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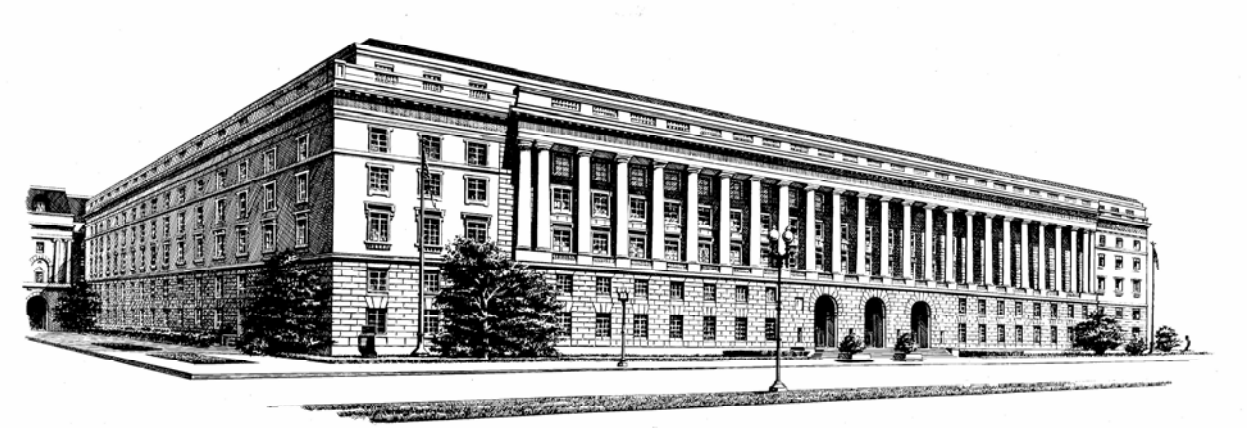

INTERNAL REVENUE SERVICE ADVISORY COUNCIL PUBLIC MEETING

NOVEMBER 15, 2007
1111 CONSTITUTION AVENUE NW
WASHINGTON, DC

INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

2007 PUBLIC MEETING
BRIEFING BOOK

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NOVEMBER 15, 2007

GENERAL REPORT
OF THE
INTERNAL REVENUE SERVICE ADVISORY COUNCIL

The primary purpose of the Internal Revenue Service Advisory Council (hereafter "IRSAC or "the Council") is to provide an organized public forum for discussion of relevant tax administration issues between Internal Revenue Service (hereafter "IRS" or "the Service") officials and representatives of the public. Authorized under the Federal Advisory Committee Act (FACA) Public Law No. 92-463, the Council is a successor to the Commissioner's Advisory Group established in 1953.

The Council's charter specifies that it is designed to focus on broad policy matters.

> The IRSAC reviews existing tax policy and/or recommends policies with respect to emerging tax administration issues, suggests operational improvements, [and] offers constructive observations regarding current or proposed IRS policies, programs, [and] procedures. . . .

Issues selected for inclusion in the annual report represent those to which IRSAC members have devoted particular attention during three to four working sessions and numerous conference calls throughout the preceding twelve months. Many are the result of specific requests for assistance by IRS personnel. Others are the result of Council member concerns. Nearly all involve extensive research efforts.

This has been a year of change for the federal government, the IRS, and IRSAC. Changes in the leadership of House and Senate committees as the result of the November 2006 elections created new areas of focus for many of the committees that deal with tax administration issues, although the tax gap continued to be a topic of significant interest. IRSAC members were briefed on legislative proposals to combat the tax gap in the President's FY 2008 budget request, some of which paralleled recommendations made by

IRSAC in prior reports. Several IRSAC members provided testimony, either as individuals or as representatives of IRSAC, in various hearings and forums regarding the tax gap as well.

Former Commissioner Everson's decision to leave the IRS after four years of his five year term and the subsequent departure of Acting Commissioner Kevin Brown created challenges for the Service in addition to those that existed by virtue of normal retirement of personnel at all levels. Fortunately, most of the high level turnover occurred after the 2006 filing season, which was complicated by legislators' last minute extension of several expiring tax provisions and by the administration of the Telephone Excise Tax Refund (TETR) program. IRSAC members participated in conference calls regarding TETR during filing season and were pleased that both hurdles were generally handled well by the Service.

IRSAC was also briefed on the results of Phase II of the Taxpayer Assistance Blueprint (TAB), a major study that will have long-lasting impact on the ways in which IRS delivers customer service. The collaborative effort behind Phase II of TAB is commendable and may serve as a model for future service-wide efforts.

In recent years, IRSAC has been organized into three subgroups corresponding to three of the four IRS operating divisions: the Large & Mid-Size Business Subgroup (hereafter "LMSB Subgroup"), the Small Business/Self-Employed Subgroup (hereafter "SB/SE Subgroup"), and the Wage & Investment Subgroup (hereafter "W&I Subgroup"). The Tax Exempt and Government Entities division works with a separate advisory committee.

In response to a 2006 recommendation by the Treasury Inspector General for Tax Administration , the Director of IRS Research, Analysis, and Statistics (hereafter "Research") requested that an advisory body be created to consult with IRS Research regarding measurement of the tax gap. To permit this body to be established quickly, the Tax Gap Analysis Subgroup (hereafter "Tax Gap Subgroup") was created as a fourth subgroup under IRSAC. Composed primarily of academicians, the Tax Gap Subgroup's first public report is contained in this document.

One of the distinguishing characteristics of IRSAC is the fact that it brings together dedicated individuals from a wide variety of backgrounds in one consultative body. Members come from the fields of accounting, law, other taxpayer services, and now academia. They represent large and small firms, urban and rural settings, and all regions of the United States. This diversity ensures that issues are considered from many angles simultaneously. It is IRSAC's hope that the dynamic discussions that frequently take place provide efficient feedback to the Service. We believe it is more valuable to be consulted before major policy decisions are made than after, but appreciate the opportunity to be of service in either case.

The members of IRSAC wish to express their appreciation to the IRS personnel with whom they have interacted this past year. This includes individuals from all levels and areas of the organization. We have enjoyed our candid discussions of current and emerging policies and procedures and hope that these conversations will continue to provide value to the IRS leadership in the future.

INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

WAGE & INVESTMENT
SUBGROUP REPORT

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NOVEMBER 15, 2007

WAGE & INVESTMENT
SUBGROUP REPORT

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INTRODUCTION/EXECUTIVE SUMMARY

The IRSAC W&I Subgroup (hereafter "Subgroup") is comprised of a diverse group of tax professionals consisting of a certified public accountant (CPA), an attorney, an enrolled agent (EA), a certified payroll professional (CPP), and a representative from a national tax preparation firm. This group brings a broad range of experience and perspective from both tax preparers' and taxpayers' views. We have been honored to serve on the IRS Advisory Council and appreciate the opportunity to submit this report.

Since January of this year, the Subgroup has had the privilege of working with the professionals within the W&I Division and found them to be extremely helpful in providing the information and resources necessary to develop our report. The Subgroup has researched and is reporting on the following three issues:

1. IRS Mail-Out Inserts - The W&I Division asked IRSAC to assist in analyzing and reducing the volume of mail-out inserts sent to taxpayers, employers, and their representatives. Although some of the documents inserted with notices are required by law, we saw many opportunities to reduce the substantial volume of paper generated each year. Notices (with accompanying inserts) relating to the same tax account, but separate tax periods, should be combined to drastically reduce mailings. Representatives with powers of attorney should be provided the opportunity to elect not to receive inserts, and not default to the same inserts as the taxpayer receives. Due to the number of notices, forms, publications, and instructions that are encompassed by this request, we suggest an ongoing effort to review the criteria used for including inserts and pare them down to a more reasonable volume. We believe substantial monetary savings can be realized by

simply discontinuing all mailings of IRS forms to taxpayers who utilize commercial tax return preparation software, or by allowing the taxpayer to "opt out" of receiving paper forms.

2. EITC Communication Strategy - IRSAC was asked to assist in improving the communication strategy regarding the Earned Income Tax Credit (EITC) to increase the participation of eligible individuals. We recommend enhancement of the EITC Awareness Day by including additional stakeholders to increase the scope of participation. To focus on areas with the most EITC-eligible individuals, we recommend the IRS analyze non-participation by metropolitan area to target those efforts where they might be more productive. We suggest coordination with other assistance programs to ensure benefits for families who may not be aware of all available assistance, including non-tax-based programs. Since employers are the frontline contact for most workers, we further believe that encouraging employers to identify and educate employees on the EITC may result in increased participation from individuals who are currently unaware of the credit.
3. EITC Return Preparer Strategy - To improve the accuracy of Earned Income Tax Credit (EITC) returns, we recommend several steps to improve the qualifications and education of return preparers, while strengthening enforcement against fraud. Increased educational opportunities and development of qualified specialists in the context of testing and licensing all professional preparers would improve EITC claim accuracy.

The Subgroup considered a fourth issue relating to the electronic submission of IRS tax levy payments by employers using the Electronic Federal Tax Payment System

(EFTPS). The advantages of the IRS' receiving these payments electronically are obvious, but could have significant impact for larger employers who currently send payments to a number of IRS payment processing centers. We also believe the notifications (Form 668-W, *Notice on Levy of Wages, Salary, and Other Income,* and Form 668-D, *Release of Levy/Release of Property from Levy*) could be sent to employers electronically, which would reduce the turnaround time necessary to process such transactions. After we discussed this subject with W&I, a project manager was assigned from SB/SE Compliance, and this issue is currently in the conceptual/exploratory phase. We appreciate the interest IRS has taken in this subject and hope to continue to work with the Service as it addresses this issue.

Each issue contains specific recommendations. We hope that our effort to provide new ideas and suggestions for improvement are helpful to the IRS.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: IRS MAIL-OUT INSERTS

Executive Summary

The W&I Division asked IRSAC to assist in analyzing and reducing the volume of mail-out inserts sent to taxpayers, employers, and their representatives. Although some of the documents inserted with notices are required by law, we saw many opportunities to reduce the extremely large volume of paper generated each year. Notices (with accompanying inserts) relating to the same tax account, but separate tax periods, should be combined to drastically reduce mailings. Notices sent multiple times for the same issue need not duplicate each insert. Representatives with powers of attorney should be provided the opportunity to elect not to receive inserts, and not default to the same inserts as the taxpayer receives. Due to the number of notices, forms, publications, and instructions encompassed by this request, we suggest an ongoing effort to review the criteria used for including inserts and pare them down to a more reasonable volume. We believe substantial monetary savings can be realized by simply discontinuing all mailings of IRS forms to taxpayers who utilize commercial tax return preparation software, by allowing the taxpayer to "opt out" of receiving paper forms.

Background

The IRS mails (by regular or certified mail) over 70 different types of inserts (forms, publications, notices, and instructions) with correspondence it sends to taxpayers. This program encompasses about 220 million inserts and 175 million separate pieces of taxpayer correspondence each year. Included in this correspondence is a set of

collection, inquiry, and refund notices that comprise about 190 million of the 220 million inserts.

The IRS organizes its "load plan" for these Individual Master File (IMF) and Business Master File (BMF) notices in seven groups, as follows:

Group Name	**Approximate Number of Notices/Year**
IMF Non Collection Balance Due Notices	7 million
IMF Refund Notices	11 million
IMF Even/Taxpayer Inquiry Notices	2 million
BMF Non Collection Balance Due Notices	5 million
BMF Refund Notices	3 million
BMF Even/Taxpayer Inquiry Notices	1 million
IMF/BMF Collection Notices	50 million (36 million in CP500 series)

The IRS tailors the inserts to the type of correspondence. For example, most balance due collection notices receive Pub. 1, *Your Rights as a Taxpayer,* and Notice 1212, *Automated Telephone Service*. Some inserts are required by law; the IRS includes others out of caution. Moreover, the IRS duplicates these inserts by mailing additional copies to taxpayer representatives when the taxpayer has filed a power of attorney. The IRS believes that the availability of all such inserts on the IRS website does not reduce the agency's perceived need to include them in hard copy mailings. Finally, in some cases, the IRS sends one letter and one corresponding set of inserts in one envelope for each of many tax periods, even though this practice unnecessarily increases the

paperwork. An example of many is CP504, *Final Notice – Balance Due*, a collection notice the IRS sends to taxpayers for delinquent payroll and income taxes. The IRS sends a separate CP504 notice, enclosing Notice 1219B, *Notice of Potential Third Party Contact* and Pub. 594, *The IRS Collection Process*, by certified mail for *each delinquent period.* If all delinquent periods were stated on one form, the IRS could save substantial cost. Also, consolidating periods on one notice would reduce confusion for taxpayers who erroneously assume the multiple notices are duplicates. It is important to note that collection notices (of which CP504 is one example) account for about 75 percent of the total number of notices described in the above chart.

