

IRS Oversight Board Annual Report 2007

March 2008

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Message from the Internal Revenue Service Oversight Board

It is now almost a decade since the enactment of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98) and the IRS Oversight Board is pleased to report that the IRS has made steady progress in meeting the letter and spirit of that landmark legislation.

Over the past nine years, the IRS has reorganized and modernized itself to think strategically and operate with a customer-centric focus. It is becoming a performance-driven, results-oriented organization that provides taxpayers with quality service through a variety of channels, including Internet, telephone, and in-person.

It is doing a better and more efficient job of enforcing the tax laws and collecting the taxes owed the federal government. The IRS has improved its ability to interact with taxpayers electronically and is now delivering benefits to all types of taxpayers. For example, the IRS can now accept electronically many types of returns including all the major tax forms and offers more Internet-based self-service options, such as “Where’s My Refund?” than ever before.

The Oversight Board praises the IRS for this across-the-board improvement. The IRS has demonstrated to its skeptics that it can change for the better. However, it still faces many challenges and must not become complacent. The existence of an annual \$290 billion net tax gap, the difference between what is legally owed and what is actually paid, is a stark reminder that improvements in tax administration are still needed.

The IRS should not settle for good performance—it must set its sights on great performance. In the Board’s view, taking that important step will require increased management focus and “breakthrough” performances in four key areas: (1) taxpayer service, (2) enforcement, (3) human capital, and (4) information technology.

To take taxpayer service to the next level, the IRS must do more than respond to taxpayer inquires. It must understand taxpayers’ needs better through new research and implement education and outreach services tailored to the needs of specific groups of taxpayers. Great service requires that the IRS proactively provides taxpayers with information that helps them easily understand their tax obligations, provides more self-service applications, simplifies information sharing, and facilitates electronic filing. On a limited basis, the IRS has demonstrated that it can form community partnerships that perform effective outreach

to taxpayers, such as the Volunteers Income Tax Assistance (VITA) program. Such programs should be expanded.

Through modern electronic tax administration (ETA) services, the IRS can provide more opportunities for taxpayers and tax professionals to interact quickly, efficiently and accurately with the IRS. Great service will entail a broader use of electronic interactions among taxpayers, practitioners and the IRS, such as account management and the ability to resolve taxpayer issues securely over the Internet, than is offered today. These capabilities are much along the lines of what large financial institutions already offer their customers.

The IRS must apply the results of its research program to increase the effectiveness and efficiency of its enforcement activity. In selecting taxpayers for audits, the IRS should have a high degree of confidence that an audit is necessary. High no-change rates for audits place unnecessary burdens on taxpayers and waste IRS resources. The Oversight Board expects that the IRS will use the results of the National Research Program (NRP) to focus its audit programs where they will be the most effective. Collection cases must also be worked as effectively as possible, based on the optimum assignment of resources for the expected return and impact on compliance.

Today, enforcement is a major part of the IRS' mission but does not dwarf taxpayer service as it did in the 1990s. In this regard, the IRS is to be commended for doing a better job enforcing the tax code in a manner consistent with RRA 98's safeguards. As taxpayer service improved, more resources were appropriately shifted to support enforcement activities. Key performance measures for enforcement are improved and enforcement revenues have increased, while taxpayer service measures such as level of service have remained stable.

Through its annual taxpayer attitude survey, the Board has also found that 94 percent of taxpayers believe it is every American's civic duty to pay their fair share of taxes. Around 86 percent cite personal integrity as a principal factor influencing whether they report and pay their taxes honestly.

The Board encourages the IRS to find ways to leverage this strong support for voluntary tax compliance and personal integrity and reinforce the message that tax compliance is a "social norm," much like obeying laws against shoplifting or drunk driving. The Board is particularly concerned that this message be reinforced with America's young people. The National Society of Tax Professionals (NSTP) is receiving recognition for its "Teaching Taxes to High School Students," which could be an excellent example for the IRS and stakeholders to partner and create similar products and programs aimed at building future compliance.

Another area that must be addressed for the IRS to achieve great performance is workforce development. Employees are the IRS' greatest

asset but the aging of the workforce represents an enormous challenge; approximately 4,000 of its employees are retiring annually. Many of them possess unique skills and institutional knowledge that are not captured when they leave, and the IRS has had difficulty recruiting a sufficient number of skilled employees to replace them.

The IRS must devote more attention to the total career development of its workforce, from hiring to retiring. It should emphasize career development throughout the entire “work life” of employees, starting from the day an employee joins the IRS. It should recruit more like the private sector and employ proven “best practices” to improve employee recruitment, retention, training, and succession planning. Employees should have clearly defined career development opportunities throughout their employment.

More progress must also be made in the IRS’ efforts to modernize its information technology (IT). The IRS has made slow but steady progress in replacing its antiquated IT systems. The most noticeable improvements include electronic filing of tax returns and Internet self-service tools such as “Where’s my Refund.” Infrastructure improvements have also allowed the IRS to improve toll-free telephone level of service through more effective call routing. However, IRS performance is still hampered by archaic data management systems used for central record-keeping that update taxpayer account information on a weekly instead of a daily basis.

The IRS will not be able to achieve great performance until it can update its central records on a daily basis, much like any other modern financial institution. Such a capability is needed to modernize both its taxpayer service and enforcement functions. Daily updating of records will provide current information to taxpayers, tax professionals, and IRS employees, improve IRS efficiency, and reduce taxpayer burden.

It is critical that the IRS make progress each year to reach its three strategic goals. However, it is also vitally important that specific quantitative measures for these long-term goals be set to follow the IRS’ performance in key areas. In March 2007, the Oversight Board approved five long-term measures with target values and requested the IRS to identify an additional set of measures for employee engagement and customer satisfaction, along with a measure to assess progress in modernizing its technology systems. The Board is pleased to see the IRS progress in measuring the achievement of its strategic goals.

In conclusion, the IRS Oversight Board commends the IRS for the progress it continues to make in modernizing itself. The IRS has established a strategic plan that sets goals and objectives and identifies measures to monitor progress. It is transforming itself from a paperbound institution to one where electronic means become the most convenient way of doing business.

Nonetheless, there is room for improvement. The \$290 billion annual net tax gap is cause for alarm in that it is affront to honest taxpayers.

IRS Oversight Board

Given the IRS' resource limitations, an expectation of dramatic progress is unrealistic, but the American taxpayer has a right to expect steady progress. The IRS must also establish an on-going process to regularly measure voluntary compliance to demonstrate that progress in reducing the gap is being achieved.

The IRS' good progress only sets the stage for the next step. The IRS is now challenged to move from "good" to "great." It will not be easy, but the Board believes such a big step forward is both realistic and doable. It will require "breakthrough" performance in key functions. It will require heightened management attention and greater employee engagement throughout the IRS. It will require applying best practices and creative thinking about how to do business in the 21st century tax administration world. It will also require the continued involvement, commitment, and support of the Congress, future Administrations, and the tax administration community to be successful. The end results will be worth the journey and hard work. The IRS Oversight Board stands ready to help in any way it can.

Preface

In June 1997, the National Commission on Restructuring the IRS recommended the creation of an IRS Oversight Board to serve as a new governance and management body that would focus 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 come from “private life” and are appointed for five-year terms by the President 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 the 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 98 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 areas:

- 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 gives the Board specific responsibilities to review and approve strategic plans of the IRS, review IRS operational functions and the selection, evaluation, and compensation of IRS senior executives, and review and approve the budget request of the IRS prepared by the Commissioner.

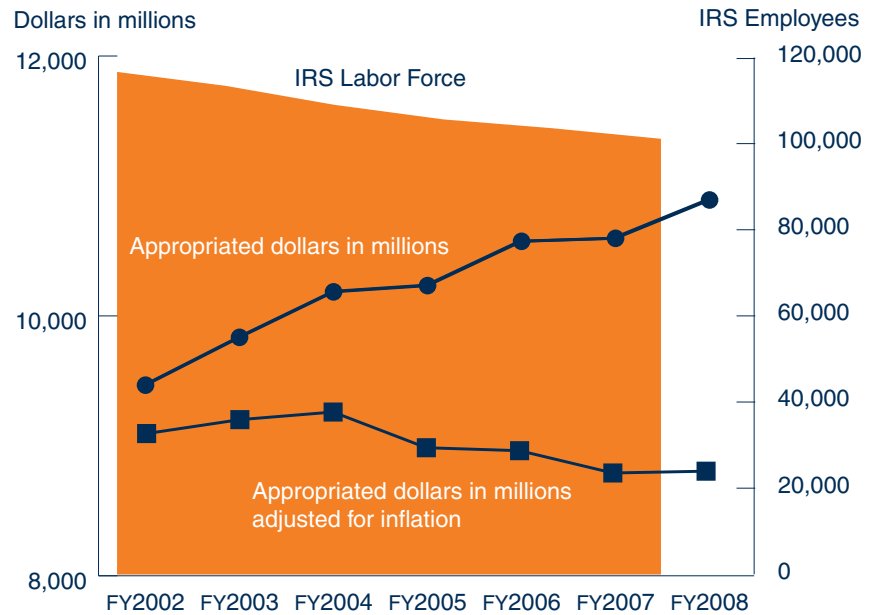
This report satisfies a statutory requirement in RRA 98 for the Board to report annually to the President and Congress. It contains a section on each of the IRS’ three strategic goals and a discussion on measuring strategic goals, followed by the Board’s conclusions.

I. Strategic Goal 1: Improve Taxpayer Service

Doing More With Less

The IRS Oversight Board commends the IRS for the steady progress it has made in delivering quality taxpayer service and improving tax return processing. To its credit, it has done so with declining resources. As shown in Figure 1, when its budget is adjusted for inflation, the IRS has received fewer resources compared to FY2002 and its workforce has shrunk by almost 15,000 employees.

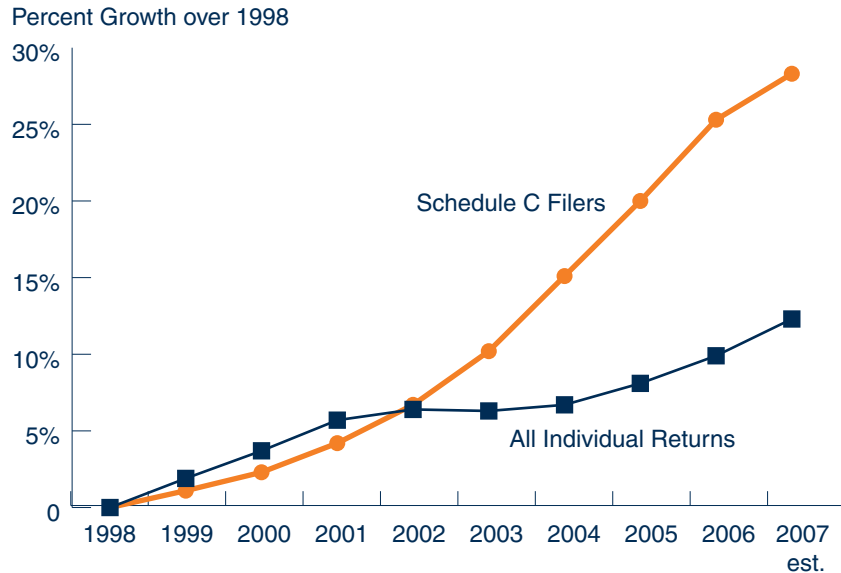
Figure 1: IRS Budget and Employees 2002-2008



Source: IRS and IRS Oversight Board Analysis

By sheer necessity, the IRS has been forced to do more with less. For example, it is estimated that the IRS processed more than 138 million individual tax returns in 2007, about 12 percent more than 1998. However, many of these returns are more complex than a simple Form 1040. Figure 2 shows the growth in more complex Schedule C returns, which has increased over 28 percent from 1998 to 2007, more than double the growth rate of individual tax returns in total.

