IRS Oversight Board
Annual Report 2004

Message from the Board

This year's annual report contains both good news and bad news for America's taxpayers. The good news is that the IRS is getting better at assisting taxpayers, who recognize and appreciate the agency's many improvements. Every year, the IRS helps millions of taxpayers understand their obligations under an extremely complex tax code by making information available on its Web site, answering questions on its toll-free telephone lines or in person at local offices, and responding to correspondence.

However, the bad news is deeply troubling. One in five taxpayers now believes that it's acceptable to cheat on their taxes. Their ranks are growing, especially among younger taxpayers. Last year, 81 percent said it was not acceptable at all to cheat, compared to 87 percent in 1999. We must stem this tide; not to do so would place the entire tax administration system in peril.

Vigorous but fair enforcement of the tax laws is a critical component of the IRS' mission. The IRS must bring back into compliance those taxpayers who won't pay what they legally owe. And it's not "the system" they are really cheating – it's you and me. We all pay more in taxes to make up for those who cheat.

Fighting back isn't easy. Since 1996, the number of enforcement personnel at the IRS required to effectively combat tax evasion has shrunk by 36 percent while workload has greatly increased. The effect of this disparity in trends is painfully obvious.

After several years of precipitous decline, examination rates for individuals are only just starting to rebound. However, audit rates for most businesses are still falling. Most disturbing of all, the amount of money which taxpayers legitimately owe, but won't pay and which goes uncollected, is a staggering $300 billion. The IRS Oversight Board has consistently argued that the IRS needs more resources to fight back and close the tax gap.

The IRS has other challenges. It must modernize its business processes and archaic technology. Both are important to improved service, enforcement and productivity. However, the IRS' program to bring modern technology to tax administration has been over budget and behind schedule. Its progress this past year was particularly disappointing, and in December 2003, the Board issued a report recommending a series of changes to turn around the troubled program. The Board believes the overall modernization plan is sound, but its implementation needs major improvement.

Finally, although the Board does not, nor should endorse any particular tax simplification proposal, it feels obligated to state again that tax code complexity impedes sound tax administration and imposes an enormous burden on taxpayers. Complexity makes it more difficult for honest taxpayers to understand and meet their obligations and is easily exploited by those who want to game the system. The Board strongly encourages Congress to consider complexity's detrimental effects in future changes to the tax code.

Overall, the Board believes that the IRS is making progress. Real change for the better is being achieved. However, the IRS is entering a critical phase where it will face numerous challenges, not the least of which is to improve enforcement without jeopardizing gains in customer service. We cannot hide from the hard truth. Continued support and attention must be provided to the IRS. As a nation, we must bring the job we began with the enactment of the IRS Restructuring and Reform Act six years ago to a successful conclusion.

And on a closing note, the Board was created to provide continuity, expertise and stability to the governance of the IRS. However, the Board is increasingly concerned that members' terms are expiring and successors are not being nominated with sufficient time to prevent a shortage of members. Currently, two of seven private-life memberships are vacant. Of the five members currently serving, two have terms that expire in September 2004. The others' terms will expire in September 2005. Without enough members, the Board cannot operate properly and provide the kind of guidance and oversight Congress intended when it created the Board. The Board urges the Administration and the Congress to identify, nominate, and confirm qualified candidates in a timely manner to allow the Board to continue its work to serve our nation's taxpayers.

Nancy Killefer, Chair
Charles Kolbe
Larry R. Levitan
Robert Tobias
Raymond T. Wagner, Jr.

Note: The Secretary of Treasury and the Commissioner of Internal Revenue also serve as members of the Board. However, to preserve its independent oversight responsibilities and objectivity, neither the Secretary nor the Commissioner approve the Board's annual report, although their comments and guidance are both solicited and welcomed.

Table of Contents

Appendix

Preface

In June 1997, the National Commission on Restructuring the IRS recommended the creation of the IRS Oversight Board to provide a new governance and management body that would provide focused attention on strategic issues facing the IRS. The following year, the IRS Restructuring and Reform Act (RRA) of 1998 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."[1]

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

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

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

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

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

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

I. Introduction

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

The IRS Oversight Board, authorized by this historic legislation, was established in September 2000. This report provides the public and Congress with a status report on the IRS as it transforms and modernizes. To guide itself in this effort, the IRS, with the approval of the Oversight Board, established three strategic goals:

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

These goals have provided the IRS with a road map to guide its transformation. The agency is now updating its Strategic Plan and refining its goals and objectives to provide direction for the next five years. The Board will review and approve this plan as well.

II. The Year in Perspective

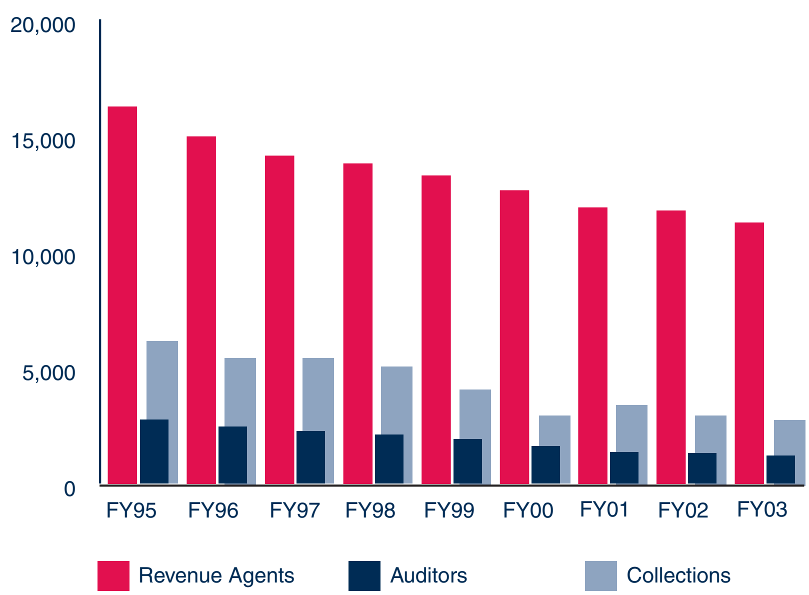
Last year the Oversight Board reported that the American tax system was at a crossroads. The IRS was five years out from the enactment of the IRS Restructuring and Reform Act (RRA), which called for the most dramatic changes in the agency in half a century. The IRS' new mission called for the agency to "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." After years of hard work, the IRS had begun to meet RRA's mandate.

In September 2002, outgoing IRS Commissioner Charles O. Rossotti released "Assessment of the IRS and the Tax System" to the Board. He cited the progress that the IRS had made since 1998, but sounded some strong warnings. Despite marked progress in improving service to taxpayers, he reported that the IRS was "outmanned and outgunned" when it came to enforcing the tax laws.[2]

In its 2003 Annual Report, the Board continued to address this issue and two conflicting, long-term trends: the number of tax returns filed, particularly complex ones, continued to grow, while the number of IRS employees continued to shrink, due to budget constraints. As more resources were needed for the IRS to perform essential services, such as processing returns and answering correspondence, resources were

The Treasury Inspector General Taxpayer Administration (TIGTA) notes that the combined Collection and Examination function enforcement staffing declined from 25,000 at the beginning of FY1996 to 16,000 at the end of FY2003, a 36 percent decline.

Number of Examination and Collection Staff Stagnant



Source: Treasury Inspector General Tax Administration (TIGTA) Analysis shifted from discretionary operations, including compliance activities. The result was a gap between the number of taxpayers who are not filing, reporting, or paying what they owe, and the IRS' capacity to ensure compliance.

The Board has also consistently argued that to succeed, the IRS must enhance its productivity and modernize its business systems. The Board also agreed — as did the National Commission on Restructuring the IRS almost a decade ago — that the agency needed steady staff growth in order to meet its objectives.

When Mark Everson was sworn in as the 46th Commissioner of the Internal Revenue Service in May 2003, the Board was pleased when he set three priorities:

- Continue to improve its services to taxpayers
- Strengthen its enforcement of tax laws and work with tax practitioners to ensure all taxpayers pay their fair share
- Modernize its antiquated business processes and technologies

These priorities, consistent with the Board's view of challenges facing the IRS, continue the long-term strategic direction that the Board is responsible to oversee.

