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.

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