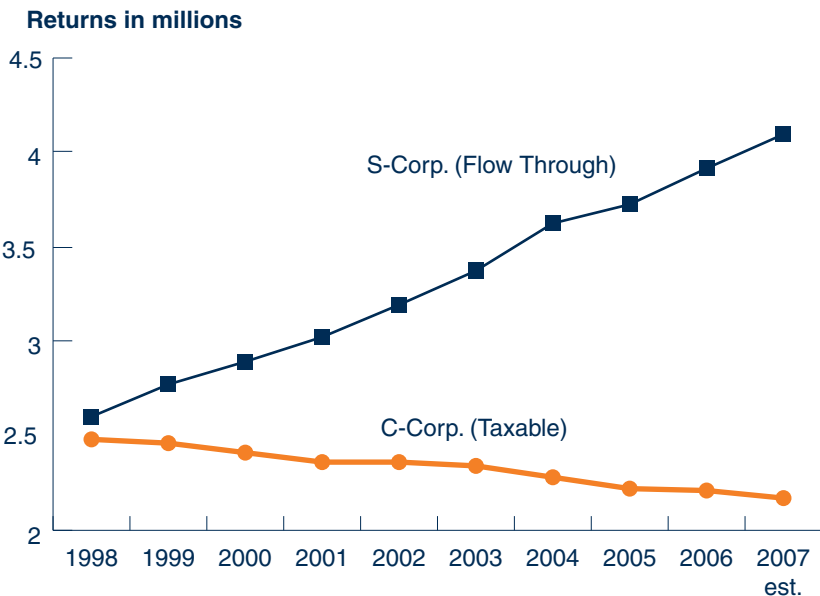
Figure 2: **Yearly Percent Growth in Individual Tax Returns Over 1998**



Source: IRS

Similarly, as shown in Figure 3, over the same period, on the corporate side, the number of flow-through S-Corporation returns has increased 57 percent, while the number of taxable corporation returns filing Forms 1120 and 1120A has actually declined. In fact, flow-through entity returns (both S-Corporation and partnership returns) make up 69 percent of total return filings for large and mid-size businesses with assets over \$10 million.

Figure 3: **Number of Flow-Through (Form 1120S) versus Taxable (Form 1120/1120A) Corporations**



Source: IRS

Stronger growth in individual returns with Schedule C and in flow-through business entities filing Forms 1120S and 1065 pose more complex challenges for the IRS for several reasons. The National Research Program has shown that Schedule C returns filed by self-employed individuals account for well over \$60 billion of the tax gap. Businesses filing Forms 1120S and 1065 require that document matching and examination efforts track the income, deductions and related transactions through to the individual income tax returns.

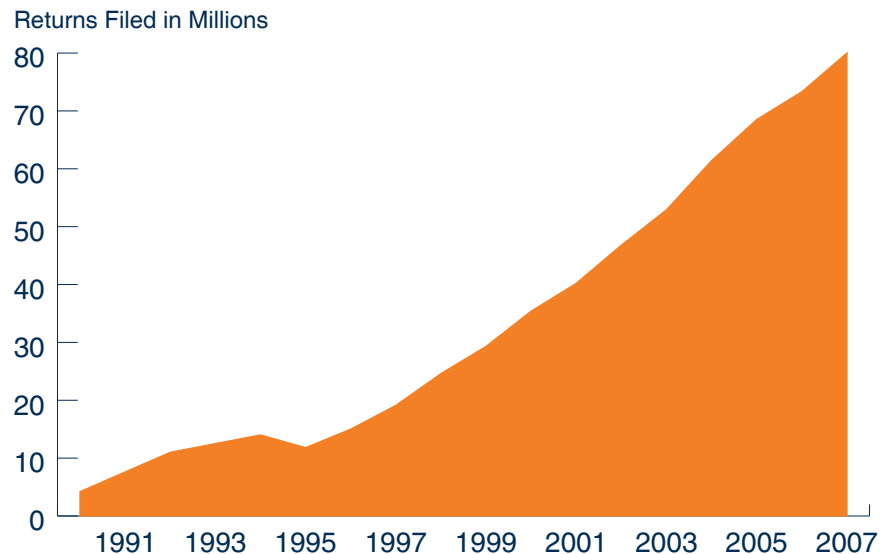
The growth in IRS efficiency is commendable and attributable in part to the growth in electronic filing. However, the Board believes that much work is left to be done, and most of the saved resources should be reinvested in other important tax administration activities.

Performance Improvements

Despite fewer employees and a bigger workload, IRS taxpayer service performance has steadily improved since FY2002. For example, Toll-Free Tax Law Accuracy and Accounts Accuracy are at 91 percent and 93 percent respectively in FY2007, as compared to 84.4 percent and 90 percent five years ago. Of particular note, overall customer satisfaction with IRS Toll-Free Service has held steady at 94 percent for four consecutive years. Such stability is most welcome and a good indicator that best practices have taken root.

The IRS has improved service by setting goals, measuring performance, reengineering processes, and developing modernized applications that take advantage of information technology, such as “Where’s My Refund” and other Internet-based functions. The Board would particularly like to highlight the IRS’ progress in individual electronic-filing, which has reached 80 million in 2007 as shown in Figure 4.

Figure 4: **Individual Returns Filed Electronically, 1990-2007**



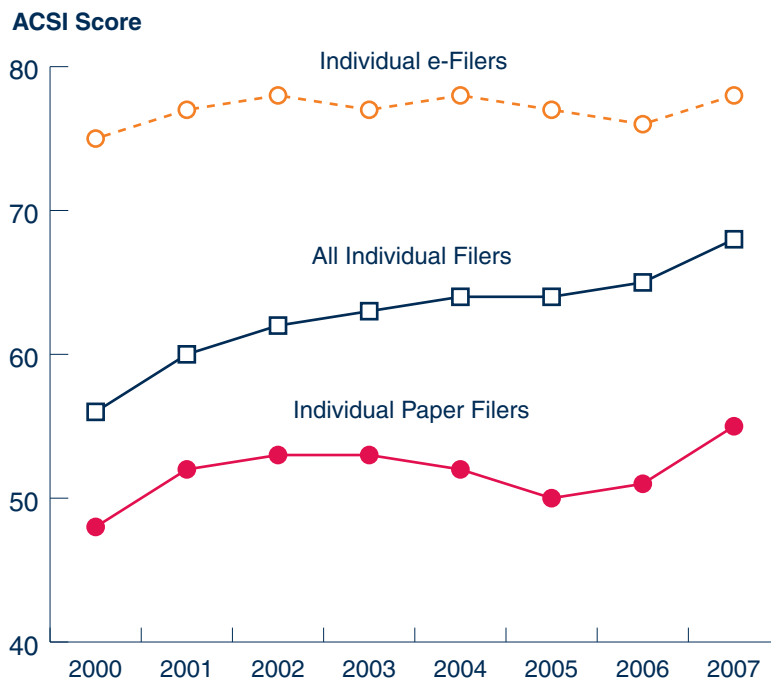
Source: IRS

Progress was not limited to individual taxpayers; business taxpayers are increasing their use of e-File, as well. The IRS announced in October 2007 that more than 800,000 of the nation's small businesses and corporations had electronically filed their corporation income tax returns, a 60 percent increase from 2006. In total, over 8 million business and tax exempt organization tax returns were filed electronically in 2007.

Customer Satisfaction Upward Trend

One customer-centric measure of the IRS' progress in delivering quality service is the American Customer Satisfaction Index (ACSI). For 2007, the ACSI score for individual electronic filers stood at 78 compared to 55 for paper filers, as shown in Figure 5. The satisfaction with e-File ranks on a par with customer satisfaction with most commercial banks and actually exceeds some of the best known national financial institutions, based on the ACSI results. As noted by Professor Claes Fornell, Director, National Quality Research Center, at the University of Michigan, "The upward trend for [all individual] tax filer satisfaction is attributable to an ever increasing number of filers turning away from the less satisfying paper methods to the vastly more satisfying electronic format."¹

Figure 5: **IRS American Customer Satisfaction Index Scores for Individual Income Tax Filers**



Source: www.theacsi.org

Integrity and Service are Both Needed to Boost Voluntary Compliance

Our system of tax administration is based on the premise that taxpayers will self-assess their tax obligations, file their taxes honestly, and pay what they owe on their own initiative. For taxpayers to achieve higher levels of tax compliance voluntarily, they must first regard tax compliance as an expected social norm, an obligation they are expected to meet. Secondly, taxpayers must have the information available to them to make their tax obligations easy to understand and fulfill.

The IRS does little to stress the need for integrity in the self-assessment process, yet the Oversight Board's annual taxpayer attitude survey found strong support for personal integrity as a principal factor in paying taxes honestly. The survey found that 86 percent of respondents cite personal integrity as a principal factor influencing whether they report and pay their taxes honestly.

The IRS needs to find ways to leverage this strong support of voluntary compliance as a critical civic duty. It must remind taxpayers that tax compliance is a "social norm" expected of every taxpayer, much like obeying laws against shoplifting or drunk driving, and that noncompliance with taxes hurts our great nation. Such campaigns can have a long-term effect on public opinion, such as that waged by Mothers Against Drunk Driving to reduce the number of alcohol-related traffic fatalities. In a similar vein, the Motion Picture Association of America created an aggressive campaign that equaled downloading music or movies illegally with stealing.

The Board is particularly concerned that the tax compliance message be reinforced with America's young people. All members of the tax administration community can help disseminate this message. For example, the National Society of Tax Professionals (NSTP) is receiving high marks for its "Teaching Taxes to High School Students." This presentation could be an excellent candidate for the IRS and NSTP to partner and create a similar product on the national level.

With high compliancy established as a social norm, excellent service makes it easier for the vast majority of taxpayers who wish to meet their tax obligations honestly to be compliant. Providing clear and easily accessible instructions and establishing convenient methods of engaging in transactions with the IRS can all influence compliance in a positive way. Providing this degree of service will require the IRS to expand its education and outreach to taxpayers in new ways.