IRSAC believes that the most effective review of the notice and load plan will require a painstaking and time-consuming review of each notice and its associated publications, forms and instructions. Still, the IRS can take several immediate steps to start reducing the paperwork.

Recommendations

1. Consolidate tax periods in notices. Send *one* collection notice of each type for multiple periods where this is feasible. Insert only one set of publications, forms and instructions. For example, CP504 contains a three-page letter (which includes a window-envelope cover sheet), Notice 1219-B (1/3 page), Notice 1212 (1/3 page), Pub. 594, *The IRS Collection Process (*12 pages), and a return envelope. All delinquent periods can be aggregated in one letter with one set of inserts.
2. Where an insert is not legally required, the IRS should consider sending documents or inserts only once in the collection process. The IRS should also include in that mailing a prominently displayed list of forms, publications, and

other documents that may be relevant, and reference where to find them on the IRS Web site.

3. Cease sending any inserts to Circular 230 representatives unless they ask to receive them. Modify Form 2848, *Power of Attorney and Declaration of Representative*, as needed for this purpose. Discontinue sending the more routine, collection-specific notices (where such notices are not legally required) to such representatives by certified mail. W&I should consider delivering notices to these representatives via e-services and a secure mailbox.
4. Because the volume of inserts and publications is so enormous, the task of analyzing all such documents will take considerable time. The IRS should continue working with tax practitioners and IRSAC on this issue, focusing on major notices, until the system has been streamlined. In response to the IRS' request for assistance, Subgroup members have begun to keep better track in their own practices regarding notices received, so they can make specific recommendations to improve the process.
5. The IRS should also continue its own review of all notices, publications, and forms to ensure they are as compact and efficient as possible. This means simplifying the notice language and arranging the text so that the notice takes up fewer pages. Pub. 1, *Your Rights as a Taxpayer*, is an excellent example of efficiency in an IRS publication.
6. Non-insert paper forms (*e.g.*, Forms 941, 1120, 1040) also represent a substantial investment of resources. The IRS should develop ways to eliminate mailing the hard copy versions of these forms when appropriate. For example, the IRS now

identifies returns generated by commercial return preparation software. The IRS could use these data to eliminate mailing hard copy forms, as it does with e-file notifications. Likewise, the IRS should consider a "check the box" insert on Forms 1040, 1120, and 941 to allow the filer to opt out of receiving mailed forms in the future. The IRS currently sends a postcard to taxpayers whose returns were filed by a paid preparer that indicates the forms will no longer be mailed to the taxpayer and advises how to get the forms if needed.

7. To reduce the cost of printing and mailing, notices should be printed on lightweight paper in gray scale (or eliminated) whenever possible. Communications printed in full-color on glossy paper should be used less often.

ISSUE TWO: EITC COMMUNICATION STRATEGY

Executive Summary

IRSAC was asked to assist in improving the communication strategy regarding the Earned Income Tax Credit (EITC) to increase the participation of eligible individuals. The IRS has made significant efforts to reach out to communities and individuals, but we have some recommendations that may enhance its current marketing campaign. We recommend enhancement of the EITC Awareness Day by including additional stakeholders to increase the scope of participation. To focus on areas with the most EITC-eligible individuals, we recommend the IRS analyze non-participation by metropolitan area to target those efforts where they might be more productive. We suggest coordination with other assistance programs to raise awareness of the EITC for families who may not be aware of all available assistance, including non-tax based

programs. Since employers are the frontline contact for most workers, encouraging employers to identify and educate employees on the EITC may result in further participation from individuals who are currently unaware of the credit.

Background

Participation in the EITC ranges from 75-85 percent, which is high compared with non-tax programs such as Food Stamps or the State Children's Health Insurance Program (SCHIP). Studies show the highest level of EITC nonparticipation is among potential claimants without children, the limited English proficient, rural residents, and non-traditional families. Substantial effort and funding have been devoted to reaching out and educating potential EITC tax filers through media campaigns, direct marketing, stakeholder partnerships, and Web-based services. However, some EITC-eligible populations remain underserved.

Recommendations

1. Continue and enhance EITC Awareness Day. The 2007 EITC Awareness Day was a success. A concentrated effort to increase the awareness of the tax credit should be continued through national and local media. In addition to partnering with non-profit and community groups, the IRS should include paid preparer organizations, trade groups and large tax firms since 70 percent of EITC claimants use professional preparers to complete their tax returns.
2. Continue to partner with social service agencies and non-profits that provide services to non-participants, and provide EITC awareness kits, including flyers and brochures that provide information on the credit. The information should

direct taxpayers to IRS Taxpayer Assistance Centers, paid preparers, or VITA sites for tax preparation assistance.

3. Develop and publicize estimates by zip code of eligible workers who aren't claiming the EITC and the estimated dollars they are missing. This effort could drive local media coverage, as well as motivate local officials and community groups (who view EITC funds as indirect economic development assistance) to aid in enlisting eligible workers to apply for the EITC. The localized data can be the basis for a targeted marketing campaign.
4. Encourage employers to notify potentially eligible employees who may fall into the EITC income requirements. The IRS should create an EITC awareness poster and include this with Form 940, *Employers Annual Federal Unemployment (FUTA) Tax Return*, when it is mailed to employers in January. California has just passed legislation encouraging employers to notify potentially eligible employees of the EITC.
5. Partner with administrators of other public assistance programs to make benefit recipients aware of underutilized programs for which they may qualify. Similarly, we know that while EITC benefits are utilized at about a 75-85 percent rate, Food Stamp and SCHIP programs only reach 50-66 percent of those eligible. It is worth exploring whether EITC recipients could be given information to determine eligibility for these programs (which can bring as much as $9,000 more to a family's income) and whether participants in those programs could be notified about their possible EITC eligibility.

ISSUE THREE: EITC RETURN PREPARER STRATEGY

Executive Summary

To improve the accuracy of Earned Income Tax Credit (EITC) returns, we recommend several steps to improve qualifications and education of return preparers, while strengthening enforcement against fraud. Increased educational opportunities and development of qualified specialists in the context of testing and licensing all professional preparers would improve EITC claim accuracy.

Background

The EITC remains a successful key federal anti-poverty program. In 2005, about 22 million low-income workers received EITC benefits averaging over $1,870 each. In 2006, benefits for a family with two or more children ranged as high as $4,536.

Participation levels are high relative to other programs that are not delivered through the tax system, and administrative costs are very low. However, the overclaim rate has been persistently high and since more than 70 percent of EITC claimants use professional or volunteer return preparers, the IRS has aimed compliance efforts at return preparers to reduce errors and fraud.

IRS efforts have clearly improved in recent years through better outreach, education, and enforcement and IRS management should be commended for its success. The EITC Assistant on the IRS Web site is also a helpful tool. However, the EITC program remains subject to close review because of the significant refund amounts that are paid to ineligible recipients, which triggers requirements of the Improper Payments Information Act of 2002 (IPIA).[1]

How can return preparers help improve accuracy? The vast majority of preparers are competent and honorable. However, the EITC is a particularly complex part of the tax code, leading to honest mistakes. A majority of errors relate to identifying qualified children, filing status, and misreported income. In some cases, preparers innocently report misinformation from their clients, and in some cases preparers are not asking the questions required to show due diligence. Unfortunately, there are also some unscrupulous preparers.

Recent audit reports have found shortcomings in the preparation of EITC returns by all segments of the tax preparation community—paid preparers, volunteers, and IRS employees.[2] While simplifying the EITC, which could ease compliance, is the responsibility of Congress, the IRS can hold tax preparers—paid and volunteer—to a higher standard of accountability.

To improve performance, we recommend several education and enforcement measures.

Recommendations

1. To improve the skill of third-party return preparers, the IRS should quickly implement any testing and certification mandate approved by Congress. Legislation for preparer licensing and continuing education has twice passed the Senate Finance Committee and once been approved by the full Senate in recent years.[3] Any testing program should include questions related to the EITC. The IRS should also consider a voluntary specialized test segment related to the EITC for preparers whose practices involve many low-income taxpayers so that they can be certified as having the skills needed to prepare those returns. If licensing is

enacted and EITC return preparers are certified, the IRS should promote use of those qualified preparers. The IRS should test whether vouchers or other financial incentives would be a cost-effective means of encouraging taxpayers to use certified EITC specialists. Every IRS-approved volunteer tax preparation site should be required to have at least one certified EITC specialist.

2. The IRS, in conjunction with tax practitioner groups and educators, should develop an online educational module to help train practitioners in preparing EITC returns and to improve their skills. Publishers of professional tax return preparation software should include similar EITC training materials in their software, or provide links to the online IRS training module. Completing the training module could be required of those tax professionals who prepare EITC returns. Use by volunteer preparers should be strongly encouraged. In addition, to supplement the six annual tax practitioner Nationwide Tax Forums sponsored by the IRS, consideration should be given to half-day workshops in major metropolitan areas at which IRS experts could educate tax practitioners on the EITC, on interview skills, and on other tax issues related to low-income taxpayers.
3. Treasury regulations set requirements to show preparer diligence in determining EITC eligibility and provide penalties for failure to comply. The requirements include: (a) completing Form 8867, *Paid Preparer's Earned Income Credit Checklist*; (b) retaining the EITC computation worksheet and other records; and (c) making reasonable inquiries to assure information is accurate and to probing further if information seems incorrect, incomplete, or inconsistent to ensure the

preparer does not know, or have reason to know, any information is incorrect.[4] Yet, at the same time, the IRS advises that the preparer is not supposed to audit his client. The IRS should provide guidance as to when preparers can rely on the representation of their clients and when further inquiry is appropriate. Consideration should also be given to adding questions to the EITC eligibility checklist—for example, "Do you have school records to support the child's residence?"

4. The IRS should continue to strengthen oversight efforts to identify preparers of multiple returns that are erroneous so that the IRS can make site visits, send letters suggesting continuing education, and monitor future performance. We support IRS efforts to improve selection methodology consistent with the best return on investment for the Return Preparer Program, the Questionable Refund Program, and the EITC Due Diligence Audit Program.[5] A "hotline" should be instituted so that the public can report incidents of preparers who file returns without signing them or e-file returns without a taxpayer's required Form W-2, as well as preparers who are required to be licensed who prepare returns without such a license. The IRS should be encouraged to utilize its statutory authority to pay monetary rewards to citizens who identify such preparer misconduct. This goal is not easy because many incompetent preparers lack a fixed location, operate on a cash basis, and relocate frequently, and we recognize that the IRS is generally short of sufficient enforcement personnel. But the IRS' efforts to halt return preparers who were filing fraudulent telephone excise tax refund claims in 2007 demonstrate that the agency can muster sufficient resources if management

makes the decision to intervene. A concerted and publicized enforcement effort, as part of a balanced overall program, could pay long-term dividends.

Overall, we found the IRS fully engaged in the challenges it faces with strong program leadership, but more can be done. We're very encouraged that the IRS has responded positively to our suggestions, and we look forward to monitoring its progress.

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[1] The IPIA, P.L. 107-300, requires agencies to review their programs annually, identify those susceptible to significant erroneous payments, and develop corrective action plans for programs with high error rates. *See* Written Testimony of the Commissioner of Internal Revenue Service Mark Everson before the Senate Homeland Security and Governmental Affairs Committee Subcommittee on Federal Financial Management, Governmental Information And International Security, on "Reporting Improper Payments: A Report Card On Agencies' Progress," Mar. 9, 2006.

[2] Treasury's Inspector General for Tax Administration, for example, has noted that "taxpayers still have just a 1 in 2 chance of having their tax returns accurately prepared by VITA program volunteers." Testimony of J. Russell George, Treasury Inspector General for Tax Administration, providing a preliminary assessment of the 2007 tax filing season, before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. Senate, May 9, 2007, pp. 3-4. *See also*, TIGTA, *Oversight and Accuracy of Tax Returns Continue to be Problems for the Volunteer Income Tax Assistance Program*, 2006-40-125, Aug. 31, 2006; TIGTA, *Improvements Are Needed to Ensure Tax Returns Are Correctly Prepared at Taxpayer Assistance Centers*, 2004-40-025, Dec. 2003; and Testimony of Michael Brostek, Governmental Accountability Office, before the Senate Finance Committee, "Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors," GAO-06-563T, April 6, 2006.

