IRS Oversight Board
Annual Report 2005

Message from the Board

The passage of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) started the IRS on a journey to become a modern financial institution for the 21st Century. The IRS is now seven years into that journey. This report describes how much progress has been made and what remains to be accomplished.

The quality of telephone service has gotten markedly better.

During this period the IRS' performance has improved for many important business functions. For example, the quality of telephone service has gotten markedly better, helping taxpayers to understand and comply with an extremely complex tax code. New ways of getting assistance using the Internet have also made a dramatic difference. More than half of individual taxpayers filed their returns electronically in 2005, and millions are using the IRS web site to download forms, get information on their tax law questions, and track the status of their refunds.

In FY2004 the IRS showed an impressive gain in enforcement revenue.

Although the agency's enforcement activities have suffered from a declining resource base during this period, in FY2004 the IRS was able to stabilize these resources and show an impressive gain in enforcement revenue, which increased to $43.1 billion from $37.6 billion in FY2003. Enforcement activities increased substantially in FY2004, with a 40 percent jump in audits of high-income taxpayers, double the number from four years ago. Audits of large businesses also increased. And in a major victory against those who participated in the particularly abusive "Son of Boss" tax shelter, the IRS has collected about $3.7 billion so far in back taxes, interest, and penalties from over 1,200 individuals.

What is important about this improved performance is that progress was made in both the IRS' service and enforcement functions—something the Oversight Board has advocated since its inception. These results clearly demonstrate that it is possible to achieve balance between service and enforcement and be successful in both areas.

It is possible to achieve balance between service and enforcement and be successful in both areas.

However, the journey is far from over. The IRS has yet to modernize the antiquated computer systems on which it maintains its central records. From FY1998 through FY2003, the IRS' computer modernization program experienced a series of cost overruns and schedule delays. We are pleased to report that the program did meet its cost and schedule milestones in 2004, and the first taxpayers have finally been moved off the old tape-based system to a modern reliable database. Despite the gains in service and enforcement, the IRS' reliance on its computer systems has prevented it from making even more substantial gains in performance.

An even bigger problem is closing the estimated $300 billion plus tax gap.

An even bigger problem is closing the estimated $300 billion plus tax gap. The tax gap is the difference between what the IRS should collect if all taxpayers paid what they owed, and what the IRS actually collects. A tax gap of this size is an affront to honest taxpayers. As Senate Finance Committee Chairman Charles Grassley said in April, "[L]et me make it clear, we will work to address the tax gap—we owe nothing less to the millions of honest working families who find tax day the toughest day of the year. It is absolutely wrong that families have to tighten their belts and find new ways to keep the family budget balanced because others are not paying their fair share."[1]

The Board is concerned that the IRS has not fully estimated the potential impact of service reductions on taxpayers.

The ultimate goal of tax administration is to produce compliant taxpayers, which can only be achieved by maintaining a balance of good customer service and effective enforcement. To increase its enforcement resources, the IRS proposed to make selective cuts in customer service resources, where it believed the impact would affect the leaset number of taxpayers, while keeping service levels relatively constant. However, the Board is concerned that the IRS has not fully estimated the potential impact of such service reductions on taxpayers—the overwhelming majority of whom want to comply with the tax code but need help. Resources should be made available to the IRS to do both, and the Board has consistently recommended that the IRS be funded at levels to enable it to do so.

Human capital is the IRS' greatest resource and strength, and one of its greatest challenges. The agency possesses an extremely talented and dedicated workforce that produces very high-quality work in spite of the technological and resource limitations, but it must acquire the skills and tools it needs to meet the demands of tax administration in the 21st century. The IRS is just beginning to address its near- and long-term human capital issues, ranging from employee training to a potential wave of retirements beginning next year.

The IRS has a strategic plan to address these issues, and by adhering to this plan, the Board believes the IRS can achieve its goals. However, the IRS could greatly benefit from having long-term outcome measures against which it can quantitatively evaluate progress and assess future needs. Past experience indicates that such measures would have an energizing effect on the agency, improve accountability, help measure progress, and in turn, assist Congress and the Administration in making informed budget decisions.

Seven years after the enactment of RRA 98, the IRS can take great pride in the balanced progress it has achieved. However, achieving progress should not be confused with fulfilling the fundamental goals set forth by the Act and the IRS Strategic Plan. Clearly, the IRS' journey is not over. In a highly effective tax administration system, compliance would be easy to achieve but difficult to avoid. Much hard work and significant risk lies ahead to reach that state.

In conclusion, let us shift the spotlight momentarily away from the IRS. During the past five years, the public has been exposed to a rash of financial scandals involving unethical and unacceptable behavior, and the world of tax administration was not exempt. Many of those responsible are starting to pay the price. Board surveys of taxpayer attitudes on paying taxes have shown that personal integrity is, by far, the most significant consideration in whether taxpayers report and pay what they owe. The Board and the entire tax administration community expect the IRS to prevent and correct non-compliance, but we must remind ourselves that the IRS can only do so much. As taxpayers, we all have an obligation to understand and pay our fair share of taxes, and we must recognize that compliance starts with each of us.

Chairman Raymond T. Wagner, Jr.
Paul B. Jones
Nancy Killefer
Chuck Kolbe
Larry R. Levitan
Robert M. Tobias

Table of Contents

Appendix

Preface

In June 1997, the National Commission on Restructuring the IRS recommended the creation of the IRS Oversight Board to provide a new governance and management body that would provide focused attention on strategic issues facing the IRS. The following year, the IRS Restructuring and Reform Act of 1998 (RRA 98) established the Board to "oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party."

The Board is composed of nine members. Seven of the nine members come from "private life" and are appointed for five-year terms by the President of the United States and confirmed by the Senate. These private life members have professional experience or expertise in key business and tax administration areas. Of the seven, one must be a full-time federal employee or a representative of employees. The Secretary of Treasury and the Commissioner of Internal Revenue also serve as members of the Board. However, to preserve its independent oversight responsibilities and objectivity, neither the Secretary nor the Commissioner approve the Board's annual report, although their comments and guidance are both solicited and welcomed.

RRA requires that the private life members of the Board be appointed without regard to political affiliation, and solely on the basis of their professional experience and expertise in one or more of the following:

- Management of large service organizations
- Customer service
- Federal tax laws, including tax administration and compliance
- Information technology
- Organization development
- The needs and concerns of taxpayers
- The needs and concerns of small businesses

The Board has many characteristics of a corporate board of directors, but is tailored to fit a public sector organization. RRA 98 gave the Board specific responsibilities to review and approve strategic and performance plans of the IRS, review IRS operational functions, review the selection, evaluation, and compensation of IRS senior executives, and review and approve the budget request of the IRS prepared by the Commissioner.

RRA also gives the Board the responsibility to recommend to the President candidates for appointment as IRS Commissioner and recommend to the President the removal of the Commissioner.

This report satisfies a requirement in RRA 98 for the Board to report annually to the President and Congress.

I. Introduction

This is the IRS Oversight Board's fifth Annual Report to Congress, and ultimately, the American taxpayer. The year 1998 was a turning point for the IRS. With the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), the IRS entered into a new era of reform and modernization.

The IRS Oversight Board, authorized by this historic legislation, was established in September 2000. This report provides the public and Congress with a status report on the IRS as it transforms and modernizes. To guide itself in this effort, the IRS, with the approval of the Oversight Board, has updated its Strategic Plan to articulate the following goals for the period 2005-2009:

- Improve taxpayer service
- Enhance enforcement of the tax law
- Modernize the IRS through its people, processes, and technology

These goals will provide the IRS with a road map to guide its transformation from 2005-2009.

The IRS faces a number of challenges in achieving these goals, including the following:

- Ensure balance
- Close the compliance gap
- Stabilize customer service
- Commit to modernization
- Focus on human capital and training
- Measure strategic goals

These challenges have formed the basis of the Oversight Board's annual report since 2003, and this report provides an accounting of how well the IRS is meeting these challenges and what it needs to do to achieve the goals and objectives in the Strategic Plan.

II. Ensure Balance

Taxpayers benefit from both good customer service and vigorous IRS enforcement. Good service leads to fully informed and satisfied taxpayers who understand their tax obligations and experience few problems in interacting with the IRS. Vigorous enforcement directly and indirectly encourages taxpayers to report and pay their tax obligations fully and honestly. Both service and enforcement lower the tax gap and thereby affect all taxpayers. The IRS today recognizes this balance by adopting as its working equation *Service Plus Enforcement Equals Compliance*. The IRS has historically encountered problems when it shifted its mission to focus too much on one part of its mission to the detriment of the other.

An effective tax administration system achieves a balance between customer service and enforcement, and achieving this balance is a challenge for the IRS. RRA 98 specifically addresses this problem by stating, "The IRS shall review and restate its mission to place a greater emphasis on serving the public and meeting taxpayers' needs."[2]

Effective tax administration cannot be an either/or proposition.

The Board has consistently stated that to be truly successful, and compatible with the spirit of RRA 98, the IRS had to succeed in all parts of its mission. Effective tax administration cannot be an either/or proposition. This balanced view is shared by many others in the larger tax community.