An Expanded View of Taxpayer Service

The IRS should now build on this foundation and take taxpayer service to the next level. Generally, the performance level of IRS taxpayer service today has been stable, and dramatic improvements, especially in its toll-free telephone operations, are not foreseen. As a result, a more pressing challenge is to deliver more extensive electronic self-assistance

tools and to perform research that identifies innovative ways to expand taxpayer education and outreach to all taxpayer segments, especially those who are now under served.

To a large degree, many of the IRS' service activities are designed to respond to taxpayer inquiries. Examples include toll-free telephone service and Taxpayer Assistance Centers. Overall, the IRS has done a good job answering questions, whether via toll-free telephone, the Internet, or in person at Taxpayer Assistance Centers.

The IRS expends considerably fewer resources on education and outreach services. A broader approach to customer service would entail giving taxpayers access to self-service applications so they could “pull” specific information on accounts or tax law, and “push” answers, information and updates to taxpayers, practitioners and other affected parties as the need for such information became apparent.

Lastly, the IRS must seize opportunities to provide innovative outreach, education and community partnerships. For example, given limited resources and elimination of programs such as TeleFile, the IRS must also work to broaden and strengthen partnerships, such as Volunteers Income Tax Assistance (VITA).

Understand Taxpayers Better

To take service to the next level, the IRS must better understand the needs and expectations of the taxpayers it serves. The IRS must conduct more insightful research, and based on this analysis, develop services better customized to the specific needs of particular taxpayer segments.

The Oversight Board's *Taxpayer Customer Service and Channel Preference Survey*² revealed a much more nuanced taxpayer base than previously known. Non-demographic traits, such as personal finance preferences, behaviors and attitudes were often the very factors that motivated and led taxpayers to look at IRS products and services differently and make their ultimate choices. More of this type of research is critical if, for example, the IRS is to migrate reluctant paper filers to e-File, or improve tax compliance through improved taxpayer service.

By better understanding taxpayers, the IRS can focus both its service and enforcement efforts to increase compliance through targeted pre-filing, filing, and post-filing efforts. The IRS must find out what kind of information and assistance taxpayers need and the most effective ways of delivering that information to them.

The Treasury Department's report, *A Comprehensive Strategy for Reducing the Tax Gap*, also recommended that the IRS make a multi-year commitment to research, including examining the linkages between taxpayer services and compliance:

Research would provide a better understanding between taxpayer burdens and compliance and the impact of taxpayer service on voluntary compliance, two areas where there has been limited work to date. Understanding the link between taxpayer service and voluntary compliance could help the IRS better target taxpayer services as well as develop programs that would both ease taxpayer burden and improve voluntary compliance.³

The Board was particularly pleased that additional research funding was part of the IRS' FY2008 appropriation. The additional funding will provide the resources to better understand the role of taxpayer service on compliance. The research will focus on four areas:

1. Meeting taxpayer needs by providing the right channel of communication;
2. Better understanding of taxpayer burden;
3. Understanding taxpayer needs through the errors they make; and
4. Researching the effect of service on overall levels of voluntary compliance.

Protect Taxpayer Privacy

High quality taxpayer service also means protecting personal taxpayer data. Privacy continues to be a major concern for taxpayers. The Board's *Taxpayer Customer Service and Channel Preference Survey* revealed that taxpayers are not confident their privacy is being protected in cyberspace, with 73 percent agreeing they "don't feel secure sharing personal financial information over the Internet." Although e-File has an excellent record when it comes to data breaches, those most concerned about privacy—almost 20 percent of those polled—are the least likely to e-File.

The IRS new Office of Privacy, Information Protection and Data Security is addressing privacy concerns in the short- and long-term through its two principal programs: (1) improving public, preparer and external stakeholder awareness of privacy policies, procedures, and general information; and (2) improving the IRS' response to taxpayers and practitioners who fall victim to data loss incidents, identity theft or online fraud. Some of its 2008 activities include developing and maintaining internal and external web sites to provide for better outreach and awareness of privacy topics.

The Taxpayer Assistance Blueprint: A Vision of Service

The IRS has defined its vision of taxpayer service for the future in the Taxpayer Assistance Blueprint (TAB). This vision entails a much broader use of electronic interactions among taxpayers, practitioners and the IRS, such as account management and the ability to resolve taxpayer issues securely over the Internet.

The TAB describes an IRS that is an “interactive and fully integrated, online tax administration Agency” with the capability “for any exchange or transaction that occurs face-to-face, over the phone, or in writing to be completed electronically.”

These types of services are much along the lines of what customers of large financial institutions already experience today but are still for the most part unavailable to taxpayers. The TAB acknowledges the challenges that the IRS faces:

As technology continues to advance, taxpayers expect the government to keep pace. The IRS currently provides electronic services and continues to modernize vast information systems. However, the electronic services offered by the IRS are limited relative to those available in the wider marketplace. Acknowledging these strategic challenges enhances the ability of the IRS to better position its service resources.⁴

As part of its Service Improvement Portfolio, the TAB has now provided a road map to that future vision. Its recommended initiatives address critical areas and gaps, such as service governance, end-to-end portal and application monitoring, Web site design and usability, online support tools, publication search capability, and authentication for account-related tools.

The vision of great taxpayer service is clear, but the IRS must execute the five year strategic plan articulated in the TAB to improve service beyond what is familiar and available today.

Achieving the Next Level of IRS Taxpayer Service

In 2006, the Department of Treasury outlined seven key components of a comprehensive, multi-year strategy to reduce the tax gap, including: Improve Compliance Activities, Enhance Taxpayer Service, and Coordinate with Partners and Stakeholders. The Oversight Board believes that this is a sound and reasoned approach. Aligning service, enforcement, and partnership functions around the common goal of improving taxpayer compliance can go a long way towards improving overall performance and taking IRS taxpayer service to the next level. However, it is now up to the IRS to implement these strategies.

The IRS must provide taxpayers with easy-to-understand information to meet their tax obligations. It must find ways to leverage taxpayers' strong support of voluntary compliance to reinforce the message that tax compliance is a social norm and a matter of personal integrity. The IRS must use better research and targeted investments to effectively and efficiently enforce our tax laws. Moreover, given current and projected budget constraints, the IRS must forge and foster community partnerships, such as the VITA program, that provide outreach and assistance to low-income, elderly and other under-served taxpayers.

In 2007, the Board had the opportunity to see firsthand two models of what the IRS can do to help meet this goal.

Atlanta

Model: Leverage Taxpayer Service Resources

Board members visited a VITA site located at a downtown facility owned and run by the Atlanta Workforce Development Agency (AWDA). In addition to hosting VITA, it houses a number of organizations and agencies offering an integrated set of services to city residents, including free workforce readiness courses, job fairs, GED courses, computer training, financial management, childcare, military enlistment, and counseling. The site is operated year-round, and provides VITA volunteers an opportunity to encourage and help those who visit AWDA to file and pay their taxes. The Board recognizes this is an excellent model and best practice that the IRS could use in other parts of the country.

Salt Lake City

Model: Effective Partnerships with Community Service Groups for Taxpayer Outreach

The Board Chair met with the Salt Lake Regional Coordinator for the Utah Community Action Partnership Association regarding the VITA program and IRS efforts to help those potentially eligible for the Earned Income Tax Credit (EITC). IRS employees reach out and support community groups focused on volunteer income tax return preparation and outreach and education for low-income and elderly taxpayers. In Salt Lake City, one such community group is GAIN (Growing Assets and Income Now), which includes local banks, Utah State University, the Salt Lake County government, the Utah Department of Workforce Services, the IRS, and other community action partnership associations and community service volunteer organizations. The coalition assists taxpayers in filing their returns and claiming EITC and other tax credits. They also help taxpayers save and manage their money and resolve problems arising from past non-filing or non-compliance.

II. Strategic Goal 2: Enhance Enforcement of the Tax Law

Tax Gap Still Takes Center Stage

One of the greatest and most persistent problems confronting the IRS today is the \$290 billion annual net tax gap—the difference between what is legally owed and what is actually paid. In 2007, it continued to grab the attention of the tax administration community much like it had in 2006. The tax gap was the subject of congressional hearings as well as the Board's 2007 public meeting, at which representatives from 14 organizations in the tax community as well as GAO and TIGTA explored with the Board different approaches to reducing the tax gap. Senate Finance Committee Chairman Max Baucus commented:

*One group alone can't reduce the gap. It will require the efforts of everyone who is a part of tax administration, including taxpayers, tax professionals, the IRS, Treasury, the Administration and the Congress. It will require people like you who care about fair, efficient and effective tax administration. ... Although it is not realistic to think the tax gap can be eliminated completely, no longer can we afford to throw up our hands and say it is impossible to do anything to improve tax compliance. It is possible and it must be done.*⁵

The imperative for closing the tax gap has never been greater. Today, important programs and initiatives must compete for scarce federal dollars. An annual net tax gap of \$290 billion averages to about \$2,200 per individual tax return, an enormous burden for the average taxpayer, and one that should not be tolerated by honest taxpayers. It is far too large to be dismissed lightly—it imposes a large burden on all taxpayers and undermines respect for tax administration.

There is no question reducing the tax gap will be difficult. Over the past two years, there has been a growing consensus in the tax administration community that there is no one solution to closing the tax gap. Rather, a multi-faceted approach that addresses the multiple causes of non-compliance is needed to make any meaningful progress.

In testimony before the Senate Finance Committee in 2006, the IRS Oversight Board suggested that reducing the tax gap would require a comprehensive set of strategies with aggressive action on many fronts—from a simpler tax code and more complete income reporting to better enforcement and quality customer service. Similar views were also expressed by the GAO and TIGTA. The Treasury Department released its tax gap strategy in late 2006 which included many of these same recommendations, and in 2007 issued a report built on the strategy that

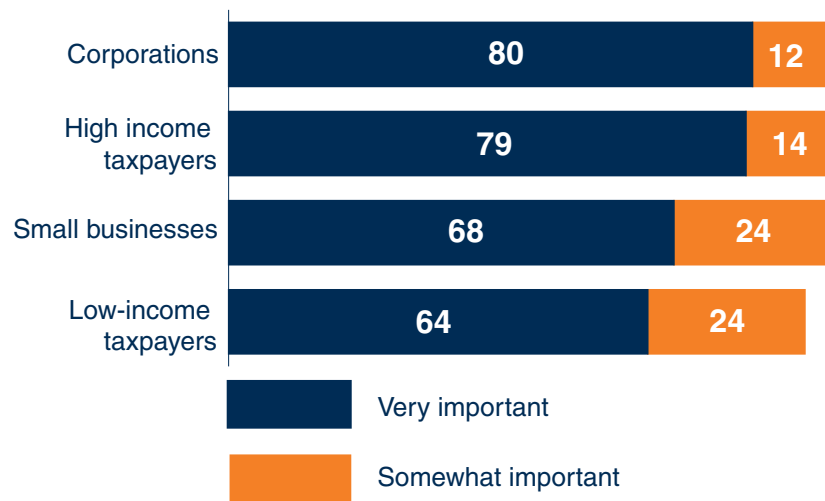
described the steps the IRS is and will be taking to increase voluntary compliance and reduce the tax gap.⁶

Most recently, the Administration stated in its FY2008 Congressional Budget Submission that the IRS will focus its efforts on implementing Treasury's strategy. The Board believes it is critical that policy makers now take definitive action on these suggestions lest the tax gap continue to grow.

