. It appears that the internal process developed has strengthened the Office of Professional Responsibility and should continue to accomplish the goal of improving the professional integrity of the tax preparer community.

returns and also educates the taxpayer of the presence of the matching program. The SB/SE Subgroup also supports a uniform K-1 to better compare information reported on the K-1 form to individual taxpayer returns.

#### **ISSUE FOUR: RECOMMENDATION**

1) The SBSE Subgroup recommends continuing the current compliance initiatives. The SB/SE Subgroup would like to see more resources devoted to compliance for flow-through entities even if it means reallocating compliance resources from individual taxpayers as there is a feeling among individual taxpayers that corporations “get away” with more non-compliance than individuals do.

2) The SB/SE Subgroup supports the compliance initiative to further investigate any S-Corporation in a service type business with no wages or salaries reported on form 1120S or with an unreasonably low officers compensation reported. Other areas of possible compliance deficiencies include the following:

- Reporting of multi-year losses for an S-Corporation without basis for those losses.
- Final year issues for both partnerships and S-corporations
- Employment tax issues regarding misclassification of employees
- Invalid TIN's
- Improper classification of partners as active or passive

#### **ISSUE FIVE: E-SERVICES**

E-services is a suite of web-based products designed to allow tax professionals and payers to do business with the IRS electronically. E-services is an important element of the IRS Business Systems Modernization agenda and of the President's E-Government initiative. It is an essential ingredient toward the achievement of the IRS mandate of 80 percent electronically filed returns by 2007.

Reporting Agents. This is a group that is computer literate and has been requesting e-services through their organizations. They would embrace e-services immediately on behalf of over one million business taxpayers and would significantly reduce IRS' resources that are devoted to the human handling of Reporting Agent inquiries.

The SB/SE Subgroup commends the Service for the e-services features that were developed this past year. Since e-services are so new, and adequate capacity and turnaround times must be ensured, it is understandable that the Service has proceeded at a measured pace in further implementations.

#### **ISSUE FIVE: RECOMMENDATIONS**

1) Though mindful of the rationale for a measured implementation approach, the SBSE Subgroup recommends the development of additional e-services features as soon as possible. Doing so will speed the penetration of e-services in the tax preparer community, contributing toward both cost reduction and transition to electronic tax return filing.

2) Through August 2004, there were 30,000 registered e-services users, and this number was increasing at an average rate of 1,000 per week. However, only 8,500 of these users were eligible for the premium services. Furthermore, the total population of firms eligible to use the premium services is estimated at 50,000. A study should be done to determine why only 8,500 firms of the 50,000 populations, that are eligible for the premium e-services, have registered for e-services. There is suspicion that this is due to lack of authorization from the principals of firms. This should be verified and a strategy developed to dramatically expand adoption of the program.

3) The SBSE Subgroup agrees with the position of the IRS Oversight Board as stated in its 2003 Annual Report on Electronic Filing, "Ultimately, the more incentives the

IRS can reasonably provide to all types of electronic filers, the more it will encourage e-filing. In the Board's view similar electronic services should be extended to other third party partners such as payroll providers, as both the IRS and the third party providers will benefit from quicker, less error prone electronic services."

4) The SBSE Subgroup believes that significant cost reductions can be obtained by increasing the e-services customer base. This can be accomplished by lowering the 100 e-file threshold for individual returns and providing e-services to Reporting Agents and others, such as the mortgage industry, who have thus far been excluded. Although the 100 return threshold for e-services is an incentive for preparers to e-file, rather than paper file, returns, cost savings could be achieved at little or no extra cost to the Service by reducing, and eventually eliminating, this entry requirement.

5) Because of the 2007 mandate and the cost reductions that both IRS and the tax preparer community can achieve from the use of e-services, we support all initiatives that will increase the utilization of e-services. This includes both increasing the number of features in the e-services suite of products and broadening the population that can partake of e-services. The SBSE Subgroup believes that e-services has been very successfully launched and would like to ensure that momentum in this project continues.