In last year's Annual Report, the Board called upon the IRS to continue to improve as it moved forward to achieve the vision set by RRA. Specifically, the Board challenged the IRS to:

- Close the compliance gap
- Boost customer service
- Commit to modernization
- Focus on people resources
- Measure long-term goals

This report describes the IRS' efforts, successes and challenges in the past year in moving toward these objectives.

III. Progress and Challenges

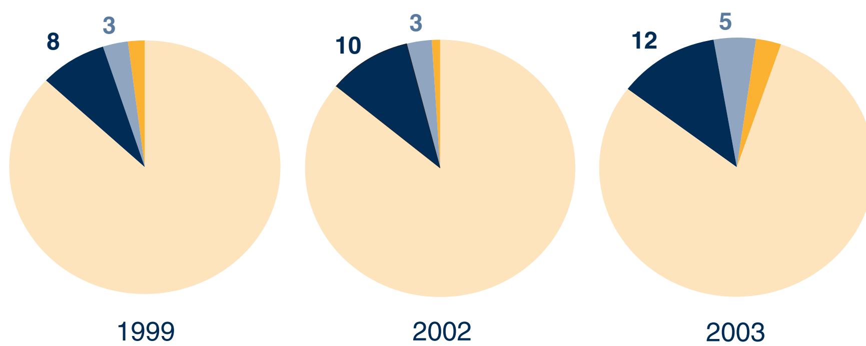
The IRS Oversight Board's role is to provide long-term guidance and direction to the agency and believes that the IRS is making progress. However, at this critical juncture, it is imperative that the IRS stays focused on addressing its major challenges.

1. Close the Compliance Gap

The nation's annual tax gap, the difference between what taxpayers are supposed to pay and what is actually collected, is estimated at $311 billion.[3] Worse, IRS Commissioner Everson testified before Congress earlier this year that current estimates of the tax gap are based on 1988 data, and when the IRS completes its new research study, the gap is likely to be even higher. This is unacceptable to honest taxpayers.

The Board's own research shows that one out of five Americans now believe that it is acceptable to cheat at least a little on their taxes.

Tax Cheating: Alarming Trends



How much, if any, do you think is an acceptable amount to cheat on your income taxes?

Not at all

A little here and there

As much as possible

Don't know/NA

Source: IRS Oversight Board Taxpayer Attitude Survey 2003

The Board applauds Commissioner Everson for his commitment — in the face of a tide of increasing non-compliance — to improved enforcement because it is both just and necessary. One out of five Americans now believe that it is acceptable to cheat at least a little on their taxes.[4]

However, actually delivering on these pledges to crack down on tax evasion has proven to be a much more difficult task. Enforcement continues to be an ongoing problem. The numbers are still at unacceptable low levels and in spite of some improvements, there is no across-the-board turnaround in sight.

The Board believes that it makes perfect sense from a business perspective to provide the IRS with a modest budget increase so the agency can begin to collect the $300 billion that is left on the table each year. In a recent article, *Washington Post* financial columnist Al Crenshaw was puzzled why the Administration and Congress "aren't falling over themselves to give the IRS more money. Tax enforcement pays for itself many times over, and it would seem to be a good way to cut the deficit."[5] The Board concurs with this assessment and urges Congress and the Administration to work together quickly to find a solution to this critical resource problem.

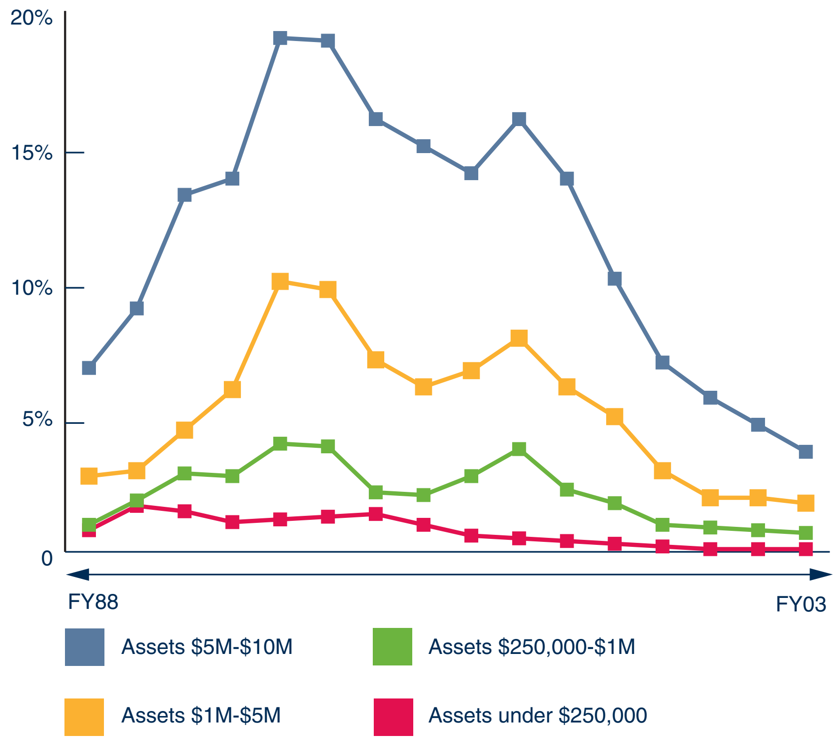
The General Accounting Office found that 63 percent of U.S. corporations did not pay any federal taxes from 1996 to 2000.

The Board is particularly concerned by the alarming data trends found in a number of recent independent reports that confirm suspicions that the IRS is not making significant progress to close the compliance gap. For example, the General Accounting Office found that 63 percent of U.S. corporations did not pay any federal taxes from 1996 to 2000.[6]

In its "Trends in Compliance Activities Report Through FY2003," [7] the Treasury Inspector General for Tax Administration (TIGTA) painted a mixed picture of IRS Collection and Examination functions. Collection activities showed a continuing modest increase, but examination actions have not returned to pre-1998 levels. Meanwhile, the inventory of delinquent accounts and the total amount of uncollected liabilities continue to grow. And while audits of individual tax returns increased in FY2003 as compared to the previous year, the number of corporate tax return examinations further declined. The overall examination rate is still 57 percent less than it was in FY1988.

Dramatic Drop in Examining Corporate Returns

The decline in face-to-face audits for all corporations was 15 audits per 1,000 returns in FY1999; seven per 1,000 in FY2003. The audit rate for "pass-through entities" also fell; 4.5 audits per 1,000 in 1999; 3.2 per 1,000 in 2003.



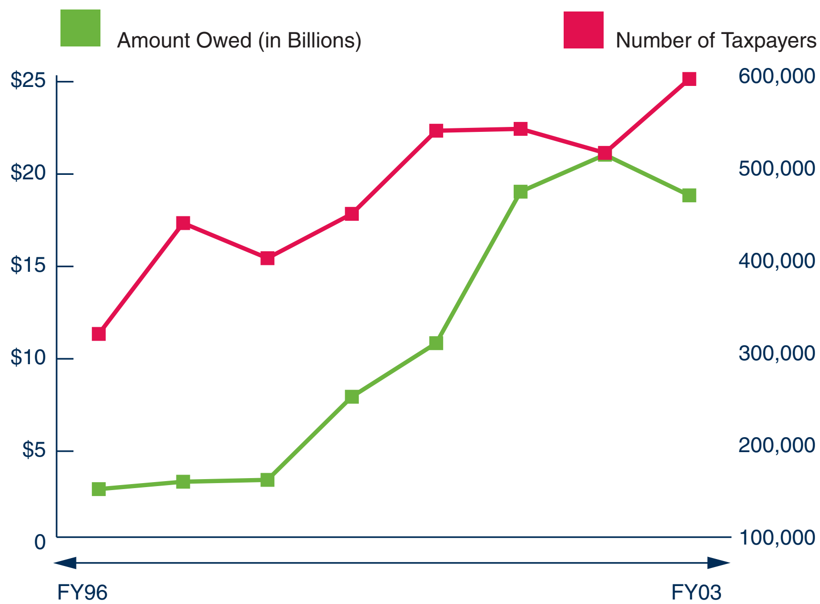
Source: TIGTA Analysis

According to the Transactional Records Access Clearinghouse (TRAC), "major IRS programs to enforce the tax laws against businesses and corporations are continuing to decline."[8] For example, it also found that audits for business taxpayers were down. Five years ago, three out of every 1,000 returns were audited; in FY2003 that rate dropped to two out of every 1,000 business tax returns. The decline in face-to-face audits for all corporations was steeper: 15 audits per 1,000 returns in FY1999; seven per 1,000 in FY2003. The audit rate for "pass-through entities" also fell; 4.5 audits per 1,000 in 1999; 3.2 per 1,000 in 2003.[9]

Collection reengineering, which the Board strongly supports, is generating positive benefits such as a 15 percent increase in the number of Taxpayer Delinquent Accounts closed and a substantial jump in the use of enforcement tools, such as liens, levies and seizures.