Taxpayers Expect Vigorous Enforcement

Despite the complexity of the tax code, at the most fundamental level taxpayers want to know that the tax laws are being fairly enforced. The vast majority of taxpayers play by the rules and have no sympathy for those who knowingly cheat and place an extra burden on them. As shown in Figure 6, the Board's 2007 *Annual Taxpayer Attitude Survey* found that 94 percent of American adults agree that it is every American's civic duty to pay their fair share of taxes, and 89 percent of those surveyed agreed that "everyone who cheats on their taxes should be held responsible." Similar numbers felt it was important that the IRS ensure that all taxpayers pay what they owe and leave no stone unturned when it comes to those who flout the law.

Figure 6: **How Important Is It To You That the IRS Ensure These Groups of Taxpayers Report and Pay What They Owe?**



Source: IRS Oversight Board 2007 Taxpayer Attitude Survey

Vigorous enforcement provides the means to correct the behavior of those taxpayers who intentionally or unintentionally are non-compliant with the tax law. Enforcement can take many forms, from soft letters on one hand to criminal prosecution on the other hand.

A Strong Enforcement Trend

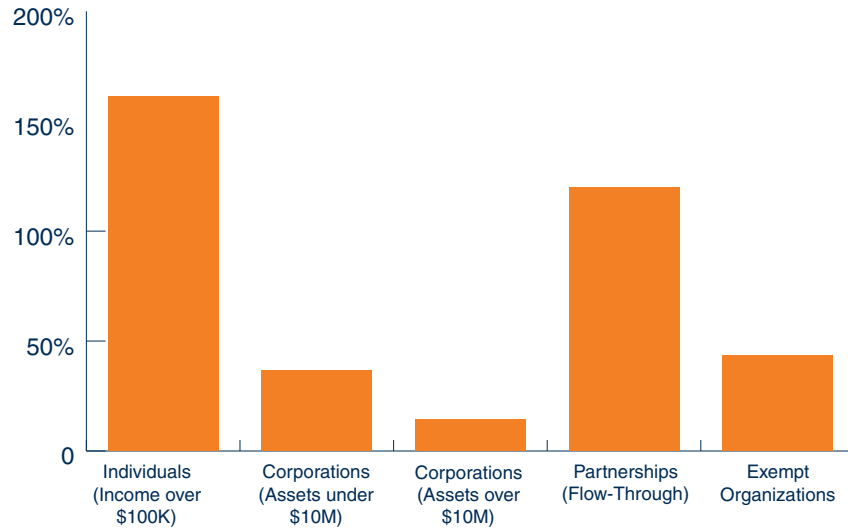
The Board believes the positive trend in enforcement activity and revenue collection over the past five years reflects meaningful IRS actions to combat the tax gap. The challenge for the IRS is to maintain this upward trend. The IRS has shifted some resources from service to enforcement to increase its enforcement activity, but the Board sees limited opportunity to further this trend without reducing taxpayer service.

The positive trend in enforcement activity crosses all taxpayer segments, including individuals, small businesses, and corporations of all types and sizes, as shown in Figure 7. From FY2002 to FY2007, the following increased activity was achieved:

- Audits of high-income taxpayers (income over \$100,000) nearly tripled—from a little over 100,000 to 293,000.
- Audits of small corporations (those with assets under \$10 million) grew from slightly under 15,000 to more than 20,000—about a one-third increase.
- Audits of flow-through partnership returns increased approximately 120 percent—from around 5,500 to nearly 12,200.
- Audits of the largest corporations (those over \$10 million in assets) rose from about 8,400 in FY2002 to over 9,600 in FY2007—over 14 percent.
- Automated Underreporter (AUR) contact closures in 2007 (unrelated to the earned income tax credit) were over 2 million—up about 28 percent from 2002.
- The number of Tax Exempt Organization returns examined increased over 43 percent—from nearly 5,300 in 2002 to approximately 7,600 in 2007.
- The number of levies by the Collection function nearly tripled—from just under 1.3 million in 2002 to nearly 3.8 million in 2007.
- The number of prosecutions recommended by the Criminal Investigation unit rose around 44 percent from just under 1,000 in 2002 to slightly over 1,400 in 2007.

In addition, since the Disclosure Initiative in December 2001, which provided taxpayers with a 120-day opportunity period to voluntarily disclose their participation in tax shelters, the IRS has continued to devote examination resources to tax shelter cases. The IRS has closed around 2,800 tax shelter returns in FY2007, and has seen a corresponding rise in the recommended assessments per staff hour on these cases from around \$7,200 in FY2002 to \$17,300 in FY2007.

Figure 7: **Percent Growth in Audits from 2002 to 2007 for Selected Taxpayer Segments**

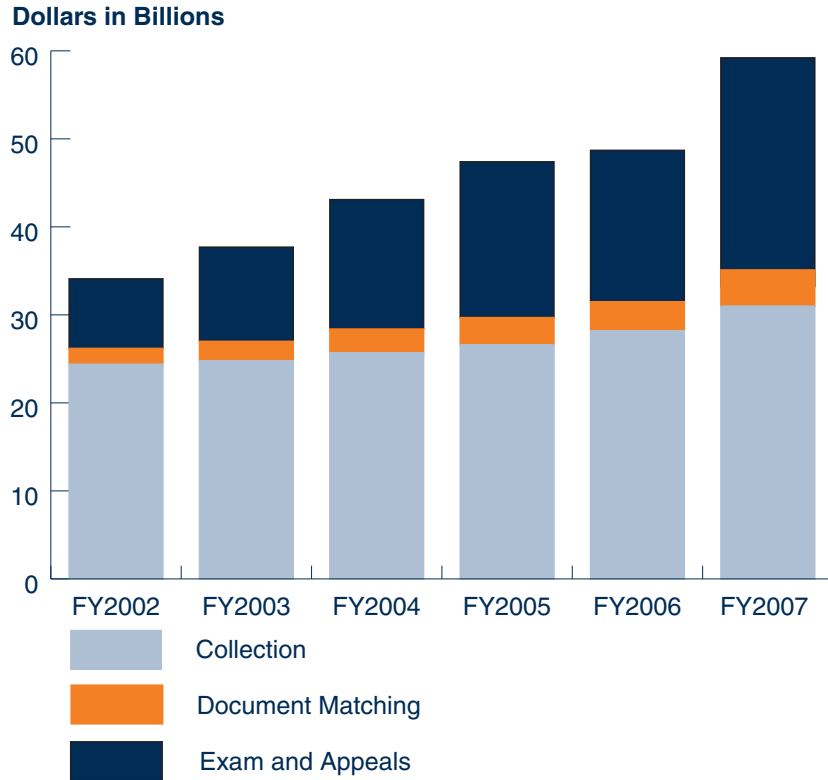


Source: IRS

The overall effect of increased enforcement activity is noticeable—enforcement revenue has increased from \$34.1 billion in FY2002 to \$59.2 billion in FY2007, a gain of nearly 74 percent, as shown in Figure 8. The IRS estimates that it can produce more than a four-to-one return on every dollar invested in additional enforcement resources, a fact that the Board believes warrants the appropriation of additional enforcement funding.⁷

By using performance targets to track progress for both taxpayer service and enforcement, the IRS has been able to maintain a balanced approach to both functions. Although enforcement resources have grown in the last several years, the IRS has stabilized taxpayer service performance at acceptable levels, thus allowing the transfer of resources from service to enforcement. Today, enforcement is a major part of the IRS' mission but does not dwarf taxpayer service as it did in the 1990s. In this regard, the IRS is to be commended for doing a better job enforcing the tax code in a manner consistent with RRA 98's safeguards.

Figure 8: **Enforcement Revenue: Collection, Document Matching, Exam and Appeals 2002-2007**



Source: IRS

Achieving the Next Level of IRS Enforcement: Making Systemic Changes

While the Board applauds these gains in productivity, it has become clear that the IRS cannot “audit its way out” of the tax gap. Even a large infusion of resources for more enforcement personnel—something highly unlikely—would not eliminate the tax gap.

Although the Oversight Board has recommended additional enforcement resources, taking enforcement to the next level requires more. Adding resources does produce a positive return on investment and results in short-term benefits, but more systemic long-range solutions are needed so that the IRS can make the most effective use of its enforcement resources.

The Oversight Board, in making its budget recommendations for FY2007 and FY2008, has identified additional research and information technology modernization as two of the highest priorities for the IRS. This recommendation was made by the Board in recognition of the long-term impact that research and technology modernization will have on the IRS’ ability to work smarter and more efficiently to reduce the tax gap.

Performing and Applying Research

Today, there is a better understanding of what constitutes the tax gap. Using the findings of the IRS' National Research Program, the Department of Treasury describes three key characteristics:

- *Over 70 percent of the gross tax gap [\$345 billion] is attributable to the individual income tax, which is the largest single source of Federal receipts.*
- *Over 80 percent of the gross tax gap is caused by underreporting of tax (i.e., by underreporting income or overstating deductions and credits), with roughly half of this amount (including self-employment tax) attributable to underreporting of net business income by individuals. Eighteen percent of the gross tax gap is attributable to underpayments of taxes or failure to file tax returns.*
- *Non-compliance is highest among taxpayers whose income is not subject to third-party information reporting or withholding requirements.⁸*

The Board believes that any changes in the IRS' enforcement strategy and/or new legislative initiatives must be based on solid research and a clear understanding of the root causes of non-compliance and measurable expectations.

The Oversight Board is pleased that the IRS' FY2008 budget includes funding for additional research, as it had recommended. Without ongoing compliance studies beyond the current NRP effort, the IRS will be forced to rely on stale or even non-existent data, which will result in serious consequences for compliance and the tax administration system. For example, the IRS was caught off guard when abusive tax shelters began to proliferate in the early 2000s. It had not detected the emerging trend and was forced to play catch-up for several years.