At the Board's 2005 annual public meeting, the American Institute of Certified Public Accountants observed: "Commissioner Everson recognizes that any increase in enforcement funding must be balanced with positive responses to the taxpaying public as customers. We encourage this type of balanced approach and stand ready to work with the Service to ensure the needs of America's taxpayers are fulfilled."[3]

These sentiments were also embraced by the Treasury Inspector General for Tax Administration J. Russell George, who said, "Enhancing enforcement while improving customer service is the proper direction for the IRS,"[4] and the National Taxpayer Advocate stated that "taxpayer service and enforcement activities work hand in hand to promote high levels of compliance."[5]

The balanced approach to tax administration is producing positive results.

More than just an equation, the balanced approach to tax administration is producing positive results. The IRS has made considerable strides in improving customer service since the passage of RRA 98 and these improvements are reflected in taxpayer satisfaction surveys, such as the American Customer Satisfaction Index (ACSI). In 2004, the overall customer satisfaction score of individual tax filers increased by almost two percent, showing a steady increase since 1999.[6]

When the IRS reported in March 2005 its latest research on taxpayer compliance, the new estimate of the tax gap captured the attention of policymakers, the tax community, and the public. An annual tax gap in excess of $300 billion clearly calls for corrective action, but balance between service and enforcement must still be maintained. In fact, the size of the tax gap shows that the IRS must still aspire to both greater service and more effective enforcement.

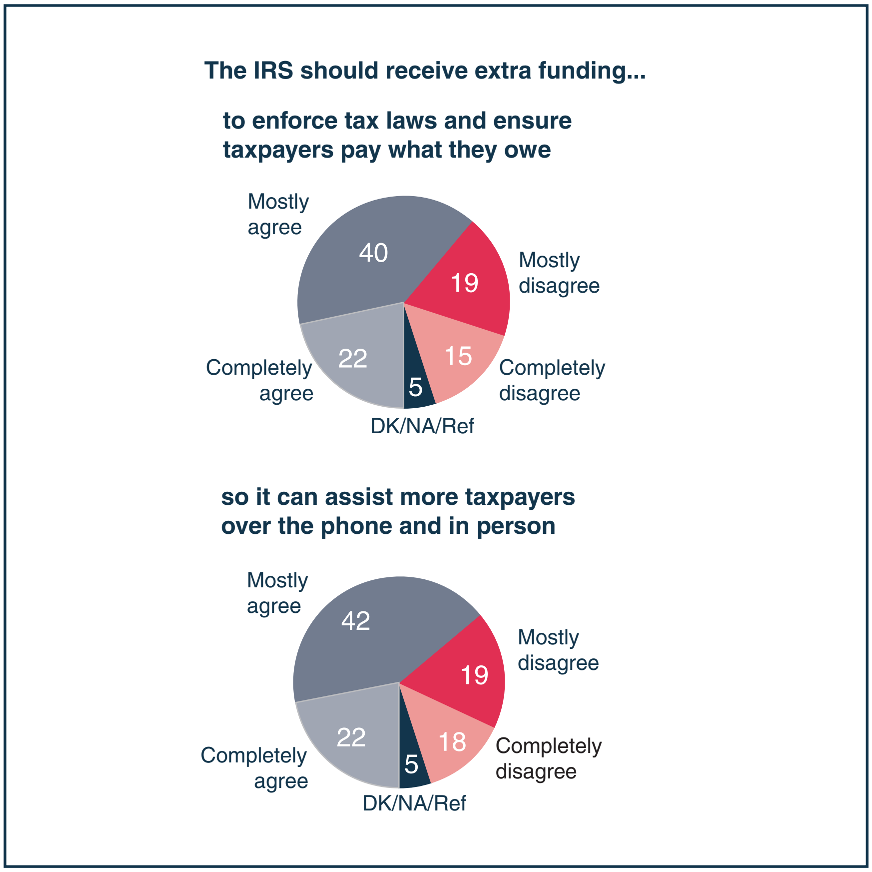
The Board's views in this regard are shared by Members of Congress, taxpayers and practitioners. At the April 14, 2005 Senate Finance Committee hearing on closing the tax gap, Ranking Member Max Baucus observed:

> *The IRS cannot close the Tax Gap simply by increasing enforcement. Issuing more liens. Conducting more seizures. Levying more bank accounts. We do need targeted, appropriate enforcement. If, however, the IRS lets taxpayer service slide—if the IRS diminishes the access and accuracy of taxpayer service—including the essential need for face-to-face taxpayer service—then we fail to help taxpayers comply with the law on the front end. Ensuring up front quality is more efficient than back end enforcement.*[7]

At the Board's 2005 public meeting, the National Association of Enrolled Agents (NAEA) made a statement in a similar vein:

> *NAEA supported the creation of the [IRS Oversight Board] as a defense against the tendency of policymakers to swing wildly between two extremes: funding taxpayer service to the exclusion of funding compliance programs on the one hand, and funding compliance programs to the exclusion of funding taxpayer service on the other. At the end of the day, both of these objectives must be adequately funded for the system to work correctly.*[8]

Taxpayers have also taken notice and want a balanced system. Almost two out of three participating in the Board's 2004 Taxpayer Attitude Survey supported additional IRS funding for enforcement (62 percent) and taxpayer assistance (64 percent).[9]



Source: 2004 IRS Oversight Board Taxpayer Attitude Survey.
DK/NA/Ref= Don't know/No answer/Refuse to answer.

Ensuring balance requires vigilance and discipline. At the same time, oversight bodies, including the Board, must be able to discern whether IRS customer service and enforcement activities are in balance. At what point is the IRS focusing too much on enforcement at the expense of customer service? Without clear measures, it is difficult to tell when a correction becomes an overcorrection.

For that reason, section seven of this report discusses the need for long-term measures in greater depth. The establishment of such measures will give stakeholders a new tool for evaluating the IRS and holding it accountable for achieving its goals.

III. Close the Compliance Gap

In March 2005, the IRS announced the results of the National Research Program (NRP), including its assessment of individual taxpayer compliance and its tax gap estimate of $312-353 billion. Reporting noncompliance[10] represents the largest component of the tax gap—between $250-292 billion, or more than 80 percent.[11]

Shortly afterward, David M. Walker, Comptroller General of the United States, testified to the Senate Finance Committee that in spite of the recent turnaround in staffing and improved enforcement results, "IRS's recent compliance estimate indicates that compliance levels have not improved and may be worse than it originally estimated."[12] Indeed, the problem is so severe that "Tax Law Enforcement" is on the Government Accountability Office (GAO)'s "high-risk" list.

Given these challenges, the Board applauds the IRS for the progress it has made in both service and enforcement activity. Ultimately, closing the compliance gap will require high levels of performance in both areas.

Service gains have been noticeable, and have caused GAO to report:

> *The most noticeable progress has been in IRS's taxpayer service, an area that has been of special concern to the Congress. Access to IRS by telephone, the accuracy of answers given to taxpayer inquiries, and the growth of IRS's Web site, which now provides a variety of services, including forms and instructions, information on the status of refunds, and answers to frequently asked questions, have been noteworthy accomplishments in the years since passage of RRA 98.*[13]

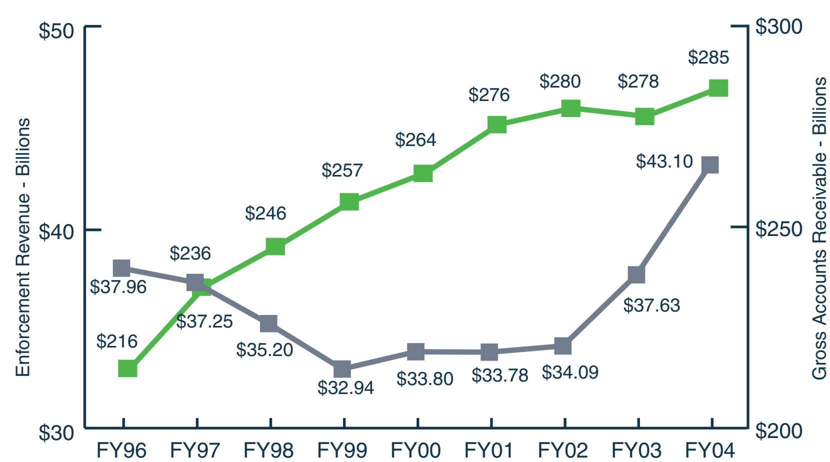
On the enforcement front, the IRS has established four enforcement priorities: 1) discourage and deter non-compliance with emphasis on corrosive activity; 2) assure that tax practitioners adhere to professional standards and follow the law; 3) detect and deter domestic and off-shore based criminal activity; and 4) discourage and deter noncompliance within tax exempt and governmental entities, and misuse of such entities by third parties for tax avoidance purposes.

During the past year, the IRS has:

- Increased audits of high-income taxpayers by 40 percent, individual audits to over one million, up from 618,000 fours years ago, and audits of large corporations to 16.7 percent, up from 12.1 percent last year, reversing eight years of decline.[14]

- Boosted enforcement revenue by $5.5 billion, rising from $37.6 billion in FY2003 to $43.1 billion in FY2004, a gain of 15 percent. However, during the same period, Gross Accounts Receivable, all unpaid tax, penalties, and interest on taxpayers' delinquent accounts, increased from $278 billion to $285 billion, an increase of $7 billion.