In spite of this disturbing picture, the Board recognizes that some improvements have been made. For example, the IRS has been able to put the brakes on the rising collection backlog. TIGTA found that many collection compliance indicators showed improvement in FY2003. Collection re-engineering, which the Board strongly supports, is generating positive benefits such as a 15 percent increase in the number of Taxpayer Delinquent Accounts closed and a substantial jump in the use of enforcement tools, such as liens, levies and seizures.[10]

In the Queue: More Fail to Pay Growing Tax Debts



Source: TIGTA Analysis

Other innovative programs are refocusing resources in key areas:

- To pursue promoters of abusive shelters, domestic and offshore abusive tax avoidance transactions (ATAT), high-income taxpayers, and unreported income, the IRS is focusing resources away from traditional examination functions into key strategic areas.

- To improve its K-1 matching program, which was initially unsuccessful, the IRS redesigned the initiative by making the forms and related instructions easier to understand, simplifying the filing process, and working closely with stakeholder groups to build understanding and support for the program.

- To crack down on abusive shelters, the IRS has increased its use of promoter audits. The IRS has over 100 such audits in progress, and established a Lead Detection Center to centralize and develop leads on abusive tax avoidance transactions.

- To shorten the cycle time on large corporate audits from five years to two years, the IRS is using a streamlined process to identify issues for audit by focusing on materiality and risk analysis.

- The IRS is strengthening its Office of Professional Responsibility, appointing a new experienced director, and proposing tougher penalties on professional standards of conduct. As Commissioner Everson has stated, “attorneys and accountants should be pillars of our system of taxation, not the architects of its circumvention.”[11]

Good news on the enforcement front is dampened by the stark budget reality: The IRS does not have the resources to close the $300 billion tax gap.

In its recent report on the proposed FY2005 IRS budget, the Board warned that proposed staffing increases for both revenue agents and revenue officers will in all likelihood not materialize because the Administration's budget fails yet again to take into account unfunded congressional mandates, such as pay increases, and rising administrative costs. As the *Washington Post* observed in its April 14, 2004 editorial, "Taxes and 'Terror'": "The result is that the nation's budget deficit is roughly twice the size it would be if tax collection were watertight and that the strain on honest taxpayers – the vast majority – increases unfairly." [12]

The Board further believes that long-range goals should be established for voluntary compliance. Senate Finance Committee Ranking Member Max Baucus has proposed a promising concept to help get the IRS back on track and, in a way that can be measured. The senator called for a 90 percent voluntary compliance rate by the year 2010 – a five percent increase over estimated current levels. His proposal would raise an additional $100 billion each year in revenues – without raising taxes. [13]

The concept of a numeric goal for the compliance rate has other merits. The Board believes that setting singular, clear goals can have an energizing effect on the agencies that own them. The IRS is no exception as demonstrated by the 80 percent e-filing goal RRA established. Although it is doubtful that the agency will meet this goal by 2007, no one can doubt the very positive changes it engendered, and the efficiencies and cost savings it continues to produce. Recent reallocations of resources to enforcement are directly tied to the closing of a major paper tax return processing center made possible by e-file growth. Although the updated estimate of the non-compliance rate will not be available until early 2005, the Board believes that similar positive benefits could be derived by establishing a challenging but realistic long-range goal for voluntary compliance.

In its recent report on the proposed FY2005 IRS budget, the Board warned that proposed staffing increases for both revenue agents and revenue officers will in all likelihood not materialize because the Administration's budget fails yet again to take into account unfunded congressional mandates.

To read the entire report, go to www.irsoversightboard.treas.gov

However, as both the Board and Commissioner Everson have consistently argued, increased enforcement is but one part of the compliance equation. Serious steps must also be taken to simplify the tax code and make it easier for honest taxpayers to comply with it. That means that the IRS must provide improved services to all types of taxpayers and do a better job educating them about their responsibilities under the law. While enforcement is an extremely important tool, particularly when applied to those who willfully evade reporting income and paying their taxes, in the Board's view, it is always the tool of last resort.

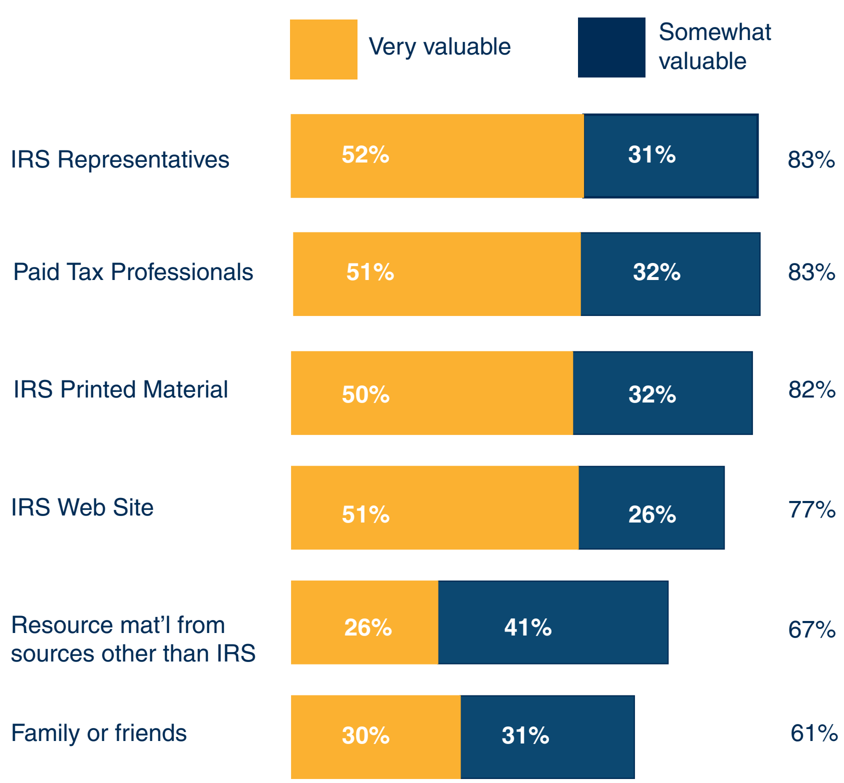
Along with paid tax professionals, the most heavily relied upon source of tax information and advice are IRS representatives, closely followed by IRS printed publications.

2. Boost Customer Service

While enforcement is still problematic, the IRS has made considerable strides in improving customer service. Taxpayers are better able to get through on the agency's toll-free lines. IRS web site usage continues to surge and new features such as "Where's My Refund?" and "Where's My Advanced Child Tax Credit" have been added. The number of electronically-filed tax returns grew by 15 percent during the past filing season. The Board believes that these hard-earned gains directly result from the investments that have been made in business systems modernization and training.

It is clear that taxpayers have come to value the services that the IRS provides. The 2003 IRS Oversight Board Taxpayer Attitude Survey found that "the most heavily relied upon source of tax information and advice are IRS representatives (83 percent see them as very/ somewhat valuable), closely followed by IRS printed publications such as brochures (82 percent) and the IRS web site (77 percent). The only non-IRS-provided information source that is as highly rated is a paid tax professional (83 percent.)"[14]

Taxpayers Value IRS Service



Source: IRS Oversight Board Annual Survey of Taxpayer Attitudes

The tax code's complexity grows with each passing year; the IRS now estimates that it takes 28 hours and 30 minutes to complete an average tax return versus 17 hours and 7 minutes in 1988.