Without good research, the IRS had little information about the compliance behavior of taxpayer segments that were undergoing enormous growth, such as individuals with incomes in excess of \$100,000, partnerships, and S-Corporations. The Treasury Department observes:

Without up-to-date studies in all areas, the IRS is hampered in its ability to respond rapidly to emerging vulnerabilities in the tax system. A multi-year commitment to research would ensure that the IRS can efficiently target its resources and effectively respond to new sources of non-compliance as they emerge.⁹

However, to be effective, research results must be more than compiled, they must be applied to increase the effectiveness and efficiency of the IRS' enforcement program. For example, in selecting taxpayers for audits, the IRS should have a high degree of confidence that an audit is

necessary. High no-change rates for audits place unnecessary burdens on taxpayers and waste IRS resources. The Oversight Board expects that the IRS will use the results of the NRP to focus its audit programs where they will be the most effective in increasing overall voluntary compliance. Collection cases must also be worked as effectively as possible, based on the optimum assignment of resources for the expected return and impact on compliance.

Applying IT Solutions to Enforcement

It is not just IRS taxpayer service that can benefit from IT modernization, so can the IRS' enforcement programs. In fact enforcement faces many of the very same problems brought on by an aging and fragmented IT base.

Examination, Collection and Criminal Investigation must also wrestle with the Master Files—a series of very large sequential files developed in the 1960s which can only be updated weekly, and can sometimes take up to two weeks before changes take effect. To make matters worse, stovepiped computer systems' data must be reconciled. This creates enormous inefficiencies and taxpayer burden, such as the generation of erroneous notices.

It cannot be stressed enough that a unified approach is needed for selecting IT investments. These investments must be part of a larger portfolio, not simply a collection of individual projects. The IRS *IT Modernization Vision and Strategy (MV&S)* takes exactly such an approach for the three "business domains" that constitute enforcement: Reporting Compliance, Filing & Payment Compliance and Criminal Investigation. For each, it identifies opportunities, expected business outcomes, and potential future projects and programs that support them.

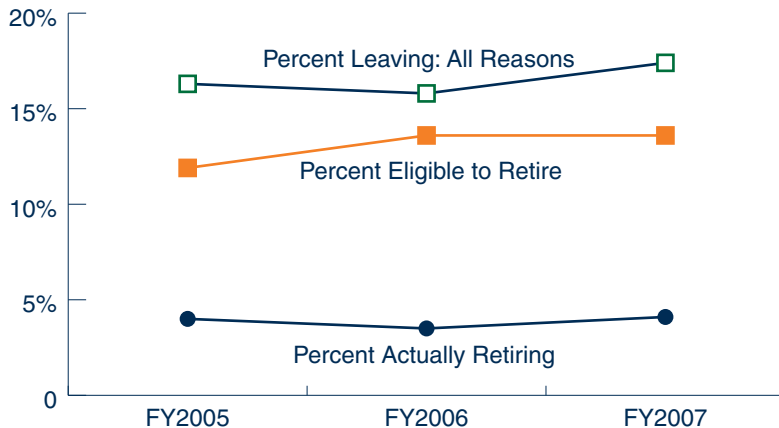
III. Strategic Goal 3: Modernize the IRS Through Its People, Processes and Technology

The State of IRS Human Capital

The IRS Oversight Board remains deeply concerned about the state of IRS human capital. Notwithstanding the great need for modern technology, the IRS ultimately relies on a very talented, skilled, knowledgeable and dedicated workforce to accomplish its mission at a high level. This talented workforce cannot be taken for granted.

As the Board has stated in previous reports, human capital is the IRS' greatest asset but is also its greatest challenge. The warning signs have been evident for a number of years. The IRS has a graying workforce; approximately 4,000 employees retire annually (around four percent of its workforce) and more than 14,000 (nearly 14 percent) are eligible to exercise that option at any time, as shown in Figure 9. The IRS is not just losing employees (around 16 percent, per year, combining all reasons); many of these individuals possess skills and institutional knowledge that are extremely difficult to replace.

Figure 9: **Attrition and Retirement Eligibility in IRS Workforce, 2005-2007**



Source: IRS

In the summer of 2007, the Board met with IRS employees at the six IRS Nationwide Tax Forums and they too were concerned about the growing number of retirements and resignations, especially those they called the “problem solvers” and “mentors” of the workplace. The IRS senior leadership team has taken notice as well.

The IRS' Human Capital Office reports that while overall retirements are continuing to occur at a consistent rate, the attrition rate of newly hired mission critical (MCO) employees has begun to increase over the past three years. For MCOs hired in FY2002, attrition after the first year was 8.8 percent; for those hired in FY2006, the first year attrition rate had risen to 15.6 percent. Mission critical employees include Revenue Agents and Revenue Officers, and the Human Capital Office is monitoring the trend through exit interviews, targeted recruitment incentives, and continued analysis of workforce drivers.

LMSB Commissioner told the Board that one of the division's strategic challenges is an increasingly retirement-eligible workforce:

The aging workforce, dwindling internal sources for recruitment, and the need for differing skills to understand complex tax issues prevalent in the evolving taxpayer organization increases risk for the LMSB organization.¹⁰

The Board believes—and the IRS concurs—maintaining and growing long-term workforce skills during this period of change must be addressed in a strategic manner. This will be beneficial to both the IRS and its employees.

However, despite these strategic challenges, the Oversight Board notes one very positive development regarding the 2007 IRS employee satisfaction survey. Sixty-four percent of employees participated in the survey, a more than 50 percent gain over last year's participation rate. The Board compliments both the IRS and National Treasury Employees Union's leadership in producing such a dramatic turnaround in participation.

There was also an improvement in employee engagement with 69 percent of all employees expressing strong job satisfaction. Nonetheless, the Board sees the opportunity for an even more dramatic boost.

Recruit Like the Private Sector

If the IRS is to replace its retirees with skilled individuals, it must change its recruitment strategies and tactics. One telling assessment of the IRS' recruitment efforts came from some of its own managers and employees who spoke with the Board at the six Nationwide Tax Forums in 2007. They told the Board that the IRS must cast a wider net in its recruitment efforts and do a better job attracting additional numbers of young, recently-graduated recruits. They observed that the standard recruitment messages of employment stability, service to country and excellent health benefits are geared more to an older audience and may not be as appealing to younger applicants who are seeking new experiences, career opportunities, training, and travel.

Moreover, employees questioned whether the IRS is effectively using available incentives such as recruitment bonuses and student debt relief. The employees said that some potential employees decline a position offered to them because the salary or incentives are insufficient to meet their needs, a key factor in high-cost areas. However, it should be noted that the IRS often lacks adequate funding for recruitment/retention bonuses and student loan repayments.

Federal regulations regarding recruitment can often lead to a lengthy and tedious hiring process. For example, a private sector recruiter at a job fair can often make an on-the-spot offer to a potential employee. Federal recruiters are not allowed to hire candidates on the spot and can lose talented applicants because of it. One IRS manager told the Board that it took almost a year to hire one new employee. Recent hires also described long periods of time without any contact from the IRS after applying for jobs; they did not know whether they were still under consideration for the post. The implications are obvious – many promising potential employees go elsewhere.

The IRS has made some improvements to its recruitment programs, such as a multi-media advertising and marketing plan for FY2007. However, the Board notes that the IRS has no measures to evaluate the results and thereby gauge the plan's effectiveness. The IRS is also attempting to streamline the hiring process including new on-line assessments for mission critical occupations, such as Revenue Officer, but lengthy background checks remain a barrier. The IRS is also authorized to increase the rate of annual leave accrual to attract an applicant who will help meet mission goals.

Make Employee Career Development a Focal Point

Both managers and employees who met with the Board were frustrated by the ill-defined and confusing career paths that exist today at the IRS. Many felt that the current organizational structure creates impediments to advancement by making it difficult to move from one operating division to another. Managers were often uncertain about the best career advice to give. The Oversight Board has recommended that the IRS monitor the attrition rate of new employees to obtain a better understanding of the problem.

Clearly, IRS employees and prospective employees need to have a positive attitude towards their career expectations at the IRS. Employees must experience in tangible ways that they have a career at the IRS—not just a job. This career path must be better defined—from hire to retire. The hiring barriers between divisions must be addressed. And there must be better mentoring and training of new employees.

Figure 10: **Career Development Should Touch All Areas of an Employee’s Work Life**



The employees who met with the Board suggested that the IRS return to “bridge positions” that allow lower-graded employees to take on more responsibilities and explore other functions in the IRS that could lead to higher-graded positions. They also said that the IRS seldom details employees to other parts of the agency, making it difficult to learn about other jobs in other parts of the IRS. They proposed that the IRS look into developing coordinated strategies for various career advancement paths that have cross-functional movement as part of job progression.

Train and Retain Talent

The IRS is not only confronting challenges when it comes to recruiting qualified individuals; it is having trouble retaining them. Attrition of employees in their first year of employment has risen during the last several years. The best recruitment efforts lose their effectiveness if employees leave after a few years or if skills and knowledge get stale without adequate refresher training.

From the Board’s discussion with employees, managers, and the IRS leadership team, the problems with training and retention are coming into sharper focus. For younger employees, particularly those in the lower grades, the lack of a career development path, inadequate training and insufficient mentoring are some of the more prominent issues.

Other employees expressed the need for quality classroom training where they can discuss actual situations with experienced employees. They also stressed the benefits of working in the field with a seasoned employee. And almost all emphasized the need for more mentoring programs to help groom new employees and managers.

Boost Engagement at Every Level

The Oversight Board has asked the Human Capital Office to develop creative, effective approaches to boost workforce engagement. These must include many of the strategies previously described such as better training, mentoring and a clear view of career advancement and development.

Consider Best Practices

The Board further recommends that the IRS look to the private sector, such as the Big Four accounting firms, for best practices and tools for attracting and retaining talented employees. Like the IRS, people are the Big Four's greatest asset and they too want to recruit and retain the best and brightest. *The Economist* reports:

Time is regularly set aside at the highest levels to chew over how best to do this. Detailed goals are set: Deloitte's 2010 business plan includes targets for staff turnover, the scores it seeks in its annual staff survey and the proportion of female managers it would like to have. Partners are increasingly measured and rewarded as managers of people, not just for the amount of money they bring in. People-related items account for one-third of the scorecard used to evaluate partners at PwC. KPMG's British firm has introduced time codes so that employees can account for how long they spend dealing with staff matters. The idea is that those who devote lots of time to people-related matters are not disadvantaged as a result in pay raises and promotions.¹¹

In seeking ways to fill its human capital and knowledge/skills gaps, the IRS should also examine ways in which retired IRS employees could fill key training and mentoring roles within their former organizations. Writing in the IBM publication, *The Business of Government*, John Hopkins University Professor Jay Liebowitz suggests:

Knowledge held by federal retirees could be shared and leveraged in a number of key ways to help the federal government address its human capital concerns. Knowledge retention programs, mentoring activities and knowledge sharing forums with retirees and current government employees are examples of activities that could help the government deal with the anticipated knowledge drain.¹²

There is one last area that bears examination: succession planning and leadership development. These are not separate issues, but as Jay A. Conger and Robert Fuller write in the *Harvard Business Review*, two sides of the same coin. Their research found that companies that have developed deep and lasting "bench strength" did so by approaching succession planning as more than merely updating a list:

Indeed, they've combined two practices—succession planning and leadership development—to create a long-term process for managing the talent roster across their organizations... [The practices] share a common goal: getting the right skills in the right place.¹³

Succession planning becomes easier with a fully engaged, highly-trained workforce. Candidates with a wide range of experiences are available to step up to the next level as attrition occurs at the top and works its way down. Nonetheless, the IRS needs to integrate succession planning into its overall career development strategy to be ready to replace experienced problem solvers and mentors who leave. Developing human capital at the IRS must be everyone's business and the Board has asked the IRS to place more focus on succession planning as part of its overall human capital strategy.