Enforcement Revenue Up; but So is Revenue Owed



Source: TIGTA Analysis of Enforcement Revenue Information System and Chief Financial Officer financial Report, 2005.

There was noticeable progress in combating tax shelters.

There was noticeable progress in combating tax shelters. Working in conjunction with the Department of Justice, the IRS won some important victories in high-profile abusive tax shelter cases. For example, in May 2004 the IRS made a settlement offer regarding a particularly abusive tax shelter known as "Son of Boss," and to date, $3.7 billion in taxes, interest and penalties have been collected from the more than 1,200 taxpayers who participated in the offer. The number of criminal prosecutions is also up, but still falls short of pre-1998 levels.

The IRS also has been revitalizing its enforcement program in the tax-exempt sector and refining methods used to identify and examine potentially non-compliant organizations. For example, some credit counseling agencies have come under scrutiny for promoting activities that may be disadvantageous to debtors and are not consistent with the requirements for a tax exemption. The use of tax-exempt organizations by shelter promoters to create abusive tax shelters is another area that is under review. The IRS is also looking at abuses in the use of historic conservation easements, which allow an income tax deduction for owners of significant property who give up certain rights of ownership to preserve their land or buildings. In some cases, these deductions have been inappropriately large or not in compliance with the law and regulations governing such deductions.

In 2004, legislation was enacted to help the IRS in its efforts. The American Jobs Creation Act of 2004 provided the IRS with two new tools. First, it authorized the IRS to use private collection agencies (PCAs) to augment its collection efforts. Second, it created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Previously, penalties had been so small that some promoters of abusive tax shelters weighed possible penalties against the fees they would make by promoting these products.

The tax gap is unacceptably high and current IRS enforcement efforts are insufficient to close it in any meaningful way.

However, in spite of these successes, the tax gap is unacceptably high and current IRS enforcement efforts are insufficient to close it in any meaningful way. The Board concurs with Chairman Grassley and others that a multi-pronged effort must be taken to shrink the tax gap. In addition to providing additional enforcement resources, other actions can and must be taken, including conducting additional research on taxpayer non-compliance, modernizing IRS computer systems to make tax administration more efficient for both the IRS and taxpayers, and simplifying the tax code.

The Board applauds the IRS for identifying S corporation compliance as a top priority.

The Board believes that while the NRP assessment of individual taxpayer compliance was a good start, but it was just that – a start. Similar assessments are needed of other major taxpayer segments, such as partnerships, small businesses, and corporations. Recently, the IRS announced that the next phase of the NRP program will examine S corporations, entities whose income and deductions pass through to its shareholders. The number of S corporations has grown from 724,749 in 1985 to 3,154,377 in 2002, and the Board applauds the IRS for identifying S corporation compliance as a top priority.

Understanding the sources of non-compliance should lead to better strategies for combating it.

Understanding the sources of non-compliance should lead to better strategies for combating it. The Board shares the National Taxpayer Advocate's concern that much more research is needed. Nina Olson stated that the IRS should be conducting extensive research now to develop a "long-term and sustained strategy for reducing the tax gap. This strategy must focus on the indirect effects as well as the direct effects of IRS initiatives."[15]

The need for better data to measure the tax gap and the effectiveness of enforcement actions was also voiced by TIGTA's J. Russell George:

> *Although better data will help the IRS identify non-compliant segments of the population, broader strategies and better research are also needed to determine what actions are most effective in addressing non-compliance… [I]n two recent audit reports, TIGTA identified examination programs that the IRS implemented nationwide before obtaining results on their possible effectiveness or before implementing an effective strategy to measure the results of the program.*

The IRS must continue to obtain accurate measures of the various components of the tax gap and the effectiveness of actions taken to reduce it. The information is critical to the IRS for strategic direction, budgeting and staff allocation. The Department of Treasury also needs these measures for tax policy purposes. Additionally, the Congress needs this information to develop legislation that improves the effectiveness of the tax system.[16]

The Board fully agrees with his assessment as we do with TIGTA's recommendation that delays in Business Systems Modernization (BSM) must be addressed. In addition to helping provide quality customer service to taxpayers, modernizing IRS' computer systems will give IRS enforcement personnel some of the tools they need. For example, the Filing and Payment Compliance project will help the PCA initiative.

Although the Board has no authority to make tax policy recommendations, we would be remiss not to mention the corrosive effect that tax code complexity has on compliance and the tax gap. The complex tax code frustrates honest taxpayers who are trying to understand and comply with the law, while providing opportunities for those who exploit its complexities to devise sophisticated and hard-to-detect illegal tax avoidance schemes.

The Chief of Staff of the Joint Committee on Taxation George Yin made the following well-reasoned argument for simplification at the tax gap hearing:

Much has been written about the benefits of simplification. In terms of ways to reduce the tax gap, I believe that simplification ranks as the most important. Complex laws spawn many inadvertent errors as well as opportunities for intentional non-compliance. Complex laws also contribute to taxpayer confusion and real or perceived unfairness in the tax system. Studies have shown that taxpayers are less likely to be compliant if they perceive the system to be inequitable.[17]

Tax code complexity as the root cause of many problems.

There are other detrimental consequences stemming from a complex tax code: IRS' enforcement workload has grown both in sheer numbers and complexity because of it. According to a TIGTA analysis, hours spent per return on examinations in FY2004 were up 23 percent for individual tax returns and 19 percent for corporate returns over the previous year.[18] Indeed, as we peel away the layers of many of the IRS' problems—from resources to customer service to enforcement—we often find tax code complexity as the root cause of many problems.

In this regard, the Board fully supports the President's federal advisory panel to reform the tax code. Reducing taxpayers' burdens, including potentially simplifying the code, would be the greatest boost of all for both service and enforcement. It is an essential element of any broad strategy for closing the tax gap.

IV. Stabilize Customer Service

Since the issuance of the IRS Restructuring Commission Report and the passage the following year of RRA 98, the IRS has achieved tangible gains in customer service. In 2005, the agency turned in yet another successful filing season.

Taxpayers can now access IRS assistors on the IRS toll-free telephone lines and the accuracy and quality of the responses to their tax law and account questions have remained steady at reasonably high levels. Taxpayers are also afforded a number of self-serve options over the telephone and the IRS' web site for obtaining assistance that help reduce the burden of filing and paying their taxes. There were almost twice as many visits to IRS.gov this filing season than last, and more than five million taxpayers took advantage of the innovative FreeFile program—a more than 40 percent increase from the same period last year.

Taxpayers recognize and value the services the IRS provides to help them understand and comply with the tax code. The 2004 IRS Oversight Board Taxpayer Attitude Survey found that "the most heavily relied upon source of tax information and advice are IRS representatives (82 percent see them as very/somewhat valuable), and IRS printed publications such as brochures (82 percent) and the IRS web site (77 percent). The only non-IRS provided information source that is nearly as highly rated is a paid tax professional (81 percent). Further, more than 90 percent of those surveyed said that IRS customer service is either very or somewhat important to them."[19]

IRS customer service is under evaluation as budget pressures are causing the IRS to place more emphasis on serving taxpayers using lower cost service channels such as the Internet and toll-free telephone service so it can shift additional resources to enforcement functions.

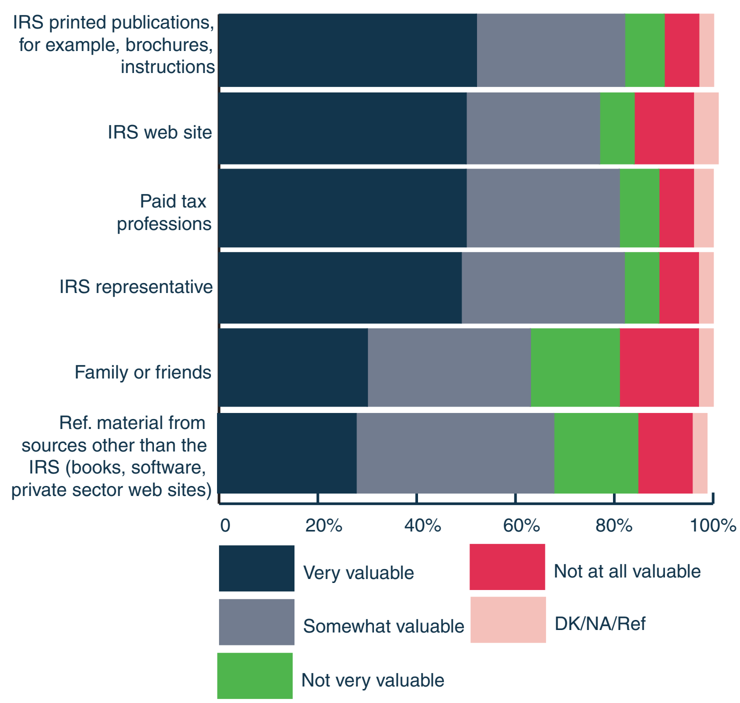
At a recent hearing of the House Ways and Means Subcommittee on Oversight on the 2005 filing season and proposed FY2006 IRS budget, GAO Director, Strategic Issues James R. White noted the pressure to re-examine IRS services because of budget pressures:

> *For at least two reasons, this is an opportune time to review the menu of taxpayer services that IRS provides. First, IRS's budget for taxpayer services was reduced in 2005 and an additional reduction is proposed for 2006. As already discussed, these reductions have forced IRS to propose scaling back some services. Second, as we have reported, IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services*

that did not exist a few years ago and has noticeably improved the quality of telephone services. This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices. Cuts in selected services could be offset by the new and improved services.[20]

However, he also noted in the same testimony that there were "slippages in telephone access such as more abandoned calls and longer wait times,"[21] and pointed out that "the risk, as IRS shifts its priorities towards enforcement, is that some of the gains in the quality of taxpayer service could be surrendered."[22]

What's Valuable to Taxpayers?



