

## IRS OVERSIGHT BOARD

JANUARY 29, 2002 PUBLIC HEARING

### TESTIMONY OF

PAUL CHERECWICH, Jr., Esq.

Good afternoon. I am Paul Cherecwich, Jr., Of Counsel with Miller & Chevalier, Chartered. Prior to my joining that firm, I spent more than thirty-five years in corporate America, most recently as Vice President of Tax for Cordant Technologies, Inc. In addition to chairing several trade association tax committees at various points during my career, I was the 1997-1998 International President of the Tax Executives Institute, the largest group of in-house tax professionals in North America. I am here today as the immediate past Chair of the 2001 Internal Revenue Service Advisory Council (IRSAC), an organization chartered to provide an organized public forum for discussion of relevant tax administration issues between Internal Revenue Service (IRS) officials and representatives of the public. I am pleased to be able to offer the views of the IRSAC with respect to IRS compliance enforcement activity.

#### Overview

The IRSAC devoted a considerable amount of time in 2001 to understanding the efforts being made by the IRS to achieve higher levels of compliance with the tax law. As stated in the IRSAC September 21, 2001 Public Report, "The IRS knows where its problems lie in the area of compliance, and is taking appropriate action as resources allow." However, there are a number of areas where it is believed that the IRS can expand upon existing efforts.

During the 2001 filing season, the IRS employed multiple outreach efforts designed to encourage compliance during the filing season, such as publishing a list of the top ten fraudulent tax saving schemes. Consideration should be given to year round publicity of this nature, in order to discourage taxpayers from entering into transactions or contemplating actions that are inappropriate.

The IRSAC has urged the IRS to respond to real or even perceived tax law abuses by announcing suspect positions or transactions. This has been done to some extent in connection with transactions identified by the Office of Tax Shelter Analysis. However, the IRSAC believes that this concept needs to be expanded to situations involving individuals and small businesses, not just large corporations. Some may say that describing a tax position or transaction as potentially abusive before the IRS or courts have had an opportunity to definitively rule might have a chilling effect on participation in such arrangements, but that is precisely the point. The IRSAC did acknowledge that reasonable people might disagree about the interpretation of a particular tax code section, and urged that special care be taken to ensure that only truly abusive transactions or positions be so described, and that competing interpretations be brought to resolution as quickly as possible. Also, while it is understood that the IRS can not publicly announce an investigation of a given individual or business, it was suggested that the IRS National Office could announce a generic investigation or area of concern whenever an individual or business is publicly identified as being in violation of tax obligations, e.g., when a business announces it is no longer withholding employment taxes.

Greater publicity for IRS actions taken will discourage non-reporting and underreporting. The communications program established by the Criminal Investigation Unit is excellent. Under that program, news releases and other media outreach are undertaken whenever courts rule favorably for the IRS in connection with criminal tax matters. The IRSAC believes that consideration should be given to identifying a means by which such a program can be replicated in the civil arena, with due regard to taxpayer privacy.

#### LMSB Recommendations

The Large and Mid Size Business (LMSB) Division is concerned with taxpayers that have assets exceeding ten million dollars. Historically the nation's largest taxpayers have been subject to continual audit to ensure compliance. LMSB has advised the IRSAC that it has developed a compliance risk scoring mechanism to identify those taxpayers that represent the greatest compliance risk, so that resources can be deployed appropriately. This assessment has validated anecdotal evidence suggesting a large increase in the number of pass-through entities, e.g., entities treated as partnerships, disregarded entities, etc.

In order for the deployment of resources to succeed, IRSAC believes that a number of things must happen. First, the workforce must become better educated to deal with complex issues, including those raised by pass-through entities, particularly in the international context. Revenue agents must be able to see and understand the broader context in which a transaction is taking place, and not get lost in the subsections and subparagraphs of the tax code. Second, audit coverage must be increased for those taxpayers in the lower end of the asset range covered by LMSB, i.e., the non-large case taxpayer. Third, in order to keep morale (and thus agent performance) at a high level, the IRS must ensure that adequate career paths exist for agents who are not assigned to large case taxpayers. Fourth, LMSB must maximize the use of technology and travel to deploy and leverage industry and technical specialists.