The Board believes that improved service directly contributes to improved compliance. Mistakes and lack of information can easily be contributing factors toward non-compliance. And it is no wonder; the tax code's complexity grows with each passing year. The IRS now estimates that it takes 28 hours and 30 minutes to complete an average tax return versus 17 hours and 7 minutes in 1988.[15] The IRS must do everything it can to help taxpayers navigate and understand their responsibilities under the Code. A failure to meet this pressing need would invite further non-compliance.

To get a better idea of how the IRS is meeting taxpayers' needs, the Board also regularly reaches out to a wide variety of external stakeholders. For example, in January 2004, the Board conducted its fourth annual public meeting with stakeholders, and during the summer of 2003, met with IRS field employees and tax professionals at the six IRS Nationwide Tax Forums.

The percentage of taxpayers who called, reached an IRS assister, and received service rose by two percent to 84 percent over the same period last year and 22 percentage points over the same period in 2002. ...

From these meetings, the Board was able to draw a number of conclusions. There is general agreement that the IRS is doing a better job than it was five years ago. Practitioners point to successes in e-filing, Practitioner Priority Services, the IRS web site and the Employer Identification Number hotlines. While recognizing the growing non-compliance problem, stakeholders stress the importance of striking a balance between enforcement and customer service. They are concerned that the IRS not inadvertently send the message that customer service is no longer important.

This anecdotal evidence of improved service is backed up by hard data. In recent testimony before the House Ways and Means Subcommittee on Oversight, the General Accounting Office found that "IRS' performance during the 2004 filing season has improved in most areas compared to this time last year and the year before, based on the data we reviewed on key filing season activities – paper and electronic processing, telephone assistance, IRS's web site and walk-in assistance. In particular, access to telephone assisters has improved and web site usage has increased."[16]

However, the same could not be said for tax law accuracy, which declined to 76 percent during the start of the 2003 filing season.

For example, the percentage of taxpayers who called, reached an IRS assister, and received service rose by two percent to 84 percent over the same period last year and 22 percentage points over the same period in 2002. Toll-free account accuracy remained stable at 89 percent. However, the same could not be said for tax law accuracy, which declined to 76 percent during the start of the 2003 filing season.[17]

Web site usage also witnessed yet another year of impressive growth and provides increasingly valuable services to all types of taxpayers. During the filing season, the IRS' Web site is one of the most highly visited with taxpayers seeking answers to frequently asked question and downloading tens of millions of forms and publications. As of April 9, 2004, use of the popular "Where's My Refund" feature has grown by 38 percent from last year.[18]

The Board finds IRS customer service to be a work in progress still with ample room for improvement in key areas such as telephone tax law accuracy. In this regard, the Board believes that complacency is the worst enemy. Indeed, it would be highly imprudent at this time to suggest that IRS customer service has reached an acceptable level, or what was envisioned in RRA. Like the best financial services institutions, the IRS must constantly work to improve customer service by measuring its progress, recognizing emerging trends and taking advantage of new technology.

3. Commit to Modernization

The Board strongly believes that the long-term health and viability of the nation's tax administration system rest upon the success of the IRS Business Systems Modernization program (BSM or Modernization).

However, during the summer of 2003, the BSM program suffered a serious setback. Virtually all of its ongoing projects experienced significant delays and budget overruns. Particularly troubling to the Board were continuing and unresolved problems with the Customer Account Data Engine (CADE) – the so-called "crown jewel" of Modernization – that will move taxpayers from the current antiquated tape-based system to a modern reliable data base.

To his credit, IRS Commissioner Everson quickly called for a number of separate independent reviews of CADE and the entire BSM portfolio of projects. This sense of urgency was well-founded. The reviews made it clear that the IRS and its Prime contractor cannot continue to operate in a business-as-usual manner. Moreover, the Board believes that the stakes are too high and BSM's problems are too severe for half-measures. They must be squarely addressed in a rigorous and open fashion.

Based on the BSM review's findings and recommendations, Commissioner Everson launched an aggressive Modernization "action plan." In December 2003, the Board also released its independent analysis of BSM which called for nine specific recommendations for turning around the critical but troubled program.

Time will tell if the IRS and the Prime will be successful in meeting these challenges. Given their combined track record, there is ample room for concern. At this critical point in Modernization's life cycle, too much still hangs in the balance. For example, since the release of the Board's report, the Integrated Financial System (IFS) has missed major milestones and the deployment of Release 1.0 has been delayed until October 2004, and that date may be in jeopardy. At a more fundamental level, the Prime has yet to meet its primary responsibility of serving as a trusted advisor and partner to the IRS in managing the program. The Board keeps looking for improvements in this area, but finds few if any to report.

However, Modernization is beginning to produce some benefits for taxpayers and practitioners, including modernized e-file, e-services for practitioners and various self-serve applications on www.irs.gov. As previously discussed, they are also creating greater efficiencies that permit the IRS to redirect precious resources to critical enforcement initiatives. The following are Modernization's key early successes

- **Modernized e-File** provides corporations and tax exempt organizations the opportunity to file their Form 1120 and 990 returns electronically for the first time.

Board's BSM Recommendations

1: The IRS business units must take direct leadership and ownership of their projects.

2: Create an environment of trust, confidence and teamwork.

3: Enhance the systems development life-cycle methodology.

4: Enhance the program's contracting process and capabilities.

5: Significantly strengthen the experience and capabilities of the BSM team.

6: Streamline the oversight process and eliminate duplication.

7: Place special attention on the CADE project.

8: Reduce the number of projects being conducted at the same time.

9: Monitor contractor performance carefully.

To read the entire report, go to www.irsoversightboard.treas.gov

The IRS Oversight Board firmly believes that the IRS modernization program cannot be allowed to fail.

- **Where's My Refund?/Where's My Advance Child Tax Credit?** provides taxpayers the opportunity to receive updates using the Internet on the status of their tax refunds and advance child tax credits. Where's My Refund? has provided approximately 17 million services during this calendar year and Where's My Advance Child Tax Credit? has provided another 10 million services over the past six months. These two projects have shifted a significant volume of customer demand away from automated telephone services, which has contributed to a measurable improvement in service for taxpayers who use toll-free telephone assistance.

- **e-Services** provide new services to tax preparers, including preparer tax identification number (TIN) applications with instant delivery, individual TIN matching for third party payers, on-line registration for electronic e-Services, and on-line initiation of the electronic return originator application. These services will encourage further use of electronic filing by preparers.

- **Internet EIN** permits small businesses to apply for and receive an Employer Identification Number on-line. The IRS has processed one million Internet EIN applications since its inception in May 2003.

In conclusion, the IRS Oversight Board firmly believes that the IRS modernization program cannot be allowed to fail. The IRS cannot continue to operate with the outmoded and inefficient systems and processes it uses today. Over time, the existing systems will become impossible to maintain and at that point, the ability to administer our country's tax system will be in grave danger. Such a risk to our nation is unacceptable. The Board remains convinced that the overall Modernization plan is sound and well-designed. The challenge is executing that plan. The IRS and the Prime must get it right this time.

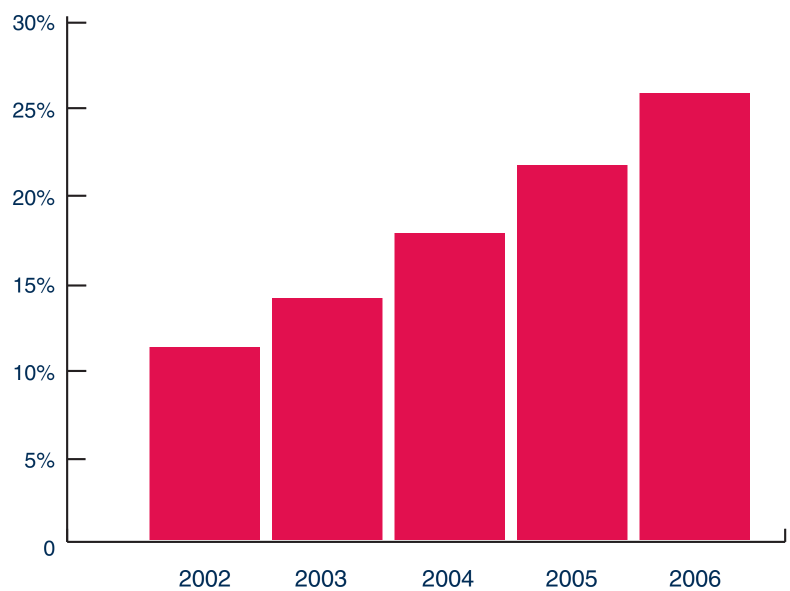
4. Focus on People Resources

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

Human capital cannot be an afterthought; it must be integrated into any IRS strategic plan.