Source: 2004 IRS Oversioght Board Taxpayer Attitude Survey
DK/NA/Ref= Don't know/No answer/Refuse to answer.

Walk-in assistance has proven to be particularly helpful for many taxpayers who do not have access to computers and the Internet, or prefer one-on-one personal assistance. Yet, according to TIGTA's J. Russell George, service levels at these sites have improved, but are still not meeting expectations.[23]

It is against this backdrop that the Board raises its concern that reductions in customer service and modernization resources in the proposed FY2006 IRS budget will have a negative impact on the

IRS' ability to delivery quality service to taxpayers and improve overall taxpayer compliance.

To achieve the most efficient use of its resources, the IRS had proposed to close 68 of 402 Taxpayer Assistance Centers (TACs, also called walk-in centers) in FY2006, which served 7.7 million taxpayers in FY2004. However, the IRS has recently suspended these plans in response to a Congressional request for an independent TIGTA study to evaluate the impact such closings would have on taxpayer compliance and assistance.

Other examples of selected service reductions designed to save money while still providing service through alternative channels include a cut in the hours IRS toll-free telephone lines would be available and the elimination of answering tax questions via e-mail. The agency further announced that it will end its TeleFile service, used by almost four million lower-income taxpayers. The Board is concerned that these taxpayers will return to paper filing, although the IRS is hoping that the affected taxpayers will take advantage of free electronic filing opportunities offered by the Free File Alliance. Additionally, tax return and tax account transcripts provided by the TACs must now be requested by phone or mail, which requires a two-week waiting period. These transcripts are often needed urgently by those applying for mortgages or other loans. This change in procedure imposes delays on taxpayers who require this service.

The Board is concerned that customer service reductions may be a false economy, because they could adversely impact taxpayer compliance in ways that are not understood.

Although the IRS is trying to stretch its service budget as far as possible by eliminating higher cost services while emphasizing lower cost service channels, the Oversight Board is concerned that these reductions in service may be a false economy, because they could adversely impact taxpayer compliance in ways that are not understood. Making service more difficult for taxpayers to obtain, either in reality or perception, risks creating dissatisfied, non-compliant taxpayers. Ways and Means Oversight Subcommittee Chairman Jim Ramstad observed that "retaining the good will of American taxpayers by providing professional service and detailed guidance on how to comply with the law are critical to sustaining voluntary compliance."[24] TIGTA expressed similar views:

> *The IRS must exercise great care not to emphasize enforcement at the expense of taxpayer rights and customer service. I believe that steps to reduce the current level of customer service should be taken only with the utmost thought and consideration of their impact, and only with all the necessary data to support these actions. Customer service goals must be met and even improved upon, or people will lose confidence in the IRS' ability to meet part of its mission of providing America's taxpayers quality service by helping them understand and meet their tax responsibilities.*[25]

These cutbacks are being done despite the fact that IRS customer service is still not on a par with private sector financial services organizations. Many financial institutions offer an integrated portfolio of customer service channels using the Internet, e-mail, telephone, and branch offices. For example, many banks offer online banking with a broad array of services available to their customers via the Internet, such as the ability to check account status, pay bills electronically, e-mail questions to customer service, and apply for loans, with parallel services offered via toll-free telephone and branch banking. A recent Federal Deposit Insurance Corporation report notes the number of bank charters has declined by 29 percent between 1994 and 2003, but during the same period, the number of physical bank offices increased 15 percent. The report found this growth striking because it occurred during a period in which automated teller machines proliferated and banking over the internet increased. Even more remarkable was that banks with the most branches were more efficient than banks with fewer branches.[26]

It is understandable in light of budget reductions that the IRS is looking to funnel taxpayers to the channels that are the least expensive for the IRS to operate. However, taxpayer needs and preferences must also be taken into account. There is little assurance that the current configuration of 400 TACs is the optimum geographic distribution to meet taxpayers' needs and most effectively influence taxpayer compliance. The IRS should perform more research to evaluate these issues and develop a strategy that manages its entire portfolio of service channels into the optimum configuration that meets both IRS and taxpayer needs. The resulting research could help the IRS decide which functions were most effectively performed by each service channel—telephone, Internet, e-mail, and in-person—and how to influence taxpayers to use the most appropriate channel for each circumstance.

As previously noted, the IRS does not have the information that allows the Board, or other oversight organizations, to measure the short-term impact of customer service reductions on taxpayer compliance or taxpayer burden. Until such research is available, the Board urges that a cautious approach be taken. Without a more informed understanding of the effects of both service and enforcement on compliance, any change could have unintended consequences. Moreover, until meaningful and substantive tax simplification is enacted into law, taxpayers will need all the help they can get to understand the present tax code.

The Board recommends that the IRS develop a long-range plan to provide customer service that is based on research of taxpayers' needs for service and the channels that taxpayers are likely to use to receive those services. The plan should include making channels available for taxpayers with special needs, such as the elderly, low-income taxpayers, and those with limited English proficiency.

V. Commit to Modernization

The IRS' once-troubled BSM program experienced better performance in FY2004.

One of the IRS Strategic Plan's goals is modernizing its old and fragmented computer systems. The Board is pleased that the IRS' once-troubled BSM program experienced better performance in FY2004. Improved management helped the BSM program deliver within cost and budget targets important technology projects that will generate greater efficiencies throughout the agency and create benefits for taxpayers.

The first taxpayers were moved to a modernized data base known as the Customer Account Data Engine (CADE) and corporate taxpayers are now able to file their corporate tax returns with the IRS electronically using the Modernized e-File system.

Future BSM deliverables are also critical to improved customer service. The IRS does not yet offer products and services familiar to customers of many financial institutions, such as daily updating of accounts, electronic access by customers to account records, and a full range of electronic transactions—options which the IRS cannot yet provide. With the help of modern technology, the IRS must close this gap if it is to be perceived by taxpayers as having services on a par with financial institutions with which they deal on a regular basis.

If the IRS can continue to demonstrate improvement in FY2005, given its success in FY2004, it would seem desirable and logical to increase BSM program funding in FY2006. Increased funding is sorely needed. BSM funding levels were severely reduced in the last several years: from $388 million in FY2004 to $203 million in FY2005, and a requested $199 million in FY2006.

Cutting back modernization funding will force the program to take longer and cost more than necessary.

The Board reiterates the position it has taken in prior years—cutting back modernization funding will force the program to take longer and cost more than necessary. Of greatest concern is the age of IRS' existing computer systems which will eventually become impossible to maintain. This dependence on old computer systems causes the probability of a disruption in our nation's tax administration system, albeit small, to increase every year. The impact of such an event is so great that prudent risk management dictates that this risk be mitigated by replacing IRS legacy systems as soon as possible.

Although BSM cost overruns are very capably and visibly reported by both GAO and TIGTA, the costs borne by taxpayers caused by BSM delays are rarely reported. For example, according to the ConsumerAffairs.com web site, in the 2003 tax filing season, an estimated 12.1 million taxpayers nationwide obtained Refund Anticipation Loans (RALs), with fees ranging from $30 to $90, not to mention other associated costs, such as tax preparation, electronic filing, and check cashing fees.

These costs fall particularly hard on families who can least afford them. A report by the National Consumer Law Center (NCLC) and the Consumer Federation of America (CFA) found that roughly 57 percent of the families who purchased RALs in 2003 received the Earned Income Tax Credit (EITC). The EITC provides financial assistance to the working poor. Those 6.92 million EITC recipients spent a total of $1.74 billion on RAL-related fees, including check-cashing fees, according to the NCLC and CFA.

However, the CADE project, which would update the IRS' master files to allow for daily updating of taxpayer accounts, would provide the IRS with the capability to issue an electronic refund in three to five days to taxpayers who file electronically. This rapid refund would reduce significantly much of the demand for RALs. Even if such a capability reduces the number of RALs by only 60 percent, EITC taxpayers would save over $1 billion a year, far more than is currently being spent on BSM annually.

The Board can offer another, more broadly-based taxpayer-focused perspective. Professor Joel Slemrod of the University of Michigan testified before the President's Advisory Panel on Tax Reform that individual taxpayers spend approximately $85 billion a year complying with the tax code. Just as online banking saves bank customers money with electronic bill paying, on-line access to records, and other electronic transactions, a modernized IRS computer system will not only save the IRS money, it will reduce taxpayer burden. If that burden is reduced by a modest estimate of only five percent, taxpayers would save over $4 billion a year. These costs of delaying BSM are often overlooked, but provide a compelling reason to accelerate the BSM program consistent with the IRS' ability to manage it properly.