The Need for Information Technology (IT) Modernization

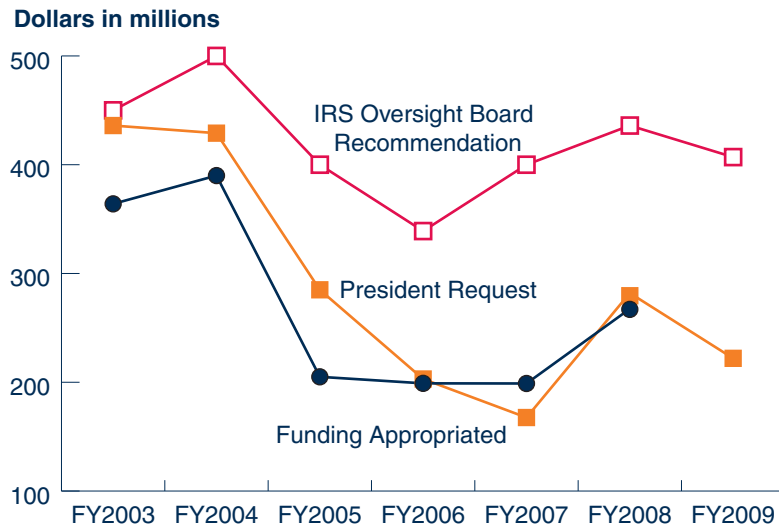
Tax administration is a knowledge-intensive activity and the IRS depends heavily on IT to leverage the knowledge and perform its mission. The IRS has made slow but steady progress in replacing its antiquated IT systems. The most noticeable improvements to taxpayers have been increased use of electronic products and services to interact with the IRS, such as electronic filing of tax returns and Internet services such as "Where's my Refund." Infrastructure improvements have also allowed the IRS to improve toll-free telephone level of service through more effective call routing. However, the IRS' performance is still hampered by archaic data management systems used for central record-keeping that update taxpayer account information on a weekly instead of a daily basis.

The IT systems that the IRS uses to perform its central record-keeping functions are an impediment to great performance. Improvements in customer service and enforcement would be accelerated if the IRS had modern IT systems to manage taxpayers' records. The IRS will not be able to achieve great performance until it can update its central records on a daily basis, much like any other modern financial institution. Such a capability is needed to modernize both its customer service and enforcement functions and will provide current information to taxpayers, tax professionals, and IRS employees, improve IRS efficiency, and reduce taxpayer burden.

The Oversight Board has advocated since its inception in September 2000 that the BSM program be funded at a higher level so progress could be made more quickly. Admittedly the program experienced a series of cost and schedule overruns during its first several years, and the result of those problems has been to slow down the funding stream to levels that dictate only modest progress can be made in modernizing the core IRS master files and account management systems. Such reductions in funding must now be restored so that the pace of IT modernization can be increased.

Figure 11 compares the BSM budget recommended by the Oversight Board, the amount requested by the President, and the BSM funding appropriated by Congress for fiscal years 2003 to 2008. BSM funding needs to be restored to the levels realized in FY2003 and FY2004 to make progress faster. Had the Board's funding recommendations been followed, the IRS would be closer to the day when it could update its central records on a daily basis.

Figure 11: BSM Funding



Source: IRS

Modernized IT systems will literally save taxpayers billions of dollars in burden reduction and make the IRS much more efficient. For example, replacement of the Individual Master File by the Customer Account Data Engine (CADE) will allow the IRS to update the tax accounts for individual taxpayers on a daily basis, instead of its current weekly update process. The Oversight Board expects that a rapid refund from the IRS of three to five days will reduce the number of Refund Anticipation Loans (RALs). The National Consumer Law Center and Consumer Federation of America estimate that approximately 12.38 million American taxpayers spent an unnecessary \$1.6 billion for RALs in 2004 (the latest year for which data is available) to obtain their refund monies faster by two weeks.¹⁴

Moreover, daily updating of account records will give IRS employees and taxpayers access to the most current taxpayer account data, eliminating the problems associated with having various data bases with less than current data. The Oversight Board expects that daily posting of account information will reduce the number of erroneous IRS notices, provide for better data analysis capability, and greatly reduce the taxpayer burdens associated with the account resolution process.

The Modernized e-File system not only makes it easier for taxpayers to file tax returns electronically with the IRS, it reduces the IRS' resources needed to receive and process tax returns, and eliminates the error-prone transcription process. For corporate filers, it helps the LMSB division improve currency and cycle time in working large corporate tax cases. When implemented for individual tax returns, it will make the electronic filing process even simpler than it is today with the current legacy electronic filing system.

Failure to fund the IRS BSM program at higher levels, in the view of the Board, is a case of being penny-wise and pound foolish.

Security in a Post 9/11 World

Most people think of IRS data security as protecting confidential taxpayer information from the prying eyes of computer hackers who could use that information to commit identity theft and other financial crimes. However, it also concerns the loss of IRS computer laptops or data storage devices containing sensitive taxpayer information. According to TIGTA, IRS employees reported the loss or theft of at least 490 computers between January 2, 2003 and June 13, 2006.¹⁵

In addition, data security has taken on an expanded meaning in a post 9/11 world. Terrorists from around the globe are actively working to exploit weaknesses in government IT security systems with the intent of producing both great physical and economic harm to our Nation. Disrupting IRS returns processing and stealing sensitive information could wreak havoc on our economy and the financial markets. While the IRS enjoys an enviable security record, it cannot be complacent. It must work with other federal agencies to develop exceptional data security systems.

IV. Measuring Strategic Goals

The IRS and the Oversight Board recognize the importance of setting strategic goals for the agency and establishing numeric measures to monitor progress in attaining the goals. Indeed, strategic goals and measures are the primary methods that enable the Board, policy makers and the American public to gauge the success of the IRS over the long term.

In regards to strategic goals and measures, the Board remains engaged with IRS on several fronts. For example, the Oversight Board approved a set of long-term measures with numeric target levels of performance that it will use to evaluate the agency's progress in achieving the three goals established by the *IRS Strategic Plan 2005-2009*.

Currently, the Oversight Board has approved five key measures which are summarized in the chart below.

Figure 12: **IRS Strategic Measures and Target Values**

Long-term Measure	Target Value
E-File participation rate for major tax returns	80 percent by 2012
Individual tax filer satisfaction	ACSI* score of 69 by 2009
Voluntary compliance rate	86 percent by tax year 2009
Employee engagement	4.0 (out of 5.0) by 2009**
Non-revenue enforcement activities	Index of 137.6*** by 2009

* American Customer Satisfaction Index

** The target value for the "employee engagement," measure was approved based on the annual IRS employee survey process, but is being recalibrated to the new survey instrument used in 2007.

*** This index measures the success of a diverse set of IRS operations focused on the tax exempt community and Bank Secrecy Act provisions.

In addition, the Board has asked the IRS to develop additional long term measures, including a specific measure to assess progress in modernizing IRS technology systems, along with two supplemental measures to gauge customer satisfaction in the specific areas of IRS taxpayer service programs and IRS enforcement operations.

TIGTA recently reviewed the long term goals approved by the Oversight Board. In its report, TIGTA concluded that the measures and target values improved the *IRS Strategic Plan 2005-2009* and met the major requirements of the Government Performance and Results Act, as well as those of the Office of Management and Budget, and the Treasury Department.¹⁶

The IRS, with the active support and approval of the Board, has also moved to establish several other strategic plans in specific organizational areas. For example, the Taxpayer Assistance Blueprint (TAB) provides a strategic plan for the future of IRS taxpayer assistance. The TAB includes various outcome and performance measures to gauge IRS success including taxpayer burden, customer satisfaction, and the percent of taxpayer service contacts delivered through electronic channels.

Similarly, the IRS Human Capital Strategic Plan (HCSP) sets forth the strategies IRS intends to adopt through the year 2009 to ensure that it builds and maintains the workforce needed to carry out its mission in an efficient and effective manner. The HCSP includes goals and measures to validate the efforts at strengthening its human capital. For example, the “percentage of mission critical occupation (MCO) hiring plans timely met” is one of the measures used to assess progress on the goal to “continually assess and shape the workforce to efficiently accomplish the IRS mission.”

In addition, the *IRS Information Technology (IT) Modernization Vision and Strategy (MV&S)* reflects the long-term approach to IRS’ IT modernization effort. It defines the key next steps in the years ahead to align IRS business priorities with its technology investments. This plan too includes many explicit goals such as expand electronic service capabilities to the tax professional community, provide on-demand access and the ability to update taxpayer account information in a single data store, and reduce system downtime due to application errors.

The Board is also pleased to report that the IRS is now moving ahead in developing a revised Strategic Plan for 2010-2015, and that it will also be assembling a strategic research plan as required in the recently passed funding bill for FY2008. The Board has been a strong advocate of both these endeavors for some time, and looks forward to actively assisting the IRS in development of both of these critically important products.

V. Conclusion

In conclusion, the IRS Oversight Board commends the IRS for the progress it continues to make in modernizing itself. The IRS is becoming a results-oriented organization that stakes out goals and evaluates its progress in meeting them. In this modernization process, it is transforming itself from a paperbound institution to one where electronic means become the most convenient way of doing business. Performance measures indicate that the IRS delivers quality service and benefits to taxpayers and collects more of the taxes due in an efficient manner.

Nonetheless, there is room for improvement. The \$290 billion annual net tax gap is cause for alarm in that it is an affront to honest taxpayers. Given the IRS' resource limitations, an expectation of dramatic progress is unrealistic, but the American taxpayer has a right to expect steady progress. Insufficient data currently exist to demonstrate that progress in reducing the gap is being achieved. The Oversight Board expects an expanded research program will help alleviate this problem.

The performance gains made by the IRS since the passage of RRA 98 are important and worthy of praise. However, this progress only sets the stage for the next step. The IRS is now challenged to move from "good" to "great." It will not be easy, but the Board believes such a big step forward is both realistic and doable. It will require "breakthrough" performance in key functions. It will require heightened management attention and greater employee engagement throughout the IRS. It will require applying best practices and creative thinking about how to do business in the 21st century tax administration world. But the end results will be worth the journey and hard work. The IRS Oversight Board stands ready to help in any way it can.