[3] *See,,e.g.*, S. 882, Tax Administration Good Government Act of 2004, 108th Congress, approved by the Senate Finance Committee Feb. 2, 2004 and substituted for H.R. 1528 by the full Senate May 19, 2004; S. 832, Taxpayer Protection and Assistance Act of 2005, 109th Congress; S.1321, Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006, 109th Congress, approved by the Senate Finance Committee Sept. 19, 2006; and S.1219, Taxpayer Protection and Assistance Act of 2007, 110th Congress. IRSAC's predecessor, the Commissioner's Advisory Group, twice recommended testing of unenrolled tax preparers.

[4] Treas. Reg. 1.6695-2. Any income tax preparer (defined in Reg. Sec. 301.7701) who prepares a return or claim for refund who fails to comply with the due diligence requirements concerning the eligibility for and the amount of an EITC shall pay a penalty of $100 for each failure.

[5] Treasury's Inspector General for Tax Administration has criticized IRS screening of preparers who originate e-filed returns. TIGTA, *Better Screening and Monitoring of E-File Providers Is Needed to Minimize the Risk of Unscrupulous Providers Participating in the E-File Program*, 2007-40-176, Sept. 19, 2007.

INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

LARGE AND MID-SIZE BUSINESS
SUBGROUP REPORT

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NOVEMBER 15, 2007

LARGE AND MID-SIZE BUSINESS
SUBGROUP REPORT

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INTRODUCTION/EXECUTIVE SUMMARY

The LMSB Subgroup (hereafter "Subgroup") is comprised of a diverse group of tax professionals licensed as CPAs and/or attorneys who work for major U.S. corporations, law firms and accounting firms. This group brings a wealth of experience, transactional expertise, and perspectives from tax advisors and taxpayers. It has truly been an honor to serve on the IRS Advisory Council, and we appreciate the opportunity to submit this report.

Since January of this year, the Subgroup has had the privilege of working with the professionals within the LMSB Division. The Subgroup and representatives of the LMSB Division met several times in person in formal meetings and communicated several other times via email and phone. The meetings were well-attended and resulted in open and frank discussions on new and continuing items of interest.

LMSB Commissioner Debbie Nolan recently announced her retirement. Since LMSB standup, Commissioner Nolan has done a great job of advancing the organization's goals of reducing cycle time, better enforcing tax law, and simplifying compliance for taxpayers. The Subgroup would like to publicly acknowledge her contributions and efforts in coordinating all the Subgroup meetings, bringing in top leadership to meet with the Subgroup, listening to the recommendations of the Subgroup and facilitating implementation of all or part of the various recommendations. We wish Commissioner Nolan the best in her retirement and are pleased that she has left LMSB in the well-qualified hands of Commissioner Frank Ng, with whom the Subgroup also has worked closely.

In recent years, LMSB has rolled out a significant number of initiatives that the Subgroup has commented on including: E-file, Compliance Assurance Process ("CAP"), Schedule M-3, and Tax Shelter Disclosures. In addition, LMSB has made great strides in the international compliance area, with a focus on many significant issues and also in looking for ways to simply compliance without impacting enforcement such as the Form 5471 Redesign Project. Domestically, LMSB has made significant strides in the national coordination of issues that they deem important through projects such as Industry Issue Resolution (IIR) and the new Tiered Issue approach.

LMSB activities in 2007 focused primarily on continuing to move forward with the implementation of significant initiatives, determining how best to measure their effectiveness (metrics) and evaluating whether changes are necessary. The remainder of our report will discuss areas of continuing focus and include some suggestions on how LMSB should proceed. We also address certain areas in which the Subgroup hopes that LMSB will dedicate more resources in the future--such as training LMSB employees on commercial awareness and engaging outside stakeholders earlier in the published guidance process.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: CAP STRATEGY

In 2005, the LMSB started a pilot program called the Compliance Assurance Process (CAP) for LMSB taxpayers. Under this program, LMSB began working with large business taxpayers to identify and resolve issues prior to the filing of their federal income tax returns. LMSB feels CAP has been very successful and has also benefitted those LMSB taxpayers who volunteered to participate in the pilot program. Currently there are 73 LMSB taxpayers participating in CAP.

In CAP, the IRS and the LMSB taxpayer collaborate during the year, and most issues are resolved and agreed upon before the income tax return is filed. As a result traditional compliance metrics such as dollars collected, issues identified and assessments made cannot be used or do not adequately measure the results of CAP.

With increased tax and external reporting requirements, the reportable transaction disclosure regimes, Sarbanes-Oxley and FIN 48, "*Accounting for Uncertainty in Income Taxes*," LMSB taxpayers are looking at ways to increase certainty in determining reserves, control risks and enhance public confidence. The Subgroup believes that the CAP program is an important tool for achieving these objectives, and that notwithstanding the challenges in measuring its effectiveness, the program should be expanded. This would also assist LMSB with the currency challenge now faced in the traditional audit process. The Subgroup also believes that LMSB should look at different metrics such as man-hours saved, resources redeployed, additional dollars generated from those deployed resources, and other non-traditional measurements to highlight the

success of the program to its stakeholders. The Subgroup commends LMSB for having the foresight to implement a program that assists with increasing currency and allowing for more efficient use of its resources.

ISSUE TWO: COMMERCIAL AWARENESS

Senior LMSB executives are participating with their counterparts from tax authorities of other countries in the so-called Organization for Economic Co-operation and Development ("OECD") "intermediary" project -- a collaborative international effort to better understand and develop effective administrative responses to the proliferation of aggressive tax-motivated transactions involving corporate and other business taxpayers. The Subgroup understands that the group plans to release a written report before year-end that focuses on the need to foster a more transparent and trust-based relationship between such taxpayers and taxing authorities. We further understand that the report will identify, as a critical aspect of such relationships, the need for a high level of "commercial awareness" on the part of tax authorities with respect to the taxpayer's business dealings.

The Subgroup applauds any effort to heighten commercial awareness on the part of LMSB personnel. Many LMSB taxpayers report that they have encountered examining revenue agents who do not understand the nature or economics of their business activities and, consequently, tend to view the mere existence of structurally complicated transactions as necessarily presenting a serious compliance risk that warrants suspicious and intensive audit activity. These knowledge gaps can relate not only to industry-specific and taxpayer-specific information, but also to fundamental principles of

finance, accounting and business economics that commonly drive the structuring and implementation of business transactions.

LMSB officials recognize that the fair and efficient conduct of audits can be seriously impeded by this lack of commercial awareness, and have sought LMSB Subgroup input regarding ways in which LMSB auditors, examiners, and supervisors can become better equipped to understand and analyze the commercial settings in which taxpayers conduct their affairs and the business reasons that underlie specific transactions.

Based on preliminary considerations, we believe that the educational programs and initiatives necessary to achieve the objective of greater commercial awareness will require ongoing participation by outside consultants from the private sector and academia, and by LMSB personnel who have specialized knowledge and experience with respect to particular taxpayer industry groups, complex financial transactions, cross-border transactions, and other areas in which commercial awareness is especially important to analyzing the proper tax treatment. Appropriate roles may exist, for example, for business school professors, industry groups, specialists from investment banking or other financial organizations, and practitioners in law and accounting firms (either individually or through professional organizations such as the American Institute of Certified Public Accountants and the American Bar Association).

Vehicles for dispensing commercial awareness education may include single or multi-session seminars, as well as lectures and workshops conducted on both survey and more advanced levels. Consideration might also be given to contracting out for specialized programs under the sponsorship of continuing professional education

organizations such as the Practicing Law Institute. In all events, it is important that such educational activities be directed toward identified groups of LMSB personnel who are most likely to benefit from the particular training offered and that the content of the training and related materials reflect, to the greatest extent possible, actual LMSB audit cases and other experience with the specific areas and issues being addressed.

ISSUE THREE: E-FILE ISSUES

For the past two years, LMSB has required certain large and mid-sized businesses to file their Forms 1120 and 1120S electronically. Electronic filing of corporate income tax returns involved considerable time effort and expense by the IRS and the business community. In general, during this past filing season, electronically filed corporate income tax returns were successfully sent by the business community and successfully received by the IRS. This initiative should ultimately benefit corporate taxpayers as well as the LMSB through greater selectivity of audits and more efficient audits. The Subgroup recommends that LMSB measure the effectiveness of e-file to determine if the additional costs incurred are resulting in the expected benefit. In addition, the Subgroup recommends that LMSB continue to assess the benefits and costs of requiring that supporting documents be filed electronically.

Requirements regarding e-filing of partnership tax returns are increasing, and the Subgroup suggests that LMSB continue to invest in making this process as cost effective and efficient as possible. The Subgroup also recommends that the LMSB continue to stay focused on maintaining the confidentiality of business tax returns.

ISSUE FOUR: EARLY STAKEHOLDER INPUT

In early 2007, the Office of Chief Counsel launched a new program designed to permit outside stakeholder groups (*e.g.*, AICPA, ABA Tax Section, Tax Executives Institute, and state bar tax sections) to work closely with IRS personnel in formulating and preparing initial drafts of specific published guidance. The pilot project for this program, announced in Notice 2007-17, relates to possible amendments to Treasury regulations concerning securitized commercial mortgage loans held by Real Estate Mortgage Investment Conduits (REMICs) -- which the notice describes as a "technical area of the tax law, where the need for guidance is driven by market changes with which taxpayers may be more familiar than are the IRS and Treasury." The notice requests policy and technical input on specific aspects of the contemplated guidance, as well as procedures for the timing and content of written submissions and ongoing involvement in the project through meetings and other interaction between stakeholder group representatives and the responsible IRS and Treasury attorneys. The notice also makes clear that "interested parties will not be invited to enter into negotiations or to participate in the decision-making process with respect to the proposed resolution of any issue."

This new initiative is of particular interest to LMSB taxpayers, who frequently are faced with uncertain technical tax issues arising under the numerous provisions of the Internal Revenue Code that affect tax planning by large and mid-sized business entities.

Tax writing committee leaders have voiced concerns over the initiative, suggesting that input received from stakeholder groups is generally slanted toward achieving more favorable tax treatment for affected taxpayer constituencies and is thus not truly objective. In view of the ultimate control that IRS and Treasury personnel will

continue to exercise over the guidance decision-making process, as well as self-imposed conflict-of-interest policies and governmental submission review procedures of the outside groups most likely to participate in the program, the LMSB Subgroup believes that any such concerns can be effectively neutralized in virtually all cases.

Treasury regulations, revenue rulings and procedures, and other forms of published guidance inform taxpayers of official IRS positions and interpretations and, in contrast to private letter rulings and internal IRS guidance, can be relied upon by all similarly-situated taxpayers. Such guidance has proven to be an important tool for reducing the number of audit disputes and the need to devote scarce IRS resources to such disputes. Practitioner members of outside stakeholder groups typically have in-depth technical knowledge and much practical experience with respect to the subject matter of most guidance projects (often including knowledge and experience gained from prior government service). These groups frequently submit useful comments with respect to already issued proposed guidance; but, with occasional exceptions, such input generally does not cause major changes in the thrust or content of the guidance as finally adopted. Permitting "front-end" input in a systematic and transparent manner should help to assure the proper targeting and high technical quality of the guidance. As confidence in this approach builds, IRS and Treasury should be able to generate more items of published interest, to do so more quickly, and to free up resources for other important work.

While not all guidance projects will be suitable for this initiative, the LMSB Subgroup believes there are numerous areas in which LMSB can utilize this approach. We recommend that one or two items from the various categories of the Treasury

Department's Annual Business Plan be designated as the primary source of such projects, and that LMSB and Treasury also be prepared to invoke the program on an expedited basis when unanticipated issues requiring priority guidance arise.