The Board has serious concerns regarding the IRS' lack of a strategic approach to human capital. Last year, the Board recommended that the IRS focus on its people resources – specifically on the way that it hires, trains and retains employees. It called upon the IRS to develop an agency-wide human capital strategic plan that keys in on five areas:

Ranks of IRS Employees Eligible for Retirement Grow



Source: IRS Data

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

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

According to Gallup, the percentage of employees who saw themselves as being engaged rose from 21 percent to 31 percent from 2001 to 2003...

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

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

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

So far, the IRS has yet to develop an agency-wide human capital plan that deals with these concerns, although some are addressed in part in its forthcoming agency-wide strategic plan.

Nevertheless, there have been some noteworthy gains. The Board was pleased to see improvements in the IRS' third annual employee satisfaction survey, conducted by The Gallup Organization, in which approximately 75 percent of the workforce participated.

According to Gallup, the IRS made "steady progress increasing employee engagement" from 2001 to 2003. It reported that the percentage of employees who saw themselves as being engaged rose from 21 percent to 31 percent from 2001 to 2003. The ranking of the IRS increased from the 34th to the 50th percentile of comparable organizations.

There are other bright spots. For example, the National Taxpayer Advocate created a Professional Development Program – a four-year training program for eight Taxpayer Advocate Service (TAS) occupations – which will help TAS employees establish clear career paths

However, these improvements are dwarfed by the challenges that still remain. According the Gallup, 69 percent of IRS employees are not engaged and the survey also showed that less than a majority of employees (43 percent) can strongly agree that they know what is expected of them at work. Greater and more focused attention is desperately needed on workforce issues.

While sixty-nine percent of IRS employees are not engaged, while a majority of employees (43 percent) can strongly agree that they know what is expected of them at work.

At last year's IRS Nationwide Tax Forums, the Board also heard from stakeholders and dozens of agency employees who saw workforce issues as the greatest challenge for the agency over the next five years. The lack of adequate training was a dominant issue. Stakeholders described an expanding training gap at the IRS, where employees often lack the expertise and skills to handle difficult, complex or problem cases. IRS employees also reported that they were inadequately or unevenly trained. Stakeholders added that in the operating divisions where employees have helped plan and design training programs, employees report higher job satisfaction and empowerment.

From all of this information, a strong conclusion can be drawn. A year after the IRS Oversight Board sounded the alarm on human capital issues, the same problems persist; the IRS has not adequately addressed them. The agency has failed to address the reality of an aging workforce and has failed to provide clear guidance, direction and training for its employees.

The Board calls upon the IRS to put forth a strategic human capital plan that deals effectively with these realities. Faced with pending retirements, the IRS must have a plan in place to refresh its workforce, preserve invaluable knowledge, and institute succession planning throughout the agency. The IRS must also have a plan to recruit and retain qualified personnel, especially future executives from the private sector who can bring to bear best practices and new ideas to the challenges and opportunities that the 21st Century brings. And lastly, the IRS must better train and equip its workforce with necessary skills. The IRS will be hard pressed to close the compliance and customer service gaps if the training gap is not closed as well.

5. Measure Long-Term Goals

The IRS has mixed success establishing its long-term goals. Although the agency is striving to improve these and associated measures, the Board believes that the IRS must also take on the more challenging and important task of setting long-term, strategic, and measurable goals that focus on outcomes and end results.

During the FY2005 budget formulation process, the IRS took the important step of aligning performance and resources requested.

The Board appreciates the difficulty associated with developing measures and performance goals. Setting long-term goals requires a high level of consultation and consensus building. Achieving agreement among Congress, the executive branch, external stakeholders and the public will be particularly challenging.

Nevertheless, some initial progress has been made. During the FY2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. However, the agency must continue to integrate performance into its decision-making and resource allocation processes to achieve completely an integrated performance budget.

Further, the IRS modified its budget and performance plans to include more customer-focused and “end result” measures. The agency also recently implemented the “Embedded Quality” program/methodology to gauge the accuracy of completed actions. As the IRS expands this program to capture even more data, it can better identify and resolve specific accuracy problems – thereby, improving the work product and in turn, the level of service to taxpayers.

Of great significance, the Board has approved the IRS’ five-year strategic plan for FY2005-2009. Building on its plan issued in January 2001 – the first since the passage of the RRA – this process provides the IRS with an excellent opportunity to improve its strategies and program plans for customer service, enforcement, and productivity. It also affords the IRS the occasion to develop mid-range (3 to 5 year) process and outcome performance measures with specific targets for many of its major programs and activities.

The Board notes that the effective use of performance measures in strategic decision-making requires long-term, measurable performance goals and objectives. In 2002, the IRS established an Executive Steering Committee to identify long-term, end-result and outcome performance measures. Regrettably, it was dissolved during the past year before any substantive work could be produced.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. The Board cannot stress enough the importance of this initiative. The National Research Program (NRP) will provide fresh data on taxpayer voluntary compliance levels – the first in more than a decade. Such data is essential to establishing

The Board notes that the effective use of performance measures in strategic decision-making requires long-term, measurable performance goals and objectives.

enforcement measures and to more effectively allocating resources to related activities. The Board expects NRP to produce some of this information by the end of 2004.

Lastly, the Board encourages the IRS to develop a more strategic approach to the entire tax administration system. The Board believes this effort will go a long way toward identifying the characteristics of an effective and efficient tax administration system. It can also help identify desired outcomes and create a road map for the next decade that will complement the IRS' strategic, budget and annual performance plans. In addition, it could be integrated into the government-wide Key National Indicators Initiative whose purpose is to help assess the overall position and progress of our nation, frame strategic issues and chart future directions.

IV. Conclusion

The Board believes that the IRS made progress in a number of key programs and activities in 2003. It should be credited with improved toll-free service to taxpayers and with providing new, helpful self-serve applications to taxpayers and practitioners over its web site. However, as noted earlier in this report, complacency is the greatest single threat to improved customer service; the job is never over — especially as the tax code grows more complex.

Business Systems Modernization will require the highest level of management attention. The Board is pleased that the IRS is implementing a number of key recommendations made by the Board — and independent reviewers — to get the troubled program back on track. The next 12 months are critical and, for the sake of the nation, we must ensure that Modernization succeeds. Failure is not an option.

Enforcement continues to be a serious and ongoing problem that threatens the very integrity of our tax administration system. Although there were improvements in some enforcement activities, they give little comfort: They make barely a dent in the staggering, $300-billion tax gap that places a burden on every honest taxpayer and a green light to every active and potential tax cheat.

At the end of the day, in spite of efforts to reallocate resources to enforcement efforts, the IRS will likely be unable to hire the qualified people it must have to collect the taxes due. The IRS needs more resources; there is no way around this simple fact. The Board believes that it makes perfect business sense to increase IRS funding so it can mount a large-scale attack on this problem.

The IRS Oversight Board finds that the IRS is making progress in achieving the letter and spirit of the Restructuring Act. It also recognizes that the IRS continues to confront enormous challenges and there are no guarantees that it will succeed in meeting them. Yet the Board is convinced that the IRS can succeed if Congress and the Administration are willing to provide the long-term commitment and resources to finish the job begun six years ago. Anything less would be a great disservice to the people we all serve – America's taxpayers.