Appendix 1. 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 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, the National Treasury Employees Union (NTEU), and other groups that have an interest in tax administration.

During 2007, the Oversight Board and staff met with tax professionals and IRS employees at the six IRS Nationwide Tax Forums in Atlanta, Chicago, Las Vegas, New York, Anaheim and Orlando. In March, the Board also conducted a public forum in Washington, DC, with discussions focusing primarily on the tax gap and how to reduce it. The following is a summary of the central themes from stakeholder meetings this year:

Broad Themes from of the IRS Oversight Board Public Meeting on Reducing the Tax Gap

Complexity is the Enemy of Voluntary Compliance

Simplification of the tax code was supported by most of the stakeholders at the public meeting. Most agreed that yearly changes in tax law make it difficult for tax professionals to remain technically proficient, and those changes also contribute to honest misunderstandings of facts or law. In this environment, taxpayers who do not have a good understanding of their responsibilities may question the fairness of the system, which could lead to erosion of confidence and declining compliance. Complexity makes it especially difficult for taxpayers who struggle with literacy and language barriers, and many complex provisions apply to low-income taxpayers, those least likely to have the resources necessary to seek help to comply.

Stakeholders agreed that tax law complexity has a broad effect on tax administration, including the impact on IRS' systems modernization efforts; IRS' technical training efforts; even the IRS' ability to target noncompliance through enforcement efforts. The requirement to do more detailed and complex audits competes with the need to do more audits overall in an environment of limited resources.

Modernization of IRS Systems is a Positive Avenue for Easing Taxpayer Burdens

Stakeholders have worked with the IRS to eliminate unnecessary notices and believe improved accuracy in IRS systems will allow the agency to focus more resources on other areas of the tax gap. In discussing proposals for additional information reporting, stakeholders suggested the IRS demonstrate its ability to effectively use the information it already receives, and how it would process the additional information that is proposed to be collected. Stakeholders think expanded secure electronic transactions for account problem resolution would solve problems quicker, prevent unnecessary notices, and free-up IRS resources for enforcement, which should reduce the tax gap.

Small Business Competitiveness Helps Grow the Economy

Some stakeholders asked how much additional burden businesses should be asked to accept to help eliminate the tax gap. While the cash economy and underreported income represent the largest part of the tax gap, data also indicate that job growth in the economy is coming from small business. However, an informal cash economy limits business competitiveness, access to venture capital, and other advantages for workers. Some suggested there needs to be a better process to help new small businesses understand their payroll reporting and other tax responsibilities, and how their compliance in tax matters contributes to the long-term viability of their enterprises.

Taxpayer Education is Essential to Improve Voluntary Compliance

Stakeholders agreed that taxpayer education is an essential ingredient for improved voluntary compliance. They urged the expansion of efforts to educate taxpayers having limited English proficiency about the tax laws and encouraged outreach to these populations through funding of clinics. They

IRS Oversight Board

also described their own taxpayer education efforts, such as initiatives to teach students about their tax responsibilities; a voluntary disclosure program designed to remind taxpayers of their ultimate responsibility for the payment of federal taxes; and preparation of selected topics for practitioner instruction throughout the continuing professional education season.

IRS Human Capital is a Critical Factor

Stakeholders said that a key element for a balanced approach to reduce the tax gap is for the IRS to have the necessary resources available to fund service, enforcement and information technology programs. They emphasized that recruitment and retention of a quality workforce is essential for the IRS to close the tax gap. One organization favored modest but consistent budget increases over a period of years to gradually rebuild the IRS workforce because it takes time and careful management to hire, train and deploy qualified professional staff. It is important for the IRS to hire additional employees and train them to have the expertise and knowledge to ensure taxpayers comply with their tax obligations and to respect taxpayer's rights and privacy.

More IRS Research Will Lead to More Effective Action

The Board has recommended a much greater emphasis and focus on research so the IRS can more effectively target areas of major non-compliance and more accurately measure the tax gap, and that the IRS develop a long-range strategic plan for research. Stakeholders at the public forum concurred with the Board's position adding that the IRS must have an accurate assessment in order to best deploy its resources to most effective use in reducing the tax gap.

Stakeholders believe that the NRP is a positive foundation for meeting the IRS' needs for data and analysis of the tax gap, but stressed the ongoing need to continuously refine the tax gap data and identify the types of industries and taxpayers contributing to the growth in the tax gap. With the time lag between IRS NRP audits and the release of data, the tax gap may have already evolved into new problem areas. Preparers are willing to work together with the IRS to reduce the tax gap, but need specific information about problem areas. All of the participants agreed that research should play a more important role in defining, understanding and ultimately reducing the tax gap. With more accurate information about non-compliance, the IRS would be in a better position to deploy its strategies and resources to target the tax gap.

Setting an Effective Goal, Setting an Effective Measure, and Having a Purposeful Drive to Reach that Goal has a Significant Impact on the Behavior of the Entire Tax Ecosystem

Establishing a goal for electronic filing has had a significant effect on tax return filing, and some stakeholders recommended a goal to reduce the tax gap to get everyone working together to achieve it. The Deputy Controller of California said her state developed a strategic approach to reducing the state's tax gap and set six goals that included five factors for success. California proposed specific initiatives, objectives, tasks, and time frames for each of the six tax gap goals. She said California has worked closely with the IRS to in the areas of Education, Enforcement, and Exchange (of information) to reduce its tax gap relating to tax shelters from \$500 million down to \$100 million.

Partnership is a Key Word: Tax Preparers have an Important Role in Helping Taxpayers be Compliant

In its 2006 Annual Report, the Board urges a more productive partnership between IRS and the tax administration community. Tax practitioners prepare over 60 percent of individual tax returns, and have a great deal of influence on taxpayer compliance levels. The Board believes that although practitioners have professional obligations to represent their clients effectively, they also have an important role in ensuring that taxpayers are complying with their legal tax obligations. Stakeholders agreed that improving the relationship between those who enforce the law and those who assist taxpayers in complying with the law would be a positive step in efforts to reduce the tax gap.

Appendix 1: Summary of Stakeholder Comments and Recommendations

Improve Taxpayer Confidence in the Tax System

Some stakeholders suggested that more cooperation from the IRS to help curb unscrupulous and/or fraudulent paid preparer behavior would impact the tax gap. They said the collective efforts of all participants in the tax administration system could, over time, enhance tax compliance, increase government revenues, and optimally build taxpayer confidence that most taxpayers are paying their fair share of tax.

There Should be More Emphasis on Personal Integrity in Making Tax Decisions, for Taxpayers and Tax Preparers

The stakeholders generally agreed that taxpayers and tax preparers should emphasize personal integrity and ethical and professional conduct in making tax decisions. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice and have a level of confidence that the tax system is fair in design and in enforcement.

Broad Themes from the Oversight Board's Meetings with Employees and Stakeholders at the IRS Nationwide Tax Forums

During 2007, Oversight Board members and staff met with tax professionals and IRS employees at the six IRS Nationwide Tax Forums and listened to their comments about the current state of the tax administration system. The comments from IRS employees and practitioners usually reflect the opinions or anecdotal comments of one or more individuals, and do not necessarily represent a consensus for each tax forum location or any statistically representative finding.

IRS Employees

Recruitment & Retention

- Many factors impact new hires, such as geography, age, area of expertise. Employees who came from outside the IRS reported a desire for reasonable work hours and valued work/family balance. Younger employees said they wanted opportunities for job variety, training, and career advancement. They attributed departures to high caseload demands, lack of adequate administrative support and more lucrative opportunities outside the IRS.
- The federal hiring process can be complex and lengthy, compared to the private sector. Compared to the speed with which private industry can make a job offer, the time required for the IRS to make an offer can take months, primarily because of the background check.
- Some employees reported that some new hires leave soon after they are recruited and trained. They said recent college graduates come to the IRS with high expectations and find the advancement opportunities, salary, work environment or culture are not what they expected. Salary or incentives may not be sufficient to their needs, a key factor in "high cost" areas such as California.
- Employees said they think IRS messages are not targeting the appropriate age group. The IRS wants to make the most of its recruiting dollars by hiring young, just-out-of-college recruits; yet employees believe the IRS messages of stability, service to country, health benefits, etc. are targeted to an older segment of the population. They think younger recruits are looking for different things: new experiences, opportunities, training, and travel, and are not necessarily attracted by the current IRS messages.
- Some employees believe a more innovative approach to recruitment and career paths may be necessary to keep qualified employees. They suggested: retention bonuses; increased mentoring; student loan payments; and employee flexibility for both work activities and advancement opportunities. A comprehensive exit interview process would help the IRS identify problem areas and improve retention. Employees also recommended more emphasis on mentoring programs for new employees and new managers.

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- Employees suggested leveraging past best-practices that built a cadre of individuals ready to move up, including: creation of “bridge positions” to transition current employees from one IRS occupation to another; hiring college “co-op” students who can transition to full-time IRS positions upon graduation; and establishment of higher graded revenue agent positions in the large case corporate tax area (now in LMSB) to serve as the career advancement path for agents in other examination areas where grade levels are lower.
- Experienced individuals, who were the problem solvers and mentors of the office, are retiring, and it is difficult for those left behind to fill the knowledge gaps. Employees said that external hires face a steep learning curve for administrative procedures as well as technical tax knowledge.

Training

- Employees report that tax law training is good, but improvement is needed in training delivery methods, timeliness and administrative/procedural training.
- Examination and collection employees said there is a need for more training for interacting with taxpayers, effective processes for handling cases, and education on other parts of the IRS and how employees fit into the overall organizational structure.
- Employees strongly emphasize the value of classroom instruction, saying they get a much better understanding of the material when they can discuss actual situations with more experienced employees who have been in similar positions.
- Employees believe their initial training is good, but also say it does not necessarily prepare new employees for their every day work. Work in the field is different than training situations and more field experience with a seasoned employee, accompanied by a mentoring program, would be beneficial.
- Employees discussed the need for separate training tracks for experienced new hires and beginners. This would enable experienced individuals to move ahead at their own pace and be utilized much quicker than is currently the case.
- The type of training and whether it is timely offered are important to employee’s current work schedules. Information technology course work must be delivered before it becomes outdated.
- Computer-based, electronic learning (e-learning) works in limited situations, such as administrative procedures, system usage, and software skills. However, classroom training and on-the-job training provide better long-term results for examination and collection personnel.

Performance Measures

- Employees report an inherent conflict between quantity versus quality. Some employees report that measures for “timely” taxpayer contacts may not reflect the time necessary to do a thorough job. A timeliness measure may not reflect quality (whether the employee did a good job on a case even if the timely contact limits were not met) or whether the overall effort contributed to enhanced compliance.
- Some measures stress efficiency to the detriment of quality; often resources are not available for employees to quickly learn and apply new legislation. Hence, an employee’s careful consideration of the taxpayer’s situation may result in his missing the target for the efficiency measure.