ISSUE FIVE: TIER ISSUES

In the spring of 2007, LMSB launched a new Industry Issue Focus (IIF) approach as part of issue management strategy that provides greater national oversight on important issues with the goal of ensuring consistency in issue resolution across industry lines. Identified issues under the IIF program are prioritized by placing them in one of three tiers based on their prevalence across industry lines and the level of compliance risk they present. The degree of national coordination and expected adherence with settlement guidelines varies depending upon the tier in which an IIF issue is categorized. Individual issues can be added or removed from any given tier based upon the best judgment of LMSB.

Tier I issues are deemed of high strategic importance and are considered to have a significant impact on one or more industries. These issues will typically include areas involving a large number of taxpayers or generally representing significant dollar risk, substantial compliance risk or high visibility, and for which there are well-established legal positions and/or LMSB directions. Additionally, Tier I includes issues that arise from new law or that have been identified so that LMSB can take proactive steps to ensure that they do not become problems. Each Tier I issue is unique and requires its own tailored development and examination process. Tier I issues require oversight and control by an assigned Issue Owner Executive, who has national jurisdiction and

responsibility for ensuring that the issue is identified, developed, and resolved in a uniform and consistent manner across the entire LMSB Division.

Tier II issues reflect areas of significant compliance risk. The issues will include emerging issues for which the law is fairly well-established, but there is a need for further development, clarification, direction and guidance on LMSB's position. Tier II issues assign coordination responsibility to the Line Authority Executive. The Line Authority Executive coordinates on issue resolution with the Issue Owner Executive, who is responsible for ensuring that the disposition or resolution of the issue is achieved in a manner that does not hinder LMSB's broader direction and/or guidance.

Tier III issues generally are industry-related identified issues that should be considered by LMSB examination teams when conducting their risk analysis. Examination teams are directed to use available direction, guidance and Audit Technique Guidelines in the development and resolution of such issues in order to ensure consistency throughout LMSB.

The Subgroup believes that the IIF program has much potential as an important compliance tool for LMSB but more time is needed to evaluate whether the program can meet its long-term goals and objectives. Following are some early observations and suggestions that the Subgroup has gleaned from LMSB taxpayers, with the hopes of improving the program so as to enhance its value to LMSB and taxpayers.

Recommendations

1. Thresholds for pursuing Tier I transactions involving Department of Justice (DOJ) settlements are unclear. Only one Industry Directive established thresholds in

pursuing Tier I transaction for DOJ settlement. The others are silent and lead to some confusion about the extent LMSB will question a transaction. In some cases, audits are being conducted if the transaction is on the return. In other cases, the audit team does not review the transaction under the same facts.

2. It is not clear whether field agents have discretion in deciding to include or exclude Tier I or II transactions. A consistent policy should be communicated.
3. There is a need for clearer communications with respect to Research and Experimentation (R&E) issues. Experience shows LMSB applies a moving standard with respect to R&E issues. The Tier I issue initially came out as R&E claims but in a number of examinations, taxpayers have been advised that R&E as filed on the original return is Tier I. There is very little difference in examining the R&E credit as originally filed or perfected via a claim, so it makes sense to treat it as one and the same.
4. LMSB must continue to offer taxpayers access to Issue Management Teams (IMTs) and Issue Owner Executives (IOEs). Access to IMTs and IOEs has improved and is particularly important when the Tier I transaction does not align perfectly with the scenarios in the industry directives. It is equally important that IMTs and IOEs approach such cases with open minds. Some IMTs have communicated that meeting with them would not change the outcome of the proposed adjustment (*e.g.* in connection with Section 936 Exit Strategies issues).
5. Confusion remains concerning taxpayers' ability to resolve tier issues in Appeals. Taxpayers know that Appeals personnel have worked with, and often hold membership on, IMTs. This has led to a perception that Appeals will not

independently address tier issues, although the National Director of Appeals has stated otherwise. It is not clear whether the IRS will allow Appeals to give a different answer than what was expected by the IMT. Guidelines should be established.

6. Communication is needed regarding the impact of removing an issue from tier status. It is not clear whether revenue agents will have to follow the directives published for such issues, whether the applicable IMTs for those issues are disbanded, or what taxpayers can expect in these areas with regards to the coordination activities seen around the Tier issues.

ISSUE SIX: INDUSTRY ISSUE RESOLUTION PROGRAM

The Industry Issue Resolution (IIR) program is designed to identify frequently disputed or burdensome tax issues that affect significant numbers of taxpayers. By recognizing these issues upfront, the goal of the IIR program is to allow the LMSB an opportunity to provide guidance that can be relied on by business taxpayers, thereby avoiding the need for case-by-case resolutions. The IIR Pilot Program was initially tested in 2000; and, after being expanded to include issues common to any size business taxpayer, became permanent in 2002. The IIR program has demonstrated the potential to resolve controversy when approached with sincerity by both taxpayers and LMSB.

Pursuant to the Internal Revenue Manual, issues most appropriate for the IIR program share two or more of the following characteristics: the proper tax treatment of a common factual situation is uncertain; the uncertainty results in frequent, and often repetitive, examination of the same issue; the uncertainty results in taxpayer burden; the

issue is significant and impacts a large number of taxpayers, either within an industry or across industry lines; and, the issue requires extensive factual development, and an understanding of industry practices and view concerning the issue would assist the Service in determining the proper tax treatment. Conversely, issues exhibiting the following characteristics are typically not suitable for the IIR program: issues that are unique to one or a small number of taxpayers; issues that are primarily under the jurisdiction of operating divisions of the Service other than the LMSB and SB/SE divisions; issues that involve transactions that lack a bona fide business purpose or transactions with a significant purpose of improperly reducing or avoiding federal taxes; and issues that involve transfer pricing or international tax treaties.

The Subgroup believes that the IIR program has generally been successful to date. However, we recognize that the inherent nature of the IIR program--a resolution program focused on single industry issues--presents challenges. For example, it can be difficult to find areas of interest in which industry members can agree to one common approach.

Issues selected for the IIR program should be broad enough to elicit industry group interest and participation. To minimize false starts, issues considered for inclusion should be consistent with the philosophies of the Service. For example, it may not make sense to push for an industry resolution calling for relief from Form 1099 reporting if the Service is calling for an increase in Form 1099 reporting. Similarly, it may not make sense to champion an initiative whose resolution would require agreement between two federal agencies not motivated by similar considerations. For instance, an industry issue may arise that implicates an employee matter subject to review by both the IRS and the

Department of Labor for which simplification may not be possible due to differing policy objectives.

The Subgroup believes that the IIR program can provide greater value when it addresses a large group of similarly situated taxpayers who experience ongoing examination in a transactional area that is not in litigation.

LMSB is encouraged to fully screen for fact patterns and situations where there is a higher chance of successful completion prior to acceptance of the issue for resolution under this program. One approach may be for LMSB to circulate a list of three or four issues a year. Another is to ask each Industry Director to identify one issue known to have wide impact. Industry members interested in resolving such issues can then be invited to attend a hearing on the issue and volunteer to work cooperatively with the IRS in seeking consensus. Once complete, LMSB can review the industry submissions and testimony and determine whether to proceed with the process. If LMSB decides to proceed, it can subsequently contact the industry members designated in the hearing to elicit a formal submission.

Seeking cooperation between federal agencies with overlapping jurisdiction and policies not in conflict may present another area for fruitful exploration. For example, the IIR program could be used to reduce burdens arising from inter-jurisdictional overlaps between different agencies. Hence, consideration might be given to situations in which the IRS has been given compliance responsibility for the tax aspect of a program (*e.g.*, Work Opportunity Tax Credit), but another agency has responsibility for administering the program.

ISSUE SEVEN: INTERNATIONAL ISSUES

International issues are having an increasing effect on the current tax environment because of globalization as well as the convergence of U.S. and International Accounting Standards. There has been a rapid growth in the number of international transactions as well as an increase in the taxpayer reporting burden. Compliance challenges in the international area include cost-sharing arrangements, foreign tax credit transactions, abusive hybrid transactions and transfer pricing. The Subgroup commented on and made suggestions last year regarding many of these challenges.

Background

This past year saw the seamless consolidation of most international functions into LMSB along with major leadership changes, as pledged in a 2006 hearing by former Commissioner Mark Everson before the Senate Finance Committee. Previously many of the international functions were in SB/SE, such as providing tax information and assistance services to U.S. taxpayers residing abroad. International Collection remains in SB/SE; Criminal Investigation activities are also unchanged. We commend the IRS and LMSB for the leadership it has provided on international issues. This focus on international is in the best interest of compliant taxpayers. It helps to bring more certainty and consistency to often complex international transactions, it reduces the burden on compliant taxpayers, and helps identify and correct abusive transactions of non-compliant taxpayers.

Identified LMSB FY2007 program priorities include (1) focus on identification, development, and resolution of high risk international issues involving individuals and businesses to improve audit coverage and (2) increased compliance focus on withholding

tax issues. There have been several initiatives, some of which are ongoing in the international area, *e.g.*, the Embassy Settlement Program; IRS participation in the Joint International Tax Shelter Information Centre (JITSIC) to identify and curb abusive tax schemes by sharing information; and education efforts regarding infrequently used or confusing forms, such as Form 1042, "*Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*," and Form W-8BEN, "*Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*." In addition, the LMSB International Group embarked on a Form 5471 Redesign Project and issued a draft Form 1120-F, "*U.S. Income Tax Return of a Foreign Corporation*," with substantial revisions in response to a Form 1120-F redesign task force. The LMSB International Group is currently reviewing approaches that involve disclosure models with more transparency to identify international compliance risks, by using threshold concepts and leveraging Schedule M-3 transparency as a compliance risk tool in a manner similar to the reportable transaction regime.

Form 5471 Redesign Project – LMSB began the Form 5471, "*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*," Redesign Project because of the increased number and complexity of international transactions, the need to align corporate financial reporting, a desire to focus on voluntary compliance and accuracy, and an interest in leveraging new tools and capabilities. LMSB has found that many of the forms received are incomplete, which is only discovered in the audit process. Because of the volume of information required, the LMSB International Group is trying to determine what information should be required from the taxpayers' perspective as well as to help them identify key issues and compliance risks. This group has appealed to

stakeholders to obtain information regarding processes and formats that companies use to collect data, how companies use the data for internal reporting purposes, and problems and costs companies incur in timely gathering accurate information.

The Subgroup provided numerous comments and suggestions regarding the revision of Form 5471, as did several stakeholder groups, and is supportive of LMSB's effort to simplify the current information reporting system as well as other related information returns. The Subgroup noted that (1) much of the data requested is gathered only to prepare the Form 5471, (2) there was confusion related to reporting in functional currency and the convergence of GAAP with International Accounting Standards, (3) most of the difficulties in gathering information are related to Schedule M, "*Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons*," and Schedule O, "*Organization or Reorganization of Foreign Corporation, and Dispositions of its Stock*." Electronic filing of international information returns should make it easier to identify issues related to transfer pricing, FTC and Subpart F. It is also noted that the penalty amounts have been increased for incomplete or untimely filed forms.

Cost Sharing Agreements – This year the Subgroup did submit comments expressing significant concerns with the IRS approach, but did not allocate its meeting time to discussing cost sharing agreements and buy-ins (the method by which external contributions of property are valued) or the recently issued Coordinated Issue Paper - Sec. 482 CSA Buy-In Adjustments (effective date September 27, 2007). The Subgroup continues to believe that, among other things, sound tax administration would best be served by risk assessing and focusing on the transactions at the extremes of the spectrum

so that no harm is done to domestic growth. As stated in our 2006 report, the legislative history regarding Section 482 is clear that there was no intention to prevent the use of bona-fide cost sharing arrangements as long as they are in accordance with the purpose of the provision and "reasonably reflect the actual economic activity undertaken by each." The Subgroup believes that bona fide cost sharing arrangements should allow participants to earn profits in conformity with the arm's length standard. It is not clear to the Subgroup that LMSB's current position is in conformity with the arm's length standard.

Foreign Tax Credit Generators – Although this year the Subgroup did not discuss foreign tax generators or the Proposed Regulations under §1.901-2(e)(5) issued on March 29, 2007, the Subgroup continues to support the IRS' focus on the transactions that lack a bona fide business purpose and economic substance and which are not compliant with the law. However, we continue to caution LMSB not to cast the net so wide that it inadvertently sweeps up legitimate business transactions that are not just tax-motivated.

Recommendations

1. Continue the focus on international tax compliance and providing top quality leadership in this complex and increasing importing area of international tax compliance.