VI. Focus on Human Capital and Training

The IRS workforce cannot be taken for granted.

Improving its human capital is another goal of the IRS Strategic Plan. The Board believes that human capital is the IRS' greatest resource and strength, and one of its greatest challenges. The agency possesses an extremely talented and dedicated workforce that produces high-quality work in spite of the technological and resource limitations previously described. However, such a workforce cannot be taken for granted. It must be carefully selected, trained and given the skills and tools it needs to meet the demands of tax administration in the 21st Century. Human capital cannot be an afterthought; it must be integrated into any IRS strategic plan.

The GAO provides a status report on government operations that it identifies as "high risk" to each new Congress. In its January 2005 High Risk Series report (GAO-05-207), GAO describes the high-risk challenges facing Federal departments and agencies, and focuses on strategic human capital management as a major area that needs urgent attention and transformation in order for the government to function in the most economical, efficient and effective manner possible. Strategic human capital management was first identified as a "high risk" area in 2001, where the report stated: "…the problem is the lack of a consistent strategic approach to marshalling, managing, and maintaining the human capital needed to maximize the government performance and ensure its accountability." GAO listed four critical human capital challenges facing the federal government:

- Leadership, continuity, and succession planning
- Strategic human capital planning and organizational alignment
- Acquiring and developing staffs whose size, skills and deployment meet agency needs
- Creating results-oriented organizational cultures

In its 2004 annual report, the Board voiced concerns regarding the IRS' lack of a strategic approach to human capital, and is pleased that the IRS is preparing a long-term Human Capital Strategic Plan, but disappointed that the plan is not yet completed. In 2003, the Board recommended that the IRS direct its attention on its people resources – specifically on the way that it hires, trains and retains employees. We called upon the IRS to develop an agency-wide human capital strategic plan that focuses on five key areas:

1. Replace lost critical talent – The IRS has a "graying" workforce with 25 percent eligible to retire by 2006. Many of these individuals possess critical skills, such as maintaining legacy IT systems, and

institutional knowledge that could easily be lost.

2. Build skills for complex work – Tax administration will become more complex in the future as demonstrated by the challenges in combating abusive tax avoidance transactions that are increasingly more sophisticated and harder to detect. Enhanced IT skills will become more important in this new environment, such as the use of technology as the preferred means of doing business.

3. Manage change – Even though the IRS customer-focused organization is firmly in place, change will continue throughout the agency. The IRS is no longer a static organization; new technology and process redesign will bring further challenges and greater change, and with it, an increased demand for leaders and managers with change management skills and experience.

4. Enhance performance – Given budgetary constraints, the IRS must enhance its performance each year to meet greater work demand and improved customer service and enforcement goals. Management skills take on greater importance in such a high-performance, goal-driven environment.

5. Engage the entire workforce – Workforce engagement remains a challenge. Surveys indicate that upper management levels of the IRS are engaged in its mission and strategic goals, but the same cannot be said for front-line managers and rank-and-file employees.

In addition to developing its human capital strategic plan, the IRS has made some progress in its management.

In addition to developing its human capital strategic plan, the IRS has made some progress in its management. The agency has designated a Human Capital Officer, reorganized its human capital division, and established a human capital board, advisory council and sub-councils. These entities work together to support human capital planning and execution, and allow service-wide decision-making on human capital policies and programs. The human capital office is working across the agency and with stakeholders to develop the IRS Human Capital Strategic Plan. The plan will cover a five year period and aligns with Office of Management and Budget (OMB) and Office of Personnel Management (OPM) guidance. It also aligns with the Department of Treasury Human Capital Strategic Plan. The completion of the plan will be a success for the IRS, but much work remains to address critical challenges, identify milestones, develop performance measures and indicators, and identify human capital best practices. The Board encourages the IRS to further develop its plan in collaboration with employees, managers, stakeholders and the National Treasury Employees Union to shape the future workforce to meet the agency's goals.

Training at the IRS

At last year's IRS Nationwide Tax Forums and the Board's 2005 annual public meeting, the Board heard from stakeholders and dozens of agency employees who saw workforce issues as the greatest challenge for the agency over the next five years. The lack of adequate training was a dominant issue.

Stakeholders described an expanding training gap at the IRS, where employees often lack the expertise and skills to handle difficult, complex or problem cases. IRS employees also reported that they were inadequately or unevenly trained. Stakeholders added that in the operating divisions where employees have helped plan and design training programs, employees report higher job satisfaction and empowerment.

There is no clear vision for training across the agency,

The Oversight Board has studied IRS' division training programs and determined that there is no clear vision for training across the agency, and no real linkage between strategic training planning at the national and operating division level, nor is there an agency-wide "champion" for training.

The IRS' ability to realize its long-term vision and goals depends upon effective, efficient, well-trained and motivated employees. It also relies on being able to implement effective measures to assess the impact of training, and to plan and design new methods of training that address emerging critical compliance needs.

Two years after the IRS Oversight Board raised concerns on human capital issues, the same problems persist: the IRS has not adequately dealt with the reality of an aging workforce and has failed to provide clear guidance, direction and training for its employees.

The Board recommends that the IRS complete development of its strategic human capital plan and its companion implementation plan to squarely address these issues. Faced with pending retirements, the IRS must have a plan in place to refresh its workforce, preserve invaluable knowledge, and institute succession planning throughout the agency. The IRS must also have a plan to recruit and retain qualified personnel, including future executives from the private sector who can bring to bear best practices and new ideas to 21st Century challenges and opportunities. And lastly, the IRS must better train and equip its workforce with necessary skills. The IRS will be hard pressed to close the tax gap if the training gap is not closed as well.

VII. Measure Strategic Goals

Meaningful and reliable outcome measures are essential to evaluating the IRS's success in achieving the goals identified in its strategic plan.

The Board firmly believes that meaningful and reliable outcome measures are essential to evaluating the IRS' success in achieving the goals identified in its strategic plan. They are critical to determining whether the desired outcomes and performance levels are achieved through investments, helping the Administration and Congress make informed decisions on resources and budgets, and ensuring a proper balance is achieved between customer service and enforcement.

During FY2004 the IRS revised its strategic plan, and is currently developing measures and quantifiable performance targets or goals for the plan. There is a general consensus among IRS stakeholders that the IRS must do more to improve its existing measurement systems, develop outcome and end result measures and establish long-term performance goals and objectives for its measures.

This imperative was clear throughout this year's Congressional hearings on the IRS. Comptroller General Walker testified that the IRS "lacks quantitative long-term goals for improving taxpayer compliance, which would be consistent with results oriented management."[27] James R. White, GAO's Director, Strategic Issues, took another tack: "IRS is developing, but currently lacks, long-term goals that can help them inform stakeholders including the Congress, and aid them in assessing performance and making budget decisions."[28] As previously noted, TIGTA came to a similar conclusion about the value of such goals.

A recent GAO report evaluated the IRS' approach to reducing the tax gap and whether the IRS' approach incorporated results-oriented planning principles. GAO came to the following conclusion:

> *Reducing the tax gap will be a challenging task given persistent levels of noncompliance and will not likely be achieved through a single solution. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time. Without long-term, quantitative voluntary compliance goals and related performance measures, it will be more difficult for IRS to determine the success of its strategies, adjust its approach when necessary, and remain focused on results, especially since factors that affect compliance change over time. Having compliance goals, coupled with recently collected NRP data, would provide a solid base upon which IRS can develop a more strategic, results-oriented approach to reducing the tax gap.*[29]

The Board appreciates the difficulty associated with developing measures and performance goals. Setting long-term goals requires a high level of consultation and consensus building. Achieving agreement among Congress, the Executive Branch, external stakeholders and the public will be particularly challenging. Nonetheless, a number of oversight organizations, including the Oversight Board, GAO, and TIGTA have urged the IRS to develop long-term goals, but little progress has been made.

As discussed in the Board's 2004 annual report, during the FY2005 budget formulation process, the IRS took the important step of aligning performance and requested resources. However, the agency must continue to integrate performance into its decision-making and resource allocation processes to fully achieve an integrated performance budget. It must continue to identify and measure those actions that are important and meaningful to taxpayers and use those measures in its public reports, performance plans and reports, and budget requests. This can create a performance-focused organization and an increased level of accountability to taxpayers.

Further, the IRS must continue to modify its budget and performance plans to include more customer-focused and "end result" measures. The Board is currently evaluating goals that the IRS should include in its FY2007 budget, and believes that these goals must include a range of balanced measures that report on results that taxpayers can readily understand, such as customer satisfaction, timeliness, and accuracy of key processes. Annual goals such as these, which challenge the IRS to produce more favorable outcomes every year, ultimately will lead to the accomplishment of the strategic goals the IRS has established.