Employee Satisfaction Survey

- Some employees believe the survey is conducted too frequently, little or no action is taken based on the results, and they don’t think it useful because there is no accountability for improvements. The employees indicated that they think it takes more than one year to make most changes and therefore, annual surveys are not effective. They suggested the IRS administer the survey every other year.

Appendix 1: Summary of Stakeholder Comments and Recommendations

- Employees generally report a difference between expectation and reality. The survey is promoted as “for employees...” and that it “will be used to identify and solve problems,” but in reality employees feel many identified problems are not addressed and that expectations are too high for the results that actually occur.

Tax Professionals

Ethics in Tax Administration

- Tax preparation is a profession and as such carries certain responsibilities. Tax professionals are very proud of their profession and feel strongly that they operate ethically. They agree that unethical preparers are an enormous problem not only for them but for the tax system. However, there is no clear agreement on what should be done or what specific responsibilities tax practitioners should have.
- Practitioners believe a fully informed public could make a difference; the IRS should have more of a marketing effort to taxpayers so they understand tax return preparation abuse. They feel the IRS needs to do more to make taxpayers aware of their responsibilities to engage a responsible and ethical tax return preparer.

Preparer Responsibilities if Regulation of All Tax Return

Preparers Becomes Law

- There is general agreement about a competency component, an enforcement component, an ethics component, and a taxpayer education component .
- There are differing views about the competency requirement; some suggest a multi-tiered exam system for individual and business returns, others favor some type of exemption or grandfathering for preparers who can demonstrate a certain skill level through experience or education.
- Regulation by professional societies is also acceptable, but practitioners believe the IRS should ultimately be responsible for enforcement. There are questions about whether the IRS would be an effective enforcement mechanism for the certification program; the concern is that currently the IRS seldom imposes preparer penalties, and then when it does, it collects only a small percentage of them.
- Any set of return preparer standards should be effectively communicated by IRS to the public. The public should be educated on universal preparer standards, particularly the preparer signature requirement.
- Some preparers believe new laws would have little effect on the most troublesome segment of preparers because the most egregious abuse is by preparers who do not sign returns.
- Taxpayers should have an accompanying set of standards:
 - ◆ report income and deductions fully and truthfully,
 - ◆ ensure the paid preparer signs the return, and
 - ◆ support the tax system by not tolerating fraudulent behavior.
- Tax professionals believe it is their responsibility to prepare an accurate and complete return, but they are not an enforcement arm of the IRS. They caution about the dangers of creating an adversarial relationship between them and their clients.
- Tax professionals want an effective system for reporting fraudulent preparers. They believe it will be effective only if the IRS has the resources to enforce it.

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Shrinking the Tax Gap

- Taxpayer education is extremely important in improving voluntary compliance. Current and future taxpayers should know how the tax system works and why voluntary compliance is important; they should understand their obligations and know how to select a competent preparer.
- Another theme is a desire for the IRS to be tougher on the noncompliant, from fraudulent EITC claims to those selling questionable tax shelters. The cash economy was viewed by most as vibrant and untouched by the government, and they view it as a growing threat to our voluntary tax system.
- Tax professionals report seeing many incorrectly prepared S-Corp returns. They believe the IRS' NRP study will find many errors in this area contributing to the tax gap. They also suggest IRS put more emphasis on identifying and quickly following up on non-filers, and initiating a public awareness campaign to educate small businesses about the importance of properly issuing Form 1099 to subcontractors and self-employed individuals.
- Practitioners were asked their reaction to major legislative proposals to require increased information reporting and document matching designed to reduce the tax gap (For example, requiring banks to report to the IRS annually the gross credit card payments made to merchants in a calendar year). Reaction was mixed. Some practitioners believe the proposal to require banks to report credit card receipts will improve voluntary compliance. Others are skeptical of its effectiveness because of IRS' antiquated data processing systems. IRS currently experiences serious problems receiving and processing Form 1099 information and may not be effective with the more complicated information reporting in the credit card legislation

Appendix 2. Biographies of Private-Life Members

The Board, by statute, consists of nine members, including the Secretary of the Treasury and the Commissioner of Internal Revenue. Following are profiles of the private-life members, who are appointed by the President and confirmed by the U.S. Senate without regard to political affiliation and solely on the basis of their professional experience and expertise:

Paul Cherecwich, Jr., Chairman
Retired Corporate Tax Counsel

Paul Cherecwich, Jr. is presently retired, having had a successful career as a tax attorney employed both in the business world and practitioner world. Employed by three Fortune 500 corporations, he retired in 2000 from Cordant Technologies, Inc. as Vice President of Tax and Tax Counsel. He subsequently joined the law firm of Miller & Chevalier Chartered as “Of Counsel”, from where he retired at the end of 2004. During his career he participated in several professional groups. As a result of his contributions, he was asked to serve leadership roles on several trade association tax committees. In addition, he was selected by his peers to be the 1997-1998 International President of The Tax Executives Institute (TEI), the preeminent association of corporate tax executives in North America. Mr. Cherecwich has served on the boards of several charitable organizations. He has also served on several government advisory groups, including the Massachusetts Governors Management Task Force, the United States Trade Representative’s Industry Advisory Committee on Customs, and the IRS Advisory Council, where he was selected by its members to be the 2002 Chair. Mr. Cherecwich earned a B.E.E. from Rensselaer Polytechnic Institute, an M.B.A. from Northeastern University, a J.D. (cum laude) from Suffolk University Law School, and an LL.M. (taxation) from Boston University Law School.

Paul B. Jones,
Executive Vice President, General Counsel and Regulatory Policy, Time Warner Telecom

Paul B. Jones is Executive 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.

Robert M. Tobias
Director of Public Sector Executive Education, American University

Robert M. Tobias is a professor, Director of Public Sector Education, and Director of the Institute for the Study of Public Policy Implementation at American University in Washington, D.C. Mr. Tobias left the National Treasury Employees Union (NTEU) in 1999 after 31 years. He served as General Counsel from 1970 to 1983, and as National President from 1983 to 1999. 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 masters degree in Business Administration, and from The George Washington University, where he received his law degree. He chairs the Oversight Board’s Operations Committee.

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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. He chairs the Oversight Board's Operations Support Committee.

Deborah L. Wince-Smith

President, Council on Competitiveness

Deborah L. Wince-Smith is president of the Council on Competitiveness—a premiere group of CEOs, university presidents and labor leaders committed to driving U.S. competitiveness. She is an internationally known expert, author, and speaker on global competitiveness, economic policy, science and technology, and economic development. She has more than 20 years of experience as a senior government official, including as Assistant Secretary for Technology Policy in the Department of Commerce during the first Bush administration. She serves on or chairs four Cabinet-level advisory groups, including a task force on nuclear energy for the Secretary of Energy. Ms. Wince-Smith is active in the governance of various national scientific labs, including the Argonne National Laboratory, Los Alamos and Lawrence Livermore National Laboratories. Ms. Wince-Smith earned a degree in classical archaeology and graduated *magna cum laude* and Phi Beta Kappa from Vassar College. She earned her Master's degree from King's College, Cambridge University. In December 2006 she received an honorary Doctor of Humanities degree from Michigan State University.

Appendix 3. FY2007 IRS Oversight Board Operations

The IRS Oversight Board has completed its sixth year of operation. During this period the Board has engaged in a variety of activities, meeting five times as a full Board, and more at the committee level. The Board met on the following dates in FY2007:

- November 29-30, 2006
- March 6-7, 2007
- May 1-2, 2007
- August 15, 2007
- September 25-26, 2007

On March 7, 2007, the Board held a public meeting at which it received public presentations from fourteen stakeholder organizations on the following topic: "What Can My Organization Do Differently than it Has in the Past to Reduce the Tax Gap?" Stakeholders participating in the meeting represented tax practitioners for individuals, small, and large businesses; payroll associations; state tax administrators; low-income taxpayers; and IRS employees. The meeting provided the Oversight Board with an excellent opportunity to learn about the tax gap from the taxpayers' perspective, and the information obtained from this meeting was used throughout the year.

During 2007, the Oversight Board developed five reports: the Board's 2006 Annual Report to Congress, its 2006 Electronic Filing Report to Congress, a budget report that presented the Board's recommendations on the FY2008 IRS budget, the Board's annual *Taxpayer Attitude Survey*, and an in-depth survey of taxpayers on service issues, the *Taxpayer Customer Service and Channel Preference Survey*. The first two reports are statutorily required; the remaining three were discretionary on the part of the Oversight Board. All reports are available on the Board's web site, www.irsoversightboard.treas.gov.

The Board continued its program of conducting stakeholder outreach to hear independent perspectives of IRS progress from various external stakeholders. In addition to the March public meeting, the Oversight Board had representation at all six Nationwide Tax Forums the IRS conducted during the summer months. At these meetings, each attended by approximately 2,000 or more 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.

The Oversight Board focused on a number of strategic issues during the year, including plans for reducing the tax gap, the performance of private collection agencies collecting tax debt, development of a Taxpayer Assistance Blueprint that established a five-year plan for taxpayer service, and a number of human capital issues, such as succession planning, IRS recruitment and retention performance, employee training, and streamlined critical pay. In March 2007, the Board approved five IRS long-term goals. The Board received stakeholder comments on the proposed goals that helped guide the Board's decision-making. In addition, the Board reviewed the operations of several major IRS organizations, reviewed employee survey results, and reviewed and approved several specialty strategic plans, such as the *IT Modernization Vision and Strategy*.

With the resignation of former Commissioner Everson in April 2007, the Oversight Board fulfilled its statutory responsibility to recommend names of candidates for the position of IRS Commissioner to the President. The Board developed a position and candidate specification which it forwarded to the President, evaluated potential candidates, and recommended names to the President for consideration.

The Board's three committees of the Oversight Board also met periodically in person or by telephone. The Operations and Operations Support Committees each met several times during the year with IRS executives to review progress in meeting performance goals for major IRS operational divisions. Measures of interest included customer and employee satisfaction, quality, and selected productivity

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goals. In keeping with the Oversight Board's statutory responsibility to review the selection, evaluation, and compensation of senior IRS executives, the Executive 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.

Two new members joined the Board this past year, Deborah Wince-Smith and Paul Cherecwich, and Charles Kolbe left the Board after serving on the Board since September 2000. In September 2007 Paul Cherecwich was elected Chairman of the Oversight Board, replacing Paul Jones, who remains a member. The Board currently has two vacancies and one member whose term has expired and is serving in a holdover capacity.

In keeping with the RRA 98 requirement to report Oversight Board travel expenses to Congress, the Board incurred \$41,473 in travel expenses for Board members and staff in FY2007, primarily for travel to and from Board and Board committee meetings, and to attend the Nationwide Tax Forums.

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