2. Continue the focus on identification, development, and resolution of high risk international issues involving individuals and businesses to improve audit coverage.

3. Continue initiatives to increase compliance focus on withholding tax issues.

4. Continue to work on the simplification of the international reporting forms by requesting only data that focuses on issues with compliance risk, simplifying the forms, and reducing taxpayer burden.

5. Continue to evaluate cost sharing transactions that present a higher risk in valuation issues without preventing the use of bona-fide cost sharing arrangements.

6. Continue the focus on the foreign tax credit generator transactions that lack a bona fide business purpose and economic substance and which are not compliant with the law without penalizing legitimate business transactions.

INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

SMALL BUSINESS/SELF-EMPLOYED
SUBGROUP REPORT

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NOVEMBER 15, 2007

SMALL BUSINESS/SELF-EMPLOYED
SUBGROUP REPORT

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INTRODUCTION/EXECUTIVE SUMMARY

The IRSAC Small Business/Self-Employed Subgroup (hereafter "Subgroup") is made up of six tax professionals. The members of the Subgroup offer the IRS Advisory Council a variety of experiences, ranging from the representation of individuals and small businesses to large corporations. The Subgroup is honored to use this depth and breadth of knowledge to assist the SB/SE Division of the IRS (hereafter "SB/SE") in any way possible.

The Subgroup enjoys a close working relationship with the professionals within SB/SE. This relationship has granted the Subgroup the opportunity to consult with SB/SE on many issues outside of the regularly scheduled meetings. Some of the subjects discussed during these consultations required immediate feedback and are therefore outside the scope of this report. The Subgroup and SB/SE consulted both formally and informally on the issues contained in this report. The Subgroup respectfully recommends the following:

1. SB/SE E-Strategy. SB/SE has recognized that in an overall effort to decrease the tax gap there must be an increase in compliance, taxpayer satisfaction, and overall efficiency in the operation of the division. An integral part of achieving this goal is to develop and implement an e-strategy whereby the technological processes and efficiencies employed in private industry are integrated into the day-to-day operations of SB/SE and IRS as a whole. SB/SE's e-strategy should include a plan to expand and increase use of e-services, better integration of internal systems and data, and provision of additional electronic payment options.

2. Allowable Living Expense Standards. Allowable living expense standards used in collection determinations were recently redesigned by an IRS task force after extensive study. The redesign resulted in many appropriate changes, but more are needed.

3. Fast-Track Collections Program. The IRS has identified many components to the tax gap and is working toward implementing processes to improve compliance without creating unnecessary burden. We propose a Fast-Track Collection Program that would not only bring in additional revenues, but would enable the IRS to communicate with taxpayers whose absence from the tax administration process may not have been detected.

4. Information on Independent Contractor or Employee Determinations. SB/SE's single largest focus of employment tax compliance in its Fiscal Year 2008 work plan will be the worker classification issue. This focus will include leads from Form SS-8, "*Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*," determinations from internal databases, and from state referrals. To promote compliance and cooperation as interest in the issue increases, consistent, understandable and thorough information on the issue that is accessible to taxpayers, tax practitioners and tax administrators, is essential. The IRS should review existing materials and their accessibility and ensure training of appropriate personnel is conducted.

5. SB/SE Tax Practitioner Satisfaction Survey. In an effort to improve its service, the IRS issued a survey to gauge tax practitioner satisfaction with the IRS. The survey identified areas where the IRS could increase practitioner satisfaction and

also increase efficient use of its resources. Some of the major areas that needed improvement included IRS review of additional information submitted with original returns, providing more reliable and efficient technical resources to the tax practitioner and improving outreach to the tax practitioner community. The survey itself also needed some improvement. The sample pool did not sufficiently represent the tax practitioner community. Tax practitioners of varying experience levels, ages and client bases should have been included in the survey.

ISSUES AND RECOMMENDATIONS

ISSUE ONE: SB/SE E-STRATEGY

Executive Summary

SB/SE has recognized that in an overall effort to decrease the tax gap there must be an increase in compliance, taxpayer satisfaction, and overall efficiency in the operation of the division. An integral part of achieving this goal is to develop and implement an e-strategy whereby the technological processes and efficiencies employed in private industry are integrated into the day-to-day operations of SB/SE and IRS as a whole. SB/SE's e-strategy should include a plan to expand and increase use of e-services, better integration of internal systems and data, and provision of additional electronic payment options.

Background

In recent years, the IRS has made significant progress in enhancing the taxpayer experience by increasing the information available in electronic format. The IRS has recently improved the content, access and overall format of its website, which has resulted in a 9 percent increase in website usage from last year. The IRS expanded tax professional access to e-services by reducing the threshold for tax practitioners to those who electronically file five or more individual or business returns. Services offered using e-services include: disclosure authorization (DA), electronic account resolution (EAR), and transcript delivery (TD). In addition, as of May 2007, the IRS has expanded the program to allow reporting agents who have on file an accepted Form 8633, "*Application to Participate in the IRS e-file Program*" to use EAR.

For tax filing season 2007, close to 79 million individual income returns were filed electronically, which represents about a 9 percent increase over 2006. Tax practitioners filed 56 million, roughly 70 percent, of these returns. Not only did refund return filing increase, but balance due e-filed returns increased 14 percent to 9.8 million returns.

Although not required for small businesses, the IRS implemented the Modernized e-File program under which certain corporations are required to file returns electronically. For SB/SE, the IRS now accepts Forms 1120/1120S, 1065, 990/990EZ, and 1041 electronically. In addition, the IRS allows submission of information returns such as Forms 1099, 1098, 5498 and W-2G under its Filing Information Returns Electronically (FIRE) program. Taxpayers may also file installment agreements electronically, as well as set up associated automatic debits via the IRS website. As of August 23, 2007, 625,000 income tax returns were filed electronically for small corporations with less than $10 million in assets. Forms W-2 and W-3 are also available to file electronically through the Social Security Administration's website. Certain payments can be made by taxpayers using EFTPS, electronic funds withdrawal or credit card payments.

However, with over 26 million small businesses in the U.S. (businesses with less than 500 employees) according to the latest Small Business Administration (SBA) and Office of Advocacy estimates, the number of electronically-filed returns for small businesses indicates that SB/SE's e-strategy to reach this segment of taxpayers is in need of significant improvement. In addition, the overall effectiveness of the IRS' tax processing responsibilities is hampered by security issues associated with interconnection

of computer systems as identified by a United States Government Accountability Office 2005 audit report, and this may further discourage SB/SE taxpayers. The IRS Oversight Board in its Electronic Filing 2006 Annual Report to Congress predicted that the IRS will not meet its 80 percent electronic filing goal for 2007. We commend SB/SE for taking the initiative to develop its first formal e-strategy in three years. Our recommendations on how SB/SE can improve, better define and achieve its e-strategy goals are as follows:

Recommendations

1. To further improve overall customer satisfaction, compliance and efficiency in serving the business taxpayer, SB/SE must take an integrated approach to update and improve its internal computer systems and create a central data warehouse or database. For instance, a taxpayer's control file should contain a list of recent contacts and memo notes with the IRS which is accessible by SB/SE customer service representatives and compliance personnel on campus, in offices and in the field to reference interactions with taxpayers. In addition, SB/SE needs to create and maintain a central repository for the documents that are received from a taxpayer. This repository should provide for an indexing system to allow customer service, collection personnel, field auditors and other IRS departments to access a central location for information received from taxpayers. Too often taxpayers or their representatives are required to re-submit information to various departments of SB/SE and other IRS departments which causes inefficiencies and delays. Improving these processes will help taxpayers feel more confident about their interactions with SB/SE and the IRS as a whole and increase compliance.

2. The IRS needs to better communicate to SB/SE taxpayers and their practitioners about information on the IRS website and the types of tools available to them. This communication can be accomplished by customer service representatives, revenue agents or revenue officers directing taxpayers to the website and providing guidance to specific links available to assist the taxpayer or practitioner. A survey by the IRS Oversight Board in 2006 indicated that taxpayer visits to the IRS website were self-initiated rather than by suggestion or information provided by the IRS or practitioners. With tax practitioners filing the majority of SB/SE returns, SB/SE must make more of the tax practitioner community aware of the benefits and solutions available online and via Nationwide Tax Forums, webcasts, phone forums and other media. Taxpayers and practitioners must be able to recognize a benefit (such as faster refunds for electronic filing) to encourage utilization of the electronic services offered by SB/SE. Such benefits might include more reliable information, faster response time, or more timely and efficient resolution of issues.
3. SB/SE should encourage existing IRS e-initiatives that provide taxpayers with alternative methods for SB/SE taxpayers and practitioners to provide information to the IRS. Taxpayers must feel confident about security, timeliness of receipt, and follow-up for the information sent. Per the IRS Oversight Board 2006 survey, 63 percent of taxpayers would like the IRS to provide tools to allow them to answer their questions or receive information themselves other than through in-person contact. On the other hand, 73 percent of taxpayers surveyed indicated some concern with sending financial information over the internet. Accordingly,

alternative methods should include faxes or secure SB/SE website upload of information sent directly to SB/SE by either tax practitioners or taxpayers. The website upload process should include online printable confirmation of receipt and a follow-up notice when documentation has been accepted or approved. However, to encourage taxpayers and practitioners to use such services, SB/SE must develop a campaign that not only highlights efficiency but also the high level of system integrity and security.

4. SB/SE should consider expanding electronic payment options currently available for electronic installment agreements (e-IA) to other types of forms, returns and payments. This could be accomplished by modifying EFTPS or developing alternative payment options accessible by SB/SE taxpayers and their practitioners directly through an SB/SE website. Such alternatives would facilitate recurring and one-time payments such as debit/credit card payments and electronic debits for tax deposits, return payments, accrued balances and/or withholding. Providing alternative electronic payment options to SB/SE taxpayers will further facilitate taxpayer compliance and enhance data processing.
5. Finally, SB/SE services through the website and e-services should be expanded to include real-time communications with customer service representatives, the ability to submit Offers in Compromise and forms such as IRS Form 720, "*Federal Excise Tax*," directly to the IRS, and the ability to view and print completed forms submitted online such as Online Payment Agreements (OPAs) and Form 2848, "*Power of Attorney and Declaration of Representative*," similar to the manner in which completed Forms SS-4 are currently available to print. In

addition, SB/SE should encourage the IRS to provide a link on its website with a detailed list and access to forms that can be submitted to SB/SE and other IRS divisions electronically.

ISSUE TWO: ALLOWABLE LIVING EXPENSE STANDARDS

Executive Summary

Allowable living expense standards used in collection determinations were recently redesigned by an IRS task force after extensive study. The redesign resulted in many appropriate changes, but more are needed.

Background

In an attempt to fairly estimate the cost of living for individuals and families, the IRS has developed tables called "Allowable Living Expense Standards." These tables are used in collection determinations, including Installment Agreements and Offers in Compromise, to determine the amount of living expenses that an individual will be allowed based on family size and locale. These tables are created using the Bureau of Labor Statistics (BLS) census data and adjusted using the current Consumer Price Index (CPI).

The tables are created from BLS data that is compiled every decade. The IRS adjusts the data by applying the CPI rate for the current year to the prior year's tables. The process continues until the tenth year, when a new census is taken and new tables based on fresh BLS data are created. It is the IRS' belief that the CPI adjustments adequately reflect the cost of inflation for any given period. A problem arises when the actual inflation rate in a particular category is higher than the overall CPI. For example,

if housing increases by six percent, but the CPI shows a general increase of 3 percent, the IRS would use three percent. Another problem arises when the inflation rate continues to rise after the CPI has been set for the year. A prime example of this is the cost of fuel. The cost of fuel may increase throughout the year having a direct impact on transportation costs as well as utilities and other household expenses. These increases impact the taxpayer's financial situation but are not reflected in the tables used to set allowable living expenses.

Another issue arises in that the IRS currently uses county-based housing data. Many counties, whether due to geography or demographics, contain wide variations in housing costs. Consideration should be given to the differences between urban and rural areas in the county and to differences in housing costs between apartments or multi-family homes and single family homes. Zip code data would provide a better indicator of true housing costs

It is also the IRS' belief that allowing a higher housing expense to individuals whose income exceeds the "norm" would mean that they would not be paying their fair share of taxes. Using zip code data might be a better indicator of whether a taxpayer should be allowed a higher allowance for housing. This is not to say that an individual who is clearly living excessively should be rewarded, but that a more balanced process should be utilized.