Endnotes

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Appendix

1: IRS Oversight Board Private-Life Members' Biographies
2: IRS Oversight Board Survey on Taxpayer Attitudes 2003
3: Summary of Stakeholder Comments and Recommendations
4: IRS Oversight Board Operations in FY2003

Biographies of IRS Oversight Board Private-Life Members

The Board, by statute, consists of nine members, including the Secretary of the Treasury and the IRS Commissioner. Following are profiles of the seven 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:

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

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

Larry R. Levitan

Retired Partner, Andersen Consulting (now Accenture)

Larry R. Levitan retired from a 34-year career with Andersen Consulting in 1997. He held key leadership positions at the firm, which grew during his career from 500 to over 50,000 employees. Mr. Levitan became a partner in 1974 and served as managing partner of numerous Andersen Consulting operational entities. He worked with world-class clients to create business strategies, restructure organizations, management processes, and mission critical information systems. Mr. Levitan currently serves on a number of corporate boards. He received a degree in accounting from the University of Florida. He chairs the Oversight Board's committee on business transformation. Mr. Levitan served as the Board's first Chairman from 2000 to 2003.

Robert M. Tobias

Professor, American University

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

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 from 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 Board's committee on human capital.

IRS Oversight Board
Taxpayer Attitude Survey 2003

1. How much, if any, do you think is an acceptable amount to cheat on your income taxes? Would you say:

	2003	2002 *in percentage*	1999
A little here and there	12	10	8
As much as possible	5	3	3
Or, Not at all	81	86	87
DK/Not sure/NR	3	1	2

2. For each statement, do you completely agree, mostly agree, mostly disagree, or completely disagree.

	Completely Agree/%			Mostly Agree/%			Mostly Disagree/%			Completely Disagree/%			DK/NA/NR		
	’03	’02	’99	’03	’02	’99	’03	’02	’99	’03	’02	’99	’03	’02	’99
It is every American’s civic duty to pay their fair share of taxes	68	72	81	27	23	14	3	2	2	2	2	2	1	1	*
Everyone who cheats on their taxes should be held accountable	60	65	64	28	25	25	8	6	7	3	3	3	1	2	1
It is everyone’s personal responsibility to report anyone who cheats on their taxes	19	21	18	29	25	30	25	24	25	24	26	24	3	4	3
Taxpayers should just have to pay what they feel is a fair amount	12	15	11	18	14	15	24	23	26	44	45	47	2	3	2
The more information and guidance the IRS provides, the more likely people are to correctly file their returns	44	NA	NA	38	NA	NA	12	NA	NA	5	NA	NA	2	NA	NA

DK = Don’t know
NA = Not asked
NR = No reply

3. How important is it to you, as a taxpayer, that the IRS does each of the following to ensure that all taxpayers honestly pay what they owe? Would you say it is very important, somewhat important, not very important, or not at all important?

	Very Important/%		Somewhat Important/%		Not Very Important/%		Not at All Important/%		DK/NA/NR	
	'03	'02	'03	'02	'03	'02	'03	'02	'03	'02
Ensure low-income taxpayers are reporting and paying their taxes honestly	63	56	24	28	7	8	4	5	2	3
Ensure small businesses are reporting and paying their taxes honestly	70	68	23	25	3	3	2	3	2	2
Ensure high-income taxpayers are reporting and paying their taxes honestly	79	77	16	16	2	1	2	3	2	2
Ensure corporations are reporting and paying their taxes honestly	83	83	12	10	1	2	2	3	2	3

4. How much influence does each of the following factors have on whether you report and pay your taxes honestly? Would you say it has a great deal of influence, somewhat of an influence, very little influence, or is not at all an influence?

	A Great Deal of Influence/%		Somewhat of an Influence/%		Very Little Influence/%		Not at All an Influence/%		DK/NA/NR	
	'03	'02	'03	'02	'03	'02	'03	'02	'03	'02
Fear of an audit	37	29	22	25	14	13	23	30	4	4
Belief that your neighbors are reporting and paying honestly	18	20	20	18	18	15	40	40	4	7
3rd parties reporting your income (e.g., wages, interest, dividends) to the IRS	37	33	27	27	11	11	21	22	4	7
Your personal integrity	73	74	15	14	5	4	5	4	2	4

5. How important is it to you, as a taxpayer, that the IRS provides each of the following services to assist taxpayers? Would you say it is very important, somewhat important, not very important, or not at all important?

	Very Important/%		**Somewhat Important/%**		**Not Very Important/%**		**Not at All Important/%**		**DK/NA/NR**	
	'03	'02	'03	'02	'03	'02	'03	'02	'03	'02
A toll-free telephone number to answer your questions	76	77	15	13	3	4	5	5	1	2
Office locations you can visit where an IRS representative will answer your questions	66	66	23	19	4	7	6	7	1	2
A web site to provide you with information	62	59	22	21	4	6	11	11	2	3
The ability to e-mail your questions directly to the IRS	55	NA	26	NA	7	NA	11	NA	2	NA
Opportunities for electronic filing of tax returns	60	55	22	24	6	6	10	11	2	3
A computer terminal located in a kiosk at a library or shopping mall	33	NA	31	NA	15	NA	19	NA	2	NA
A tax assistance van that visits locations not convenient to IRS offices to provide information and assistance	43	NA	35	NA	9	NA	11	NA	2	NA
Community-based tax clinics at convenient locations, such as schools, community centers, libraries, etc.	51	NA	31	NA	7	NA	9	NA	1	NA

6. How likely would you be to use each of the following services for help with a tax issue? Would you be very likely, somewhat likely, not very likely, or not at all likely?

	Very Likely/%	Somewhat Likely/%	Not Very Likely/%	Not at All Likely/%	DK/NA/ NR/%
A toll-free telephone number to answer your questions	58	23	6	11	1
Office locations you can visit where an IRS representative will answer your questions	43	29	12	14	2
A web site to provide you with information	26	24	21	26	2
The ability to email your questions directly to the IRS	52	20	9	18	2
Opportunities for electronic filing of tax returns	43	23	12	20	2
A computer terminal located in a kiosk at a library or shopping mall	22	24	20	33	2
A tax assistance van that visits locations not convenient to IRS offices to provide information and assistance	25	32	19	23	2
Community-based tax clinics at convenient locations, such as schools, community centers, libraries, etc.	33	33	14	20	1

7. You said you would be likely to use a toll-free telephone number to contact the IRS. How long are you willing to wait to speak to a customer representative when calling an IRS toll-free telephone number?

	%
None	2
1 minute or less	6
2 to 5 minutes	44
6 to 10 minutes	23
11-30 minutes	20
31 to 60 minutes	2
60+ minutes	2
DK/NA	1

Mean (including none) = 11 minutes
Median (including none) = 5 minutes
Mean (excluding none) = 11 minutes
Median (excluding none) = 5 minutes

8. You said you would be likely to use office locations where an IRS representative will answer your questions. Would you prefer to schedule an appointment to speak with a representative at a specific time or would you prefer to walk in at your convenience and wait for the next available representative?

	%
Prefer to schedule appointment	59
Prefer to walk in	39
Don't Know	2

8a. How long are you willing to wait to speak to a customer representative if you visited an IRS walk-in assistance center without an appointment?

	%
None	2
5 minutes or less	3
6 to 10 minutes	17
11-15 minutes	18
16-30 minutes	37
31 to 60 minutes	18
60+ minutes	5
DK/NA	1

Mean (including none) = 31 minutes
Median (including none) = 19 minutes
Mean (excluding none) = 32 minutes
Median (excluding none) = 20 minutes

9. How valuable would you say each of these sources is for getting tax advice or information? Would you say it is very valuable, somewhat valuable, not very valuable, or not at all valuable?

	Very Valuable/%	Somewhat Valuable/%	Not Very Valuable/%	Not at All Valuable/%	DK/NA/ NR/%
IRS representatives	51	32	6	10	2
IRS printed publications, for example, brochures, instructions	50	32	8	8	2
IRS web site	51	26	7	14	2
Paid tax professional	52	31	7	9	2
Family or friends	30	31	17	20	2
Reference materials from sources other than the IRS (for example, books, software, private sector web sites)	26	41	14	17	2

10. Most people have had some type of interaction with the IRS, whether it's just filing your tax return or actually speaking with an IRS representative. How satisfied would you say you have been with your personal interaction with the IRS? Would you say very satisfied, somewhat satisfied, not very satisfied, or not at all satisfied?