Over the last several years, LMSB has undertaken a number of initiatives to identify and resolve issues in a timely manner. These initiatives include the pre-filing agreement program, the industry issue resolution program, etc. The most recent program (contained in Announcement 2002-02) will result in waiver of the accuracy related penalty if a taxpayer comes forward with information about promoted shelters. These efforts should lead to an overall improvement in compliance by LMSB taxpayers and resource allocation by LMSB, and are to be commended.

#### SB/SE Recommendations

The Small Business/Self Employed (SB/SE) Division is concerned with taxpayers engaged in businesses that utilize assets of less than ten million dollars. The number of tax returns filed by this group increases yearly, so that maintaining the same percentage of audits each year means increasing the absolute number of audits. The STABLE hiring program will help in this regard, but more audits are not the only solution.

Taxpayers need to be discouraged from playing the "audit lottery". One way to do this is to publicize the audits that do take place. The IRS does periodically report audit statistics. The numbers reported tell only part of the story. IRS "back office" audits, such as document matching and resulting inquiries, should be reported as well. A taxpayer that receives a letter pointing out underreported income believes that an audit has taken place, even though the IRS does not technically count such a letter as an "audit". By publicizing a statistic that combines audits with other types of taxpayer contacts, perhaps more taxpayers will be persuaded that the audit lottery is not a game to play.

The IRS has advised that paid practitioners prepare more than eighty percent of SB/SE tax returns. Another way to increase compliance would be to target unethical or incompetent tax preparers. I am not suggesting regulation of tax return preparers. I am instead suggesting that it is possible to identify those preparers whose returns have an inordinate number of problems, and penalize or otherwise prosecute those preparers.

#### W&I Recommendations

The Wage and Investment (W&I) Division is responsible for individual taxpayers not otherwise covered by the other two divisions. It has the largest number of returns with which to deal. The number of returns audited annually has declined in recent years, in part due to deployment of IRS staff elsewhere.

The efficient identification of returns to be audited has suffered as a result of Congress prohibiting the IRS from using techniques successfully used in the past. The Taxpayer Compliance Measurement Program used statistics to develop audit "flags" from the results of detailed audits of individual taxpayers. Congress believed that the audits required to develop these flags were too intrusive, and thus has prohibited the IRS from continuing with the program. This has left a void. Just last week the IRS announced the National Research Program, an effort that will involve more efficient techniques to develop audit flags. This effort

should be given top priority, because the IRS will never have enough resources to effectively use random audits to enforce compliance by individuals.

The Earned Income Credit (EIC) program is an entitlement program for low-income taxpayers that has complex qualifying rules, and where abuse has been clearly demonstrated by both taxpayers and preparers. The IRS is well aware of these problems, and has approached them with vigor. Visits have been made to high volume preparers for purposes of education. Math Error Authority rules have been used to correct problem returns without the need for formal deficiency notices, thus addressing compliance problems more efficiently than would otherwise be possible. IRSAC has monitored this effort, and believes the IRS needs to continue along the path it has started.

#### K-1 Matching Recommendations

The IRS has established a group to investigate how to more effectively use existing information reporting for pass through entities, including partnerships, trusts and Subchapter S corporations. Such information is reported on Form K-1, and has not been used by the IRS in the past in an effective manner. The simple reason for this is that the rules for pass through entities are complex.

In recognition of the problems associated with the use of Form K-1 information to enforce compliance, the IRSAC made a series of recommendations to the IRS. At a minimum, Form K-1 data should be used to determine such basic questions as whether or not the recipient of the Form K-1 has in fact filed a tax return. Also, certain items such as interest and dividends reported on Form K-1 are directly transferred to Form 1040, Schedule B (for individuals) and thus could be subject to a matching program similar to the program involving Form 1099. The need for all the information presently collected on Form K-1 should be evaluated in the context of being able to use the information for audit matching purposes. A number of other detailed recommendations were made by the IRSAC, and I am confident they are being given consideration.

#### Summary

The great majority of individuals and businesses in the United States willingly pay their fair share of income tax. The IRS has a duty to those who voluntarily comply to ensure that those who do not voluntarily comply are identified and appropriate action taken. Thus enforcing compliance should be a key mission of the IRS.

The IRS should be urged to continue to meet with various stakeholder groups for their suggestions on how to improve compliance, because it is in the mutual interest of both the government and compliant taxpayers to work together to ensure the effective administration of tax laws.

Thank you for the opportunity to present these views.