The tables do not allow any expense for higher education. This is based on the belief that an individual who does not have the ability to send children to college should not be punished and be forced to pay more toward his/her tax obligation than an individual having the ability to pay for a child to attend college. This way of thinking

does not help us as a country stay ahead of the rest of the world technologically or economically nor does it help us grow as a country in general. Additionally, in many instances, those individuals who are in the higher tax bracket are unable, due to financial reasons, to take advantage of scholarship, grant money, and student loans and thus are forced to pay the tuition out of pocket. Many average citizens qualify for and receive federally-funded grants, scholarships, and student loans. Admittedly, creation of an allowable amount for higher education would be difficult given differing tuition rates.

Finally, the tables were most recently revised to add an allowable living expense related to out-of-pocket health care costs of $54 per month for each individual under age 65 and $144 per month for those over age 65. Although this addition is commendable, the standards may be inadequate for individuals who do not have health insurance. According to the National Coalition on Health Care's 2007 report on Cost of Health Care, about 44 million people in this country have no health insurance and another 38 million have inadequate health insurance. It is estimated that $5,600 per capita is spent for health care each year and not covered by insurance.

Recommendations

1. Adjust the Housing and Utility allowance on a zip code basis rather than by county. This can be done by creating a standard that takes into account the average of the people actually living within the zip code area.
2. Encourage IRS revenue officers to use more discretion in the adjustments to take into consideration variations in specific costs and to properly deviate from standard tables, as is currently allowed in Internal Revenue Manual 5.15.1.7.

3. Calculate a maximum allowable per credit hour rate for higher education utilizing the cost per credit hour of the state-funded schools in each state. This rate would then be multiplied by the actual number of hours being taken by the student.
4. The out-of-pocket health care standard should be revised annually based on trends in health care costs rather than by applying a general cost of living increase. We further recommend that the IRM be updated to explicitly indicate that actual out-of-pocket health care expenses can be utilized if higher than the new standards.

ISSUE THREE: FAST-TRACK COLLECTION PROGRAM

Executive Summary

The IRS has identified many components to the tax gap and is working toward implementing processes to improve compliance without creating unnecessary burden. We propose a Fast-Track Collection Program that would not only bring in additional revenues, but would enable the IRS to connect with taxpayers whose absence from the tax administration process may not have been detected.

Background

For the past few years, there has been a growing awareness of the tax gap and emphasis has been placed on trying to reduce it. In this effort, the IRS has taken a more aggressive approach in the collections arena. Not all non-compliant taxpayers show up on the IRS' radar, though. There are a large number of taxpayers that may not be included in the tax gap calculation.

The IRS and the public must have realistic expectations about reducing the tax gap, and the collection process itself must be broadened and simplified. The IRS

collection processes need to become more streamlined, and taxpayer behavior needs to become more compliant.

Individuals who have not filed income tax returns for several years may decide that they want to become compliant for a variety of reasons. Generally, these individuals are Schedule C filers. The current process is very cumbersome and time-consuming and does not afford the individual an opportunity to resolve the tax deficiency in an efficient manner. For example, assume a self-employed individual has not filed taxes for the years 2003 through 2006. The taxpayer seeks the assistance of a preparer to help prepare the returns. Once the returns are completed, the amounts owed are $5,000 for 2003; $10,000 for 2004, $12,000 for 2005, and $8,000 for 2006, for a total of $35,000 before penalty and interest assessments. It is unlikely that this individual would be subject to criminal investigation by the Criminal Investigation division of the IRS. This individual does not have the money on hand to pay the total amount due or possess the ability to borrow the funds. At this point, the taxpayer must: (1) request an installment agreement; (2) contact the abatement department and request that the penalties be abated; (3) file an application for an offer in compromise or (4) do all of the above. A problem arises because the individual is not currently in the system and various payment/collection options may not be available on a "pre-assessed" basis. The current process requires the individual to file the returns, wait until all the returns have been processed, and then make the request(s) above. This delay can have a huge impact on the IRS' ability to collect the taxes owed in a timely fashion and can cause resources to be wasted (i.e. through the mailing of notices, taking up call center time and resources, and assigning a revenue officer to the collection process).

Recommendations

1. Establish a unit within Collections to handle a Fast-Track Collection Program.
2. Because utilizing resources unnecessarily is a key concern, limit the program to those taxpayers using the services of a tax preparer that is subject to Circular 230, who can represent the taxpayer before the IRS.
3. In addition, limit the program to Form 1040 filers who have never been in the program and whose aggregate assessment is under a threshold to be determined in coordination with Criminal Investigation.
4. Create a form by which a taxpayer could request inclusion in the Fast-Track Collection Program. The form would be submitted to the unit, and--once received--a revenue officer would be assigned to the file. That assignment would take place within seven days. Upon being assigned, the revenue officer would then make contact with the preparer. This would establish a direct line of communication, with both sides having the ability to contact one another.
5. Grant the revenue officers the authority to negotiate within the guidelines of the offer in compromise, penalty abatement, and installment agreement policies and to negotiate reduced penalties under guidelines to be determined. The negotiations would utilize the pre-assessed taxes but would not be finalized until the total assessment had been made. This would enable the processing of the returns to be occurring simultaneously with the gathering of financial data and determination of the ability to pay. Any change in the final assessment could be easily incorporated into the process without much delay or additional effort.

ISSUE FOUR: INFORMATION ON INDEPENDENT CONTRACTOR OR EMPLOYEE DETERMINATIONS

Executive Summary

SB/SE's single largest focus of employment tax compliance resources in its Fiscal Year 2008 work plan will be the worker classification issue. This focus will include leads from Form SS-8, "*Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*," determinations from internal databases, and from state referrals. To promote compliance and cooperation as interest in the issue increases, consistent, understandable and thorough information on the issue that is accessible to taxpayers, tax practitioners and tax administrators, is essential. The IRS should review existing materials and their accessibility and ensure that training of appropriate personnel is conducted.

Background

The Internal Revenue Code and Treasury Regulations provide only basic guidance on the question of "who is an employee?"

The IRS, faced with the responsibility to make determinations of the status of individuals, uses a "facts and circumstances" approach appropriate with its statutory authority. Thus it has largely fallen to the courts to determine whether various facts and factors are relevant to the determination of "who is an employee." Over time that body of cases and rulings under our system of jurisprudence becomes what is referred to as the "common law." In 1987, in Rev. Rul. 87-41, 1987 C.B. 296, the IRS distilled the "common law" related to who is an employee into 20 factors.

Section 530 of the Revenue Act of 1978 made some of the most significant changes in the common law based process of determining the classification of an

individual as employee or independent contractor. Originally enacted as a temporary provision to provide Congress more time to sort through the contentious debate over the appropriate rules regarding classification, the section was made permanent in 1982. Section 530 is an off-code provision; it was modified in 1986, 1996, and 2006. Under Section 530, certain types of workers such as direct sellers and real estate agents were specifically designated as not employees. For other industries, Section 530 provided a "safe harbor," which is generally stated in the negative:

> Section 530 allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common law test, unless the taxpayer has no reasonable basis for such treatment or fails to meet certain requirements.

One provision of Section 530 that has had an influence on the determination process over the last 30 years states:

> No regulation or Revenue Ruling shall be published on or after the date of the enactment of this Act and before the effective date of any law hereafter enacted clarifying the employment status of individuals for purposes of the employment taxes by the Department of the Treasury (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes.

The regulation prohibition provision of Section 530 limits the nature and number of outreach, education, compliance and enforcement "tools" the IRS can make available to taxpayers, tax practitioners, and tax administrators to understand their responsibilities and rights in the determination process.

Most determinations are made on the basis of the completion of Form SS-8 by the individual performing the services and the service recipient. For many years the Form SS-8 tracked what had come to be known as the traditional 20 point common law test. Form SS-8 was recently revised to conform to the three "basket" concept of the IRS examiner training manual.

In 1996, mindful of the regulation prohibition, the IRS published a training manual for examiners, entitled "*Independent Contractor or Employee? Training Materials.*" The manual grouped the common factors in three categories: (1) behavioral control; (2) financial control, and (3) relationship of the parties. The manual also "updated" commentary on the relevance of some of the traditional common law factors in the economy as it was in the 1990's.

In addition to Form SS-8 and the training manual, there are only a few other IRS tools available to taxpayers, tax practitioners and tax administrators, to assist in understanding the issue and the process. They include:

- Publication 15-A, "*Employer's Supplemental Tax Guide,*" which includes a comprehensive discussion of the determination of an individual's status as an employee or independent contractor.
- Publication 1779 "*Independent Contractor or Employee*"
- Tax Topic 762 "*Independent Contractor vs. Employee*"
- Publication 1976, "*Do you qualify for Relief under Section 530*?"
- Webpage: "*Distinguishing Between Self-Employed Individuals and Independent Contractors*"
- Webpage: *Independent Contractor versus Employee*
- Various Industry Audit Technique Guides

The IRS' current work program and initiatives, changes in the economy and technology, and concerns about the tax gap, indicate a renewed interest in classification determinations. SB/SE's single largest focus of employment tax compliance resources in its Fiscal Year 2008 work plan will be the worker classification issue. This focus will

include leads from Form SS-8 determinations, from internal databases, and from state referrals.

Recommendations

The goal of our recommendations is to provide taxpayers, tax practitioners and tax administrators with the best education, outreach, compliance and enforcement "tools" to ensure maximum compliance with minimum amounts of confusion and confrontation.

1. Review all current IRS tools to determine whether they are up-to-date, consistent, and complete and that they convey information in understandable language.
2. Review the delivery mechanisms for these tools to determine whether they are readily accessible to taxpayers, tax practitioners and tax administrators. The review should consider both physical accessibility as well as "intellectual" accessibility. For example, with respect to physical accessibility, a taxpayer must navigate through several poorly identified web pages to find information. The training manual can only be reached by a general search of the site or a multiple step browsing of the website. With respect to intellectual accessibility, many of the tools are structured around "employee" information rather than "independent contractor" information. A taxpayer would not know to check, by its title, Publication 15-A, "*Supplemental Employer's Tax Guide*" for information on using independent contractors.
3. The IRS should provide within the available tools additional clarification of the elements of "behavioral control," as that has been identified as an important criterion used in determinations, but it has also been identified as one of the least understood.

4. Encourage the Department of the Treasury to recommend that Congress establish fair and objective standards for determining the status of an individual as an independent contractor or employee.

ISSUE FIVE: SB/SE TAX PRACTITIONER SATISFACTION SURVEY

Executive Summary

In an effort to improve its service, the IRS issued a survey to gauge tax practitioner satisfaction with the IRS. The survey identified areas where the IRS could increase practitioner satisfaction and also increase efficient use of its resources. Some of the major areas that needed improvement included IRS review of additional information submitted with original returns, providing more reliable and efficient technical resources to the tax practitioner and improving outreach to the tax practitioner community. The survey itself also needed some improvement. The sample pool did not sufficiently represent the tax practitioner community. Tax practitioners of varying experience levels, ages and client bases should have been included in the survey.

Background

SB/SE utilized the assistance of Pacific Consulting Group to administer a tax practitioner survey from November 2006 through January 2007. The survey was a computer-assisted telephone survey of SB/SE tax practitioners. Each practitioner received two letters requesting his or her participation in the survey and detailing how the survey would be conducted. Forty-nine percent of the practitioners that received these two letters participated in the survey.

The practitioners were selected from a list provided by Dunn & Bradstreet based on the following criteria:

1. The practitioner must have filed as least 50 tax returns for the 2005 tax year;
2. At least 10 percent of the tax returns filed for the 2005 tax year had to be Business Master File ("BMF") tax returns, which include but are not limited to Forms 941, 1120 and 1065;
3. At least 50 percent of the tax returns filed for the 2005 tax year had to be SB/SE returns, which include but are not limited to a BMF tax return and a Schedule C filing on a Form 1040; and
4. The practitioner could not work for a nationwide tax return preparation company.

The above criteria resulted in a sample pool in which 70 percent of the tax practitioners were CPAs and 68 percent had been in the profession between 20 and 39 years. It is likely the criteria used to select the sample pool biased the survey results.

Practitioners want to address taxpayer issues with the IRS in an efficient and expeditious manner. If more issues can be addressed prior to filing a tax return, then notices and audits can be minimized, which increases practitioner satisfaction and increases IRS efficiency.