	%
Very satisfied	41
Somewhat satisfied	41
Not very satisfied	5
Not at all satisfied	6
DK/NA/NR	8

Summary of Comments and Recommendations from IRS Oversight Board Stakeholder Meetings

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

During the past year, the Board met with stakeholders on several occasions. In January 2004, the Board conducted its fourth annual public meeting with stakeholders to listen to their comments regarding the IRS' efforts to reorganize and modernize. In July 2003, in Des Moines, Iowa, the Board met with IRS employees, representatives that assist low income taxpayers, and tax practitioners. And during the summer of 2003, Board members met with IRS field employees and tax professionals around the country at six IRS Nationwide Tax Forums. At these meetings, Board members asked stakeholders if the IRS is effectively and efficiently meeting taxpayers' needs for tax administration services. There was agreement that the IRS has shown vast improvement in many areas, but that progress in other areas has been uneven. Several main themes emerged from these discussions:

General Agreement That IRS is Better Than It Was Five Years Ago
IRS has made great strides in improving customer service. Successes have included e-filing, Practitioner Priority Services, the irs.gov web site, centralized CAF and the EIN hotline. The Taxpayer Advocate Service was praised as a success, as was electronic filing, which was described as an efficient, easy-to-use method to file tax returns. Practitioners seem eager to embrace new ways to interact with the IRS, including e-Services and electronic filing of corporate returns. They cite electronic interactions with the IRS and enhancements to the IRS web site for contributing to an "improved" IRS. Tax professionals also applaud IRS' efforts to develop and maintain better relationships with them that assist them in resolving their clients' problems.

Practitioners indicated that consistent communication and coordination across the agency, though improving, is still a challenge. Employees suggested cross-training between divisions would be a major benefit to the agency, providing them with knowledge about other operating divisions and envisioning the IRS as an integrated whole rather than a group of separate organizations. Employees also discussed broad performance measures across the entire organization and suggested that there might be a way to overcome segmentation that has occurred as a result of the reorganization. They expressed concern that collaborative efforts across the agency are not given the same recognition as successful efforts within a single division.

Practitioners find centralization of some processes cumbersome, yet find others, such as Practitioner Priority Services, working well. They suggested that the lack of the “local connection” and face-to-face contact allows some IRS employees to separate themselves from the taxpayer, abandon a “fix-it-now” attitude, or fail to take ownership of the taxpayer’s problem. Both practitioners and employees expressed the need for more attention to enforcement, but had concerns that a new focus on compliance would drain resources away from customer service.

Tax Law Complexity/Limited Resources Impact IRS

The IRS faces challenges implementing its enforcement programs in an environment of limited resources. Stakeholders recognize that IRS needs adequate and reliable funding to address a growing public perception of widespread non-compliance, and suggested, alternatively, that the IRS do more to target its enforcement programs to reach the most non-compliant taxpayers and do it more quickly and efficiently.

The American Bar Association Section of Taxation described two factors which play a significant role in the Service’s ability to improve its efforts to serve taxpayers and enforce the law: tax law complexity and limited resources. The ABA suggests that a cornerstone of the IRS strategic plan for the next five years must be a meaningful effort to simplify the tax law itself and the Service’s procedures for interacting with taxpayers. The ABA also recommends that the IRS have adequate resources to perform its mission and that, in a limited resource environment, the IRS must devote its strategy, personnel, and resources to do more to simplify administrative and regulatory processes to make them work more efficiently.

Other stakeholder recommendations for targeted compliance initiatives that encourage compliance and discourage disrespect for the tax system include prioritizing collection of trust fund taxes, aggressively pursuing collection from repeat delinquent taxpayers, approaching delinquent taxpayers sooner, and implementing serious efforts to bring nonfilers into compliance.

Tax professionals acknowledge that there are unethical and incompetent preparers in the marketplace and recommend that the IRS examine its role in federal regulation of the industry. Both employees and practitioners suggested the IRS find ways to protect taxpayers from unscrupulous tax preparers and offered a number of suggestions. As the IRS moves toward greater compliance efforts, it should also look at taking action to impose standards of ethical conduct on currently unregulated preparers as a way of improving compliance for low- and middle-income taxpayers.

Tax professionals discussed various levels of practitioner regulation, including requirements for registration and/or licensing; continuing professional education, including ethics instruction; and suggestions that the national professional tax associations encourage and monitor some form of registration or regulation. They agree that the issue is very complex with no easy solutions and suggest that a diversified task force study the issue and make recommendations.

It is clear from stakeholder comments that in the enforcement area, the IRS faces many challenges as it streamlines and centralizes its processes into a modernized organizational structure while operating in an environment of limited resources, growing tax law complexity, and increasing taxpayer non-compliance. Yet at the same time, stakeholders emphasize the IRS must address specific issues of its varied customer base and provide specialized services to meet those needs, doing it in the most efficient and cost-effective manner possible.

Achieving Balance Between Enforcement and Service is Vital
Stakeholders noted that as part of its enforcement strategy the IRS achieve and maintain the proper balance between service and enforcement. Stakeholders also recommended that IRS strategies deal with risk assessment in focusing resources where noncompliance is greatest, and address the protection of taxpayers from purveyors of schemes, through public education, research, and oversight of paid preparers.

As the IRS moves forward and places more emphasis on building up enforcement resources, the agency must be careful not to inadvertently send a message that customer service is no longer important. Practitioners and employees agree that service and enforcement are not opposite ends of a metaphoric pendulum that swings back and forth between the two. Commissioner Everson emphasized in his address at the IRS' Nationwide Tax Forums that "service and enforcement equal compliance." While practitioners are supportive of IRS' efforts to improve and expand compliance, they also believe IRS employees should continue to treat taxpayers in a professional and courteous manner.

Stakeholders also recognize that IRS' efforts to modernize have resulted in greater difficulties for low-income taxpayers who, to a large extent, are not part of the new electronic age. These taxpayers face a greater burden in communicating with the IRS via a streamlined and centralized process rather than face-to-face meetings with local IRS personnel — which was the agency's former geographic-based structure. The low-income taxpayer community needs overall financial education and training, as well as more multilingual communications from the IRS. Representatives that assist low-income taxpayers told the Board that it is important that the IRS do more in creating partnerships with community-based organizations that have access to this audience. They claim that more Earned Income Tax Credit errors result from taxpayers' misunderstanding the EITC than from attempts to cheat the tax system.

Stakeholders urged the IRS to incorporate external input into its planning process as it develops programs and procedures that impact taxpayers. The IRS made significant changes to its implementation plan for EITC pre-certification after considering public comments and meeting frequently with stakeholders who had extensive knowledge about the low-income taxpayer community. It was recommended that the IRS foster liaison activities that promote respect and understanding among tax professionals as a central component to its strategic plan.

Modernization Key to IRS' Success

In order for modernization to be fully successful, the IRS' computer technology must be improved. In discussing ways to assist IRS in reaching its goal of an 80 percent e-file rate, practitioners noted that there is a need to modernize all of IRS' computer systems. IRS' ability to offer e-file incentives, such as e-Services that provide practitioners with access to electronic taxpayer information, is one compelling reason for the agency to quickly modernize its technology systems. Access to this technical information was suggested as one way to sell e-filing to larger firms, such as CPAs, that would have an interest in e-filing their clients' business returns if there were additional incentives to convince them to switch from the paper environment. While sympathetic to security and privacy issues, practitioners see IRS as lagging far behind private business in systems modernization, and taking far too long to show any progress. Credibility is becoming an issue as IRS promises new systems, such as e-Services and CADE, but cannot deliver.

Stakeholders cited a number of barriers standing in the way of major increases in e-filing. IRS has experienced delays in modernizing the electronic platform for Form 1040. Additionally, e-Services for practitioners have not been delivered as promised, and IRS also experienced several glitches in e-filing as the current tax filing season began, prompting the Council for Electronic Revenue Communication Advancement (CERCA) to comment that the biggest incentive to bring a reluctant tax professional or individual taxpayer into the e-file program is smooth performance.