#### **Issue: Office of Professional Responsibility**

The Office of Professional Responsibility (OPR) is charged with the oversight of those who may practice before the Internal Revenue Service as defined by Circular 230.

This group comprises a relatively small percentage of the approximately 1.2 million preparers. Best estimates are that between 300,000-600,000 tax return preparers are not

regulated by any licensing authority. In addition, they are not subject to any minimum requirement of competency or requirement to engage in continuing professional education for their field of endeavor. Those who are licensed and so regulated by virtue of Circular 230 or by state licensing, may be punished for substandard work by OPR. The rest, who are unregulated are subject only to the civil suit process brought by their clients or criminal/civil suit brought by the Justice Department.

Fraudulent preparation, failure to sign as the paid preparer and promotion of abusive tax shelters are some of the more egregious acts of those less than qualified in the tax preparation field. Preying upon unsuspecting clientele who assume there is oversight and control of this field, is made easy under the current system. In the past OPR generally waited for the problem to be brought to them, either the taxpayer filed a formal complaint or another operating division of the Service would sometimes forward such concerns internally. OPR has developed an internal communication and action process to address the numerous issues that involve this office. The sharing of information and concerns regarding the preparer/practitioner community by internal stakeholders has been almost nonexistent. At the present OPR has recognized 68 separate areas of concern where the internal IRS process needs improvement to elevate the involvement, awareness and strengthen IRS' programs in the tax preparer/practitioner arena. The areas fall into four separate categories: a) Communications-Education and Outreach, b) Penalties, c) Fraud/Referrals/Ethics, and d) Legislation and Regulation. Within each area there are Recommendations, Resolutions, Stakeholder ownership and Status to help improve the communication process as well as the result. Of the 68 areas 58 have been addressed and completed or are of such a nature that

they are ongoing. One of the areas under Communication-Education and Outreach is to encourage best practices and positive behavior of a tax preparer, as well as educating the public on choosing a preparer and the importance of a preparer's signature. The 68 internal process improvements were identified just a few months ago and are already seeing improvement. The SB/SE Subgroup fully supports this process. Elevation of the office of OPR was long overdue and will only increase overall compliance especially in the practitioner community.

The SB/SE Subgroup understands that there is an issue as to once the program is completed and functioning who should have ownership, since there are many stakeholders involved. The options are a) leave the program with OPR, b) hand the program to SB/SE, or c) give each item back to the major stakeholder.

#### **ISSUE SIX: RECOMMENDATIONS**

- 1) The SB/SE Subgroup recognizes the effort expended by OPR and the enormous task that lies ahead. We also understand that ownership of these issues is paramount. We recommend that OPR should continue to oversee these internal process and whatever ultimate action taken will be jointly determined. If the process is given back to each stakeholder or SBSE only, OPR may be left out of the loop.
- 2) The SB/SE Subgroup recommends that future concerns as related to the office of OPR, initially identified within the operating divisions, be immediately forwarded to OPR for cooperative action.





The SB/SE Subgroup believes that e-services has the potential to significantly improve the interaction between IRS and the tax preparing public. It will have an impact similar to that of e-pay and e-file and, quite simply, could completely change the way IRS provides service to tax professionals. Since e-services is available 24/7, tax preparers have the ability to receive needed information at any time – a vast improvement over telephone-based customer service methods, especially during the January-April tax period.

The first, basic e-services (registration, PTIN and e-file applications, TIN matching) were launched in October 2003. In the spring of 2004, IRS added important new “premium” features to e-services: Disclosure Authorization, Electronic Account Resolution, and Transcript Delivery System. While the combination of basic and premium services reduces telephone calls and provides a more cost effective, efficient experience for both IRS and e-services users, the premium services create the biggest impact. However, the premium services are available only to tax professionals who are active participants in the IRS e-file program and who e-file more than 100 *individual* income tax returns per year. These restrictions preclude the use of e-services by many individual income tax return preparers and by all business tax preparers and payroll processors.