Recommendations

1. The criteria for the practitioners selected for the survey needs to be revised to include a more representative mix of enrolled agents and other non-CPA preparers. This could be accomplished by eliminating the minimum number of tax returns a practitioner must have prepared and including those individuals that do not prepare tax returns, but only represent taxpayers before the IRS. By

reaching out to a wider group of preparers, the IRS may see a significant impact in survey results when the next survey is circulated.

2. The pool of practitioners needs to be demographically expanded to include a larger percentage of those practitioners that have been practicing for less than 20 years. The survey revealed that the practitioner pool is not utilizing e-services as predominantly as the IRS would like, but this could be more a result of the technological inexperience of the practitioners surveyed rather than a lack of IRS initiative.
3. The IRS should develop a system to review additional information submitted with an original tax return, instead of automatically generating a notice. The survey showed that 67 percent of the notices received by the respondents resulted in either no change or with the IRS owing money to the taxpayer. This is an inefficient use of IRS resources. IRS resources could be reallocated to review additional information submitted with the original tax return, which should decrease the number of notices sent to taxpayers, thereby focusing resources on only those tax returns containing a legitimate error. The development of a system that could allow statements and other materials to be e-filed with the tax return would address some of these issues. Such a review system would result in fewer notices being sent to tax practitioners, which would decrease the use of practitioner and client resources. This should result in an overall increase in tax practitioner satisfaction.
4. The IRS should partner with vendors of tax software to encourage the use of the IRS website for additional guidance and information. Most tax practitioners rely

on software to prepare tax returns; therefore, software developers could be an efficient medium for the IRS to advertise the resources it offers.

5. The IRS should improve the staffing and administration of the Practitioner Priority Service (PPS) line to make it a source where practitioners can receive detailed technical advice or assistance with general client account questions in a quick and efficient manner. Although the use of telephone communication is expensive, the survey showed that practitioner use of the PPS line is decreasing while use of the general IRS 1040 line is increasing. This data indicates that practitioners are not moving to electronic methods of communication, but are moving away from the PPS line because it is not meeting the practitioner's needs. Use of the general IRS 1040 line, however, forces practitioners to endure long waits in the queue and does not offer the technical level of expertise that practitioners are seeking. Practitioner satisfaction will increase if their questions can be addressed quickly and accurately through a dedicated channel, instead of having to waste time going through the general IRS 1040 line.
6. The IRS should provide a system whereby a tax practitioner could continue communication with a single person on the PPS line, instead of having to speak to a different person each time the tax practitioner initiates a call.
7. The IRS should create a secured "live chat" whereby practitioners can have live internet-based discussions with an IRS employee regarding non-account specific technical questions. The "live chat" could be protected through passwords that would allow only the practitioner and the IRS employee access. All information

would remain on the IRS controlled website, which should assist with security, while providing practitioners real time assistance.

8. The IRS should continue to increase out-reach to local practitioner groups by providing free continuing professional education on the use of e-services. To many practitioners, e-services are overwhelming, but a face-to-face seminar through a local practitioner group may "de-mystify" e-services and result in higher utilization.

INTERNAL REVENUE SERVICE
ADVISORY COUNCIL

TAX GAP ANALYSIS
SUBGROUP REPORT

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NOVEMBER 15, 2007

TAX GAP ANALYSIS
SUBGROUP REPORT

The Tax Gap Analysis Subgroup (hereafter "Subgroup") was established in January 2007. It is charged with helping the IRS improve its estimates of the tax gap. The most current estimate of the gross tax gap, based on Tax Year 2001 data, is $345 billion.

The Subgroup met April 10th, May 22nd, and July 24th, and held conference calls March 2nd and September 18th. These meetings were primarily informational and covered the methodologies used by the IRS to estimate the size of the tax gap, as well as the ongoing work to develop and deploy reporting compliance studies. This foundational information-sharing is a necessary precursor to the subgroup being able to develop high-value recommendations for the Service. The briefings included:

- A review of the specific studies underlying the existing tax gap estimates
- Presentations on the methodology used to adjust individual reporting compliance study results for undetected non-compliance (using Detection Control Estimation)
- Status reports on the ongoing reporting compliance study of Subchapter S corporations and the upcoming reporting compliance study of individual income tax returns
- A discussion of the various approaches to estimate the corporate income tax gap using results from operational audits
- Reviews of current methods of estimating filing compliance

It is expected that, in the coming year, the Subgroup will provide advice to the Service on a number of issues related to the tax gap estimation process. These include:

choosing a methodology to estimate the corporate income tax gap, helping develop the optimal sequencing of future studies of specific areas of tax compliance, improving the estimates of the individual income tax gap, and developing better ways to present and interpret the data used in tax gap estimates.

Subgroup members expressed interest in exploring three additional topics that may help in better understanding and measure the tax gap:

- Understanding the role of and limitations of disclosures under Financial Accounting Standards Board Interpretation No. 48, "*Accounting for Uncertainty in Income Taxes*," in helping understand the size of the corporate income tax gap
- Conducting studies based on enterprise size rather than form type filed (for example, a reporting compliance study of large entities, combining partnerships and corporations, rather than conducting separate studies on partnerships and corporations of all sizes)
- Exploring ways of making better use of operational audit data to supplement random audits in developing better estimates of the tax gap and its components

These will be the subject of upcoming meetings.

Internal Revenue Service Advisory Council
2007 Member Biographies

Herbert N. Beller

Mr. Beller, JD, has practiced federal tax law in Washington, DC for over 35 years and is currently a partner with Sutherland Asbill & Brennan LLP. His particular focus is on corporate tax planning and controversy work for publicly-traded and closely held entities. In addition, he frequently represents taxpayers before the IRS National Office and IRS Appeals Offices, and has litigated tax cases in the U.S. Tax Court and Federal Claims Court. He also has significant experience in the exempt organizations area. Mr. Beller is a former Chair of the ABA Section of Taxation and served as Co-Chair of the National Conference of Lawyers and Certified Public Accountants. Also a CPA, he holds a J.D. (cum laude) from Northwestern University Law School and a BSBA from Northwestern. **(LMSB Subgroup)**

Marsha Blumenthal

Dr. Blumenthal is a professor of Economics at the University of St. Thomas in St. Paul Minnesota and works on small business and tax exempt issues. She has taught economics for 22 years. Dr. Blumenthal has published articles on a number of tax issues, including the annual compliance costs of the U.S. individual and corporate income taxes, experimental evaluations of alternative tax administrative strategies for increasing compliance (reducing the tax gap); and the participation of low-income households in the Earned Income Tax Credit. Dr. Blumenthal holds a Ph.D. degree from the University of Minnesota and A.B. and M.S.W. degrees from the University of Michigan. **(Tax Gap Analysis Subgroup)**

Michael P. Boyle

Mr. Boyle JD, LLM, recently retired as a Corporate Vice-President, Finance with the Microsoft Corporation in Redmond, Washington. Mr. Boyle worked closely with senior management and had primary responsibility for the tax department. He oversaw worldwide tax policy, tax planning and compliance activities for the company. In addition, he created a world class tax department with professionals based in the United States, China, Europe, Japan, India and Singapore. He has experience in dealing with global and domestic tax planning, compliance audits, litigation and final resolution of complex tax issues. Mr. Boyle was highly influential in setting policy in the U.S. and globally with respect to the emerging taxation of software and e-commerce. Mr. Boyle served as the International President of Tax Executive Institute, Inc., from 2005-2006 and is an active member of the board of TEI and the Tax Foundation. Mr. Boyle holds a BSBA, (cum laude) and a J.D. from Creighton University and a L.L.M. (taxation) from Boston University. **(LMSB Subgroup)**

Charles Christian

Dr. Christian is a Professor at Arizona State University and currently serves as the Director of the School of Accountancy. He has taught federal taxation at the undergraduate level and a tax policy research seminar in the doctoral program for the past twenty-two years. During 1991-92, Dr. Christian worked with the Taxpayer Compliance Measurement Group of the IRS Research Division in Washington under an Intergovernmental Personnel Act appointment. In 2006 Dr. Christian spent nine weeks at Canterbury University, Christchurch, New Zealand, on a fellowship to study multinational tax issues and conduct research on income shifting by multinational corporations. Dr. Christian has published numerous articles on taxation and has given many presentations including one to the IRS LMSB Commissioner's Compliance Strategy Council. Dr. Christian holds a Ph.D. from the University of Georgia and a J.D. from the University of Virginia. **(Tax Gap Analysis Subgroup Chair)**

Francis X. Degen

Mr. Degen, EA is the owner of Francis X. Degen, EA in Setauket, New York. His practice includes tax preparation and tax planning for individuals and small businesses. Mr. Degen also specializes in taxpayer representation before the Internal Revenue Service and other taxing authorities. He is one of the few non-attorneys that have been admitted to practice in the United States Tax Court. In addition, he is a member and a former President of the National Association of Enrolled Agents (NAEA) and has served on the NAEA board of directors. He has testified on behalf of NAEA before both houses of Congress. Mr. Degen holds a Bachelors degree in mathematics from Iona College and a Masters from Johns Hopkins University. **(SBSE Subgroup)**

Karla R. Hyatt

Ms. Hyatt, JD, LLM, is the Assistant Tax Counsel for Willis North America Inc in Nashville, TN. Prior to joining Willis North America Inc., Ms. Hyatt was a Senior Tax Counsel with the Tennessee Department of Revenue. In addition, Ms. Hyatt was a partner with Waller Lansden Dortch and Davis, LLP, focusing on federal and state tax matters including business formations, the use of Limited Liability Companies (LLCs) and healthcare. She also served as a Judicial Law Clerk for the Honorable William J. Haynes, Jr., United States Magistrate Judge in Nashville, TN. Ms. Hyatt holds a BS Degree in Business Administration from the University of Tennessee and a LLM in taxation from the University of Florida School of Law and a JD from Tulane University School of Law, New Orleans, Louisiana. **(SBSE Subgroup Chair)**

Angel Ingram

Ms. Ingram, CPA, is a Senior International Tax Manager for NCR Corporation in Dayton, OH. Prior to joining NCR Corporation, Ms. Ingram worked as a Manager in International Tax reporting at Tyco International. She also held the position of Senior International Tax Analyst at Eli Lilly and Company, Whirlpool Corporation, Water Management Inc. and IVAX Corporation. Ms. Ingram is a CPA and has over 20 years of experience in accounting and taxation primarily working in large multinational companies. She is a current national board member of the National Association of Black Accountants, Inc. where she holds the position of Central Region President. Ms. Ingram holds a BA Degree in Accounting from the Michigan State University and a M.S. Degree in Taxation from DePaul University, Chicago, IL. **(LMSB Subgroup)**

Joan C. LeValley

Ms. LeValley, EA, is the owner and President of JCL and Company, a full accounting practice in Park Ridge, IL. Ms. LeValley has over twenty-nine years experience in taxation. Her firm specializes in accounting and tax preparation for businesses. She was President of the Independent Accountants Association and continues to actively serve on its committees. In addition, she is serving her second year as Chair of the Federal Taxation Committee of the National Society of Accountants (NSA). Ms. LeValley holds a BA Degree in Business Administration and Accounting from Manchester College, N. Manchester, IN and is an Accredited Tax Advisor and an Accredited Tax Preparer. **(W&I Subgroup)**

Andrew B. Lyon

Dr. Lyon is a Principal at PricewaterhouseCoopers LLP in Washington, D.C. Dr. Lyon has over twenty years experience providing tax analysis and consulting on complex tax matters in governmental, private sector, and academic employment. At PricewaterhouseCoopers, Dr. Lyon is a partner in the National Economic Consulting group, which is engaged in a broad range of economic, statistical, and modeling services in the areas of taxation, social security, health, and other policy areas. Prior to joining PricewaterhouseCoopers LLP, Dr. Lyon was an Associate Professor of Economics at the University of Maryland, responsible for teaching and advising graduate and undergraduate students in public finance and microeconomic theory. Dr. Lyon holds a Ph.D. in Economics from Princeton University. **(Tax Gap Analysis Subgroup)**