Additionally, Congress would be helped in its deliberations if long-range measures for achieving a desirable, effective, and realistic tax administration system were established. These goals would set a valuable context for making informed decisions on the proper balance between service and enforcement. They would also create an environment of accountability where everyone who is part of the system—taxpayers, the IRS, and decision-makers in the executive and legislative branches—is aware of overall goals and their needed contributions to achieve them.

The Board also believes it is imperative to identify the key attributes of an effective tax administration system. Such attributes can identify desired outcomes and create a roadmap for the next decade that will complement the IRS' strategic, budget, and annual performance plans. In addition, it could be integrated into the government-wide Key National Indicators initiative whose purpose is to help assess the overall position and progress of our nation, frame strategic issues and chart future directions.

VIII. Conclusion

The Board strongly believes that a highly effective tax administration system is an economic and societal necessity. In such a system there would be balance between customer service and enforcement, and taxpayers would find that compliance was easy to achieve but difficult to avoid.

Since the passage of RRA 98, the IRS has been on the right track and making progress toward that goal, but it still faces significant challenges to become the modern 21st Century institution we want it to become. We must continue the relentless pursuit of that goal, and make sure we give the IRS the tools, guidance, and resources it needs to finish the job.

Endnotes

1. Senate Finance Committee Chairman Charles Grassley, Opening Statement before the Senate Finance Committee, April 14, 2005.
2. P.L. 105-206, Title I, Section 1002.
3. American Institute of Certified Public Accountants, Statement to the Internal Revenue Service Oversight Board Public Meeting, February 1, 2005.
4. Treasury Inspector General for Tax Administration J. Russell George, Testimony before the Senate Finance Committee, April 14, 2005.
5. National Taxpayer Advocate Nina M. Olson, Testimony before the Senate Finance Committee, April 14, 2005.
6. American Customer Satisfaction Index, "*ACSI Overall Federal Government Scores with Historic Scores of Agencies Measured 1999-2004*", December 15, 2005.
7. Senate Finance Committee Ranking Member Max Baucus, Opening Statement before the Senate Finance Committee, April 14, 2004.
8. National Association of Enrolled Agents, Statement to the Internal Revenue Service Oversight Board Public Meeting, February 1, 2005.
9. Internal Revenue Service Oversight Board, Annual Taxpayer Attitude Survey, April 2005.
10. Reporting noncompliance includes understated income, improper deductions, overstated expenses and erroneously claimed credits.
11. IRS Fact Sheet
12. Comptroller General of the United States David M. Walker, Testimony before the Senate Finance Committee, GAO-05-527T, April 14, 2005.
13. GAO Report GAO-05-707T, *IRS Modernization: Continued Progress Requires Addressing Resource Management Challenges*, dated May 19, 2005, page 1.
14. TIGTA Audit Report Trends in Compliance Activities through FY2004, Audit Report 2005-30-055
15. Olson, op. cit.
16. George, op. cit.
17. Joint Committee on Taxation Chief of Staff George K. Yin, Testimony before the Senate Finance Committee, April 14, 2005.
18. George, op. cit.
19. Internal Revenue Service Oversight Board, Annual Taxpayer Attitude Study, April 2005.
20. Government Accountability Office Director, Strategic Issues James R. White, Testimony before the House Ways and Means Subcommittee on Oversight, GAO-05-416T, April 7, 2005.
21. Ibid.
22. Ibid.
23. Treasury Inspector General for Tax Administration J. George Russell, Testimony before the House Ways and Means Subcommittee on Oversight, April 7, 2005.
24. Chairman Jim Ramstad, Opening Statement before the House Ways and Means Subcommittee on Oversight, April 7, 2005.
25. George, op. cit.
26. Ronald Spieker, FDIC Future of Banking Study, *Bank Branch Growth Has Been Steady—Will it Continue?* Report FOB-2004-08.1
27. Walker, op. cit.
28. White, op. cit.
29. GAO Report GAO-05-753, *Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap,* dated July 2005, page 27.

Appendix

A. Biographies of IRS Oversight Board Private-Life Members

The IRS Oversight Board, by statute, consists of nine members, including the Secretary of the Treasury and the IRS Commissioner. Following are profiles of the private-life members, who are appointed by the President and confirmed by the U.S. Senate.

Chairman Raymond T. Wagner, Jr.
Legal & Legislative Vice-President, Enterprise Rent-A-Car
Raymond T. Wagner, Jr. is Legal & Legislative Vice-President for Enterprise Rent-A-Car, headquartered in St. Louis, Missouri. Previously, he served in the cabinet of Illinois Governor Jim Edgar as the Illinois Director of Revenue until 1995. Prior to that, he was Director of the Missouri Department of Revenue under then-Governor John Ashcroft. Since 1993, he has been an Adjunct Professor of Law at Washington University School of Law. He served as Law Clerk for then-Chief Justice Andrew Jackson Higgins of the Missouri Supreme Court. He received his Master of Business Administration and undergraduate degrees from St. Louis University, and his law degree from University of Missouri-Kansas City School of Law. He also holds a Master of Laws-Taxation degree from Washington University School of Law.

Paul B. Jones
Senior Vice President
General Counsel and Regulatory Policy, Time Warner Telecom
Paul B. Jones is Senior Vice President, General Counsel and Regulatory Policy for Time Warner Telecom in Littleton, Colorado. He began his career practicing law with the Coudert Freres Paris office, specializing in corporate and tax structuring transactions largely for multi-national business. In 1973, he moved to the Coudert Brothers New York office. There he served as a defense trial lawyer representing the three major broadcast networks. CBS' 60 Minutes became his principal client. Press coverage of the issues raised in one of his 60 Minutes cases brought his name to the attention of the Federal Communications Commission, where he served as a co-director of a task force charged to explore the economics of video program production and distribution, with a goal to recommend regulatory change required to expand program choice for the American public. He later became Assistant General Counsel. Mr. Jones went on to serve as Vice President for Strategy and Business Development for the CBS Publishing Group, as General Counsel for Warner Communications Cable business, and as Senior Vice President Corporate Development for Time Warner Cable Ventures. Mr. Jones graduated from Yale College in 1968, and received his J.D. from Yale Law School in 1971. He chairs the Oversight Board's committee on operations support.

Nancy Killefer
Senior Partner, McKinsey and Company
Nancy Killefer is a senior partner at McKinsey and Company, an international management consulting firm. She leads their Washington, D.C., office and specializes in developing market strategies and improving organizational effectiveness. In 1997, President Clinton appointed Ms. Killefer as Assistant Secretary for Management/Chief Financial Officer of the Department of the Treasury. She held this post until returning to McKinsey in December 1999. At the Department of the Treasury, Ms. Killefer reported directly to the Secretary on all matters involving financial and internal management of the Department and its Bureaus—including budget, personnel, management, and procurement policies. Ms. Killefer co-chaired the Vice President's IRS Customer Service Task Force and was a major contributor to the reform and restructuring of the IRS. Ms. Killefer is a graduate of the Massachusetts Institute of Technology and Vassar College, where she received degrees in management, finance, and economics. Ms. Killefer served as the Board's Chair from 2002 to 2004.

Charles L. Kolbe
Owner, Kolbe Cattle Company
Chuck and his wife Sue have managed Kolbe Cattle Co. since graduating from Iowa State University in 1965. They still do this today on land that has been in the family for the last 125 years. In 1986, Kolbe started Midland Cattle Co., a cattle trading partnership which yearly purchases and places over 150,000 head of cattle from many locations in North America. In the early 1990s, Kolbe was a founding partner in Red Oak Farms, a branded beef company that specialized in high quality fresh and pre-cooked beef products. Midland Cattle was sold to Red Oak Farms and subsequently Red Oak Farms is under the management of Premium Quality Foods. Kolbe is past president of the Iowa Cattlemen and chairman of the Iowa Beef Industry Council. A serious bicycle accident in 1997 forced him to cut back on some of the more rigorous aspects of his life but he still remains active in much of it. He was inducted into the Iowa Cattlemen's Hall of Fame in 2000.

Larry R. Levitan
Retired Partner, Andersen Consulting (now Accenture)
Larry R. Levitan retired from a 34-year career with Andersen Consulting in 1997. He held key leadership positions at the firm, which grew during his career from 500 to over 50,000 employees. Mr. Levitan became a partner in 1974 and served as managing partner of numerous Andersen Consulting operational entities. He worked with world-class clients to create business strategies, restructure organizations, management processes, and mission critical information systems. Mr. Levitan currently serves on a number of corporate boards. He received a degree in accounting from the University of Florida. Mr. Levitan served as the Board's first Chairman from 2000 to 2002.

Robert M. Tobias
Professor, American University
Robert M. Tobias is a professor at American University in Washington, D.C., and is also the Director of the Institute of Public Policy Implementation. Mr. Tobias retired in 1999 after 31 years with the National Treasury Employees Union (NTEU), where he served as General Counsel from 1970 to 1983, and as National President from 1983 until his retirement. At NTEU, and as a member of the President's National Partnership Council, Mr. Tobias focused on establishing cooperative/collaborative labor-management relationships in the Federal government. In 1996, President Clinton appointed him to the National Commission on Restructuring the IRS. Mr. Tobias also was a member of the IRS Executive Committee. He is a graduate of the University of Michigan, where he received a master's degree in Business Administration, and from The George Washington University, where he received his law degree. He chairs the Oversight Board's committee on operations.