Especially noteworthy is the lack of e-services for the 2,200 registered Reporting Agents. They represent the payroll provider industry that services more than one million employers with a combined total of more than 35 million employees – one third of the entire private sector workforce. By partnering with the Service, Reporting Agents have been instrumental in the development of the e-file and EFTPS systems. Nevertheless, Reporting Agents have been excluded from e-services to the detriment of both the Service and the tax paying public. In terms of cost reductions, there is a compelling case for e-services to

**Internal Revenue Service Advisory Council  
2004 Member Biographies**

**Judith A. Akin, EA**

Ms. Akin is the owner and manager of Judith A. Akin, EA, Tax and Financial Services. Some specialties of her practice include but are not limited to bookkeeping and tax preparation for individuals, small business, partnerships, corporations, estates, trusts, as well as tax planning, business and financial planning. She also specializes in taxpayer representation before the Internal Revenue Service and other taxing authorities. Judy is a graduate of the National Tax Practice Institute. Judy is the past President for the National Association of Enrolled Agents. **(W&I Subgroup Chairperson)**

**Timothy B. Clay**

Mr. Clay owns and manages Accounting & Business Consultants, Inc., a financial management company that serves small businesses and individuals. His firm assists businesses in QuickBooks set-up, organizational structure configuration, tax issues, and preparation of SBA applications, IRS representation, payroll, and loan packages. Mr. Clay is also the former Executive Director of the Birmingham Minority Business Development Center, where he organized weekly meetings for potential start-up businesses. Timothy provided a mechanism for information exchange among partners such as, the SBA, the IRS, and state and local governments. Mr. Clay holds a BS in Business Administration, with a minor in Accounting, from Oakwood College, and an MBA from the University of Alabama at Birmingham with a concentration in Accounting/Data Processing. **(SB/SE Subgroup)**

**Jon M. Contreras**

Mr. Contreras is currently a Director with Deloitte & Touche LLP in Fresno, CA, in their Internal Revenue Service Tax Controversy Practice and has been with the firm for six years. Prior to joining Deloitte, Mr. Contreras was with the Internal Revenue Service for 15 years in the Examination Division, concluding his career with the Fresno Service Center. Throughout his professional career, Mr. Contreras has been extensively involved in compliance activities. He has a thorough knowledge of Examination processes, as practiced in the Internal Revenue Service field and service center operations. Mr. Contreras is both a Certified Public Accountant and Enrolled Agent, he holds a BS Degree in Accounting from California State University, Fresno. **(LMSB Subgroup)**

**Richard D'Avino**

Mr. D'Avino is Senior Vice President, Tax, for General Electric Capital Services in Stamford, CT, where he is responsible for leading global tax compliance, policy and planning for GE's financial services businesses, operating in over 45 countries. Richard holds a BS in Economics from the Wharton School of Business, University of Pennsylvania, and a JD from the University of Pennsylvania. **(LMSB Subgroup)**

**Felecia G. Dixon**

Ms. Dixon is an Enrolled Agent and President of Accounting Technologies, Inc. specializing in Online Training in Salem, MO and a Partner with Alfermann Gray & Co., CPA's in Rolla, MO. She is the past Committee Chair of the Special Enrollment Examination Advisory Committee for the Internal Revenue Service, and an editor and writer of the Illinois Farm Tax School Manual, University of Illinois. A member of the National Association of Tax Professionals, National Society of Accountants, and Accreditation Council for Accountancy and Tax Inc. Ms. Dixon has more than 20 years experience in the tax business, working with clients, both for profit and nonprofit organizations. **(SB/SE Subgroup)**