Access to the IRS remains an issue, especially two-way communication in an electronic environment. Effective communication from the IRS to taxpayers and tax professionals is a theme repeatedly embedded in stakeholders' testimony. For example, stakeholders recommended better communication about e-file and its benefits as a way to expand the program. They commended the IRS' efforts to communicate with them regarding enforcement programs such as the National Research Program and K-1 Matching, and asked for continued cooperation and outreach. They cited a problem with poor communication in the Offer in Compromise program that inadvertently raises taxpayer expectations beyond the level of service the IRS is able to provide. They pointed out areas where taxpayers have difficulty communicating with the IRS, such as low-income taxpayers who must deal with remote audits and taxpayers who have limited proficiency with the English language.

Stakeholders claim that IRS' increasing reliance on technology is adversely affecting employee performance. Practitioners raised concerns that the increased use of technology is causing IRS employees to rely on what is on the computer screen rather than applying initiative to help taxpayers, and suggested that a larger problem is that the IRS is unable to effectively deploy and utilize technology to assist taxpayers. Employees describe IRS' computer systems as outdated, complex and difficult to understand. The systems are old, slow, and totally different than the current environment employees experience on the Internet.

Taxpayer and tax practitioner access to and communication with the IRS are important facets of IRS' modernization process. Effective IRS internal communication, within and between operating divisions, also impact the agency's modernized operations. Stakeholders note that as the IRS implements modernized business processes and information systems, communications will play an ever more critical role in the way the agency interacts with its customers.

Human Capital Issues Have Major Impact

Stakeholders generally agreed that workforce issues may be the greatest challenge for the IRS over the next five years. There was strong support for an increased budget that will allow the IRS to addresses increasing tax law complexity and its need for more staffing, better training, and advanced technology and equipment. The IRS needs funding that allows for recruitment and retention of qualified personnel, especially attracting, training, and retaining specialists from private-sector sources. It is also necessary for the IRS to continually upgrade its communication and information systems to give employees the tools to provide timely and effective customer service.

Adequate training for IRS personnel is critical if the IRS is to become a successful, world-class organization. Stakeholders noted an expanding training gap at the IRS, where employees often lack the expertise and skills to handle difficult, complex or problem cases. Practitioners faced with this response take their clients' cases to the Taxpayer Advocate Service (TAS), often the only way they can find resolution, but this clogs the TAS system with cases that should have been resolved.

Stakeholders said that the IRS needs to look at the training employees need not only from the agency's perspective but also from the employee's perspective. In divisions where employees have been engaged in planning and designing training programs, such as TAS, LMSB and TEGE, the employees report higher job satisfaction and empowerment. They also suggested that the IRS look at models in the private sector to determine where resources would bring the greatest return on investment. One suggestion was whether, in a limited funding environment, the IRS would be better off with fewer employees who are better trained. One difficulty for the IRS is in defining an outcome goal to measure progress in training, for those who receive it and deliver it, and how to evaluate its long-term impact on the agency.

Improved training is critical as the IRS continues to modernize. IRS employees feel they are inadequately and unevenly trained and practitioners report similar observances. Employees face an increasingly complex tax code, changing technology systems, growing workloads, attrition of senior, experienced employees, and an accelerating pace of improved training is critical as the IRS continues to modernize. They expressed frustration in dealing with all these factors in an environment where they are expected to keep up with everything as they are also asked to assume more and more responsibilities.

Gradual reductions in personnel over the past several years combined with the impending retirement of many experienced employees over the next few years will have a significant impact on the agency. The impending manpower shortage and lack of recruiting will have a major impact on compliance. Because of the people shortage, more taxpayers are becoming aware of the agency's inability to enforce the tax law and are becoming more aggressive in avoiding taxes.

IRS Oversight Board Operations in FY2003

The IRS Oversight Board has completed its third year of operation. During this period the Board has engaged in a variety of activities, meeting six times as a full Board, and more times at the committee level. The Board met on the following dates in FY2003:

- December 9-10, 2002
- January 27-28, 2003
- March 18-19, 2003
- June 23-24, 2003
- July 29-30, 2003
- September 29-30, 2003

The January 26-27, 2003, meeting included a public meeting at which the Oversight Board received public presentations from 15 customer and stakeholder organizations on four topics of strategic interest to the Oversight Board: the future direction of electronic tax administration, enforcement challenges, effective collection strategies, and workforce empowerment. Major organizations representing tax practitioners for individuals, small businesses, large businesses; payroll associations, state tax administrators, tax software companies, electronic services industry representatives, low-income taxpayers, and IRS workers were all included in the meeting. The meeting provided the Oversight Board with an excellent opportunity to learn about the IRS' performance from a customer perspective, and the information obtained from this meeting was used throughout the year.

The June 2003 meeting featured two new members of the IRS Oversight Board: Mark Everson, the new IRS Commissioner, and Ray Wagner, a new private life member of the Oversight Board. Commissioner Everson became the 46th Commissioner of Internal Revenue, succeeding Commissioner Charles Rossotti, and Ray Wagner was nominated to fill the unexpired term of George Farr. Karen Hastie Williams transitioned off the Board in September 2002, having completed her three-year term.

Because the transition to the new commissioner occurred during the middle of the budget formulation process, the Oversight Board's review and approval of the IRS FY2004 budget occurred over several months starting in June and ending in September. Additional time was provided during the process to allow Commissioner Everson to participate fully and personally in the FY2004 budget process.

During 2003, the Oversight Board developed three reports to Congress: the Board's 2003 Annual Report to Congress, its report on Electronic Filing, and a special report titled An Independent Analysis of the IRS' Business Systems Modernization (BSM) Program. The first two reports are statutorily required; the report on the BSM program was discretionary on the part of the Oversight Board. The third report was prepared because of the Board's concerns about the performance of the BSM program after it suffered serious setbacks in its ability to deliver quality products on time and under budget. Because of the critical nature of the BSM Program, the Board is continually reviewing the progress of this program, and prepared the report because it believed that corrective action was required.

The Oversight Board also invested time in several other topics of strategic importance. The IRS Business System Modernization (BSM) program was on the agenda at virtually every Board meeting, and the Board was deeply involved in discussions with IRS executives on progress made, problems encountered, and appropriate corrective action for this critical program, both at full Board meetings and at Modernization committee meetings.

The Board continued its program of conducting stakeholder outreach to hear independent perspectives of IRS progress from various external stakeholders. In addition to the January public meeting, the Board conducted one of its bi-monthly meetings in Des Moines, Iowa, and included meetings with several groups of taxpayer representatives as part of the two-day meeting. In addition, the Oversight Board had representation at all six Nationwide Tax Forums the IRS conducted during the summer months. At these meetings, each attended by over 2,000 tax professionals, the Oversight Board sought out the opinions of attendees on IRS operations, and conducted small group meetings with both tax professionals and employees to discuss IRS issues with each group.

Other strategic issues the Oversight Board evaluated during the year included the IRS employee survey conducted by Gallup, the Offer-in-Compromise program, K-1 matching, IRS capital facilities replacement plan, the use of private collection agencies, the Earned Income Tax Credit Certification program, the Embedded Quality program, and technology-enabled learning.

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

The Performance Management Committee met four times during the year with IRS executives to review progress in meeting performance goals for major IRS operational divisions, in addition to several planning meetings it conducted. The Oversight Board focused on customer and employee satisfaction, quality, and selected productivity goals. These reviews with

IRS division executives proved to be very effective in understanding the progress each division was making, and provided the Oversight Board with valuable data to use in its year-end review of executive evaluation and compensation.

In keeping with the Oversight Board's statutory responsibility to review the selection, evaluation, and compensation of senior IRS executives, the Committee on Personnel and Organization conducted a thorough review of the performance evaluations and proposed bonuses for 11 top IRS executives. This review was coordinated with the Performance Management Committee to ensure that executive evaluations were consistent with operating division performance.

In keeping with the RRA 98 requirement to report Oversight Board travel expenses to Congress, the Board incurred $41,545 in travel expenses for Board members and staff in FY2003, primarily for travel to and from Board and Board committee meetings, and to attend the Nationwide Tax Forums.

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