B. Summary of Stakeholder Comments and Recommendations

The IRS Oversight Board reaches out to a wide variety of external stakeholders each year to listen to their views on tax administration and its impact on individual taxpayers. The Board consults regularly with external groups that include tax professionals, representatives of state tax departments, taxpayer advocacy groups, business associations, IRS advisory councils and committees, IRS employees and the National Treasury Employees Union (NTEU), and other groups that have an interest in tax administration.

During the past year, the Board asked stakeholders for their views on the following occasions:

- The Board met with IRS field employees and tax professionals at the IRS Nationwide Tax Forums held in Atlantic City, Orlando, Minneapolis, New Orleans, San Antonio, and Las Vegas.
- In July 2004 the Board met with IRS employees and tax professionals in Kansas City.
- In October 2004 the Board sent a letter to stakeholders requesting their views on the most important strategic issues in tax administration that the Board should address in 2005.
- In February 2005 the Board conducted a pubic meeting in Washington, DC with external stakeholders to listen to their comments regarding the IRS' efforts to reorganize and modernize. Key comments and discussions centered on challenges facing the IRS, the agency's renewed focus on enforcement, proposals to regulate unenrolled tax preparers, human capital issues, and the importance of stakeholder input into IRS' decision-making processes.

The Board synopsized the following issues from what it heard at these sessions.

There is a Growing Public Perception of Widespread Non-Compliance that the IRS Must Address in an Environment of Limited Resources and Tax Law Complexity

Both practitioners and employees agree that the IRS needs a renewed emphasis on enforcement to address a growing public perception of widespread non-compliance. They said that giving the IRS the necessary resources to properly enforce the tax laws is vital to maintaining our voluntary compliance system. Since the IRS is an agency that generates revenue for the federal government, stakeholders called for an adequate budget that allows the IRS to meet reasonable goals for compliance, customer service and systems modernization.

The Internal Revenue Service Advisory Council (IRSAC) advised the Board that the need to close the tax gap crosses all IRS operating divisions; and that the IRS needs to "touch" more taxpayers through notices, communications, and audits to both improve voluntary compliance and collect unpaid taxes.

Employees feel the IRS faces a huge challenge in implementing enhanced enforcement because the agency does not have the technology or trained employees to keep up with tax schemes currently multiplying through the tax system. They also feel that human capital strategies, such as outsourcing, consolidation, centralization, changes in training, and new hiring practices are poorly communicated to them. IRS employees in general feel that modernization of IRS' information technology systems, rather than enforcement, is the single biggest issue facing the IRS. With improved technology, employees feel they could better deal with enforcement issues.

To Function Better, the IRS Should Simplify Tax Administration to the Benefit of Both Taxpayers and the IRS' Own Enforcement Efforts
Stakeholders reported that the Large and Mid-Size Business (LMSB) division implemented a number of initiatives to enhance enforcement while also simplifying administration for taxpayers, practitioners, and IRS employees. Stakeholders also commended LMSB's innovative procedures to improve the examination process and promote currency, and recognized that these procedures all share the common denominator of issue resolution at the lowest level.

Another area for which the IRS received stakeholder praise was its development of strategies to resolve disputes before returns are filed. The American Bar Association (ABA) Tax Section believes that the Pre-Filing Agreement Program has been a tremendous success and supports continuation and expansion of the program, and recommended that the Service continue to expand post-filing dispute resolution programs, continue efforts to develop clear guidelines for resolving difficult issues, and supplement these with voluntary error correction programs.

Stakeholders also emphasized that the most successful approach to streamlining tax administration and decreasing taxpayer burden is to maximize the partnership between the IRS and industry. The Council for Electronic Revenue Communication Advancement (CERCA) complimented IRS progress in its modernization programs, citing successes with the Customer Account Data Engine (CADE), e-Services, and modernized e-File projects. The Electronic Tax Administration Advisory Committee (ETAAC) urged the IRS to bring individual tax return e-filing to the modernized platform as quickly as possible because it believes the modernized system will result in greater levels of participation by practitioners in IRS e-File. It also recommended that e-filing by paid practitioners be mandated.

The National Payroll Reporting Consortium (NPRC) told the Board that IRS' implementation of e-Services cuts government operating costs by allowing authorized self-service and provides customers with ready access to high quality government services. However, it also said that reporting agents currently do not have access to the e-Services system, and the NPRC maintains that if they were provided access it would significantly reduce IRS burden and many taxpayer problems would be either prevented or immediately resolved.

The IRS Faces the Challenge of Maintaining Customer Service Levels While Changing the Focus to Enforcement

Both employees and practitioners believe that customer service plays a critical role in taxpayer compliance. They described past outreach efforts to the immigrant and non-English speaking communities, and say significant reductions in this area leaves these taxpayers vulnerable to unethical and fraudulent preparers. In particular, representatives of low income taxpayer clinics suggest that the IRS do more to help taxpayers comply with their tax obligations, and disagreed with significant reductions in the level of funding and training for Volunteer Income Tax Assistance (VITA) volunteers, which impacts the EITC program.

Employees noted a decline in customer service, but feel it is related more to changes in procedures and consolidation of functions rather than the lack of resources, and reported as one example the decline in available services at Taxpayer Assistance Centers. However, they feel the Practitioner Hotline and Employee Identification Number Hotline have enhanced customer service. Employees also say they are under-utilized as ambassadors to the public in communicating new enforcement efforts, and say they can be the “eyes and ears” for the IRS in their communities. As enforcement resources are increased, stakeholders believe the IRS’ enforcement resources should maintain an equitable distribution between wealthy and poor taxpayers so that taxpayers in all income groups receive fair as well as fast results, and alternative routes to case review and resolution continue to be available and open. The IRS also should devote sufficient resources to enforce preparer penalties and disciplinary sanctions.

Stakeholders Have Concerns about How IRS Will Implement the Private Agency Collection of Tax Debt

The NTEU opposes the use of private collection agencies and cautioned that such a program could risk exposing taxpayers’ private information, subject taxpayers to abusive tactics, and be more costly than if additional IRS employees were hired and trained to do the job. Representatives of low income taxpayers also expressed concerns to the Board about IRS’ use of private collection agencies. They say it is not clear what will happen to low income taxpayers once they become subject to private collectors who may have limited knowledge about tax issues and focus only on collecting the debt. Resolution of these cases on a fair basis involves cultural, communication, language and other barriers that may lead to unfair outcomes. Some practitioners believe that the IRS would be more effective if could hire more exam and collection personnel, train them properly, and give them the authority to resolve taxpayer non-compliance problems.

The Federation of Tax Administrators (FTA) told the Board that every state utilizes private debt collection agencies, in some form or another, usually to collect out of state debts. Typically the private collection agency is the collector of last resort for older accounts, but New Jersey and Delaware are two exceptions and use private collection agencies as the collector of first resort. In all cases the private collectors are actively managed by the states for quality and results and their employees are subject to the same rules and restrictions as state employees.

Modernization of IRS' Information Systems, While Beneficial to the Agency, Can Create Difficulties for Certain Taxpayers
The National Association of Enrolled Agents (NAEA) commended the IRS' e-Services program for freeing up thousands of staff hours at the agency and saving taxpayers millions of dollars worth of practitioner costs. Several stakeholders called for further expansion of the program with new technology investments and open access for all tax professionals. The ETAAC presented its view of end-to-end electronic tax administration, and told the Board that newly released products within the e-Services suite and those contemplated for the future have the potential to fundamentally alter the way in which practitioners and taxpayers transact business with the IRS.

Several stakeholders identified possible negative effects of modernization on low income taxpayers. The IRSAC commented that modernization and centralization have both good and bad points. Technology provides benefits and efficiencies for the agency, and can increase service and reduce burden for many taxpayers, but has the potential to burden taxpayers who believe they must seek professional representation because they are unable to meet with a live person who can understand and solve their problem. Low-income taxpayers in particular find that dealing with the reorganized and centralized agency has become more difficult, impersonal, frustrating, and costly, according to Janet Spragens, Director, American University Federal Tax Clinic. These taxpayers generally have limited or no proficiency in English and are not yet part of the information age, and tend to be better helped through face-to-face interaction.

There are Ways the IRS Can Work More Closely With Stakeholders to Increase Levels of Voluntary Compliance
Several organizations suggested ways the IRS could work with stakeholders to leverage its resources and foster an increase in tax compliance. For example, the American Institute of Certified Public Accountants (AICPA) described its members' *pro bono* efforts to work with the IRS to utilize CPA volunteers at disaster relief sites in certain states. The AICPA also said the IRS has asked CPAs within state societies to teach local tax practitioner courses and small business workshops that IRS personnel have taught in the past. The National Society of Accountants (NSA) believes that the IRS must work more closely with its external stakeholders to create a more compliant taxpayer population. Essential to this process is a formal means of communication at both the national and local levels for tax professionals and the IRS to meet, discuss, and resolve issues of mutual concern. Lastly, the Tax Executives Institute (TEI) noted that while it wholeheartedly supports electronic filing, it had some concerns about recently issued temporary regulations mandating e-filing of large corporate income tax returns for the 2005 filing season, and suggested that had the IRS issued proposed regulations, the process of soliciting comments from vendors and stakeholders would have been more orderly and more helpful.