**John A. Glennie**

Mr. Glennie completed his chartered accountant's designation in Toronto and shortly thereafter joined the Department of National Revenue. In 1978 he joined Shell Canada in the Tax and Insurance Department in Toronto. Mr. Glennie is the General Manager, Tax and Insurance. Prior to becoming the General Manager he was the Director, Tax and Insurance. Mr. Glennie was the International President of the Tax Executives Institute for 2002/03 and he currently sits on the Board of Directors. Mr. Glennie is also a member of the Advisory Committee to the Minister of National Revenue in Canada. He holds a Bachelor of Arts Degree from the University of Toronto. **(LMSB Subgroup)**

**Mary Harris**

Ms. Harris is an enrolled agent who with her husband co-owns Sirrah, Inc; an Arkansas Corporation dba Jackson Hewitt Tax Service. Mary has been in the tax preparation industry since 1969 and is very involved in the day to day operations of her business. The last 18 years she served as district manager with 18 city offices and 27 satellites operations across Arkansas for which she provided assistance. Her Jackson Hewitt operation includes 62 tax offices throughout Arkansas and Texas with approximately 300 employees. They prepared over 25,000 tax returns in the 2002 tax season with over 98% electronically filed. She served on the IRS Arkansas/Oklahoma Liaison Committee, is a member NAEA, NSTP. **(W&I Subgroup)**

**Tracy Hollingsworth**

Ms. Hollingsworth is currently Vice President, Finance for Manufacturers Alliance/MAPI in Arlington, VA. She has been with Manufacturers Alliance for the last twenty-plus years, providing technical, networking and meeting services to the corporate tax directors of their member companies. She has published numerous articles, i.e., Treasury Suspends Overarching Final Research Tax Credit Regulations; Asks for Comments, LAR-447 (February 2001), and Corporate Tax Shelters: Finding a Measured Response, LAR-433, and (April 2000). Ms. Hollingsworth is active in the American Bar Association, District of Columbia and the Massachusetts Bar Associations, and holds a BA from Scripps College, Claremont, CA, and a JD from Boston University, Boston, MA. **(Chairperson)**

**Ann K. Hubbard**

Ms. Hubbard is an Enrolled Agent and the owner of Hubbard Financial Services, Inc. She is currently President of the Texas Society of Enrolled Agents, a member of the National Society of Enrolled Agents and an active member of NAEA's Leadership Committee. Ms. Hubbard is also a Fellow of the National Tax Practice Institute, and a well-known tax seminar speaker in the Houston area. Ann was the Treasurer for the Annise Parker Houston City Council Campaign and volunteered for the Houston Chronicle Tax Hotline. **(SB/SE Subgroup)**

**Pamela P. Kulish**

Ms. Kulish is the President and Chief Operating Officer of Computer Accounting Service, Inc. Through her company, Ms. Kulish provides tax preparation services, financial analysis and planning relative to taxes and investment strategies, to nearly 300 individual clients. Corporate clients include approximately 50 retail and service organizations with gross revenues ranging up to \$7 million. Services directed to corporate clients include: live payroll; monthly financial reporting; analysis and recommendations of cafeteria employee benefit plans; business plans; development of budgets and projects; and local, state, and federal tax preparation. Ms. Kulish is a member of the Maryland Society of Accountants, the National Association of Enrolled Agents, and the National Society of Accountants. **(SBSE Subgroup Chairperson)**

**Richard M. Lipton**

Mr. Lipton has been in practice for over twenty four years and is currently a partner with Baker and McKenzie. He has served as tax counsel in many of the largest transactions in the country, and in the City of Chicago has been closely involved in transactions concerning the Sears Tower, John Hancock Building Aon, Prudential, etc. He has expertise in representing large corporations in complex partnership transactions and has served as an expert witness on matters concerning partnerships and partnership taxation. He has written numerous publications and articles. Mr. Lipton is the former chair of the Tax Section of the American Bar Association as well as the former chair of the Chicago Bar Association Tax Committee and the Chicago Federal Tax Forum. He is a fellow and a regent of the American College of Tax Counsel. Mr. Lipton is a graduate of the University of Chicago Law School and received his B.A. from Amherst College. **(LMSB Subgroup)**