Lillian F. Mills

Dr. Mills is an Associate Professor at the University of Texas at Austin. Her published academic research concerns corporate tax compliance, financial accounting for income taxes and earnings management. Dr. Mills serves on several editorial boards for tax and financial accounting journals. Her current interests include tax reserves for uncertain tax benefits. In 2005-2006 Dr. Mills was the Stanley Surrey Senior Research Fellow at the U.S. Department of Treasury. Since 1996, she has consulted with IRS's LMSB Research group on a variety of risk assessment issues. She served on the task force that developed the Schedule M-3 to reconcile corporation net income to taxable income. She holds a Ph.D. in Accounting from the University of Michigan and an M.S. and B.S. in Accounting from University of Florida. Prior to her academic career, Lillian Mills was a senior tax manager with Price Waterhouse. **(Tax Gap Analysis Subgroup)**

Daniel T. Moore

Mr. Moore, CPA, is a Senior Accountant and Chief Financial Officer for the Moore Agency, Incorporated where he operates the Accounting Solutions Department in Salem, OH. He serves as a professional and community steward providing multiple solutions to key problems and recognizing there should always be options. In addition to his accounting and tax practice, Mr. Moore has played an extensive role in developing a sustainable comprehensive plan for the Salem, Ohio area. He has served as Ambassador and facilitator for the regional planning initiative in Northeast Ohio called Voices and Choices. Mr. Moore holds a Bachelor of Business Administration (cum laude) with a major in accounting from Kent State University, and an MBA in Public Administration from Gannon University. **(W&I Subgroup)**

Robert G. Nath

Mr. Nath, JD, is the managing member of Robert G. Nath, PLLC in McLean, Virginia. He is a recognized tax attorney with 30 years' experience, including eight with the Tax Division, U.S. Department of Justice, and is active in numerous aspects of tax practice. He concentrates in tax controversies, litigation, procedure, and representation between the Internal Revenue Service, United States Tax Court, other federal courts, and state tax authorities. Mr. Nath is the author of a book and numerous professional articles on IRS practice and procedure. Mr. Nath holds a Master of Laws in Taxation from Georgetown University, a J.D. from the University of Pennsylvania, and a Bachelor of Arts (cum laude, with Honors), from Yale University. **(W&I Subgroup)**

Robert E. Panoff

Mr. Panoff, JD, LLM, is an attorney with the firm of Robert E. Panoff, PA in Miami, Fl. Mr. Panoff has over thirty years experience in taxation. He limits his practice to civil and criminal tax controversies, strategic analysis, internal tax compliance investigations and related matters. He has been an adjunct Professor at the University of Miami School of Law. He is a frequent speaker at CLE and CPE programs on tax litigation topics and has written a number of articles on this subject. Mr. Panoff is a past chair of the Tax Section of the Florida Bar and a past President of the Greater Miami Tax Institute. He was selected as the Tax Section's 2006/2007 recipient of the Gerald T. Hart Outstanding Tax Attorney of the Year Award. He is also a member of the American Bar Association and was the principal draftsperson of the American Bar Association's "Comments on the OECD Draft Convention on Mutual Administration Assistance in Tax Matters." Mr. Panoff was chair of the IRS South Florida District Compliance Plan Study Group. He was also an invited guest at the United States Tax Court Judicial Conference in 1999, 2003, 2005, and 2007. Mr. Panoff holds an AB Degree from Brandeis University, and a JD and an LLM in Taxation from the University of Miami. **(SBSE Subgroup)**

Cathy Brown Peinhardt

Ms. Peinhardt, CPA, is a Licensed Tax Consultant who owns Coast Business Services in Gearhart, OR. She has over thirty years experience in accounting and taxation, primarily working with individuals and small businesses. Ms. Peinhardt served as Controller/Treasurer for Information Science Incorporated in Montvale, NJ. She began her career with Arthur Andersen & Company, New York, NY. Ms. Peinhardt holds a BA Degree in Art History from Princeton University and a Masters Degree in Accounting from NY University. **(Chairperson & SBSE Subgroup)**

George A. Plesko

Dr. Plesko, an Associate Professor of Accounting at the University of Connecticut School of Business in Storrs, Connecticut, has more than 20 years experience in tax policy analysis in both government and academe. Dr. Plesko's research has addressed numerous issues in corporate tax policy, including the interactions of financial and tax reporting, the characteristics and magnitude of book-tax income differences, the effects of the corporate Alternative Minimum Tax, capital structure and financing decisions, and the effects of individual and corporate taxation on entity choices of closely-held businesses. His current research

	focuses on tax accounting issues and their interaction with businesses' financial reporting decisions. Dr. Plesko holds an M.S. and Ph.D. in Economics from the University of Wisconsin-Madison, and a B.A. in Economics from the George Washington University. **(Tax Gap Analysis Subgroup)**
Joni Johnson-Powe	Ms. Johnson-Powe, JD, CPA, is currently a Tax Partner at Terry & Stephenson, PC. Prior to merging with Terry & Stephenson, Ms. Powe was Managing Director of her own firm for 6 years, J.P. Powe & Associates, LLC. Ms. Johnson-Powe has worked for KMPG, L.L.P. as a Manager in the State and Local Tax National Communications Practice and Ernst & Young, LLP as a Tax Consultant. Ms. Johnson-Powe's expertise is in individual, small and medium business taxation, government audits, corporate tax consulting and compliance, and business legal services. Ms. Johnson-Powe is a CPA and holds a BS Degree in Accounting from the University of Nebraska-Lincoln and a JD from the University of Colorado School of Law. **(SBSE Subgroup)**
Patti M. Richards	Ms. Richards, JD, CPA, is currently a member manager at The Richards Law Firm, LLC in Atlanta, GA. Ms. Richards has over fifteen years experience in taxation. Her expertise is in domestic and international tax controversy and tax-exempt organizations. Prior to starting her own firm, she was with Powell Goldstein, LLP in Atlanta, GA. She worked for Dewey Ballentine LLP and Burt Maner, Miller and Staples in Washington, DC. In addition, she worked as an Attorney-Advisory (Tax) for the Internal Revenue Service, Office of Chief Counsel, Income Tax & Accounting. Ms. Richards holds a BS Degree from Centenary College of Louisiana, an MA Degree from Louisiana State University, an a JD from Georgetown University Law Center. **(LMSB Subgroup)**
Margaret A. Roark	Ms. Roark, CPP, is the owner and President of M&D Consulting, Inc. in Fairfax Station, VA. Ms. Roark has over 30 years experience in employer payroll taxation audits, compliance and administration. Prior to starting her own business in 1996, she was Director of Payroll/Sales Audit for Woodward & Lothrop, Inc. She has received numerous awards from the American Payroll Association (APA) and was President of the Washington Metropolitan Area Chapter of the APA. Ms. Roark speaks nationwide on many payroll issues, has written and published numerous articles, and been a contributing editor to major payroll publications. In 1999, she was chosen to serve a three-year term on the American Payroll Association's Certification Board, the

	board responsible for writing the Certified Payroll Professional exam. Ms. Roark serves on the Research Institute of America's Board of Advisors and is a contributing writer for RIA's *Guide to Taxation of Benefits* and *Payroll Guide*. **(Vice Chair & W&I Subgroup Chair)**
Donna Rodriguez	Ms. Rodriguez, CPA, JD, is the managing manager of Donna L. Rodriguez, PLLC located in The Woodlands, Texas, where she operates a full service accounting and tax practice focusing on start up and small to medium companies. She is an attorney and Certified Public Accountant with a diverse background as corporate counsel, chief financial officer for an international conglomerate, Special U.S. Attorney/Assistant Attorney General-Guam, and with Ernst & Young. As a special US Attorney assigned to prosecute tax crimes in Guam, she became very familiar with the Tax Code. Ms. Rodriguez has a Juris Doctorate from the University of Oklahoma and a BSBA degree in Accounting from the University of Texas. **(SBSE Subgroup)**
John S. Satagaj	Mr. Satagaj, JD, is a solo law practitioner in Washington, D.C. Mr. Satagaj specializes in small business, trade association and tax matters. Mr. Satagaj also serves as President of the Small Business Legislative Council (SBLC), a position he has held since 1985. The SBLC is an independent coalition of nearly 80 trade and professional associations that share the commitment to the future of small business. He earned his Juris Doctor law degree from the University of Connecticut and a subsequent LL.M in Taxation from George Washington University. **(SBSE Subgroup)**
John K. Scholz	Dr. Scholz is a professor of economics at the University of Wisconsin – Madison. In 1997-98 he was the Deputy Assistant Secretary for Tax Analysis at the U.S. Treasury Department, and from 1990-91 he was a senior staff economist at the Council of Economic Advisors. Dr. Scholz directed the Institute for Research on Poverty at UW–Madison from 2000-2004. Professor Scholz has written extensively on the earned income tax credit and low-wage labor markets. He also writes on public policy and household saving, charitable contributions, and bankruptcy laws. He is a research associate at the National Bureau of Economic Research; a research professor at DIW Berlin, Germany; and a senior research affiliate at the Michigan National Poverty Center. His undergraduate degree is from Carleton College in Northfield, Minnesota and his Ph.D. is from Stanford University. **(Tax Gap Analysis Subgroup)**

Philip M. Tatarowicz Mr. Tatarowicz, JD, LLM, has worked in the tax field for 30 years and is a Partner and Ernst & Young's National Director of State and Local Tax Technical Services in Washington, DC. He is responsible for assisting the firm's clients and offices worldwide in multi-state tax matters, coordinating the development and quality of its state and local tax practice, and ensuring that E&Y's services reflect the latest regulatory and precedent-setting developments. In addition to being the former chairman of the American Bar Association's Subcommittee on Interstate Transactions, Mr. Tatarowicz is Chair of the ABA's Committee on State and Local Taxation, a member of the American Institute of Certified Public Accountants, and an adjunct Professor of Law at Georgetown University Law Center. He holds a BA in Accounting and Business Economics; a Juris Doctorate (Northern Illinois University College of Law) and LLM (Tax) from Georgetown University Law Center. **(LMSB Subgroup)**

Mitchell S. Trager Mr. Trager, JD, LLM, is currently the Senior Tax Counsel for Georgia-Pacific Corporation in Atlanta, GA and has been with Georgia-Pacific Corporation for 17 years. Mr. Trager has over twenty-three years experience in taxation. He has significant experience in research and planning, including work on compensation and benefits issues, IRS audit procedures, and issues involving capitalization. Prior to joining Georgia-Pacific, Mr. Trager was a tax attorney with The Joseph E. Seagrams Corporation in New York. In addition, he is the former chair of Tax Executives Institute's Federal Tax Committee and a two-time member of TEI's Executive Committee. Mr. Trager holds a BA Degree in Accounting from Queens College, NY, NY, a JD and a Masters in Taxation, LLM from the University of Bridgeport, School of Law. **(LMSB Subgroup Chair)**

Eric J. Toder Dr. Toder is a Senior Fellow with the Urban Institute in Washington, D.C. and Urban-Brookings Tax Policy Center. He performs and directs research on tax and retirement policy issues for government agencies and private foundations. Prior to joining the Urban Institute, Dr. Toder served in high level management positions at the Internal Revenue Service, U.S. Department of Treasury, and the Congressional Budget Office and worked as a consultant for the New Zealand Treasury. He holds a Ph.D. and M.A. in Economics from the University of Rochester and a BS in Mathematics from Union College. **(Tax Gap Analysis Subgroup)**

Robert A. Weinberger Mr. Weinberger, JD, is Vice President for Government Relations for H&R Block, Inc. and has headed its Washington Office since 1996. His responsibilities include liaison with the White House, the Treasury Department, IRS, Congress and business, consumer and public policy groups. Mr. Weinberger graduated from Oberlin College and the University of Illinois College of Law. In addition, he studied at the University of Illinois Institute of Government and Public Affairs and at Harvard's Kennedy School of Government. **(W&I Subgroup)**

George K. Yin Mr. Yin, JD, is the Edwin S. Cohen Distinguished Professor of Law and Taxation at the University of Virginia School of Law, Charlottesville, Virginia and has been in the tax profession for 30 years. He has been a law professor specializing in taxation for about 20 years. Mr. Yin has also served as Chief of Staff of the Joint Committee on Taxation where he supervised all aspects of the work done by the staff and testified more than 20 times before Congress at markups and hearings on a variety of tax matters. Mr. Yin holds a Juris Doctorate with honors from George Washington University and has a BA in Mathematics and Economics from the University of Michigan. **(Tax Gap Analysis Subgroup)**