The FTA described numerous ways that states and the IRS have partnered to leverage their resources, such as sharing of data files and joint collection of federal and state taxes owed by a taxpayer, and suggested that the states and the IRS should be seeking new opportunities in a more systematic manner.

Janet Spragens said that the IRS Low Income Taxpayer Clinic (LITC) program is an unqualified success story and the program contributes toward the goal of educating and assisting low income taxpayers to understand and comply with their tax obligations. She called for more funding for the program and greater efforts on the IRS' part to inform taxpayers about the clinics.

Most Tax Professional Organizations Favor Some Form of Registration and/or Regulation for Tax Preparers And Want a National Discussion on the Topic.

Practitioners and IRS employees generally agree about the need to address problem preparers, but see difficulties in implementing a registration and/or regulation program. Many practitioners believe the IRS must address the problem of unscrupulous and/or unethical preparer behavior and that it is important the IRS knows who is preparing tax returns by having a registration system. Practitioners also believe an honest practitioner community is one of the IRS' biggest allies in the area of voluntary compliance. The IRSAC, for example, cited the lack of effective oversight, control, and regulation of the entire tax preparation community for having a significant impact on voluntary compliance.

Tax professionals and IRS employees favor some type of program that would curtail incompetent or unscrupulous preparers, but see many complications in developing and administering one, including the type of registration to be required, the extent to which competency testing and continuing professional education should be required, and how the new system would be regulated and what sanctions should be imposed. Practitioners also believe the IRS should tighten Electronic Return Originator (ERO) standards, and do a better job of enforcing preparer penalties. They expressed frustration with the appearance that IRS does not take any action upon receiving a report about a problem preparer, and suggested that the IRS develop a process for practitioners to report preparer incompetence or unethical behavior. Regulation without enforcement will not solve the problem.

The NAEA told the Board that Circular 230 tax professionals are an important factor for increasing taxpayer compliance and urged the IRS to support practitioners that take the time and effort to certify and maintain their competency, and said that the IRS directly benefits, because without competent tax return preparation, the agency's overall enforcement costs would surge dramatically.

Recruitment, Development, and Retention of a Qualified Workforce is Essential for the IRS in Today's Complex Tax Environment

Stakeholders agree that maintaining a skilled workforce will be critical as the agency deals with major challenges implementing its 2005-2009 Strategic Plan and that it is critical for the IRS to recruit, retain, and train talented personnel. The "graying" of the workforce, complexity of the tax laws, and competitive nature of recruiting are three issues that they believe the IRS needs to confront. However, practitioners also believe that the IRS has an opportunity to create a new agency culture as younger, more technologically skilled employees are hired. Practitioners said that IRS should train employees in people skills, including public relations and marketing, in addition to technical skills, and emphasized the need for language skills to assist non-English speaking taxpayers.

Employees would like to see more opportunities for training, classroom time to network with other employees, and emphasis and time for on-the-job training and mentoring. They told the Board they do not receive adequate training in using computers, or believe they are given enough time to read and comprehend training updates or professional materials. Employees believe that the IRS' ability to collect the taxes owed has been inhibited both by lack of resources and by "old style" mangers unable or unwilling to investigate new ways to meet the enforcement challenge. They see more opportunities to increase teamwork, reduce pending collections, and improve enforcement as new, younger managers replace retiring managers. Employees say that since the Employee Satisfaction Survey began, they have seen improvements in equipment and tools, but have seen little improvement in work-life and family issues. They would like to see the survey occur every two years rather than every year, to give them a chance to asses the impact of their opinions.

NTEU was critical of IRS' planned reduction-in-force associated with the centralization and consolidation of case processing and insolvency work. NTEU believes that IRS' business case assumptions are faulty and that there are few savings when the cost of hiring and training new employees is considered. It also believes it would cost less to re-train current employees into new jobs and that, considering the amount of reorganization the IRS has accomplished in the past few years, every effort should be made to ease the realignment for current employees.

Despite Consolidations, Employees Still Report the Lack of a Sense of One IRS Across Operating and Functional Divisions

Employees told the Board that as the IRS continues to modify its modernized structure they still experience anxiety, disruptions in workflow, and productivity impacts, and feel the agency does not give enough consideration to "employee satisfaction." Some employees believe that continued consolidation of functions hampers communication and teamwork, reduces their ability and authority to address local problems, blurs accountability, and reduces effectiveness.

Employees at the local level report that they miss the sense of community that once existed under the pre-RRA-98 geographical structure. They now say they feel a sense of separation from other employees at their post of duty, who may be with a different division, with different goals, performance measures, and resource allocations. Employees reported fewer group meetings and poor communication of important issues between IRS Headquarters and the field reduced their ability to work as a team and to help each other get the job done in an effective manner.

C. FY2004 IRS Oversight Board Operations

The IRS Oversight Board has completed its fourth year of operation. During this period the Board has engaged in a variety of activities, meeting six times as a full Board, and more times at the committee level. The Board met on the following dates in FY2004:

- December 3-4, 2003
- January 26-27, 2004
- March 10-11, 2004
- May 10-11, 2004
- July 26-27, 2004
- September 22-23, 2004

On January 26, the Board held a public meeting at which it received public presentations from fifteen customer and stakeholder organizations on four topics of strategic interest to the Oversight Board:

- Strategic Planning: Where Is The IRS Headed Over the Next Five Years
- Managing Change: Investment in People Resources
- Achieving the Goal for e-Filed Returns
- Tax Practitioners and Professional Responsibility

Major organizations representing tax practitioners for individuals, small businesses, large businesses; payroll associations, state tax administrators, tax software companies, electronic services industry representatives, low-income taxpayers, and IRS employees were all included in the meeting. The meeting provided the Oversight Board with an excellent opportunity to learn about the IRS' performance from a customer perspective, and the information obtained from this meeting was used throughout the year.

During 2004, the Oversight Board developed three reports to Congress: the Board's 2004 Annual Report to Congress, its report on Electronic Filing, and a special report that presented the Board's recommendations on the FY2005 IRS budget. The first two reports are statutorily required; the report on the FY2005 budget was discretionary on the part of the Oversight Board. The budget report was prepared to present the Board's FY2005 budget recommendations and its rationale for those recommendations.

In May 2004 the Board approved the 2005-2009 IRS Strategic Plan, culminating several months of in-process review of the plan with the IRS. IRS strategic plans are written to cover five years into the future, and are normally updated every three years. The last strategic plan approved by the Board was in January 2001. The IRS has committed to the Board to develop an addendum to the plan in 2005 that sets appropriate quantitative values for the measures in the Strategic Plan.

The Board continued its program of conducting stakeholder outreach to hear independent perspectives of IRS progress from various external stakeholders. In addition to the January public meeting, the Board conducted one of its bi-monthly meetings in Kansas City, Missouri, and included meetings with several groups of taxpayer representatives as part of the two-day meeting. In addition, the Oversight Board had representation at all six Nationwide Tax Forums the IRS conducted during the summer months. At these meetings, each attended by over 2,000 tax professionals, the Oversight Board sought out the opinions of attendees on IRS operations, and conducted small group meetings with both tax professionals and employees to discuss IRS issues with each group. Other strategic issues the Oversight Board evaluated during the year included the IRS employee survey conducted by Gallup, the Earned Income Tax Credit Certification program, enforcement strategies, site consolidation, training in all operating divisions, performance measures, and the use of private collection agencies,

The three committees of the Oversight Board also met periodically in person or by telephone. The Modernization Committee met several times to review in-depth progress of the IRS' Business Systems Modernization program, including such topics as management capability, schedule progress, and needed improvements to the program.

The Performance Management Committee met four times during the year with IRS executives to review progress in meeting performance goals for major IRS operational divisions, in addition to several planning meetings it conducted. Measures of interest included customer and employee satisfaction, quality, and selected productivity goals.

In keeping with the Oversight Board's statutory responsibility to review the selection, evaluation, and compensation of senior IRS executives, the Human Capital Committee conducted a thorough review of the performance commitments of senior IRS executives in the beginning of the fiscal year, followed by a review of the performance evaluations and proposed bonuses for the same executives at the conclusion of the fiscal year.

During FY2004 the Treasury Inspector General for Tax Administration (TIGTA) conducted an audit of the Oversight Board to determine if the Board was fulfilling its duties under the IRS Restructuring and Reform Act of 1998. The TIGTA Report, The Oversight Board Has Achieved Much of Its Original Intent, but There Are Opportunities for Increased Effectiveness, September 2004, Report Number 2004-10-193, can be found at the TIGTA web site, http://www.ustreas.gov/tigta/. In response to the TIGTA report, the Board conducted a self-assessment in December 2004 and reorganized its committee structure into an Operations Committee, Operations Support Committee, and Executive Committee.

In keeping with the RRA 98 requirement to report Oversight Board travel expenses to Congress, the Board incurred $40,099 in travel expenses for Board members and staff in FY2004, primarily for travel to and from Board and Board committee meetings, and to attend the Nationwide Tax Forums.