**Susan W. Martin**

Ms. Martin is currently Associate Vice-President for Academic Affairs and a Professor of Accounting and Taxation at Seidman School of Business at Grand Valley State University. Prior to her current position, Ms. Martin was the Commissioner of Revenue for the State of Michigan. She co-authored a textbook titled, *Today's Essentials of Government and Not-for Profit Accounting and Reporting*, and has published numerous articles. Ms. Martin holds a BS in public speaking from Central Michigan University, an MBA in Accounting from Michigan State University, and a Ph.D. in Accounting from Michigan State University. **(SB/SE Subgroup)**

**Kenneth C. Nirenberg**

Mr. Nirenberg has worked in the payroll industry for over thirty years and is currently a Senior Software Developer for Intuit Inc., specializing in tax filing systems. Prior to this, and until its sale, he was President of Charter Information Corp, a payroll services firm with offices in Texas and Massachusetts. Mr. Nirenberg is a representative to the National Payroll Reporting Consortium and has been involved with the IRS RAF Modernization Committee and Reporting Agent Forum. He spent three years as a Peace Corps Volunteer in Malaysia, during which time the Malaysian government requested his services to assist in the computerization of its federal government payroll. Mr. Nirenberg received his B.A. in Economics from Brandeis University and serves on the Brandeis University Alumni Admissions Council. **(SBSE Subgroup)**

**William F Reilly**

Mr. Reilly received his Enrolled Agents license from the Director of Practice in June 1981 and immediately opened his own practice. His practice currently serves more than 400 clients ranging from the simplest returns to partnerships, corporations, trusts and includes payroll, write up, representation and business consulting. He is an active participant in his local chapter of the California Society of Enrolled Agents (CSEA), a member of CSEA Board of Directors and is currently nominated for the office of Treasurer of the Society. In addition, he serves on the Board of Directors of the California Tax Education Council. Mr. Reilly studied math and physics at the University of San Francisco. **(W&I Subgroup)**

**Gary C. Rohrs**

Mr. Rohrs owns and operates A. Clyde Rohrs & Associates, Inc. Accountants, in Independence, Missouri. This is a full service accounting, tax consulting, tax preparation and financial services firm of forty-seven years duration. He is also a Registered Representative for Terra Securities, Inc. which is part of the GE Financial Independent Accountants Network. He was President of the National Society of Accountants 1993-1994, and continues to actively serve on its committees. He was President of the Missouri Society of Accountants 1980-1981 and has served as its Legislative Chair for many years. Mr. Rohrs received his BA in Political Science & English from Central Missouri State University. **(SBSE Subgroup)**

**Denise Strain**

Ms. Strain is Vice President and General Tax Counsel for Citicorp/Citibank and has been with the corporation for over 24 years. Ms. Strain directs all aspects of the global tax function through the management of over 120 tax professionals in eight countries. Denise is Vice Chairman of the Tax Committee for the National Foreign Trade Council, an active member of the American Bankers Association, and the Business Round Table Tax Committee. Denise Chairs the New York Bankers Association Tax Committee, and holds a BA in Psychology from Fairfield University, a JD from St. John's University, and an LLM in Taxation from New York University. **(LMSB Subgroup)**

**Carol Tremble**

Ms Tremble owned her own business for more than 15 years, Carol B. Tremble, Certified Public Accountant, serving 500+ clients; 200 of whom are small business owners. Ms. Tremble prepares taxes and provides general business and computer consulting. Carol served as a Selectman in her town for 15 years retiring in 2003. She now serves on several volunteer committees related to encouraging bicycling as an ecologically friendly means of transportation and is a member of the local Cub Scout planning committee. She is a member of the American Institute of Certified Public Accountants, the New England Peer Review Board, and the Vermont Society of CPA's. Ms. Tremble holds a BA in Mathematics from the University of Vermont. **(SB/SE Subgroup)**

**David A. Uhler**

Mr. Uhler is a certified public accountant and a Partner in the tax department of Bartlett, Pringle & Wolf, LLP in Santa Barbara, California. He heads up the firm's Business Tax Group which assists businesses and their owners with active, strategic tax planning focused on entity structuring, compensation planning, and tax incentive optimization. Prior to joining Bartlett, Pringle & Wolf, Mr. Uhler was a manager in the tax department of Arthur Andersen, LLP. Mr. Uhler currently serves as an officer on the Board of Directors of the Central Coast MIT Enterprise Forum and Central Coast Venture Forum, two organizations focused primarily on fundraising for new business ventures throughout the Central Coast of California. Mr. Uhler has a Bachelor of Science in Commerce degree with an emphasis in accounting from Santa Clara University. **(LMSB Subgroup)**

**Thomas Wharton**

Mr. Wharton is currently the Vice-President of Tax at Pearson Inc. and US subsidiaries, located in New York City. He is responsible for Pearson's US income tax affairs, including nine billion dollars in assets and five billion in revenues. He has over twenty-eight years in corporate tax experience. Mr. Wharton is past-president of the New York Chapter of TEI and is currently the Chair of the Chapter's IRS Administrative Affairs Committee. He holds a BS Degree in Psychology and a minor in Chemistry from Rensselaer Polytechnic Institute, Troy, NY a BS in Accounting from New York Institute of Technology and a Masters of Science Degree in Taxation from C.W. Post University, Greenvale, NY. **(LMSB Subgroup)**

**Betty M. Wilson**

Ms. Wilson retired on 12/31/2003. She was previously Vice President of Taxes, MGM Mirage Corporation. In that role, Betty developed the Corporate Tax Department for MGM Mirage, and was named one of the 20 Most Influential Women in Southern Nevada for 2001 by "INBUSINESS LAS VEGAS". As the International President of Tax Executives Institute from 2000-2001. Ms. Wilson continued and enhanced the partnership among Tax Executives Institute, the Section of Taxation of the American Bar Association, and the Tax Division of the American Institute of Certified Public Accountants for the promotion of the joint tax simplification project. Ms. Wilson holds a BS in Accounting from Colorado State University. (**LMSB Subgroup Chairperson**)



Statement of  
Tracy Hollingsworth  
On behalf of the  
Internal Revenue Service Advisory Council (IRSAC)  
IRS Oversight Board Hearing  
Washington, DC  
January 26, 2004

Panel 1: Strategic Planning: Where Is the IRS Headed Over the Next Five Years?

Good afternoon. My name is Tracy Hollingsworth, Director of Tax Affairs for the Manufacturers Alliance/MAPI. I appear today as Chair of the Internal Revenue Service Advisory Council (IRSAC). On behalf of the IRSAC, I appreciate the opportunity to share in discussions about strategic plans for IRS over the next five years.

IRSAC advises the Internal Revenue Service (IRS) on tax administration policy, programs, and initiatives. Conveying the public's perception of IRS activities to the Commissioner and the Service as a whole, the Council comprises individuals who bring substantial, disparate experience and diverse backgrounds to the Council's activities. Membership is balanced to include representation from the taxpaying public, the tax professional community, small and large businesses, state tax administration, and the payroll community.

The Service's strategic plan for 2000-2005 described three broad goals that continue to be relevant:

- Top-quality service to each taxpayer in every interaction
- Top-quality service to all taxpayers through fair and uniform application of the law

- Productivity through a quality work environment.

In pursuing these goals, Commissioner Everson has indicated that he is emphasizing service, modernization, and enforcement. The IRSAC in its public report this fall expressed agreement with the Commissioner's goals and priorities. IRSAC believes that efforts must be made to enhance enforcement and to assure taxpayers that all are being treated equally and all are paying their fair share. IRSAC commends Commissioner Everson for recognizing the need to find a proper balance between service and enforcement.

The group did offer one cautionary note that the "e" word must be used with care lest the IRS create the impression that it is returning to the "old" ways that led to the Restructuring and Reform Act of 1998. That said, we do recognize that compliance improves when the public is aware that there is a real risk that underreporting will be detected. Moreover, the Service might want also to publicize that the majority of taxpayers do conscientiously meet their federal tax obligations, even when the complexity of the tax law makes that a challenge.

IRS statistics show and a September 2002 assessment report to this Board highlights that audit coverage rates across all categories of taxpayers plummeted in recent years. It goes almost with out saying that low levels of audit coverage promote noncompliance. One theme that emerges from the September report and from the IRSAC public report is that IRS must continue to hone its risk assessment and containment skills. As the September 2002 report pointed out, the IRS does not have the resources to attack every case of noncompliance. Instead, it must focus resources where the risk of noncompliance is the greatest while maintaining adequate coverage generally.

Business systems modernization (BSM) offers an important key to effective risk management. At one level, it allows IRS to shift resources from processing paper to providing service and

enforcement (IR-204-03). At another, higher level, BSM should assist the IRS in risk assessment activities—identifying the taxpayers and the issues that should be examined, spotting compliance trends, and focusing in on specific categories of transactions. As an example, the ability to generate an organization chart of linked pass-through entities using tax identification numbers would assist an auditor in determining her audit plan.

The National Research Program (NRP) that is now underway will provide data that the Service will use in identifying individual returns that present compliance risks. Plans are underway to conduct separate NRP projects for pass-through entities and for corporations. As is pointed out in the IRSAC public report, great care must be devoted to designing NRP projects and to ensuring that the revenue agents who participate are well trained. The potential benefits of these programs are great, particularly when combined with the promise of BSM. Screening returns electronically for the criteria developed under NRP should allow the IRS to apply its audit resources more effectively.

In the past two years, the IRS has begun to use new tools to attack high-risk compliance exposures. The multi-pronged corporate tax shelter compliance initiative has virtually shut down abusive transactions in larger companies. It is slowing them at mid-size companies. Similar efforts with respect to trusts and offshore accounts and underreporting by higher-income individuals are bearing fruit. The combination of guidance, publicity, and enforcement is a model that the IRS can apply to other areas of compliance concern. The IRSAC believes that all the Operating Divisions should be challenged to identify high risk areas and develop innovative techniques to identify and deter noncompliance.

Two techniques the Service used effectively are worth highlighting—vigorously seeking out the promoters and advisors and educating taxpayers about schemes and problematic transactions. Going

directly to the promoters chills their practices and provides a road map to the taxpayers who used the techniques they promoted. This approach should be extended to other areas where preparers and promoters take advantage of taxpayers by, for example, persuading them to over claim benefits. Members of the IRSAC were very disturbed by reports of taxpayers who have been victimized by EITC promoters. Taxpayers need to be protected from the purveyors of schemes. Moreover, they need to be educated through guidance and public notices about the risks of some of these schemes and their compliance obligations.

The Taxpayer Advocate in her annual report to Congress recommended that IRS should enhance its oversight of preparers, and we agree with this goal. She, also, suggested that IRS should provide a mechanism for taxpayers to file complaints about preparers and should conduct research on problems and compliance risks associated with return preparers.

The IRSAC for many years has recommended that the IRS receive adequate funding. The September, 2002 report states, “We are winning the battle, but losing the war.” This he attributes to an imbalance in the size and complexity of the tax system relative to the size of the Service, which has declined in recent years. The report argues that addressing this imbalance—winning not the battle, but the war—means 2 percent annual net increases in IRS staffing over five years. It also means adequately funding computer modernization programs. IRSAC welcomes the Treasury Department announcement on January 13, 2004 that the President’s FY 2005 Budget proposes to increase the total IRS budget by 4.8 percent to \$10.674 billion (JS-1096). It also would provide an installment of \$285 million for business systems modernization.